Sixth Five Year Plan of Bangladesh
2011-2015

Background Papers

Volume 1
Macroeconomic Issues

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ACRONYMS

ADA	Accelerated Depreciation Allowance
ADB	Asian Development Bank
ADP	Annual Development Programme
AFD	Armed Forces Division
AFMC	Armed Forces Medical College
AGOA	African Growth and Opportunity Act
AIDS	Acquired Immune Deficiency Syndrome
AMCL	Asset Management Company Limited
APC	Armoured Personnel Carrier
ASEAN	Association of South East Asian Nations
ATC	Agreement on Textile and Clothing
BADP	Border Area Development Programme
BAF	Bangladesh Air Force
BB	Bangladesh Bank
BBS	Bangladesh Bureau of Statistics
BCCF	Bank Credit Capital Formation Ratio
BDR	Bangladesh Rifles
BEER	Behavioural Equilibrium Exchange Rate
BEI	Bangladesh Enterprise Institute
BEPZA	Bangladesh Export Processing Zones Authority
BGTB	Bangladesh Government Treasury Bond
BICM	Bangladesh Institute of Capital
BIDS	Bangladesh Institute of Development Studies
BIIF	Bangladesh Infrastructure Financial Facility
BIISS	Bangladesh Institute of International and Strategic Studies
BIMSTEC	Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation
BKB	Bangladesh Krishi Bank
BMA	Bangladesh Military Academy
BMET	Bureau of Manpower, Employment and Training
BMTF	Bangladesh Machine Tools Factory
BN	Bangladesh Navy
BO	Beneficiary Owners

BOESL	Bangladesh Overseas Employment and Services Ltd
BOF	Bangladesh Ordnance Factory
BOI	Board of Investment
BOO	Build, Own and Operate
BOP	Border Outpost
BOT	Build, Own and Transfer
BRAC	Bangladesh Rural Advancement Committee
BSF	Border Security Force
BSRS	Bangladesh Shilpa Rin Sangstha
BSTI	Bangladesh Standards and Testing Institution
BTCL	Bangladesh Telephone Company Ltd
BTMA	Bangladesh Textile Mills Association
BTTB	Bangladesh Telegraph and Telephone Board
BVC	Border Village Community
CAD	Central Ammunition Depot
CAGRR	Compound Annual Growth Rate
CBA	Capabilities-based Approach
CBM	Confidence Building Measure
CBTPA	Caribbean Basin Trade Partnership Act
CCEA	Cabinet Committee on Economic Affairs
CDBL	Central Depository Bangladesh Limited
CDS	Central Depository System
CHT	Chittagong Hill Tracts
CIT	Corporate Income Tax
CMI	Census of Manufacturing Industries
CMTD	Central Mechanical Transport Depot
CNS	Comprehensive National Security
COD	Central Ordnance Depot
COSATT	Consortium of South Asian Think Tanks
CPA	Chittagong Port Authority
CPI	Consumer Price Index
CRAB	Coastal Rapid Action Battalion
CSO	Civil Society Organisation
CTED	Counter Terrorism Executive Directorate
CTITF	Counter Terrorism Implementation Task Force

DBM	Department of Border Management
DCC	Defence Committee of the Cabinet
DCI	Development Cooperation Instrument
DCNB	Domestic Credit by Nonbank and Bank Ratio
DEDO	Duty Exemption and Drawback Office
DEGN	DSE General Index
DESA	Dhaka Electric Supply Authority
DFI	Development Financial Institution
DFQF	Duty Free and Quota Free
DGFI	Directorate General of Forces Intelligence
DNC	Department of Narcotics Control
DSCSC	Defence Services Command and Staff College
DSE	Dhaka Stock Exchange
DW&CE	Directorate of Works and Chief Engineer
EBA	Everything But Arms
EDF	Export Development Fund
EEZ	Exclusive Economic Zone
EMP	Exchange Market Pressure
EPB	Export Promotion Bureau
EPZ	Export Processing Zone
EU	European Union
EW	Early Warning
EWEC	East West Economic Corridor
FBCCI	Federation of Bangladesh Chambers of Commerce and Industries
FCB	Foreign Commercial Bank
FDI	Foreign Direct Investment
FRC	Financial Reporting Council
FSR	Financial Sector Review
FTA	Free Trade Arrangement
FY	Financial Year
GATT	General Agreement on Trade and Tariff
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GEP	Group of Eminent Persons
GNP	Gross National Product

GPS	Global Positioning System
GSP	Generalised System of Preferences
GTAP	Global Trade Analysis Project
HDO	Higher Defence Organization
HI	Herfindahl Index
HIV	Human Immunodeficiency Virus
HUJI	Harkatul Jihadal Islami
HuJIB	Harkatul JehadalIslami Bangladesh
IBBL	Islamic Bank Bangladesh Limited
IBM	Integrated Border Management
IBMW	Integrated Border Management Wing
ICB	Investment Corporation of Bangladesh
ICOR	The Incremental Capital Output Ratio
ICT	Information and Communication Technology
IDESI	The Institute for Development of the Informal sector
IDU	Injection Drug Users
IED	Improvised Explosive Devices
IGP	Inspector General of Police
IISS	International Institute for Strategic Studies
IMB	International Maritime Bureau
IMF	International Monetary Fund
IOC	International Oil Company
IPCC	Intergovernmental Panel on Climate Change
IPO	Import Policy Order
IPP	Independent Power Producers
IPS	Instant Power Supply
IRCA	International Revealed Comparative Advantage
IRS	Interest Rate Spread
ISPR	Inter Services Public Relations
IT	Information Technology
IWGNS	International Working Group on National Security
JBDP	Joint Border Development Programme
JCC	Joint Command Centre
JCTE	Joint Combined Training Exchange
JMJB	Jagrata Muslim Janata Bangladesh

KAS	Konrad Adenauer Stifung
KII	Key Informant Interview
km	Kilometres
KSY	Khulna Shipyard
LCT	Landing Craft Tanks
LDC	Least Developed Country
MDG	Millennium Development Goals
MES	Military Engineering Services
MFA	Multi Fibre Arrangements
MFI	Micro Finance Institution
MHQ	Martime Headquarters
MIST	Military Institute of Science and Technology
MNC	Multinational Corporation
MOD	Ministry of Defence
MODC	Ministry of Defence Constabulary
MOF	Ministry of Finance
MoU	Memorandum of Understanding
MPR	Monetary Policy Review
MRA	Micro Credit Regulatory Authority
MRP	Machine Readable Passports
MTBF	Medium Term Budget Framework
NBFI	Non Bank Financial Institutions
NBR	National Board of Revenue
NCCF	Nonbank Credit-Capital Formation Ratio
NCH	Nationalised Commercial Bank
NCIC	National Committee for Intelligence Coordination
NCO	Non Commissioned Officers
NCSA	National Committee for Security Affairs
NDC	National Defence College
NEER	Nominal Effective Exchange Rate
NFASEDF	Small Enterprise Development Fund
NFCA	Non-resident Foreign Currency Account
NGO	Non Government Organisation
NIP	New Industrial Policy
NITA	Non-resident Taka Account

NPR	Nominal Protection Rate
NPTDA	New Partnership for Trade Development Act
NSI	National Security Intelligence
NSS	National Security System
NSS	National Saving Scheme
NTS	Non-traditional Security
ODA	Official Development Assistance
OSCE	Organisation for Security and Cooperation in Europe
PAU	Policy Analysis Unit
PCB	Private Commercial Bank
PCJSS	Parbatya Chattagram Jana Sanghati Samity
PDB	Power Development Board
PDS	Primary Dealer System
PKSF	Palli Karma-Sahayak Foundation
PLA	People's Liberation Army
PLC	Public Limited Company
PM	Prime Minister
PPP	Purchasing Power Parity
PPP	Public Private Partnership
PRSP	Poverty Reduction Strategy Paper
PSC	Production Sharing Contract
PSI	Preshipment Inspection
PSIG	Private Sector Infrastructure Guidelines
PSO	Principal Staff Officer
RAB	Rapid Action Battalion
RAKUB	Rajshahi Krishi Unnayan Bank
REER	Real Effective Exchange Rate
RMG	Readymade Garment
RoA	Return on Asset
RoE	Return on Equity
RoO	Rules of Origin
RTA	Regional Trading Arrangement
SAARC	South Asian Association for Regional Cooperation
SAF	Structural Adjustment Facility
SAFTA	South Asia Free Trade Area

SALW	Small Arms and Light Weapons
SAP	Structural Adjustment Programme
SAPI	South Asia Partnership International
SAPTA	South Asian Preferential Trading Arrangement
SAR	Search and Rescue
SB	Special Branch
SBMC	Special Border Microcredit
SBW	Signal Base Workshop
SD	Supplementary Duty
SEC	Securities and Exchange Commission
SEZ	Special Economic Zone
SFYP	Sixth Five Year Plan
SLOC	Sea Lines of Communications
SMC	SAFTA Ministerial Council
SME	Small and Medium Enterprise
SMEF	Small and Medium Enterprise Facility
SOE	State Owned Enterprise
SSA	Sub Saharan African
SSF	Special Security Force
STOMD	SAARC Terrorist Offences Monitoring Desk
SWADS	Special Warfare and Diving Salvage Unit
TAR	Trans Asian Railway
TCB	Trading Corporation of Bangladesh
TCGD	Total Credit-GDP Ratio
TCI	Trade Complementary Index
TDP	Town Defence Party
TIP	Trade and Investment Policy
Tk	Taka
ToT	Terms of Trade
TRADE	Trade Relief Assistance for Developing Economies Act
TRQ	Tariff Rate Quota
TS	Traditional Security
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development

UNCTED	United Nations Counter Terrorism Committee Directorate
UNDP	United Nations Development Programme
UNESCA	United Nations Economic and Social Commission for Asia and the Pacific
UNFCC	United Nations Framework Convention on Climate Change
UNGCTS	UN Global Counter Terrorism Strategy
UNODC	United Nations Office of Drug Control
UNPOA	United Nations Programme of Action
UPS	Uninterrupted Power Supply
USA	United States of America
USPACOM	United States Pacific Command
USTR	United States Trade Representative
UW	Unconventional Warfare
VAT	Value Added Tax
VDP	Village Defence Party
WBI	World Bank Institute
WDI	World Development Indicators
WIPO	World Intellectual Property Organization
WTO	World Trade Organisation
XPB	Export Performance Benefit

FOREWORD

Air Vice Marshal (Retd.) A. K. Khandker
Minister
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Government of the People's Republic of Bangladesh

I am happy to learn that the General Economics Division (GED), Planning Commission and the Bangladesh Institute of Development Studies (BIDS) are jointly publishing the technical framework results and the background studies conducted for preparation of the country's Sixth Five Year Plan (2011-2015).

The technical framework of the Sixth Plan and the background studies generated quantitative/qualitative benchmark values and targets for all relevant sectors/indicators of the plan and identified critical macroeconomic foundation for future intervention. It also forms the basis for determining sectoral targets for prudent responses during the Sixth Plan period.

I am particularly pleased to note that this is a first attempt made in our plan history to publish the results of the economic models and background papers in six volumes that form the basis for the preparation of the Sixth Five Year Plan Document. It will be a useful reference to the policymakers, development planners, academics and researchers alike to examine and evaluate the rationale of plan targets and resource allocation. I am sure it will also provide impetus for preparing future models when formulating Seventh Plan for Bangladesh.

I am confident that the Sixth Five Year Plan will amply guide us in realising our "Vision 2021" goal of becoming a middle-income country by 2021 when we will celebrate the Golden Jubilee of our Independence.

Both the GED of the Planning Commission and the BIDS deserve my special thanks for undertaking this novel venture.

Air Vice Marshal (Retd.) A. K. Khandker

PREFACE

The National Economic Council (NEC) In May 2009 decided to prepare the country's Sixth Five Year Plan (2011-2015) within the framework of the Perspective Plan (2010-2021) and keeping the goals of the Vision 2021 in view. The Planning Commission constituted a high level inter-ministerial "Steering Committee" with the Planning Minister as its chair and formed a "Panel of Economists" for guiding the process of formulating the Plan within a participatory framework.

The preparation of the Plan necessitated the formulation of the technical framework for finalising the Plan strategies and indicating the desirable development path that would lead to fulfilling its objectives. Several background studies were also undertaken for generating quantitative/qualitative benchmark values and targets for relevant indicators of the Plan and fill-in critical knowledge gaps. The Bangladesh Institute of Development Studies (BIDS) was assigned to conduct the background studies and develop the technical framework of the Plan for which renowned economists and development practitioners in the relevant fields were engaged to complete the tasks within the stipulated time period. The drafts of the studies were reviewed by relevant experts in the government as well as from the professional and academic community. Based on such elaborate feedbacks, the drafts were modified and finalised by the authors under the overall supervision of BIDS.

These studies provided valuable information/inputs which significantly contributed towards drafting the Sixth Five Year Plan. The studies are rich in contents and, if made available, will enrich the knowledge base relating to development challenges and development options facing Bangladesh. In view of the importance of these studies, it has been decided that BIDS and the General Economics Division (GED) of the Planning Commission will jointly publish these studies, including the technical framework, for making these available to interested readers and users. It may be added here that similar studies conducted during the preparation of the earlier Plans have not been made available in the public domain.

The studies have been published in six separate volumes. It is expected that these volumes will help the readers to understand the rationale for the choice of the specific paradigm underlying the Plan and the design of the policy package adopted for the Plan for reconciling the goals of efficiency with those of equity. The studies attempt to spell out a reform strategy and agenda for agriculture, food security, industrialisation, poverty reduction, social development, sustainable management of natural resources, and other development issues in Bangladesh in the light of current conditions as well as past experience.

We would like to express our deep gratitude to the authors of the technical framework and background studies for their sincere efforts in finalising the manuscripts in time. We are also indebted to the relevant officials of GED and BIDS for their untiring support and cooperation. We hope that the relevance of the issues and the diverse contents and analysis of the publications would make these volumes useful for the research community, policymakers, and others interested in understanding the development challenges of Bangladesh.

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Chapter 1

Macroeconomic Framework and Financial Sector Development

Mustafa K. Mujeri
Monzur Hossain

1.1 INTRODUCTION

Bangladesh enters the Sixth Five Year Plan (SFYP, 2011-2015) with a reasonable growth performance averaging more than 6 per cent over the last five years, the highest during any such period so far. The higher growth of the period has been underpinned by several sources of strength. The economy has shown significant resilience in the face of global economic crisis and natural calamities, saving and investment rates have risen, real sector growth (especially in agriculture and manufacturing) has shown upward trend without much volatility, and perception of foreign investors about the country has become more favourable. Bangladesh's recent growth performance strongly suggests that the economy is now poised for sustained and rapid growth with the potential to put the country on a path to a middle-income economy within the next decade.

However, there are several areas of weakness as well that need attention. A major weakness of the past growth is its tendency toward raising inequality and not being sufficiently inclusive for the poor and the disadvantaged groups. Similarly, although several indicators of human development, such as school enrolment rates, literacy, and maternal and infant mortality rates, have shown steady improvements, the progress is slow. The sectoral composition of growth also needs attention. Agricultural growth remains slow that has contributed to widening rural-urban divide and the emergence of occasional food insecurity. Although total employment has risen, labour force has grown at a faster rate leading to some deterioration in the employment situation. The vast majority of the labour force remains employed in agriculture and the informal sector with low wages and insecure job conditions. Also, economic growth across the country's different regions has not been balanced which has led to persistence of unacceptable economic inequality. The delivery of essential services needs significant improvement in quality along with more efficient and improved access, especially for the poor.

Bangladesh's development experience of nearly forty years suggests that, while there are significant achievements for which the country can be proud of, it is still far from achieving the social goals as articulated in the Vision 2021. The Sixth Five Year Plan (2011-2015) provides an opportunity to consolidate the gains achieved in the past, correct the deficiencies of earlier efforts, and open up new opportunities to move toward the Vision. The challenges, however, are unlikely to be addressed in a slow growing economy; Bangladesh needs to achieve rapid, broad-based, and inclusive growth in order to create an enabling environment for achieving the multiple objectives of the Sixth Plan. For the Sixth Plan, high economic growth should be taken as an essential strategic element for achieving the planned targets and objectives of the Plan.

In addition, rising inequality in the distribution of income and widening socioeconomic disparity among different regions of the country would require specific policy attention during the Sixth Plan. In this context, measures would be needed, among others, to (i) enhance endowments and capabilities of the lagging regions through earmarking special allocations in the Plan; (ii) adopt strategies/ measures to strengthen the employment nexus between economic growth and poverty reduction taking into account the diversity and heterogeneity of the informal economy in the lagging regions; (iii) initiate measures to raise the productivity of informal enterprises through access to capital, business development services, infrastructures, and supportive regulations and policies; and (iv) increase public investment in lagging regions, adopt programmes to strengthen education and skill training.

1.1.1 Review of Past Development and Challenges

The government has decided to embark on preparing the Sixth Five Year Plan after a gap of eight years as the Fifth Five Year Plan (1997-2002) ended in 2002. Since the time, the government prepared an interim Poverty Reduction Strategy Paper (PRSP) in 2004 which was followed by the first PRSP (2005-07) and the second PRSP (2009-11). The Fifth Plan articulated its objectives around the cherished goal of alleviation of poverty and bringing about socioeconomic transformation for building a happy and prosperous Bangladesh. The Plan aimed at achieving an average yearly economic growth of seven per cent during the Plan period along with creation of substantial employment opportunities and increase in productivity. The dominant strategies of the Plan included accelerated agricultural production, vitalisation of local level institutions for participatory rural development, employment and income generation, limiting population growth, developing human resources, focusing on export led industrialisation, and promoting good governance.

The implementation of the Fifth Plan was frustrated by a number of factors including a change of the government. The realised average GDP growth during the

Plan period was 5.2 per cent per year as against the target of 7.0 per cent. Most other targets were also not realised due to adverse social and economic processes including frequent occurrences of natural disasters. The Bangladesh economy, however, has shown reasonable stability in recent years despite the threats from depressed external developments and domestic constraints, especially in the power and energy sector. The major macroeconomic indicators have shown reasonable stability.

Several factors have paved the way toward recovery of the world economy starting from late 2009: (i) reasonable price stability in the world commodity market leading to the start of an unwinding process of adverse terms of trade effects, especially in oil importing countries like Bangladesh; (ii) end of the intense drag on US growth by the housing sector leading to the start of the recovery cycle of the financial sector creating positive effect on global financial system and the world economy; and (iii) resilience and less affected status of emerging economies providing the momentum to recovery for the global economy. The recovery process, however, is likely to be gradual. In the backdrop of economic slowdown and unprecedented uncertainty that characterises the global economy at present, Bangladesh needs to take prudent actions to move forward.

The typical pattern of the global crisis in Bangladesh has been a growth deceleration which is unlike the pattern of outright recession that can be observed for the developed nations. The adverse impact of the crisis was preceded by food and energy price shocks of 2007-2008 that produced some transient episodes of poverty. In terms of policy responses to the global recession, Bangladesh implemented fiscal assistance packages. The scope and the impact of these packages were, however, limited in view of the fact that the key determinants of effective response include the availability of feasible policy options, adequate fiscal resources, and institutional capacity. In general, Bangladesh has low fiscal and institutional capacity that constrains its ability to engage in countercyclical measures to deal with external shocks and to sustain development momentum. It would, therefore, be important for the Sixth Plan to fortify the country's capacity to cope with any global economic volatility in future in order to sustain Bangladesh's long-term development strategies and the overarching objective of meeting the Millennium Development Goals.

Recent developments indicate that the Bangladesh economy needs to address five major challenges: (i) raise the level of investment; (ii) accelerate economic growth and promote food security; (iii) manage inflation and lower inflation expectations; (iv) reduce regional variation in economic performance; and (v) improve governance. Bringing about changes in the above areas would entail a combination of short and medium to long term measures but the Sixth Plan needs to make a determined beginning from the very start.

It would be important for the Sixth Plan to bring about an economic transformation that has faster economic growth and greater equity as twin objectives. For ensuring effective poverty reduction, the Sixth Plan should identify the nature of growth that has unfolded in Bangladesh and specify the extent of change that would be necessary in the quality and quantity of growth in order to bring the desired pro-poor orientation. Similarly, although economic growth has featured prominently as the central pillar of the country's earlier plans, the strong and sustained emphasis on pro-poor growth remained partly understood in the absence of credible analysis of the underlying issues determining the quality of growth. In this context, improved growth analytics are needed to understand the major factors that influence the environment of pro-poor growth in the country and the mechanisms by which the poor people are connected with it.

In addition, much of the analysis relating to strategic thrusts and supporting strategies in the country's policy framework have remained qualitative with less specificity on policy and institutional reforms. For example, the country's open trade regime has been taken to offer better opportunities for poverty reduction and accordingly trade is being mainstreamed. Such concern, however, stemmed more from the perspective that improved trade performance would generate more resources that Bangladesh needed to reach its goals and inadequate consideration of trade related opportunities and vulnerabilities and suitable complementary and mitigating measures to trade reforms.

1.2 PAST GROWTH PERFORMANCE, GROWTH POTENTIAL AND RESOURCE ENVELOPE

To some extent, the growth potential of an economy can be judged by its past performance. Table 1.1 gives the average growth rates achieved since the country's independence. It shows that growth rate was slow till the 1980s which started to pick up in the 1990s. During 2001-05, the average GDP growth rate was 5.5 per cent which rose to 6.3 per cent in 2006-09. The economy is likely to grow at around 6 per cent in FY2009-10 which is the base year of the Sixth Plan.

Some analysis shows that the Bangladesh economy has now attained a trend growth path in which the economy can grow at around 5.5 to 6.0 per cent per year without significant new policy initiatives. Any sizeable acceleration of future growth, however, would have to be driven by additional investments to create new capacities. With existing capacities on the brink of exhaustion, productivity growth and other efficiency raising measures are not likely to be adequate to raise the growth rate to above 7 per cent and sustain it for longer periods in the near future.

TABLE 1.1

GROWTH PERFORMANCE OF THE BANGLADESH ECONOMY

Period	GDP growth (per cent)	
	Target	Realised
First Five Year Plan (1973-1978)	5.5	4.0
Two Year Plan (1978-1980)	5.6	3.5
Second Five Year Plan (1980-1985)	5.4	3.8
Third Five Tear Plan (1985-1990)	5.4	3.8
Fourth Five Year Plan (1990-1995)	5.0	4.2
Fifth Five Year Plan (1997-2002)	7.0	5.2
2001-2005	…	5.5
2006-2009	…	6.3

Source: Plan documents and BBS**.**

Note: The growth rates are expressed at base year prices of respective plans. For the remaining years, these are expressed at 1995-96 prices.

Some alternative projections based on the analysis using the technical framework of the Sixth Plan are given in Table 1.2. It shows that with supportive policies under a baseline scenario, it is possible to achieve an average growth of 6.7 per cent during the Sixth Plan, with growth accelerating from 6.3 per cent in the first year to 7.1 per cent in the terminal year of the Plan. Under the medium and high policy shift scenarios, higher growth averaging 7.2 per cent and 7.8 per cent respectively during the Plan period could be achieved. In the medium policy shift scenario, GDP growth accelerates from 6.5 per cent in FY2011 to 8.0 per cent in FY2015, while the high policy shift scenario envisages growth acceleration from 6.5 per cent in the first year to 9.0 per cent in the terminal year of the Plan. Thus the Bangladesh economy, with its inherent resilience and strengths and gradually accelerating growth over the past fifteen years, is in a position to achieve higher growths during the Sixth Plan period. The actual realisation of the growth potential, however, would depend upon the extent and nature of policy shift that the government would accommodate within the agenda of the Plan framework.

It needs to be mentioned here that the baseline scenario allows the current economic trends to unfold in future and retraces the trends to create the pathway for the Sixth Plan guided by pragmatic assumptions. On the other hand, the high policy shift scenario reflects optimistic changes in growth promoting indicators and associated policies together with definite breaks with the past to transit to a significantly higher growth path. The medium policy shift scenario provides for a moderate shift (and probably more realistic) and falls between the baseline and high policy shift scenarios.

TABLE 1.2
ALTERNATIVE GROWTH SCENARIOS (GDP GROWTH IN PER CENT)

Scenarios	FY11	FY12	FY13	FY14	FY15	Average (FY11-FY15)
Baseline	6.3	6.4	6.7	6.9	7.1	6.7
Medium policy shift	6.5	6.7	7.0	7.5	8.0	7.2
High policy shift	6.5	7.2	8.0	8.5	9.0	7.8

Source: Plan Technical Framework.

Under the above growth scenarios, per capita income would grow by between 5.3 per cent and 6.4 per cent a year, thus significantly raising the per capita income (and consumption) of the population. Moreover, if the growth can be made more inclusive then it will have a much greater impact on poverty and living standards of the poor than in the past. Higher GDP growth will also boost revenue earnings of the government allowing implementation of a wider set of public sector programmes to achieve the social goals.

1.2.1 Resource Envelope

Under the present conditions, the main source of growth of the Bangladesh economy is factor accumulation, especially accumulation of capital. For achieving desired growth rates of the SFYP, the factor accumulation process, however, needs to be supplemented by technological progress in several key areas including the agriculture sector. While moderate improvements in total factor productivity could generate growth as stipulated in the baseline scenario, substantially large improvements would be necessary to achieve the growth dynamics under medium and high policy shift scenarios.

The resource requirements and related macroeconomic parameters for alternative scenarios of the SFYP are given in Table 1.3. In the baseline scenario, strengthening of the present efforts need to be supplemented by specific measures to create growth-friendly environment in several key areas including (i) investment; (ii) project implementation capacity and economic governance; (iii) infrastructure; and (iv) power and energy. The investment-GDP ratio (I/Y ratio) will have to increase to 26 per cent in FY2015 from 23.4 per cent in FY2011. In absolute terms, raising the I/Y ratio to 26 per cent would mean nearly doubling of total investment by the terminal year. Thus although the growth and investment targets may appear modest in the baseline scenario, realisation of these targets will require concerted efforts to usher a new era of economic performance and associated economic management in Bangladesh. In particular, the private sector will have to play the key role in raising investment and producing the growth momentum in the economy.

TABLE 1.3
RESOURCE REQUIREMENTS AND MAJOR MACROECONOMIC BALANCES UNDER ALTERNATIVE GROWTH SCENARIOS FOR SFYP

	FY10 (est.)	FY11	FY12	FY13	FY14	FY15	Average (FY11-FY15)
A. Baseline scenario							
Growth and Inflation (per cent)							
Nominal GDP growth	11.8	12.8	12.8	13.1	13.2	13.4	13.1
Real GDP growth	5.8	6.3	6.4	6.7	6.9	7.1	6.7
Inflation	6.5	6.4	6.4	6.4	6.3	6.3	6.4
Investment and saving (billion Tk.)							
Gross investment	1608.3	1816.3	2055.4	2333.7	2681.5	3110.8	2399.5
Public	347.6	379.1	416.9	462.3	513.0	569.6	468.2
Private	1260.7	1437.2	1638.5	1871.4	2168.6	2541.3	1931.4
National saving	2268.1	2453.1	2689.2	3013.5	3371.3	3810.9	3067.6
Government revenue	769.7	886.5	1023.2	1181.1	1363.6	1572.1	1205.3
Tax revenue	618.5	719.2	837.2	974.5	1134.2	1317.4	996.5
Government expenditure	1120.2	1272.6	1444.4	1649.9	1885.0	2154.3	1681.2
External sector (billion US$)							
Exports	17.6	19.6	21.9	24.5	27.4	30.9	24.9
Imports	22.0	24.7	27.7	31.3	35.5	40.3	31.9
Remittances	10.7	11.8	13.4	15.0	16.5	18.1	15.0
B. Medium policy shift scenario							
Growth and Inflation (per cent)							
Nominal GDP growth	11.8	11.4	11.6	11.9	12.3	12.8	12.0
Real GDP growth	5.8	6.5	6.7	7.0	7.5	8.0	7.1
Inflation	6.5	6.4	6.5	6.6	6.9	6.9	6.7
Investment and saving (billion Tk.)							
Gross investment	1608.3	1932.6	2303.8	2745.1	3272.5	3895.5	2830.0
Public	347.6	393.4	448.7	511.8	583.6	665.5	520.6
Private	1260.7	1539.3	1855.1	2233.4	2688.8	3229.9	2309.3
National saving	2268.1	2511.4	2970.6	3355.0	3874.8	4457.6	3433.9
Government revenue	769.7	903.8	1061.7	1247.9	1466.3	1722.6	1280.5
Tax revenue	618.5	726.5	854.7	1006.6	1185.5	1396.0	1033.9
Government expenditure	1120.2	1283.9	1474.6	1696.9	1961.1	2270.9	1737.5
External sector (billion US$)							
Exports	17.6	19.8	22.5	25.6	29.5	34.4	26.4
Imports	22.0	25.0	28.9	33.3	38.6	45.2	34.2
Remittances	10.7	11.9	13.2	14.9	17.0	18.2	15.1
B. High policy shift scenario							
Growth and Inflation (per cent)							
Nominal GDP growth	11.8	11.4	11.6	11.9	12.3	12.8	12.0
Real GDP growth	5.8	6.5	7.2	8.0	8.5	9.0	7.8
Inflation	6.5	6.4	6.5	6.6	6.6	6.6	6.5
Investment and saving (billion Tk.)							
Gross investment	1608.3	1959.8	2475.0	2991.2	3542.2	4188.1	3031.3
Public	347.6	417.7	484.8	563.1	653.6	758.5	575.4
Private	1260.7	1542.1	1990.2	2428.1	2888.5	3429.6	2455.7
National saving	2268.1	2592.6	3106.8	3568.0	4110.0	4679.9	3611.5
Government revenue	769.7	913.1	1095.2	1312.4	1558.1	1839.8	1343.7
Tax revenue	618.5	731.4	880.1	1061.2	1264.9	1498.0	1087.1
Government expenditure	1120.2	1313.6	1537.5	1798.2	2098.8	2448.2	1839.3
External sector (billion US$)							
Exports	17.6	20.1	23.0	26.7	31.3	36.9	27.6
Imports	22.0	25.5	29.9	35.3	41.7	49.6	36.4
Remittances	10.7	12.1	14.2	16.5	18.8	22.7	16.9

Source: Plan Technical Framework.

In the baseline scenario, revenue collection is projected to rise from 11.4 per cent of GDP in FY2011 to 13.0 per cent in FY2015, of which 83 per cent would come from taxes on average. Total government expenditure will rise by more than 92 per cent over the base year and, as a share of GDP, is set to increase to 18 per cent in FY2015 from 16.4 per cent in FY2011. The budget deficit is estimated at slightly less than 5 per cent of GDP. Export is set to increase from US$ 20 billion in FY2011 to US$ 31 billion in FY2015. Import is set to increase from US$ 25 billion in FY2011 to about US$ 40 billion in FY2015.

In the case of medium policy shift scenario, economic growth is expected to rise to 8 per cent in FY2015. The I/Y ratio will have to rise to 30 per cent in FY2015. This would require pragmatic interventions in terms of mobilising investment in the public sector and creating facilitating climate for attracting the required private investment including FDI; improving economic management and project implementation capacity; developing infrastructure including power and energy; creating skilled manpower; and identifying and promoting new growth generating activities. Growth policies will be needed to be sharpened along with more effective coordination among different arms of macroeconomic policy. Revenue efforts will have to be significantly enhanced along with more effective implementation of the public expenditure programme. The high policy shift scenario reflects a still more optimistic scenario with higher growth resulting from more rapid rise in investment and adoption of growth promoting policies.

1.2.2 Potential Sources of Growth and Key Issues

It is stipulated that the private sector will play the prime role in raising the investment rate to the required levels during the SFYP period. The pre-requisite would be that public investments and policies shall create necessary investment climate and heighten investors' (both local and foreign) confidence to undertake the required investments. Some key areas of improvement in this context would be: (i) energy supply including electricity and gas; (ii) infrastructure including roads, railways, bridges, embankments and dykes; (iii) telecommunication; (iv) ports; (v) legal and administrative systems including property rights issues; (vi) project implementation capacity; (vii) socioeconomic environment including law and order situation; (viii) market oriented incentives; and (ix) sound monetary policy and sustainable management of public finances.

The pivotal role of the public sector would be to create the conducive environment necessary for realising stipulated investments for which a visible improvement in the above and related areas is necessary. Although the government in the past has relied exclusively on the public sector to implement public investment programmes (e.g. through the Annual Development Programme, ADP), the procedure is likely to be inadequate to meet the demands on public investment fully during the SFYP. This is mainly because of the large size of public investment programmes especially in the infrastructure sector and the limited capacity of public sector organisations to undertake such investments. The government will have to put in place an effective mechanism for monitoring ADP implementation. Current arrangements in this regard have not proved to be adequate. In order to improve the quality of ADP projects, there should be a careful scrutiny of the projects that are currently included in the ADP so that low-quality projects could be dropped and resources could be reallocated in favour of high priority projects for the Sixth Plan.

It would be important to explore innovative approaches (such as the Public Private Partnership (PPP) model) in order to expand capacity and enhance effectiveness of public investments, especially in large scale infrastructure projects. The big challenge is to set up the institutional framework for preparing and implementing the PPP budget with capacity to ensure innovative ways, independent operation, and accountability of planning and budget process of the private sector. Rapid progress needs to be ensured to meet these challenges. For achieving success, it would be important to unveil the operational details of PPP at the earliest. For establishing a well functioning PPP framework, the government needs to address three major issues: (i) put in place a proper regulatory framework either by revising the 2004 Private Sector Investment Guidelines (PSIG) or enacting a new PPP Law; (ii) create a functional PPP Cell with proper institutional framework, required manpower, and other resources; and (iii) declare an appropriate incentive regime and viability gap funding mechanism to attract private investment in the infrastructure and other sectors. The key challenge in this respect would be to secure some early successes and show that the PPP system is workable. For the purpose, a few medium sized PPP projects in selected sectors such as energy, roads, healthcare and similar other areas could be selected initially within the SFYP framework. Which can be taken as pilot projects and the lessons learned from these can be replicated to undertake bigger and complicated projects of the SFYP.

Another critical area for the SFYP is to ensure large inflow of FDI, especially under the medium and high policy shift scenarios. The process of financial intermediation needs to improve substantially to tap domestically available resources (including remittances) for investment. Considering the large and rising inflow of remittances, appropriate policies would be needed to attract larger flows of remittances to productive investments. An important avenue would be to initiate new programmes to maximise benefits and reduce risks for the remittance receiving households, especially in rural areas. The support could take the form of promoting formal and semi-formal remittance services taking into the advantage of well spread microfinance network. The potential services may include: (i) encourage increased remittance inflows through formal channels by providing low cost, quick, and reliable services; (ii) enhance awareness, accessibility, and use of formal channels and spread information on relevant financial and non-financial services; (iii) create better and accessible investment opportunities especially for small remittance receiving families ensuring productive and relatively risk free use of remittance incomes e.g. developing appropriate investment opportunities, supporting microenterprise development, and providing enterprise and business development services.

For enabling the public sector to play its desired role during the SFYP, one of the key concerns is to raise tax efforts to the required level to generate public resources to meet the needs of the SFYP. At present, Bangladesh collects around 9 per cent of its GDP as taxes, which is 17 per cent in Sri Lanka and 18 per cent in India. Some analysis shows that, despite the low level of per capita income, Bangladesh's tax, potential could be around 14-15 per cent of GDP at present. Moreover, Bangladesh suffers from serious base erosion due to tax incentives granted to taxpayers, deficient tax design, weak tax administration, and low tax compliance. During the SFYP, it would be important to implement effective measures to widen the tax base through phasing out undue incentives, improving tax administration and structural framework, and improving compliance. The ongoing effort to revamp the VAT and income tax systems needs to be implemented in time and expanded to other areas to improve the entire revenue collection system.

In the external sector, the key requisite for ensuring stability during the SFYP is to maintain the high growth of exports (especially of RMGs) and raise the growth and diversity of non-RMG exports. The import projections suggest that imports will increase rapidly during the Plan period to meet consumption requirements resulting from rising income growth and for financing capital and raw material needs of the expanding economy. Along with new products and new markets, a diversified export basket will be critical to reducing vulnerability to negative external shocks during the period. As for remittances, both demand responsive skill up gradation of manpower export and new destinations are necessary to keep the remittance inflows at levels needed during the SFYP.

For achieving the objectives of the SFYP, the potential advantages of regional integration need to be fully exploited through all potential means e.g. SAFTA, BIMSTEC, and bilateral FTAs. This will be necessary to enhance Bangladesh's access to potential export markets in neighbouring countries.

The growth acceleration during the SFYP will depend on projected developments in infrastructure and related services, especially in two critical areas e.g. increased supply of electricity and gas, and timely completion of the Padma Bridge in 2013. These are needed to raise income, facilitate trade expansion, and reduce regional disparity to spur desired growth and poverty reduction.[1] To take full advantage of the Padma Bridge, the SFYP needs to incorporate specific plans for the south-east region e.g. development of multi-modal transport system, revival of Mongla port and creation of special economic zones (SEZs), establishment of rail link with other regions, improvement in power supply, exploitation of farm and non-farm potentials, and promotion of tourism.

Some macroeconomic parameters associated with the three alternative scenarios of the Sixth Plan are shown in Table 1.4. It can be seen that higher GDP growth during the Sixth Plan would require a significant increase in the investment-GDP ratio from an average of 24.5 per cent during 2005-09 to between 26.1 per cent and 32.0 per cent in the terminal year of the Sixth Plan depending upon chosen scenario. It is also expected that there will be some improvements in the incremental capital output ratio (ICOR), mainly due to developments in infrastructure and increased efficiency and competitiveness resulting from growing openness of the economy.

1.2.2.1 Key Issues underlying the Macroeconomic Framework

The accumulation of capital, along with some improvements in total factor productivity, will be the main sources of additional economic growth during the SFYP period. While manufacturing activities will be the key sectoral source of additional growth, agriculture will also experience significant improvement in production technology in both crop and non crop activities in order to raise agricultural growth to adequate level to ensure food and nutrition security and contribute to rural growth and poverty reduction.

The private sector would play the prime role in mobilising resources for the SFYP. For the purpose, investment climate would remain conducive to support heightened confidence of investors (both local and foreign) and the government would implement effective policies and programmes to improve essential infrastructure, ensure adequate supply of power and energy, improve telecommunication and port facilities, and ensure good economic administration and supportive legal framework.

It is expected that the public sector will play the pivotal role in creating the required investment-friendly climate during the SFYP. Historically, the government has relied on the Annual Development Programme (ADP) for implementing public

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[1] A World Bank study shows that the Padma Bridge would boost the country's GDP by 1.2 per cent, revive the fortune of the Mangla Port, and contribute to reducing poverty in the South-East region, which is the poorest region of the country.

sector projects including those in infrastructure. Although the ADP model has worked in the past when the domestic resource base was small and the country relied more on foreign assistance to carry out public sector investment programmes, the ADP based implementation mechanism is unlikely to be adequate to meet the public investment requirements during the SFYP. Experiences in many countries suggest that PPP model can become an effective supplementary tool for implementing large scale infrastructure projects.[2] Thus, in addition to strengthening the ADP implementation, the PPP framework needs to be made operational especially for implementing infrastructure and energy projects for the SFYP. For ensuring the required role, PPP investment as a share of GDP should be targeted to rise to at least 3 per cent in FY2015. Large inflow of FDI is expected to take place during the SFYP to meet the investment requirements of the SFYP. For achieving this, improved financial intermediation would be a precondition to tap domestically available resources (e.g. remittances and household savings) for investment.

Considering the important role of remittances, appropriate policies will be needed to promote remittances as a tool of promoting both welfare of recipient households and raising productive investments. Along with institutional support to maximise remittance inflows through formal channels, better investment opportunities would be needed for sustainable and productive use of remittance incomes. The prerequisite would be to develop investment opportunities, expand microenterprises and provide credit, business, and enterprise development support.

Reflecting a very low tax effort, Bangladesh collects only 9 per cent of GDP as taxes, whereas tax potential is estimated to be in the range of 14-15 per cent. The gap between the potential and actual collection is an indication of poor tax administration in Bangladesh, which needs to be addressed during the SFYP. For widening of the tax base, SFYP would need measures to phase-out tax incentives and improve structural tax characteristics, administration, and compliance. For the purpose, it would be important to implement the current initiatives to reform the VAT and income tax system within FY2011.

For meeting the export targets, the RMGs sector would have to experience high growth. Also, non-RMGs export will have to rise substantially. The SFYP will have

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[2] Many countries in the region have successfully adopted the PPP framework for meeting investment needs in the critical infrastructure sector. The examples of China, East Asia, Middle East and India are particularly noteworthy. In the oil producing Gulf Cooperation Council (GCC) countries, the massive $2 trillion investment plan, currently underway, is largely implemented under various PPP arrangements. Infrastructure investment in India under PPP is projected to increase to US$500 billion under the current five year plan.

to speed up the process of diversification of the current concentrated export basket in order to reduce the vulnerability of the economy to any negative external shocks. Regional integration efforts would be critical to enhancing Bangladesh's access to markets of neighbouring countries.

The completion of the Padma Bridge in time will be critical to unleashing the growth dynamics of the economy, especially in the southern region, with positive effects on income generation, trade facilitation, and poverty reduction. The government needs to take advantage of the Padma Bridge during the SFYP to embark on developing the southwestern region covering a number of areas e.g. development of multi-modal transport system, establishing rail link with other regions, and exploiting regional cooperation and trade with neighbouring countries.

One of the key concerns of the Sixth Plan would be to limit inflation and inflation expectations within the stipulated range. For the purpose, an appropriate option or a combination of a number of options could be considered: (i) within the purview of the Bangladesh Bank's monetary policy response, monitor liquidity expansion, and adopt, if necessary, measures to minimise pressure especially in the asset markets (stock and real estate markets) and in non-food prices; (ii) lower inflation expectations by building credibility, adopt prudent monetary policy, and augment capital formation in the farm sector to bridge structural supply-demand imbalances in agriculture; (iii) take appropriate measures and reduce market rigidities to contain the pass-through of higher prices in the international market which is likely to add on to inflation pressures at least in the near term; (iv) adopt direct measures to reduce inflationary pressure such that the burden of keeping inflation at low levels does not fall on demand management policies alone. The policies may include: maintaining adequate strategic buffer stock of food which could be released when needed through different food transfer programmes targeted to the poor and food insecure households. Similarly, targeted safety nets programmes, feeding programmes for school children, food-for-work programmes, open market sales, and employment programme for the poor and disadvantaged households, especially during the lean seasons, could be used in the short run to enhance food entitlements and stabilise prices; and (v) make the Trading Corporation of Bangladesh (TCB) effective in playing a major role in stabilising the market of important commodities. The TCB should plan in time (e.g. one year ahead) both to import at competitive prices (take advantage of future markets) and dampen domestic price speculation.

1.2.2.2 Some Social Outcomes of Alternative Scenarios

In the baseline scenario, economic growth would rise to slightly over 7 per cent in FY2015. The sectoral share in GDP will not undergo any drastic change. In

FY2015, the share of agriculture will decline to less than 19 per cent while that of industry will rise to 29 per cent. The share of services sector will be close to 52 per cent. An estimated 18.8 million new jobs will be created. Out of total employment of 76.4 million in FY2015, 30.2 million will be in agriculture, 13.7 million in industry, and 32.5 million in services. The incidence of poverty will fall to 25.3 per cent in FY2015.

Under the high policy shift scenario, large structural shifts will be needed in several areas to generate the desired growth momentum. While investment will have to be raised at a fast rate, measures will be needed to attract large amounts of FDI, ensure generation of 7,000 megawatt of electricity by 2013, explore new markets for Bangladeshi goods and services (including manpower), ensure growth supportive monetary and fiscal policies, and expand the productive capacity of the economy by facilitating required increase in imports of capital machinery and industrial raw materials. Sectoral growth projection in this scenario shows that the sectoral share in GDP will undergo significant change. In FY2015, the share of agriculture will decline to less than 15 per cent while that of industry will rise to 38 per cent. The share of services sector will be close to 48 per cent. An estimated 22.5 million new jobs will be created. Out of total employment of 80 million in FY2015, 31.7 million will be in agriculture, 14.4 million in industry, and 34.0 million in services. The incidence of poverty will fall to 22.4 per cent in FY2015.

In the medium policy shift scenario, economic growth would rise to slightly over 8 per cent in FY2015. The sectoral share in GDP will undergo some change. In FY2015, the share of agriculture will decline to 17 per cent while that of industry will rise to 31 per cent. The share of services sector will be 52 per cent. An estimated 20.6 million new jobs will be created. Out of total employment of 78.2 million in FY2015, 31.2 million will be in agriculture, nearly 14 million in industry, and 33.1 million in services. The incidence of poverty will fall to 24.4 per cent in FY2015.

For achieving the target growth of the high policy shift scenario, total investment requirement during the SFYP is estimated at Tk. 15,061 billion (average of Tk. 3,012 billion per year) compared with an estimated amount of Tk. 1,608 billion in FY2010. For the baseline scenario, the required amount is Tk. 12,049 billion that gives an average of Tk. 2,410 billion per year. For the medium policy shift scenario, total investment requirement is Tk. 14,056 billion (average of Tk. 2,811 billion per year).

With globalisation and growing openness of the Bangladesh economy, the importance of ensuring sectoral balances has somewhat declined over time since balances for tradable goods can be ensured, if necessary, through adjustments in external trade. It is, however, important to plan for ensuring balance between demand and domestic supply for the non-tradable sectors, especially for important infrastructure services such as electricity, road transport, ports, telecommunications, and similar other areas. It would be desirable therefore to work out the demand for these non-tradable outputs and accommodate their investment requirements within the Plan.

TABLE 1.4

MAJOR MACROECONOMIC PARAMETERS UNDER ALTERNATIVE GROWTH SCENARIOS

Parameter	2005-2009	FY11-FY15 (first year-last year)		
		Baseline	Medium policy shift	High policy shift
Investment-GDP ratio (%)	24.5	23.4—26.1	25.0—30.2	25.4--32.0
Revenue-GDP ratio (%)	10.4	11.4—13.2	11.7--13. 3	11.8--14.0
Public expenditure-GDP ratio (%)	14.2	16.4—18.1	16.6--17.6	17.0--18.7
Export-GDP ratio (%)	16.2	18.0—18.8	18.0--19.1	18.3--20.3
Import-GDP ratio (%)	21.4	22.7—24.3	22.8--25.1	23.2--27.2
National savings-GDP ratio (%)	29.0	31.7—32.0	32.5—34.5	33.6--35.7

Source: BBS and Plan Technical Framework.

Table 1.5 gives indicative projections of sectoral growth consistent with the three growth scenarios for the Sixth Plan. It may be seen that agriculture grew rather slowly in recent years. Similarly, both industry and services sectors showed consistently higher growth performance and a similar trend is likely to continue during the Sixth Plan period.

TABLE 1.5

SECTORAL GROWTH PROSPECTS FOR THE SIXTH PLAN

Sector	2008-09	2011-2015 (average per year)		
		Baseline	Medium policy shift	High policy shift
Agriculture	3.4	3.5	4.1	4.4
Industry	7.2	8.2	8.5	9.1
Services	6.1	7.0	7.4	7.9
GDP	5.9	6.7	7.2	7.8

Source: BBS and Plan Technical Framework.

1.2.3 Sectoral Growth

Overall, the slow growth of agriculture remains a major area of concern both for ensuring food security and for promoting more inclusive growth. In Bangladesh, more than half of the population, especially those belonging to lower income groups and living in rural areas, derives a greater share of their income from agricultural activities and hence a rapid agricultural growth can provide a significant boost to their incomes. Rising agricultural income is also necessary to open up mutually beneficial interactions between farm and non-farm sectors and raise non-farm incomes in the rural areas. This will contribute to both raising rural incomes and help in redressing rural-urban imbalances.

The Sixth Plan, therefore, needs, to give priority to the agriculture sector with a targeted growth of around 4 per cent on average for the Sixth Plan period. Such a growth upturn in agriculture is achievable in view of the recent performance of the sector. Between 2000 and 2009, agricultural growth exceeded 4 per cent in six years out of a total of 10 years.

The growth of the industry sector was more than 7 per cent in FY2009 which was underpinned by improved performance of two major subsectors—manufacturing and construction. This is a major achievement of recent policies. The challenge for the Sixth Plan would be to improve the performance of industry sector further especially for creating decent jobs in the non-agriculture sector. Within the sector, manufacturing is the key activity accounting for nearly 70 per cent of industrial output, the growth of which decelerated to 5.9 per cent in FY2009 from a high of 10.8 per cent in FY2006. One factor that explains this low manufacturing growth in recent years is the impact of global economic recession which adversely affected the export oriented manufacturing activities. It would be important for the Sixth Plan to revive the dynamism of the manufacturing activities and increase the share of manufacturing in GDP which has remained stagnant at less than 18 per cent over the last five years. This will also help generate more employment opportunities for the increasing labour force. The Sixth Plan should aim at double digit growth both in manufacturing and industry. At the same time, it would be critical to improve the performance of several growth augmenting sectors (including SMEs, steel, cement, fertiliser, and other intermediate and capital goods supplying sectors) to ensure adequate supply of essential inputs in supporting the projected industrial growth. Accelerated industry sector growth will be instrumental in generating more formal sector employment that usually creates quality jobs.

The services sector has witnessed reasonable growth over the last decade along with some acceleration (average of 6.5 per cent over 2005-2009 period) in recent years. In addition to traditional services sector activities, this reflects rapid growth in financial intermediation, mobile phone services, ICT, and other high-tech services. In moving toward "Digital Bangladesh," significant new opportunities would open up in ICT related services. This will also create new and attractive employment opportunities for the educated youth. Further expansion of services sector activities is, therefore, expected during the Sixth Plan leading to an average growth of 7-8 per cent per year in the services sector. This will also be supported by more rapid expansion in health, education, tourism, and other community, social, and personal services that are likely to get further boost during the Sixth Plan period.

In terms of the policy framework for accelerating sectoral growth, several issues need to be explicitly addressed in the Sixth Plan. These include, for instance,: (i) the alarming rate of loss of agricultural land to competing uses (e.g. roads, non-agricultural activities, homestead, etc.) which is estimated at 1 per cent per year; (ii) fast increase in the price of land reducing the economic return to agricultural production with potential adverse impact on agricultural growth; (iii) need for boosting up industrial growth as the major source of additional growth during the Sixth Plan; and (iii) fast expansion of technology-based service sector activities to create job opportunities, especially for the educated youth.

1.3 SAVINGS AND INVESTMENT

1.3.1 Investment

The level of investment is critical to expanding the productive capacity of an economy and a rising rate of investment is needed to accelerate the rate of economic growth. The investment rate in Bangladesh has not changed much over the last five years. The total investment rate, measured by the investment-GDP ratio, averaged 24.4 per cent over the 2005-2009 period with a declining trend in the last three years (Table 1.6). It is stipulated that the rate of investment would have to rise progressively to reach 31 per cent at the end of the Plan period, yielding an average of around 29 per cent in the entire Plan period.

One important aspect of the country's recent investment behaviour is the change in the relative share of public and private investment (Table 1.6). Although total investment as a share of GDP has remained mostly unchanged, private and public investment rates show opposing trends. While public sector investment as a share of GDP has declined from 6.2 per cent in 2004-05 to 4.6 per cent in 2008-09, similar share of private investment has risen from 18.3 per cent to 19.6 per cent over the same period. As a result, the share of public investment in total investment has declined from 25.3 per cent in 2004-05 to 19.1 per cent in 2008-09. This declining trend of public investment as a share of GDP has been continuing for several years and needs to be reversed in the Sixth Plan. The private sector investment, on the other hand, needs to be made further buoyant to meet the investment requirements of the Sixth Plan.

The increase in private sector investment is in large part a reflection of the adoption of the private sector led growth strategy and reforms carried out since the 1980s. These reforms dismantled undue restrictions on private investment and implemented measures to create a more favourable investment climate. The private sector responded positively to these changes. Further efforts need to be made to encourage private investment during the Sixth Plan. In addition, measures like the PPP could play instrumental role in directing investment to sectors like infrastructure and energy. As for the public sector, the reversal of the declining trend of public investment as a share of GDP is a priority for the Sixth Plan. This, however, should be justified through improvements in the efficiency of public investment. One compelling rationale for increasing public investment during the Sixth Plan would be the large gaps that exist in several areas such as in infrastructure and social sectors so that any rise in public investment would necessarily crowd in private investment in these and related areas as well as the economy at large.

TABLE 1.6

INVESTMENT-GDP RATIO AND ITS PUBLIC-PRIVATE COMPOSITION

(per cent)

Year	Total investment	Private investment	Public investment	Public investment as % of total investment
2002-03	23.4	17.2	6.2	26.5
2003-04	24.0	17.8	6.2	25.8
2004-05	24.5	18.3	6.2	25.3
2005-06	24.7	18.7	6.0	24.3
2006-07	24.5	19.0	5.5	22.3
2007-08	24.2	19.3	5.0	20.7
2008-09	24.2	19.6	4.6	19.2
Sixth Five-Year Plan (2011-2015) (first year--last year)				
Baseline	23.4–26.1	18.6–21.3	4.9–4.8	20.9–18.3
Medium shift	25.0–30.1	19.9–25.0	5.1–5.2	20.4–17.1
High shift	25.4–31.9	20.0–26.1	5.4–5.8	21.3–18.1

Source: BBS and Plan Technical Framework.

At present, private investment accounts for around 78 per cent of the total investment in the economy along with a larger share of employment. This shows that the private sector will be the key to achieving faster and more inclusive growth during the Sixth Plan. The agriculture sector and activities like SMEs will be important avenues of making economic growth regionally balanced along with more dispersed employment opportunities, especially in the rural areas in the Sixth Plan. The Sixth Plan should therefore aim at raising private investment to an average of 25-26 per cent of GDP from an average of around 20 per cent at present. This requires a more investment friendly climate, creation of opportunities for new entrepreneurs to enter into the market, supportive government policies, availability of quality infrastructure services, and good economic governance. Since SMEs would have to create the bulk of the employment opportunities during the Sixth Plan, the problems of the sector would require special attention including inclusive and efficient financing of these activities.

The major areas of attention for public investment in the Sixth Plan would be agriculture and water management, energy and infrastructure, and social sectors. It is expected that public investment on average will rise from less than 5 per cent of GDP at present to at least 6 per cent during the Sixth Plan.

1.3.2 Savings

The targeted increase in investment in the Sixth Plan needs to be supported by commensurate rise in domestic savings. Table 1.7 gives the present savings scenario and the required rates of savings during the Sixth Plan. The domestic savings rate (as measured by domestic savings-GDP ratio) has remained almost unchanged with a slightly declining trend over the last two years. Both public and private savings have stagnated in recent years.

TABLE 1.7

SAVINGS-GDP RATIO AND ITS PUBLIC-PRIVATE COMPOSITION

(per cent)

Year	Domestic savings	Private savings	Public savings	National savings
2002-03	18.6	17.4	1.2	24.8
2003-04	19.5	18.2	1.3	25.4
2004-05	20.0	18.6	1.4	25.8
2005-06	20.3	18.8	1.4	27.7
2006-07	20.4	18.9	1.4	28.7
2007-08	20.3	19.0	1.4	30.2
2008-09	20.0	18.7	1.3	32.4
Sixth Plan (average)	27.0–28.0	24.5–25.0	2.5–3.0	31.6–35.3

Source: BBS.

Note: In the national accounts, domestic saving is measured residually as the difference between GDP and final consumption. Denoting C=consumption, I=investment, X=exports, M=imports, and S_d=domestic saving, we get from the national income identity, GDP=C+I+(X-M) or S_d=I+(X-M). On the other hand, gross national saving (S_n) is measured as S_n= I+CAB= I+(X-M)+NFI+NCT where CAB is current account balance from the balance of payments, NFI is net factor income, and NCT is net current transfer.

In the backdrop of the current developments, it is important that both public and private savings grow during the Sixth Plan. The public savings rate needs to rise to around 2.5 to 3.0 per cent of GDP compared with only 1.3 per cent in 2008-09. This desired increase in public savings would require massive efforts on the part of both public entities and the SOEs to improve their performance. Also, if the pay hike of public sector employees in FY2010 does not create much inflationary impact, this may contribute to raising the level of private savings. Moreover, if some of the subsidies financed by the government can be moderated by bringing efficiency and removing leakages, it would be easier to realise the stipulated public savings target. In addition, better budgetary management and innovative management of rural and micro financing could pave the way to increased overall savings in the economy during the Sixth Plan.

In the case of private savings, the Sixth Plan needs to come out of the stagnating rate observed over the last few years and target a rate of 24.5 to 25.0 per cent of GDP. Thus private sector savings effort will have to be strong with noticeable improvement in savings performance. This is feasible in view of the low rate of private savings that prevails now and the expected rise in income of both household and private corporate sectors during the Sixth Plan period. The role of the national savings instruments needs to be rationalised in the light of its potential impact on distortion of the financial market. Similarly, exploring innovative non-banking channels for sending remittances and special measures to attract progressively larger shares of remittances to productive investment would provide impetus to further expanding the productive capacity of the economy.

1.4 MONETARY POLICY AND THE FINANCIAL SECTOR ISSUES

Two of the primary goals of the country's monetary policy are to maintain reasonable price stability and promote sustained and high economic growth. The Bangladesh Bank (BB) formulates monetary policy with the objective of keeping inflation at target levels using repo, reverse repo, and BB bill rates as policy instruments for influencing financial and real sector prices toward the targeted path of inflation.

Specifically, the annual monetary programme adopts reserve money (RM) as the operating target, while broad money (M2) is used as the intermediate target.[3]

[3] On the liability side, RM consists of currency with the public, cash in tills of scheduled banks, balances of scheduled banks with BB, and balances of other financial institutions with BB. On the other hand, sources of RM are BB's claims on government (net), scheduled banks, and other institutions, and net foreign and other assets. Broad money (M2) covers narrow money (M1, comprising of currency and demand deposits) and time deposits.

The underlying assumption is that the growth of monetary aggregates (such as M2) has a direct impact on the domestic price level. Therefore, by controlling the growth of monetary aggregates, BB aims to achieve price stability. In practice, BB sets the growth rate of RM that is deemed consistent with targeted inflation, with the expectation that this RM growth will in turn lead to a growth rate of M2 that is consistent with target inflation and adequate liquidity in the economy.[4] However, if the close link between RM and M2 weakens as the financial sector develops and a more diverse array of financial assets becomes available, a new approach to monetary policy would be warranted.

1.4.1 Inflation and M2 Growth

The relationship between the growth rate of M2 and inflation is relatively weak in Bangladesh (Figure 1.1).[5] In general, there does not exist any credible evidence of a clear, stable relationship between the growth of M2 and inflationary dynamics. The recent relationship seems to have become much less clear even after taking into account the lagged impact of M2 growth on inflation. This shows that although BB is able to influence the monetary aggregates using the policy tools, the tools are losing effectiveness in controlling inflation in view of the increasingly complex nature of price dynamics in the country. One important implication of the above development is that, in such situations, contractionary monetary policy may not be very effective in maintaining low inflation.

One reason for this weak relationship lies in the underlying sources of inflationary pressure. Recent inflationary pressures have originated largely from supply side shocks affecting several key prices such as food, fuel, and other essential products.[6] In such situations, undue reduction of M2 growth may become counterproductive through worsening the negative impact of inflationary supply side shocks on economic growth through reducing liquidity and raising interest rates. Thus one of the potential costs of pursuing tight monetary policy in supply

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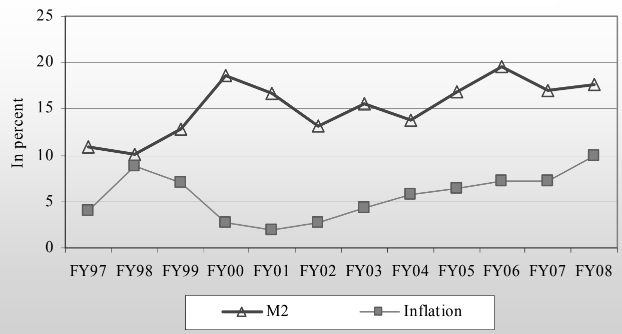
[4] An analysis of the dynamic relationship based on impulse response and variance decomposition among the components of RM, however, shows that two sources which are mostly beyond the control of BB (net foreign asset and net government borrowing) have greater influence on RM changes, thereby significantly loosening the degree of controllability of BB over RM. See Islam (2008).

[5] Over the last 12 years, the correlation coefficient between M2 growth and inflation has been negative, while the value is 0.33 between FY2000 and FY2008.

[6] Monetary aggregates influence the domestic price level through demand side effects on purchasing power. If, however, inflationary pressures originate from supply side shocks, changes in M2 growth will have a limited impact on inflation dynamics. For details on characteristics of current inflation, see Mujeri, Mortaza, and Shahiduzzaman (2008).

side triggered inflation dynamics is the rise in real interest rate thereby reducing investment and consumer spending.

Figure 1.1: Movement of M2 Growth and Inflation



Source: Economic Trends, BB and BBS

1.4.2 Interest Rate Issues

Figure 1.2 shows the average real (inflation-adjusted) deposit and lending rates of the banks. The real lending rate has remained relatively high in Bangladesh although there is evidence of some downward movement in recent years. This brings out one prominent feature of the country's banking structure that is indicative of high cost of credit. In addition, there is evidence of limited access of the rural people, especially the poor, to institutional credit in line with key poverty reducing sectors, such as agriculture, SMEs, and rural non-farm activities. High interest rates make credit expensive to support the expansion and development of many of these labour-intensive activities. This brings out the need to target short term interest rates at levels consistent with long run labour-intensive growth.

The interest rate spread (IRS) that is the difference between deposit and lending rates is another area of concern. In general, it can be said that the greater the spread, the higher the cost of credit to the borrowers for any given deposit rate. A high spread could also mean that the deposit rates are unusually low, which discourage savings and reduce resources available to finance bank credit. The IRS has remained relatively high in Bangladesh with the real deposit rate turning negative in a number of years (Figure 1.3). It may be mentioned that with no clear guidelines to set the nominal interest rate structure prior to the financial sector reforms in the 1990s, the complexity and rigidity of the administered lending and deposit rates significantly undermined domestic savings mobilisation and efficient credit allocations in the economy. In recent years, although IRS showed a marginally declining trend, it still remains high (Table 1.8).

Several factors seem to have contributed to the existence of the observed large spread between deposit and lending rates in Bangladesh. The existing financial system is dominated by a few large banks. Under the situation, the large banks have some degree of market power to raise lending rates and lower deposit rates. Moreover, the banks have a preference to hold low risk assets (such as government bonds) and a bias toward trading and commercial lending over lending in production activities, especially in the small scale and rural sectors.

Figure 1.2: Trends in Real Deposit and Lending Rates

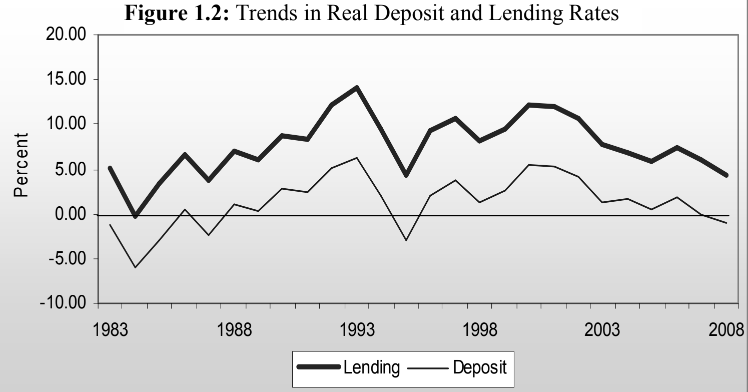
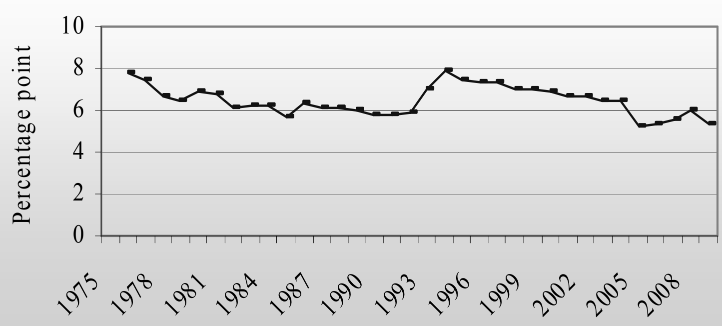


Figure 1.3: Trend in Interest Rate Spread



In addition, high risk premium raises average lending rates for the borrowers. The borrowers are required to pay high risk premiums in the formal credit market due to the widely held perception that most creditors are high risk borrowers. In general, high risk premiums result from a variety of sources, including excessive economic volatility, lack of good information systems on potential borrowers, inaccurate assessments of lending risk by financial institutions, and weak monitoring and enforcement mechanisms.[7] In order to mitigate the situation, banks and financial institutions need to collect reliable information on the creditworthiness of their potential borrowers so that the risk premiums can be adjusted to reality especially those relating to small and rural borrowers.

In part, institutional constraints in the financial sector leading to large risk premiums and high real interest rates create a situation in which available resources are not efficiently channeled to productive sectors. Moreover, given the choice between holding of government securities with high, relatively risk free rates of return vis-à-vis extending "risky" loans to private sector producers with potentially high transaction costs, the banking sector tends to prefer the former. The average asset portfolio of the country's banking sector in recent years shows that the banking sector holds nearly one-fifth of the amount that it extends in loans and advances in the form of government bills and bonds. In other words, with appropriate measures, the banking sector can significantly increase its current level of lending to support domestic investment, which could be targeted to employment-intensive activities.

TABLE 1.8

RECENT MOVEMENTS IN IRS

Period	Weighted average of all banks		
	Deposit rate	Lending rate	IRS
Jun 2001	7.03	13.75	6.72
Jun 2002	6.74	13.16	6.42
Jun 2003	6.30	12.78	6.48
Jun 2004	5.65	11.01	5.36
Jun 2005	5.62	10.93	5.31
Jun 2006	6.68	12.06	5.38
Jun 2007	6.85	12.77	5.92
Dec 2007	6.77	12.75	5.98
Jun 2008	6.95	12.29	5.34

Source: *Bangladesh Bank Quarterly,* various issues, Bangladesh Bank.

[7] See, Mujeri and Islam (2008).

Thus the country's financial system operates with some disjuncture under which most commercial banks, especially the private and foreign ones, are not willing on their own to lend to rural and small enterprises.[8] As a result, the expansion of these activities faces credit squeeze as informal and other sources of fund are too limited to satisfy their rising credit needs. Under the situation, along with deepening the existing efforts of the government and the Bangladesh Bank to channel a larger share of credit flows to these priority sectors, a complementary approach could be develop to strengthen relationships and linkages between the formal financial system and the credit-seeking potential enterprises in these sectors using the NGO and other networks, such as cooperatives and savings and credit associations, that can facilitate group savings and lending to SMEs, micro enterprises, and other rural activities. These initiatives could also be tied to refinancing, credit guarantees, and other policies that promote credit allocation to priority sectors and thrust activities for poverty reduction.[9]

1.4.3 Role of Financial Policy

The financial policy serves as a tool for poverty reduction in two principal ways. *First,* it creates direct impact on productive activity, and hence on employment and income generation, and on income and asset distribution. *Second,* it indirectly influences the fiscal and monetary policy stances which are important determinants of employment and output growth and hence of poverty reduction.

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[8] In an effort to increase formal credit facilities to SMEs, Bangladesh Bank introduced the refinance scheme for SMEs in May 2004. However, still the financing of SMEs by the formal sector is inadequate. In spite of allowing refinance facility, the banks availing refinance facility provided only about 18 per cent of their total loans and advances to the SME sector in FY2007. Moreover, while the banks get funds at the Bank Rate (5 per cent) from the Bangladesh Bank, their lending rates are high varying within 14 per cent to 24 per cent for different banks. See Rikta (2007). Similarly, the Equity and Entrepreneurship Fund (EEF) was created in FY2001 to encourage investments in prospective industries. Although most of the enterprises which have availed the EEF are SMEs, total disbursement shows a declining trend in recent years mainly due to low demand by participating banks and financial institutions. See Islam, Rahman and Rikta (2008).

[9] Although the access to formal financing, especially bank financing, for SMEs has been increasing in recent years due to efforts by the Bangladesh Bank such as introduction of refinance facilities, urging the banks to open special windows for catering to SME loans and similar other measures, common norms in bank-SME relationship are needed across all banks so that SMEs can access credit in a timely and efficient manner. Similarly, banks and financial institutions need to evolve and expand innovative financial product lines for SMEs to meet their diverse demands such as raising funds through syndication and domestic factoring which have emerged as successful tools of SME financing in many countries.

In Bangladesh, under the market based financial system, if no regulations exist then market signals would determine the allocation of investible resources and therefore the demand for and allocation of savings through financial intermediaries. However, in the case of activities where externalities are present and there exists divergence between private and social returns, the market is likely to direct less credit to these sectors and more to non-priority (from the point of view of poverty reduction) but more profitable sectors or to few large borrowers and already developed centres of economic activity. This would retard the pace of poverty reduction and worsen income distribution. It is, therefore, important for the government to intervene in the financial sector.

The direct effects of financial sector policies on poverty can be mediated through different ways, such as cost and other conditions for access to credit, level and pattern of private investment, and means of financing fiscal deficits. For example, several financial policies in Bangladesh are likely to positively affect poverty reduction through their efforts of directing adequate credit to structurally disadvantaged sectors like agriculture, SMEs, and the rural non-farm sector which are important from the point of view of poverty reduction. Two specialised banks, Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB), are involved in the distribution of agricultural credit. The Bangladesh Bank has encouraged other commercial banks to provide credit to agriculture and other pro-poor sectors and these banks are now disbursing increasingly larger amount of credit to these priority sectors. Similarly, the micro finance institutions (MFIs) serve as important conduits to bring credit to the vulnerable households in the country.

Obviously, an appropriate institutional framework and regulatory structure is needed for the financial sector in order to reinforce the adopted policies and ensure that the quality and coverage of financial intermediation, especially in the priority sectors, are satisfactory. Bangladesh Bank has been issuing prudential guidelines in different areas with the objective of improving the overall health of the financial sector and fostering bank credit to priority sectors. Bangladesh Bank also permits to hold a part of the banking system deposits in the form of government securities. This ensures that the banks make a certain volume of investment in government debt, and these bonds are used to finance government expenditures including those warranted by the government's poverty reduction strategy. Thus, Bangladesh Bank is not only playing the role of investment coordinator, but also using the financial system to direct investment to sectors that are more relevant to poverty reduction.

1.4.4 Raising Effectiveness of Monetary Policy

The above raises important issues relating to the effectiveness of monetary policy in Bangladesh. If the banking sector remains constrained in providing adequate credit to more productive and employment-intensive sectors, then monetary policy is unlikely to create the desired effects in the economy. To remedy the situation, changes in regulatory and institutional environment in which the banking sector operates are required such that the banks would be able to mobilise financial resources more effectively for employment centered development. Monetary policy operation in isolation, however, will not be able to bring the desired changes without support from complementary measures such as programmes to improve creditworthiness by developing better business planning, financial management and book-keeping skills of employment oriented small and medium enterprises, investments in efficiency enhancing power, transport, and related infrastructure, and similar other measures.

In effect, the current monetary policy framework needs broadening beyond monetary aggregates covering low inflation and stabilisation to extending support to sustainable pro-poor growth. In this context, the priority in Bangladesh is to improve the flow of credit to employment-intensive sectors and activities. Although the concentration of employment in Bangladesh is in agriculture and informal sectors, several factors such as high risk premiums, asymmetric information flows, significant transaction costs, and the general lack of incentives on the part of the banks limit the availability of adequate credit in these activities.

To change the situation, new and innovative actions are needed aiming to improve credit flow to the priority areas. Loan guarantees in selected activities can reduce risk premiums, information systems can be improved to lower transaction costs, and incentives can be put in place for banks to encourage shifting toward developmental loans. Along with improving credit availability to priority sectors, such interventions would also enhance the ability of the monetary policy to support development goals. In addition, forging links between commercial banks and other financial institutions with ability to serve small-scale enterprises and own account producers (such as MFIs) can bring efficient outcomes in terms of mobilising deposits and other financial resources on the one hand and administering small scale credit programmes on the other.

1.5 FINANCIAL SECTOR DEVELOPMENT

Financial intermediation provides the crucial link between savings and investment. A well-functioning financial system should be able to mobilise resources effectively and allocate them to the most productive investment opportunities. Without effective financial intermediation, the incentive to hold financial savings is depressed and investment tends to concentrate on the sector in which the savings take place, which may not be the most productive. As a result, there are fewer resources mobilised and these are allocated to less productive investments. Building a sound financial system is therefore an immense necessity for the economic development of a country. Financial system provides a strong mechanism for collection and allocation of financial resources among the various alternatives. However, in a developing country like Bangladesh it is very hard to reach in a sound financial system due to the lack of requisite institutions, expertise and resources. Many legal and regulatory frameworks are needed to ensure discipline in the financial system. For these reasons, a careful assessment of the financial system is necessary in order to ensure more efficient allocation of capital and higher levels of savings and investment.

This section considers two aspects of financial development—financial liberalisation and financial deepening. Financial liberalisation, on the one hand, refers to a reduction in the role of government, and an increase in the role of the market in allocating credit. Financial deepening, on the other hand, refers to an increase in the volume of credit being intermediated in financial markets, and is typically measured by indicators such as M2, credit to the private sector, or stock market capitalisation relative to GDP. Although the two tend to be related, they are not equivalent. Financial deepening affects access to finance, while liberalisation affects the incentives with which credit is deployed.

The demand for financial services in Bangladesh is expected to be high, despite the low income levels. Households need financial services to manage the risks linked to the volatility of their income sources, and firms need financing in order to grow. The financial system in Bangladesh largely depends on the banking sector. Currently 48 commercial banks are working along with 29 non-banking financial institutions. The capital market consists of two stock exchanges—Dhaka and Chittagong, which is still in a rudimentary stage. A large proportion of the people of rural Bangladesh still depends on the semi- and non-formal financial institutions for financial services. The formal financial sector mainly concentrates on the higher market-end, and a larger informal financial sector concentrates on the lower market-end. There is very little interaction between the two sectors and there is a considerable gap in the financial services market in between the two market ends.

1.5.1 An Overview of the Financial Sector

The financial sector of Bangladesh, as like as other developing nations, comprises of three sectors:

1. Informal financial sector
2. Semi-formal financial sector
3. Formal financial sector

1.5.1.1 The Informal Financial Sector

The informal financial sector refers to all institutions and transactions occurring outside the country's official financial services system. Institutions offering financial services in the informal sector range from large savings groups to individual moneylenders. The range of services offered is similarly vast, with a large array of different savings collection instruments and lending arrangements, including non-commercial financial transactions between friends and relatives. Some of the most prevalent institutions in this sector are deposit collectors, moneylenders and credit associations. Institutions in the informal financial sector typically focus either on deposit collection or on loan extension. The few institutions that offer both services are generally open only to members.

Because of the absence of official records of the informal market's transactions, it is very difficult to estimate the significance of informal credit in Bangladesh. The Bangladesh Bank does not recognise this market as a legitimate medium of financial intermediation and does not collect any information on a regular basis on such markets. There is no firm estimate of the size of this market. The Rural Credit Survey for the year 1986, the first such attempt in the country, estimated that about 64 per cent of total credit (Tk 14.1 billion) was transacted in the informal financial sector. Another study estimated the size of the informal financial market at about 63 per cent of the total financial market. Activity-specific studies show that a significant proportion of raw materials are bought on credit with informal borrowing accounting between 50 per cent and 100 per cent. About 40 per cent of the expansion capital of handlooms, over 25 per cent of the expansion capital in the small engineering and metal fabrication sector and nearly 45 per cent of working capital for brickfields is raised from informal sources. The formal and informal financial markets have been complementary to each other, as demonstrated by BIDS surveys (1989). BIDS study of lending operations of a number of bank branches indicates that a significant proportion of the loans extended find its way to the informal sector through on lending by the bank's borrowers. The informal borrowers face problems in raising loans from banks for several reasons:

(a) they may not have access to information about bank lending;

(b) they may not have adequate literacy to seek loans;

(c) they may be reluctant to incur "extra costs" in obtaining bank loans; and

(d) they may not have the necessary collateral to offer as security for the loan.

The BIDS study further shows that there is a remarkable degree of uniformity in the rate of interest among various segments. About two-thirds of the large loans are extended with the modest interest rate of 10 per cent per month. The uniformity of interest rate indicates that resources are allocated between segments in response to the returns from lending in each segment. The growth of informal borrowing, the use of borrowed funds for meeting expansion and working capital needs, and the extent to which informally financed micro enterprises provide sustenance to a growing number of workers are all testimony to the increasingly positive role of informal financial markets.

Financial transactions in the informal financial sector are typically small and frequent, reflecting the low level of disposable income and the high liquidity preference of poor households and small businesses. The sector is dynamic, varied and responsive to the needs of the population in terms of financial services. It does not, however, play a significant role in financial intermediation, despite its strong capacity for savings mobilisation. It appears that the risk management strategies employed by informal financial institutions, which allow them to operate in the lower end of the financial market, also constrain their expansion. Informal financial institutions rely on personal relations and repeated transactions as principal risk-reducing strategies. The social pressure exerted by the community in which transactions take place is also of key importance in reducing the likelihood of fraud or default.

It is therefore necessary to develop mechanisms to establish linkages between formal and informal financial institutions in order to provide with a smooth flow of financial services to SMEs and households using comparative advantages of both sectors.

1.5.1.2 Semi-Formal Financial Sector

An important phenomenon in the financial system of Bangladesh has been the emergence of microfinance institutions. These are commonly defined as financial institutions dedicated to assisting small enterprises, the poor and households that have no access to the more institutionalised financial system, in mobilising savings and obtaining access to financial services. They include institutions from the informal sector as well as a small but growing part of formal financial sector institutions. A number of microfinance institutions, however, fit in neither the informal nor the formal sector. These are institutions that are registered and often regulated to some degree, yet are not treated as banks or subject to the strictest application of prudential regulation. The emergence of this semi-formal sector holds great potential for bridging the financial services gap that still exists between the informal and formal financial sectors. Many microfinance institutions use the methods and sometimes even the agents of the informal financial sector in providing financial services to poor and rural areas without incurring prohibitive costs. There are also linkages emerging between microfinance institutions and banks as microfinance institutions use large formal banks for deposit and credit facilities.

Microcredit programme in Bangladesh is implemented by NGOs, Grameen Bank, different types of commercial banks and specialised programmes of some ministries of Bangladesh Government, etc. Despite the fact that more than a thousand of institutions are operating microcredit programme, but only 10 large MFIs and Grameen Bank represent 87 per cent of total savings of the sector (around BD taka 93 billion) and 81 per cent of total outstanding loan of the sector (around BD taka 157.82 billion) (Table 1.9). Near about 2 lakh people are employed in MFIs and Grameen Bank. Around 30 million poor people are directly benefited from microcredit programmes. Through the financial services of microcredit, these poor people are engaging themselves in various income generating activities. At present, financial service of BD taka 160 billion (approx.) is being rendered among 30 million poor people, which help them to be self-employed that accelerates overall economic development process of the country (information provided by Microcredit Regulatory Authority 2009).

1.5.1.3 Microcredit Regulatory Authority (MRA)

Microcredit Institutions have been providing various social and financial services to the poor to alleviate poverty from the society for the last three decades. However, they remained outside any central supervisory system. To bring microcredit sector under regulatory framework, the government of Bangladesh enacted "Microcredit Regulatory Authority Act, 2006" on July 16, 2006 with effect from August 27, 2006. "Microcredit Regulatory Authority (MRA) has been established under this Act which is empowered and responsible for monitoring and supervising the microcredit activities of the MFIs. According to the Act, no MFI can operate microcredit programme without obtaining license from MRA. Within the stipulated period, 4,236 MFIs applied for license. Among them, 335 MFIs have been licensed till September 2008. Applications of 438 institutions could not be considered; 2,599 small institutions are advised to fulfill minimum criteria of obtaining license (either minimum balance of outstanding loan at field level BD taka four million or minimum borrower 1,000) within June 2009. Rest of the applications is being processed.

Semi-formal microfinance institutions deal with risk partly by using agents and methods, such as group-based lending, from the informal financial sector. The main form of risk management, however, is the development of a large client base and the limitation of loan amounts.

TABLE 1.9

MICROCREDIT ACTIVITIES OF GRAMEEN BANK AND 10 LARGE NON-GOVERNMENT MICROCREDIT INSTITUTIONS, JUNE 2008

SL No.	Name of the institutions	Districts covered	No. of branches	No. of members	No. of borrowers	Outstanding loan (in million)	Savings (in million)
1	Grameen Bank	64	2,517	7,527,700	7,527,700	39,920	54,260
2	BRAC	64	3,005	8,448,107	7,053,798	43,240	14,850
3	ASA	64	3,324	7,132,427	5,675,784	29,180	5,240
4	Proshika Manobik Unnayan Kendro	58	213	2,724,101	1,761,638	3,940	2,160
5	TMSS	44	684	698,741	563,630	2,930	1,090
6	Buro Bangladesh	43	294	472,984	371,285	2,270	920
7	Jagorani Chakra Foundation	20	233	348,150	265,535	1,440	500
8	Shakti Foundation	45	195	181,990	158,763	1,170	570
9	Padakhep Manabik Unnayan Kendra	43	207	170,754	166,950	1,140	330
10	Caritas Bangladesh	40	243	376,922	302,196	1,030	600
11	RDRS Bangladesh	11	144	348,324	280,351	890	390
	Total		11,059	28,430,200	24,127,630	127,150	80,910

Source: Micro-credit Regulatory Authority, 2009.

The strengthening of this semi-formal sector can potentially help deepen and diversify financial systems in Bangladesh. These institutions can play a crucial role in financing small and medium-sized enterprise growth. They can also participate in increasing the mobilisation and pooling of financial resources, thereby contributing directly to increasing the amount of domestic resources available for productive investment.

1.5.1.4 The Formal Financial Sector

Banking Financial Institutions

The formal financial sector in Bangladesh, as in other regions of the developing world, essentially consists of banks. Although non-bank financial institutions and stock markets have been developing in Bangladesh, their influence generally remains marginal compared to the banking sector. The banking sector comprises of 48 banks including 4 state-owned banks (SOBs), 30 private commercial banks (PCBs), 5 specialised banks (SBs) and 9 foreign commercial banks (FCBs) (Table 1.10).

TABLE 1.10

SCENARIO OF THE BANKING SECTOR IN BANGLADESH, MARCH 2009

Bank type	Number	Number of branches			Percentage of total asset	Percentage of total deposit
		Rural	Urban	Total		
State owned commercial banks (SCBs)	4	2,146 (63.4%)	1,240 (36.6%)	3,386 (100%)	30.66	48.07
Private commercial banks (PCBs)	30	634 (30.3%)	1,461 (69.7%)	2,095 (100%)	53.71	29.71
Specialised banks (SBs)	5	1,206 (88.5%)	157 (11.5%)	1,363 (100%)	6.08	8.31
Foreign commecial banks (FCBs)	9	0	56 (100%)	56 (100%)	9.55	13.91
Total	48	3,986 (57.8%)	2,914 (42.2%)	6,900 (100%)	100.00	100.00

Source: Bangladesh Bank.

Table 1.10 shows that role of SCBs has declined. The SOBs' share in total assets has declined from 54 per cent in 1998 to 31 per cent in March 2009. Private banks' (including foreign banks) share has risen from 33 per cent in 1998 to 63 per cent in 2009. In 2008, the ratio of liquid liabilities (M3) to GDP, an indication of the monetary resources mobilised by the formal financial sector, was 55 per cent in Bangladesh, compared with 49 per cent in East Asia and the Pacific, and 100 per cent in high-income countries. In 2008, private sector credit as a ratio of GDP, a key to the intermediary performance of the financial sector, was also 55 per cent in Bangladesh, compared with 30 per cent in South Asia, and 107 per cent in high-income countries (Honohan and Beck 2007).

Additionally, private banks in Bangladesh tend to be concentrated in the principal cities, with few branches in rural areas (30 per cent of total branches). Furthermore, they often have rules and procedures for both deposits and loans that prevent poorer households and small businesses from gaining access to their services. Such barriers include minimum deposits and balance for deposits, and high collateral requirements and interest rates for loans. As a result, the banking sector in Bangladesh is effectively closed off to a large part of the population.

In Bangladesh, around 25 per cent of the population has access to the banking sector (considering number of bank accounts, 2009). Per capita deposits and loans are Tk. 17,752 and Tk. 13,792 respectively (Schedule Bank Statistics, Bangladesh Bank). Interest rates, particularly lending interest rates, remain high for long time in Bangladesh even after interest rate deregulations in the 1990s. The interest spread is expected to decline over time as liberalisation is accomplished and the financial sector develops. But in Bangladesh, financial liberalisation initiated in the 1990s seems to have led to a widening interest rate spread (more than 5 per cent). The factors that appear to propel this are distortions in the loans market, institutional impediments and the policy environment.

Furthermore, banking sector of Bangladesh, particularly state-owned commercial banks (SCBs), suffer from high non-performing loans (around 30 per cent in 2008 for SCBs). Contract enforceability is often weak in Bangladesh, making legal recourse against defaulting borrowers an uncertain, lengthy and costly exercise, which contributes to high non-performing loans. The low risk-management capacity of banks in Bangladesh is in large part due to the legacy of pervasive state interventionism in the financial sector.

Two specialised banks, namely Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB), are engaged in providing financial services towards agricultural development of Bangladesh. While BKB has 951 branches, RAKUB has 364 branches all over Bangladesh, mainly in rural areas. The SBs distributed Tk. 4,450 crore in the fiscal year 2007-08, which is 52 per cent of total agricultural credit and 1.2 per cent of total domestic credit in that year. However, there is dissatisfaction among people that a major portion of agricultural credit often goes for non-agricultural purpose and non-farmers, and the operation and management of BKB and RAKUB are corrupt and not efficient.

Prior to reforms started in the 1990s, banks were mostly government-controlled and political imperatives were consistently given priority over commercial viability. Competition between banking institutions remained stifled and banks had little incentive to develop their activities. As a result, the institutional capacity of banks to manage the systemic and idiosyncratic risks in financial systems has failed to develop sufficiently. In part to remedy these problems, Bangladesh underwent financial sector reforms starting in the early-1990s. These reforms, which were part of a broader set of market-oriented, often donor-led reforms, generally entailed financial liberalisation and institutional reforms to prudential regulation systems and distressed government-owned banks. They have succeeded in limiting the scope of government intervention in the financial sector and in strengthening prudential regulation of financial institutions. Mostly, however, they have not succeeded in significantly deepening or diversifying the financial sector. In fact, competition has not increased significantly and the banking sector in Bangladesh still remains oligopolistic.

TABLE 1.11

PERFORMANCE INDICATOR OF THE SPECIALISED BANKS

Year	Total Asset (Tk. in billion)	Gross NPL Ratio	Return on Asset (ROA)	Return on Equity (ROE)
2001	290.8	54.5	0.7	12.3
2002	296.5	48.0	0.3	5.8
2003	329.5	38.3	0.0	-0.6
2004	345.7	23.0	-0.2	-2.1
2005	401.6	22.6	-0.1	-2.0
2006	432.4	23.6	-0.2	-2.0
2007	387.9	19.0	-0.3	-3.4
2008	377.6	17.0	-0.6	-6.9

Source: Annual Report, Bangladesh Bank.

1.5.1.5 Non-Bank Financial Institutions (NBFIs)

The NBFIs represent one of the most important parts of a financial system. In order to ensure flow of term loans and to meet the credit gap, NBFIs have immense necessity in the economy of Bangladesh. Starting from 1981, currently 29 NBFIs are operating in Bangladesh. NBFIs in Bangladesh mainly focus on real estate & housing (13 per cent), power & energy (12 per cent), textile (11 per cent) and transport sector (9 per cent) (based on 2005 data). NBFIs are also exploring other sectors namely “pharmaceuticals & chemicals,” “iron, steel & engineering”, “garments & accessories,” “food & beverage” and “agro industries & equipment” (Hossain and Shahiduzzaman 2002).

The growth of NBFIs in terms of assets and liabilities and diversification of business has significantly increased from the time of inception. As available data shows, total outstanding financing of NBFIs at the end of June 2006 stood at BDT 7.3 billion, which reflects a 15.50 per cent growth (on an annualised basis) over December 2005. Annual average growth during 2002-2005 was 33.89 per cent. Total asset of the industry reached at Tk. 59 billion in June 2006, which reflects a growth of 18.47 per cent over December 2005 (Ahmed and Chowdhury 2007). NBFIs register an annual average growth of 34.91 per cent over the last four years. Therefore, it appears that the growth of the industry has been impressive considering competitive pressures from banks and other financial institutions.

1.5.2 Linkage between Formal and Informal/Semi-Formal Financial Sector

To enhance the role of domestic resources in economic development, it is essential to increase the quantity and quality of financial intermediation. Greater integration between the formal and informal financial sectors, possibly through the expansion of the semi-formal sector, would increase the coverage of the financial sector and ensure that the financial needs of more households and firms are met. A more integrated financial sector would be better able to pool mobilised resources and perform essential maturity transformation between volatile savings and stable long-term investments. An efficient financial system with better coverage could raise the level of financial resources in the economy, make a larger proportion of these resources available for investment and improve the allocation of funds for productive investment.

There has been considerable interest around the world in bridging the formal sector (banks) with the semi-formal sector (NGOs) exploiting the comparative advantages of each. The informal and semi-formal sectors have a comparative advantage over the banks in lending small loans without collateral or in "relending" to women and poor borrowers. NGOs mobilise savings from their members but not from non-members which deny them access to large savers. They are therefore in a position to lend more than they can mobilise as deposits. Creating a link between NGOs and banks, therefore, ensures the comparative advantage of both sectors.

At least three different linkage patterns can be seen in operation. The *First* is a model in which NGOs function as intermediaries, taking on themselves the resulting loan losses. An example of this linkage is found in the IFAD-financed Oxbow Lakes Small Scale Fishermen Project with BKB onlending funds through BRAC. The Bangladesh Bank provides IFAD funds to BKB at 6 per cent and the ultimate borrower paying 15 per cent. The interest spread of 9 per cent is shared by BKB (2 per cent) and BRAC (7 per cent). There is not enough data to assess the adequacy of interest spread available to BRAC. The *second* is a model in which the bank lends directly to borrower groups. NGOs assist borrowers with paperwork, analysis of proposals and so forth. They also "retail" loans from banks to beneficiaries, either charging the borrower a fee or receiving a subsidy for this service from the government. Women's World Banking is a good example of this credit model, operating in some 50 countries, and extending loans to women through commercial banks with the use of a guarantee mechanism. Several governments in Latin America have also set up mediating agencies along these lines. The Institute for Development of the Informal Sector (IDESI) in Peru is a well-known example, which can be considered a *third model*.

In Bangladesh, linkage between formal and semi-formal is not a new idea. However, it needs to be strengthened and streamlined. Several new avenues can be explored under this kind of arrangements during the sixth five year plan. Recent share-crop lending agreement between Bangladesh Bank and BRAC can be another example of linkage between formal and semi-formal financial institutions.

1.5.3 Financial Reforms during 2000-2009

1.5.3.1 Interest Rate Deregulations

After independence, Bangladesh Bank (BB) adopted an administered interest rate policy under which the level as well as the structure of interest rates was controlled. Nominal interest rates were fixed at relatively low levels in the 1970s (the nominal deposit rate varied between 3.51 per cent in 1975 and 4.27 per cent in 1979, while the nominal lending rate was 11.28 per cent in 1975 and 11.12 per cent in 1979); and the interest rates maintained a slowly rising trend throughout the 1980s.

Banks were allowed to freely adjust their own interest rates from February 19, 1997. Further flexibility in the interest rate policy was introduced on July 12, 1999 permitting banks to differentiate interest rates to individual borrowers except lending to exporters only. With liberalisation in the banking sector policies, interest rates started to decline in 1992 which continued till 1996. For real interest rates, significant fluctuations can be noticed with real deposit rate becoming negative for a number of years in the 1980s and remaining very low in recent years (Mujeri and Islam 2008). Despite liberalisation efforts, the IRS is still considered to be high in Bangladesh.

TABLE 1.12

INTEREST RATE STRUCTURE (YEARLY AVERAGE)

Year	Savings rate	Fixed deposit rate	Interest on agri loan	Interest on large term loan	Interest on small term loan	Interest on working capital	Interest on exports	Interest on trade financing	Interest on house financing	Interest on consumers loan
2004	5.50	7.60	9.37	11.50	10.88	11.88	7.00	12.49	10.02	7.29
2005	5.56	7.91	9.41	11.61	10.97	12.01	7.00	12.59	10.15	8.81
2006	5.99	9.59	9.92	13.19	12.08	13.59	7.00	14.30	12.95	13.66
2007	5.99	9.82	9.93	12.90	11.98	13.75	7.00	14.41	12.98	14.16
2008	5.95	10.98	10.41	12.48	12.10	13.07	7.00	14.07	12.85	14.56

Source: *Economic Trends*, Bangladesh Bank; *Annual Reports of Banks.*

Despite the removal of restrictions and reforms in the banking sector to facilitate the adoption of a market oriented interest rate policy, interest rates remained high and are yet to become fully responsive to the market (Hossain 2010**).** In this context, the BB as the regulatory authority of the country's banking and financial system has taken steps to persuade the banks to reduce the IRS in a rational manner. Since Banks are not willing to reduce lending interest rates by their own, in 2008, Bangladesh Bank placed a ceiling of lending interest rates at maximum 13 per cent, and a ceiling of deposit rates at maximum 10 per cent.

However, this kind of financial control should be considered as a short-term measure. Otherwise, it may create distortions in the money market. For effective monetary policy transmission, it is necessary for Bangladesh Bank to work toward bringing efficiency and competitiveness in interest rates structure.

Capital Adequacy of Banks

- Minimum capital requirement on risk-weighted basis was raised from 8 per cent to 9 per cent;
- Minimum capital requirement raised from Tk. 40 crore to Tk. 100 crore ($17 million).
- To implement Basel-II, from December 2008, "Guidelines on Risk Based Capital Adequacy for Banks" (Revised Regulatory capital Framework in line with Basel-II) has been issued.
- To enhance the financial base of banks, banks have to increase (within three years from August 2008) the amount of paid-up and authorised capital to Tk. 400 crore, in which paid-up capital must not be lower than Tk. 200 crore.
- In order to enhance capital collection, banks are advised not to distribute net profit in cash and if necessary they can raise capital through IPO and Right Shares. If banks cannot comply with the requirements, they have to be merged with other banks to meet up the requirements.

Outcome:

- Increased floating of banks' share in capital market to source capital;
- Healthy increase in share prices of banks;
- Banks' share in total market capitalisation rose from 10 per cent in June 1998 (PCBs capital adequacy ratio was 9.2 per cent) to 53 per cent in December 2008;
- Capital adequacy ratio as measured by capital to risk-weighted asset ratio remained significantly above the regulatory requirement of 10 per cent for FCBs (22.86 per cent) and marginally higher for PCBs and SBs (10.36 per

cent and 10.63 per cent respectively) in 2007. However, SOBs capital adequacy remained lower than the requirement in 2007 (-7.1 per cent).

Corporate Governance: Measures taken during 2002-2008

1. Fit and Proper test for CEOs of banks tightened,
2. Fit and Proper test for bank directors introduced,
3. Provision of independent directors representing depositors' interests,
4. Maximum number of directors for bank reduced to 13,
5. Limiting directorship of banks to six years or two terms,
6. Only one director allowed from each shareholding family,
7. Two directors will be appointed from depositors based on their qualifications for three-year period,
8. Instructions issued to constitute Audit Committee of each bank's Board to assist in financial reporting, audit, and internal control,
9. Much enhanced annual financial disclosures required including publication in newspapers and ensuring availability for public view in bank branches,
10. Risk Management Guidelines introduced.

Risk Management Guidelines

- Risk management guidelines on major risk areas covering Credit, Market and Operational risks issued, (Credit, asset-liabilities, foreign exchange, internal control/systems, anti-money laundering);
- Prudential Guidelines for Consumers Credit issued,
- Prudential Guidelines for Small Business lending issued.

1.5.3.2 Reforms in SCBs

With a view to monitoring overall performance of banks including capacity enhancing, bringing financial solvency, and increasing performance of SOBs as part of financial sector reform programmes, the following steps have been taken: Agrani Bank, Janata Bank and Sonali Bank have allowed to undertake their business operations as Public Limited Companies (PLCs) under the Banking Companies Act 1991. The asset, liabilities and the capital of the previous SOBs have been transferred to the newly constituted PLCs by vendor's agreements under the Bangladesh Bank (Nationalization) Order, 1972, Section 27A.

These banks are now named Sonali Bank Limited, Janata Bank Limited and Agrani Bank Limited. Under the new arrangement these have prepared "Three Year Transitional Plan" to revamp their financial position. However, it is necessary to examine the impact of such transformation on these banks' performance.

1.5.3.3 Reforms in Monetary Policy Operation

- Daily and weekly Liquidity Forecasting Framework Developed [since 2002];
- BB introduced repo [2002] and reverse repo [2003] facility for more effective monetary policy operation – i.e., managing liquidity on a daily basis;
- Long-term Treasury Bonds for 5 year and 10 year introduced in 2003 for effective benchmarking of long-term loans;
- Electronic registry of bonds (scrip less) introduced in 2003.

1.5.3.4 Legal Reforms

To expedite the settlement of disputes regarding loan recovery of financial institutions, the Money Loan Court Act, 2003 *(Artha Rin Adalat Ain, 2003)* has been made effective. In order to strengthen the process of recovering defaulted loans, banks, under this Act, are now empowered to sell the collaterals without prior approval of the court. Effective application of this Act has started yielding encouraging results. As of June 2008, 10,3563 cases were filed, of which 64,524 cases were settled accruing the recovery of Tk. 3,940.87 crore against the claim of Tk. 28,635.42 crore.

1.5.3.5 Reforms in the Bangladesh Bank

Implementation of "Central Bank Strengthening Project" is underway which is tasked to formulate and implement a prudent monetary policy, enhance the regulatory capability of Bangladesh Bank to supervise financial institutions, establish banking policies and regulations that conform to international standards and increase operational efficiency of Bangladesh Bank through computerisation. A Policy Analysis Unit (PAU) has been established in Research Division of Bangladesh Bank under this project, in order to conduct high level research activities on macroeconomics including monetary policy and central banking along with increasing the efficiency of policy reviewing capacity.

Components of Bangladesh Bank Strengthening Programme:

1. Computerisation of operations of BB;
2. Human resource development through reforms of recruitment, promotion and compensation policies;
3. Direct recruitment taking place every year (for the past three years);
4. Promotion policy being radically changed to emphasise merit;
5. Restructuring the different departments;
6. Reengineering the business processes;

7. Capacity building in the core activities;
8. Enhancing capacity for better enforcement of laws and regulations;
9. Within Research Department, a Policy Analysis Unit (PAU) was set up initially under the assistance of the World Bank Institute (WBI) for two years 2005-2007. After a successful completion of assignments, PAU has been extended until August 2010 with own funding of Bangladesh Bank. The goal is to foster high quality research works including policy notes, working paper and preparation of Financial Sector Review (FSR) and Monetary Policy Review (MPR).

1.5.3.6 Money and Financial Market Reforms

Measures have been taken to improve the existing banking system to international standards and also to strengthen the overall banking system of the country. Important among the initiatives taken in FY2007-08 are as follows:

- To improve and to accelerate the quality of the clientele service and to modernise and update the banking system, Bangladesh Bank issued directives to all commercial banks to introduce the online banking facility for their customers to pay the bills, fees of the national, autonomous and semi-autonomous bodies along with the utility bills.
- Government has introduced 15-year and 20-year Bangladesh Government Treasury Bond (BGTB) from 2007-08 in order to create a benchmark yield curve of government securities by attracting the long-term investment fund from the Insurance companies, Provident Fund, Mutual Fund and so on.
- To strengthen the capital base and to implement Basel-II Accord, the commercial banks have been asked to maintain 10 per cent capital of the risk weighted assets and to maintain core capital at least 5 per cent of their risk weighted assets.
- To prepare two different manuals namely "Credit Risk Grading Manual for Banks" and "Credit Risk Grading Manual for NBFIs" in order to determine the credit risk of the Bank to Bank Finance and Bank to NBFI Finance.
- The interest rate of the import credit of the consumer goods like rice, wheat, sugar, edible oil (refined and raw), onion, spices, etc. has been kept at 12 per cent temporarily to ensure the supply and to keep the price level tolerable.
- To encourage infrastructure development by private sector entrepreneurs, Bangladesh Bank is implementing a project titled "Investment Promotion and Financing Facility (IPFF)" (except local financial institutions). This project aims at providing long-term financial assistance for infrastructure

development projects and creating value addition to the domestic financial market.

1.5.4 Financial Market Development

1.5.4.1 Development of Bond Market

Government Bond Market: Bonds of different tenors (5 and 10 years) issued to develop yield curve and encourage term lending by setting benchmarks for long-term interest rates.

- Securitisation: BB, SEC and NBR developed an enabling legal, regulatory framework for bonds/securitisation of receivables. Securitisation of receivables of private financial institutions started. First ever securitisation was completed. Works are ongoing on securitisation of Jamuna Bridge revenue.

Housing Finance:

- Initiatives underway to develop long-term housing finance. Key issues being addressed: transaction costs (property transfer tax, registration, title transfer, etc.), tax incentives, availability of long-term funds.
- Private commercial banks have begun to move to housing market with longer tenures and lower interest rate.

Development of Inter-bank Market

- Inter-bank market for foreign exchange developing fast–following floating of Taka
- Initiatives underway to further develop inter-bank money market for effective intermediation of surplus liquidity in banks.

Strengthening Bangladesh Bank

- Departments restructured;
- Services standards established for different department to speed up decision making;
- Work flow analysis completed for some departments to reduce unnecessary steps in decision making;
- Same day clearing service introduced for high value checks;
- Clean note campaign initiated–number of soiled/torn notes in circulation reduced significantly;
- Direct recruitment through competitive examination being done on an annual basis;

- Recruitment for some specialised positions being made through open competition.

TABLE 1.13
SHARE OF EQUITY IN INVESTMENT CAPITAL (TK. IN BILLION)

Fiscal year	Newly issued debt and equity	Disbursement of term lending by banks and NBFIs	Total invested capital	Equity as share of total capital (%)
FY03	1.1	39.7	40.8	2.7
FY04	10.7	66.8	77.5	13.8
FY05	6.0	87.0	93.0	6.4
FY06	11.9	96.5	108.4	11.0
FY07	19.0	123.8	142.8	13.3
FY08	25.3	206.1	231.4	10.9
Average	12.3	103.3	115.7	10.7

Source: *Bangladesh Bank Quarterly*, various issues, Bangladesh Bank.

1.5.5 Assessing Performance of the Financial Sector

1.5.5.1 Performance of Banks

Financial deepening and growth

Using annual data during 1976-2005, Rahman (2007) investigates the historical overview of indicators of financial development and their association with investment activities (measured by fixed capital formation as a share of GDP denoted) as well as per capita income as shown in Table 1.14. It shows that all three indicators of financial development display steady increasing trend, indicating widening and deepening of the financial system in Bangladesh over time. It is also observed that the average credit, deposit and broad money to GDP ratios increased substantially from 6.6 per cent, 14.9 per cent and 19.0s per cent respectively over 1976-1980 to 28.8 per cent, 35.01 per cent and 40.0 per cent respectively over 2001-2005. Investment as a per cent of GDP and per capita income (in current USD) also displays a similar pattern and move broadly together reflecting a close association among financial development, investment and per capita income during the period.

Rahman (2007) shows that financial development has a positive and statistically significant long-run impact on both the investment-GDP ratio and on per capita GDP in Bangladesh. A one per cent positive shock to financial development (credit-GDP ratio in this case) will generate about 0.7 per cent positive impact on investment-GDP ratio and about 0.6 per cent positive impact on per capita income meaning more domestic credit to the private sector generates more investment activities and hence more per capita income.

TABLE 1.14

TRENDS OF THE INDICATORS OF FINANCIAL DEVELOPMENT, INVESTMENT AND INCOME

Period average	Interest rate (lending)	Credit to private sector (% of GDP)	Total deposits (% of GDP)	Broad money (% of GDP	Gross fixed capital formation (gross investment) (%GDP)	GDP per capita at current US dollar
1976-1980	11.09	6.59	14.86	19.03	10.44	160.0
1981-1985	13.68	13.67	20.23	24.54	10.51	192.0
1986-1990	14.71	19.08	24.75	28.67	13.87	242.0
1991-1995	13.90	16.58	23.07	26.68	17.93	283.0
1996-2000	13.83	23.17	26.7	31.01	21.51	353.0
2001-2005	12.33	28.83	35.08	40.02	22.63	395.0
2006-2008	13.40	34.5	45.0	45.0	24.4	565.5

Source: Bangladesh Bank and Ministry of Finance.

Gross and Net Non-Performing Loans (NPL)

- Gross and net NPL ratios of all banks improved during 1998-2008;
- Gross NPL for private banks declined from 28 per cent in 1998 to 5.4 per cent in 2008.
- Gross NPL ratio of SCBs declined from 40 per cent in 1998 to 30 per cent in 2008.

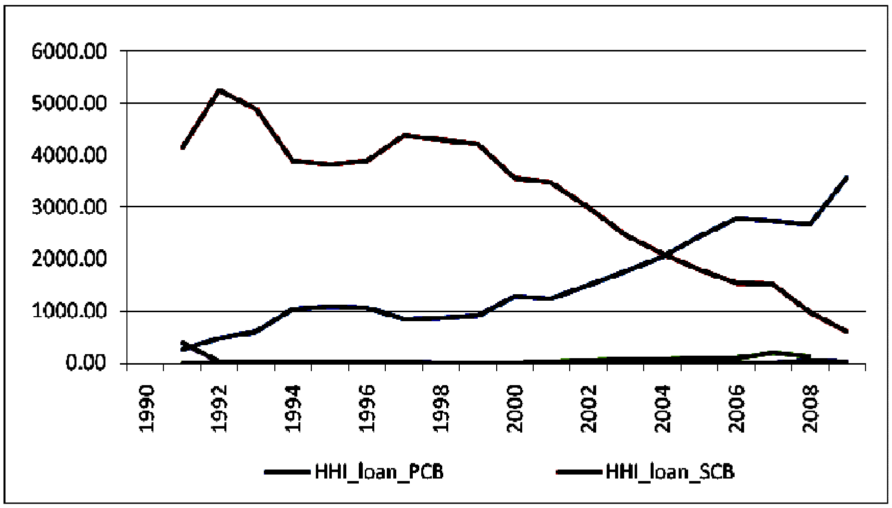
It appears that the situation of NPL in SCBs has not improved over the period 1998-2008.

Competition and Efficiency of the Banking Sector

- Interest rate spread remains high despite various policies of BB indicating lack of competition in the financial sector.
- Our estimates of Herfindahl Index (HI) for loan show, Figure 1.4 that market power has gradually transferred from SCBs to PCBs from the early 2000s and the market structure is, by and large, oligopolistic.

Estimated return on asset (ROA) and return on equity (ROE) shows that PCBs and FCBs are doing better than public financial institutions (Table 1.15).

Figure 1.4: Market Concentration: Herfindahl Index



Source: Authors' estimate.

TABLE 1.15

ROA AND ROE FOR BANKS

Bank Types	ROA (%)			ROE (%)		
	2006	2007	2008	2006	2007	2008
SCBs	0.0	0.0	0.7	0.0	0.0	22.5
PCBs	1.0	1.3	1.4	10.2	16.6	16.37
SBs	0.9	-0.3	-0.6	-2.1	-3.4	-2.01
FCBs	2.8	3.1	2.9	14.4	20.4	17.75

Source: *Financial Sector Review*, 2009, Bangladesh Bank.

Management Efficiency

In general, lower value of ME ratio and higher value of OE ratio is an indicative of inefficient management of banks. Table 1.16 shows that all types of banks are operating well as the OP is lower than 1. Relatively, FCBs are in a better position. Management efficiency of SCBs and SBs is not good, while operating efficiency of PCBs is not good compared with other types of banks.

TABLE 1.16

INDICATORS OF MANAGEMENT AND OPERATING EFFICIENCY OF THE BANKING SECTOR

Year	PCBs		SCBs		FCBs		SBs	
	ME	OE	ME	OE	ME	OE	ME	OE
2003	0.12	0.12	0.07	0.07	0.10	0.10	0.01	0.01
2004	0.08	0.08	0.05	0.05	0.06	0.06	0.00	0.00
2005	0.08	0.08	0.06	0.06	0.06	0.06	0.00	0.00
2006	0.10	0.10	0.06	0.06	0.07	0.07	0.01	0.01
2007	0.10	0.10	0.04	0.04	0.07	0.07	0.03	0.03
2008	0.09	0.09	0.06	0.06	--	--	0.04	0.04

Source: Authors' estimate.

Note: Management Efficiency (ME) = Interest expense/Total Loans; Operating Efficiency (OE) =Total operating expense/Net Income after tax.

1.5.5.2 Performance of NBFIs

The contribution of NBFIs' financing activities (lease, loan, housing, investment, etc.) to the overall economy persistently increased over the years, as can be seen in Figure 1.6. In 2001, the share of NBFIs' financing to total GDP had been only 0.84 per cent, which was more than doubled within 5 years and became 1.83 per cent in 2005. The comparative figures for the banking sector were 34.55 and 41.32 per cent in 2001 and 2005 respectively. The average yearly growth of NBFIs' contribution to GDP was about 22 per cent during this period as compared to 4.7 per cent of that by the banking sector. Even in the regional context, performance of NBFI sector is quite robust. As of December 2004, NBFIs contributed 5 per cent of the total bank credit as against 3 per cent in India, 6 per cent in Pakistan and 8 per cent in Sri Lanka (Chowdhury 2005). The share is increasing over the years and reached 5.2 per cent in 2005.

Table 1.17 shows performance ratios of NBFIs in terms of percentage of private credit growth and percentage of classified loans to total loans. It shows that NBFIs are performing better in 2008 in terms of private credit growth. However, overdue as a share of outstanding industrial loans increased to 8.0 per cent in December 2008 from 6.8 per cent in December 2007. This shows that the NBFIs need to streamline their loan disbursement methods with focus on low risk industrial segments and instill better monitoring mechanisms in order to reduce risks associated with their assets.

TABLE 1.17

PERFORMANCE RATIOS OF NBFIS

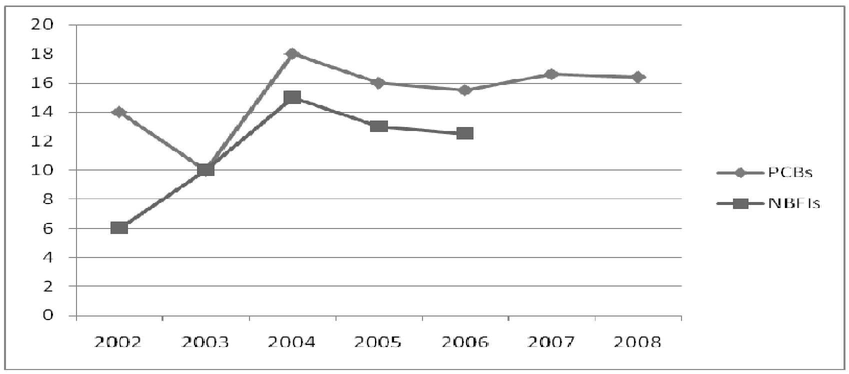
Year	Private credit growth (%)			Percentage of classified loans to total loans		
	2006	2007	2008	2006	2007	2008
Q1	24.0	24.0	16.0	8.0	7.0	7.7
Q2	23.0	22.0	24.0	7.0	6.7	7.8
Q3	20.0	18.0	32.0	6.5	7.9	8.0
Q4	15.0	16.0	39.0	5.5	6.5	6.5

Source: *Financial Sector Review*, Bangladesh Bank.

Figure 1.5 compares ROEs of NBFIs and PCBs. Both the curves follow a similar pattern from 2003 with ROEs of NBFIs lying a little lower than their competitors. This is likely to be due to the higher cost of funds incurred by NBFIs. The return on equity (ROE), which shows the earning capacity of shareholder’s book value investment, shows significant variation across NBFIs. In June 2008, the highest ROE is observed for IDCOL (24.1 per cent), followed by Prime Finance (22.9 per cent) and DBH (20.9 per cent). On the other hand, ROEs of several NBFIs were lower than the industry average and the interest rate on deposits indicating requirements on the part of these NBFIs to access both low cost funding and ensure better portfolio management to improve performance (Financial Sector Review, January 2009).

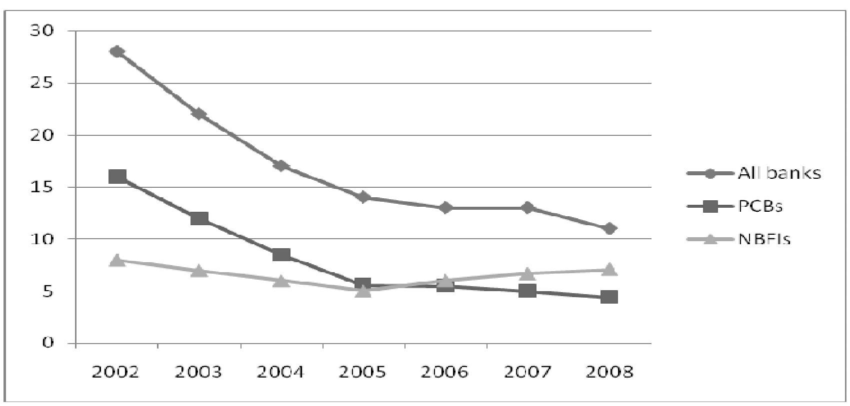
The share of classified lease/loan of NBFIs came down from 8.42 per cent in 2002 to 6.06 per cent in December 2005 but again increased to 7.18 per cent in June 2006. Figure 1.6 shows that classified loans of their major competitors, namely PCBs, also have a similar trend. Classified loans of PCBs had declined from 16.38 per cent in 2002 to 5.62 per cent in 2005 and 5.98 per cent in 2006. It may be noted that though NBFIs form a much newer market segment than PCBs, they have been able to maintain the share of classified loans within a range that is well below than that in the banking sector, although the scenario for PCBs has improved significantly in recent years.

Figure 1.5: ROEs of NBFIs and PCBs



Source: Authors' calculation; Bangladesh Bank.

Figure 1.6: Gross NPL to Total Financing of Banks and NBFIs



Source: Annual Report and Financial Institution Department, BB.

1.5.5.3 Challenges for the Financial Sector

In order to make the financial sector more efficient and effective for fostering economic growth in the coming days, the following challenges have to be confronted:

- Increase of efficiency in SOBs;
- Introduction of information technology in the banking system in a faster pace,

- Corporate Governance has to improve further. It should be a continuous process;
- Financial soundness indicators show an upward trend, but there are weaknesses and vulnerabilities that will need continued watching;
- The investment requirement for infrastructure development is large. While these investment needs to be financed through public investment, there is a need to develop ways to bring in larger private sector financing through the banking system and capital markets;
- Market based interest rates;
- Further financial liberalisation;
- Restructuring of Bangladesh Krishi Bank (BKB) and Rajshahi Krishi Unnayan Bank (RAKUB);
- Creating an efficient bridging system between formal and informal sector;
- Capacity building of the Bangladesh Bank, particularly in supervision and research.

1.5.6 Policy Recommendations for the SFYP

This section identifies some areas of reforms during the Sixth Five–Year Plan (2011-2015) and provides policy recommendations to make the financial sector more vibrant and resilient.

1.5.6.1 Strengthening SCBs in terms of Operational and Management Efficiency

State-owned commercial banks perform worse compared with the private commercial banks in terms of asset quality, operations and management efficiency. Interest rates are not responsive to market because SCBs cannot make any impact on PCBs through increased competition. To make SCBs more efficient and service oriented, the following measures can be undertaken:

- Appointment of directors and chairman of the banks should be based on qualifications and expertise.
- Government and ruling party influence on loan disbursement should be kept as minimum as possible.
- Computerisation of all branches of SCBs needs to be completed within next five years in order to deliver efficient services.
- ATM machines should be introduced for all SCBs. All four SCBs can create a consortium for expenditure sharing in this purpose.

- Retrenchment of inefficient and excess employees in a reasonable manner should be done in coming years on an urgent basis.
- All district branches should be brought under online banking.
- A higher pay structure can be implemented once the banks are in full computerised operation and employee size becomes reasonable.

1.5.6.2 Restructuring/Revitalising BKB and RAKUB

To ensure easy flow of loans to genuine farmers and agricultural sectors, it is necessary to increase efficiency and reduce corruption in these two banks. It is also necessary to reassess the activities of the banks in order to make them more effective and up-to-date. The following measures are proposed to make these banks more effective and efficient:

- Increased efforts are needed to reduce corruption and inefficiencies of bank management.
- Computerisation of all branches.
- Effective linkages with NGOs and other semi/non-formal financial institutions in agricultural loan marketing.
- Reduction of excess employees and expenditures.

1.5.6.3 Monitoring Unit for Islami-Shariah based Banking

In recent years, Islami shariah-based banking has become popular in Bangladesh. Many local banks and some foreign banks also started Islami banking operation. Whether banks are properly maintaining Islami-Shariah in their banking operations, a unit in Bangladesh Bank can be formed to monitor Islami banking in Bangladesh. That Unit can consist of Islami scholars and knowledgeable persons. Prudent regulations and policies are needed to meet the growing needs of Islami banking in Bangladesh over the years.

1.5.6.4 Reforms in Bangladesh Bank

Human Resource Development

Human resources of Bangladesh bank are still poor in terms of educational qualification and expertise. In order to make BB a modern central bank, highly qualified people are needed to be recruited and necessary incentives can be provided. Policies are needed to provide overseas and local trainings to qualified persons. Promotion policies should be made competitive and merit-base. Although some of such policies are taken, still many flaws persist in such policies. Further efforts are needed for human resources development.

Strengthening Research Department

The Research Department of BB needs to be strengthened. The Policy Analysis Unit (PAU) should continue under the Research Department and division of labor should be outlined properly among the researchers.

<u>Some recommendations for PAU</u>:

- The PAU must continue with its current mandate to conduct quality and timely research on monetary policy and financial sector.
- The PAU is now running with a higher salary structure than the BB's normal pay structure. This anomaly must be removed for proper functioning of the PAU.
- Other than offering separate pay scale, PAU researchers can be given output-basis additional incentives.
- The PAU researchers even can be allowed to do collaborative research with other reputed research organisations.
- Alternatively, BB can accomplish its research activities by outsourcing—either by hiring competent consultants or giving responsibilities to a reputed organisation like BIDS.

Strengthening Banking Supervision System/Activities

Banking supervision is a compelling necessity for ensuring soundness of the financial system. Bangladesh Bank runs these supervisory activities through two of its departments (banking supervision and foreign exchange supervision). However, the quality of supervision is questionable for two main reasons: one, lack of qualified and experienced officers because of transferable job, and two, corruption.

To overcome the problem of expertise in banking supervision, an independent supervisory unit can be formed under the auspices of Bangladesh Bank or Ministry of Finance. Permanent employment can be offered for employees and strong and corruption-free supervision mechanism can be developed.

Market-based Interest Rates

Market-based interest rates provide the financial sustainability of intermediating institutions. Important to note that subsidised interest rate or setting ceiling of interest rate is not the answer to bring efficiency in interest rate setting. Bringing more efficiency in the financial sector would make interest rate more market oriented. The market failure in rural credit markets may, however, require some form of supportive government intervention.

Savings Mobilisation and Private Bank Branches in Rural Areas

Savings mobilisation through interest bearing accounts is an effective tool, not only for asset accumulation but also for serving as collateral for loans. Infrastructure in the form of branch locations and mobile bank staff is an essential feature of this activity. Private banks' can be encouraged to establish branches in rural areas.

An Early Warning System for Banks

An early warning system for banks needs to be developed based on a rigorous modeling. This kind of warning system can help understand ex-ante the signal of banking crisis and necessary remedies can be taken accordingly.

Linking the Formal and Informal Financial Sectors

For the development of the financial system, one approach is to mobilise the respective comparative advantage of the informal and formal rural financial sectors. The informal sector brings to bear critical information on the creditworthiness of potential borrowers and relationship with the community that can promote timely repayment. The formal sector, meanwhile, can offer considerably more resources for lending than can the informal lenders. Therefore, effective bridging between these two sectors can be helpful for deepening the financial sector.

Government Support of Formal and Informal Linkages

Governments can play an effective supporting role to build or strengthen linkages between the formal and informal financial sectors. Specifically, governments can improve the ability of banks to reduce loan losses and establish clear property rights for borrowers. They can also set interest rates that reflect lending costs and use of local sanction to enforce repayment. Legal framework can also be improved to facilitate SMEs' use of formal finance.

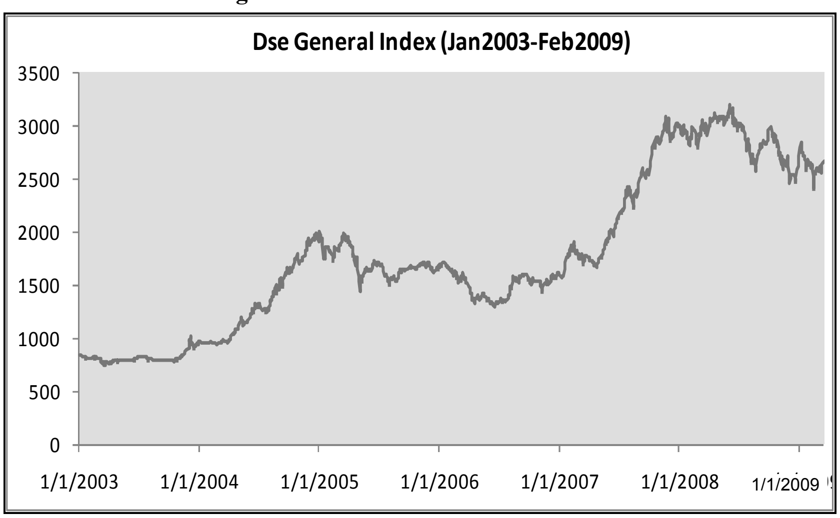
1.6 DEVELOPMENT OF THE CAPITAL MARKET

The level of development of the capital market is an indicator of the state of development of an economy. To achieve private sector-led growth objective, it is necessary to make capital market more efficient. Stock markets can contribute to the deepening and diversification of the financial system and play an important role in risk allocation and risk sharing. A well-functioning capital market might have a positive and significant impact on the financial system as well as on the economic growth.

The capital market watchdog, "Securities and Exchange Commission" (SEC) of Bangladesh, was formed on June 8, 1993 under the "Securities and Exchange Commission Act, 1993" in order to ensure proper issuance of securities, safeguarding the interest of investors in the stock exchange, controlling the stock market and development of the capital market. Currently, two stock exchanges are operating in Bangladesh: Dhaka Stock Exchange (DSE) and Chittagong Stock Exchange (CSE). Both the stock exchanges are autonomous non-profit organisations and operate in fully automated systems.

In recent years, Bangladesh capital market has achieved phenomenal growth in size, depth and maturity due to various regulatory and institutional reforms taken by the SEC and private sector stakeholders. Market capitalisation increased from Tk.71.36 billion in 2000 to Tk.788.82 billion in 2008 while DGEN (DSE General Index) posted around 24 per cent CAGR (Compound Annual Growth Rate) for the last 5 years. Market capitalisation in 2008 touched 25 per cent of GDP, which was only 6 per cent in 2003. Currently, about 1.4 million Beneficiary Owners (BO) accounts exist, of which 0.5 million are regularly used in active trading. Average daily turnover grew from Tk.66 million in 2003 to Tk. 2,818 million in 2008. In March, 2009 daily turnover crossed Tk.1,200 crore, which created a landmark in the history of DSE. The establishment and relatively good growth performance of Bangladesh stock markets is an encouraging sign.

Figure 1.7: Trend of DSE General Index



Despite its phenomenal growth, still the role of capital market in `Bangladesh is limited in respect to market capitalisation to GDP ratio. In FY2008, the amount of industrial term loans disbursed by banks and NBFIs stood at Tk 201.5 billion (of which the amount disbursed by NBFIs was Tk. 23.9 billion) compared with only Tk. 6.9 billion by new capital issues through private placements, public offerings, and right offerings in the capital market. This indicates an overwhelming preference of bank finance in industrial investment financing and a weaker position of the capital market in the economy.

After the stock-market crash in 1996, the SEC has taken many steps to safeguard investors' right as well as to develop the capital market of Bangladesh. As a result, Bangladesh stock market has showed resiliency amid global financial crisis. While major global stock market indices declined by 30 to 60 per cent, DGEN, the benchmark index of Dhaka Stock Exchange, decreased by only 7.1 per cent in the year 2008 making it one of the best performing market. Another reason for such resilience is the non convertibility of capital account and lower integration of the local financial system with global market.

Despite various measures taken by the SEC, Bangladesh Bank and other concerned authorities, the lower level of development of the capital market is characterised mainly by: (i) slow growth of institutional investments including mutual funds, pension funds, and professional portfolio manager fund; (ii) inadequate flow of securities with good fundamentals, corporate and government bonds; (iii) inadequate supply of professional investment analyst; (iv) inadequate flow of research based information; and (v) weak monitoring and enforcement capacity of the regulator.

Several studies and market analysts identify some structural weaknesses of capital market of Bangladesh that hinder its overall development. Some of the key weaknesses are:

- Market is still small, and relatively less liquid
- Absence of a sound secondary bond market
- Lack of well developed government securities market
- Inefficient pricing mechanism due to poor corporate governance and high cost of listing
- Inadequate information disclosure due to lack of quality information and existence of inside trading
- High volatility in stock prices.

During the Sixth Plan period, it is necessary to address the weaknesses, both structural and operational, in order to strengthen the capital market for meeting up long term financing demand for facilitating higher economic growth.

1.6.1 An Overview of the Capital Market

Table 1.18 provides a scenario of the capital market of Bangladesh at a glance as on September 2009.

TABLE 1.18

AN OVERVIEW OF THE CAPITAL MARKET OF BANGLADESH, APRIL 2010

Total Number of Listed Securities		439
Total Number of Companies		241
Total Number of Mutual Funds		24
Total Number of Debentures		8
Total Number of Treasury Bonds		164
Total Number of Corporate Bonds		2
Total number of Shares/Certificates:		**(No. in mln)**
Total Number of Shares & Mutual Fund Certificates of All Listed Securities*		5,641
Total Number of Shares of All Listed Companies		4,567
Total Number of Certificates of All Listed Mutual Funds		1,065
		(No. in ' 000)
Total Number of All Listed Debentures		409
Total Number of All Listed Gov. T-Bonds		3,849
Total Numberof All Listed Corporate Bonds		4,336
Total Issued Capital of :	**Figure in mln Tk.**	**Figure in mln US$**
All Listed Securities	571,914	8,257.50
All Companies Shares	170,660	2,464
All Mutual Funds	10,966	158
All Debentures	140	2
All Listed Govt. T-Bonds	385,813	5,571
All Listed Corporate Bonds	4,336	63
Total Market Capitalisation of:	**Figure in mln Tk.**	**Figure in mln US$**
All Listed Securities	2,344,969	33,857
All Listed Companies Shares	1,927,688	27,833
All Listed Mutual Funds	27,143	392
All Debentures	576	8
All Listed Govt. T-Bonds	385,813	5,571
All Listed Corporate Bonds	3,749	54
Conversion Rate: BDT against USD	69.26	

Source: DSE Monthly Review.

*Total No. of Shares/Share Capital/Market Capital includes Bonus/Right of shares.

Trading operations of both DSE and CSE are shown in Table 1.19. While the number of listed securities in DSE was 412 in 2008, it was 238 in the CSE. Total market capitalisation stood at 105,953 crore taka in the DSE and 80,768.40 crore taka in the CSE in 2008. Both the stock exchanges have shown steady progress in terms of all indicators of capital market over time.

TABLE 1.19

TRADING OPERATIONS OF DSE AND CSE

End of Period	Listed Securities (Mutual Fund & Debentures)	IPO	Issued Capital (Crore Taka)	Market Capitalization (Core Taka)	Total turnover (Core Taka)	General Share Index
Panel A: Trading Operations of DSE						
2003	267	14	4605.50	9758.70	1915.21	967.88
2004	256	2	4953.20	22492.30	5318.11	1971.31
2005	286	22	7031.30	23307.50	6483.48	1275.05
2006	310	12	11843.7	32336.8	6506.93	1321.39
2007	350	14	21447	75395	32282.01	2535.96
2008	412	12	37215.60	105953	66796.47	2309.35
2009	443	--	45790	124130	89380	2520
Panel B: Trading Operation of CSE						
2003	195	10	4196.76	8531.23	668.86	1642.78
2004	199	3	4697.87	21501.08	1755.13	3597.70
2005	210	16	5551.93	21994.28	1404.27	3378.68
2006	213	6	6937.84	27051.07	1589.31	3724.39
2007	227	13	8917.39	61258	5259.03	7657.06
2008	238	--	12160.32	80768.40	9980.37	8692.75
2009	246	--	26070	97500	12520	10477.7

Source: *Bangladesh Economic Review, 2009*; *Financial Sector Review*, Bangladesh Bank, 2009.

Table 1.20 indicates the growth of several capital market development indicators during 2003-2008. The growth of companies listed in the securities market was not very much encouraging as on an average yearly 10 companies were listed. Although the growth of market capitalisation was substantially high, its ratio with respect to GDP is still lower than the regional level. In FY2008, market capitalisation reached 25 per cent of GDP, which was 14.5 per cent a year ago.

Performance of different sectors is analysed in terms of the share in total market capitalisation. Table 1.21 shows that banks and insurance companies dominate the market followed by pharmaceuticals, fuel and power and cement industries. Despite notable progress of the other service sectors including telecommunications and real estate, its share is negligible in the equity market. Therefore, more telephone companies, IT firms, and real estate companies should be encouraged to float their shares in the stock market. Recently Grameen Phone started IPO placement, which got huge response from the potential investors.

TABLE 1.20

INDICATORS OF CAPITAL MARKET DEVELOPMENT

Year	Listed companies	Issued capital (Tk. M)	Market cap. (Tk. M)	Market cap. As % of GDP	Daily average turnover (Tk. M)	General index
2003	251	355370	721630	2.9	66	830.46
	(1.2)	(3.59)	(10.38)		(-12.4)	(4.78)
2004	259	487180	1418510	5.6	198	1318.92
	(3.19)	(37.09)	(96.57)		(200)	(58.82)
2005	251	526652	2121757	7.9	250	1713.17
	(-3.09)	(8.10)	(49.58)		(26.26)	(29.89)
2006	269	645500	2035020	7.15	285	1339.52
	(7.17)	(22.57)	(-4.09)		(14.0)	(-21.81)
2007	273	835860	4115470	14.5	1373	2149.32
	(1.49)	(29.49)	(102.23)		(381.75)	(60.45)
2008	286	1088360	7888220	26.0	2818	3000.50
	(4.76)	(30.21)	(91.67)		(105.24)	(39.60)
2009	--	--	--	--	--	--

Source: Dhaka Stock Exchange (DSE); *Economic Trends*, Bangladesh Bank.

- Percentage growth is in parenthesis.

TABLE 1.21

SECTORAL PERFORMANCE (% OF TOTAL MARKET CAPITALISATION)

End of period	Banks/ financial sector	Fuel and power	Pharmac-euticals	Services and Real Estate	Cement industries	Insurance	Others
2003	28.31	5.28	15.52	2.19	5.12	5.19	37.02
2004	35.80	4.84	2.94	16.93	1.45	13.63	23.2
2005	46.27	1.91	15.25	0.81	14.71	3.93	16.6
2006	49.64	5.48	11.84	0.63	11.06	4.05	16.37
2007	56.16	11.69	9.21	0.44	7.43	2.92	10.86
2008	52.79	9.27	10.77	0.88	5.22	6.58	10.91
2009	38.6	16.62	11.53	2.8	4.3	5.5	6.99
2010 (April)	37.58	13.51	8.23	1.72	2.41	4.84	-

Source: *Economic Trends*, April, 2009, Bangladesh Bank.

Table 1.22 shows that there were only 14 mutual funds with market capitalisation of Tk. 9.5 billion in 2008. Market capital of the bond market was Tk. 178.9 billion compared to total market capitalisation of Tk. 964.9 billion.

TABLE 1.22

INDICATORS OF MUTUAL FUNDS AND BOND MARKET (DSE)

	FY03	FY 04	FY 05	FY 06	FY 07	FY 08	FY09 (up to Dec, 09)	FY10 (April)
Listed Mutual Funds								
Number of Mutual funds	10	11	12	13	14	14	19	24
Market capitalisation (billion TK)	0.5	0.8	1.3	1.2	3.3	9.5	18.0	27.14
Bond Market:								
Number of listed bonds	8	8	26	34	52	93	152	166
Government	….	….	18	26	44	84	151	164
Corporate	….	….	….	….	….	1	1	2
Debenture	8	8	8	8	8	8	8	8
Market capital (billion TK)	0.5	0.5	12.2	20.6	80.2	178.9	360	390
Total Market capitalisation (billion Tk)	69.2	142.4	213.0	205.3	412.2	964.9	360	389.5

Source: *Monthly Review*, DSE.

The above analysis indicates a bank-dominated financial system where the dependence on bank loan is substantial. Table 1.23 indicates the overwhelming preference of bank finance in industrial investment financing indicating a limited role of the capital market on the economy. From the figure of FY08, only 10 per cent of total capital invested comes from the debt and equity market, and the rest 90 per cent are covered by banks and NBFIs. Even no sign of declining dependence on bank financing can be seen from Table 1.23.

International comparison shows that Bangladesh's capital market is still small and relatively less liquid, and has a heterogeneous composition compared with developed and well functioning capital markets (Table 1.24, Figure 1.8). It also indicates that there is a scope of increasing the base of capital market compared to GDP of Bangladesh.

TABLE 1.23

FINANCIAL MARKET STRUCTURE (BILLION TAKA)

Fiscal year	Newly issued debt and equity (% of total capital)	Disbursement of term lending by banks and NBFIs (% of total capital)	Total invested capital
FY 03	1.1	39.7	40.8
	(2.7)	(97.3)	
FY 04	10.7	66.8	77.5
	(13.8)	(86.2)	
FY 05	6.0	87.0	93.0
	(6.4)	(93.6)	
FY 06	11.9	96.5	108.4
	(11)	(89)	
FY 07	19.0	123.8	142.8
	(13.3)	(86.7)	
FY 08	25.3	206.1	231.4
	(10.9)	(89.1)	

Source: Akhteruzzaman *et al.* (2009).

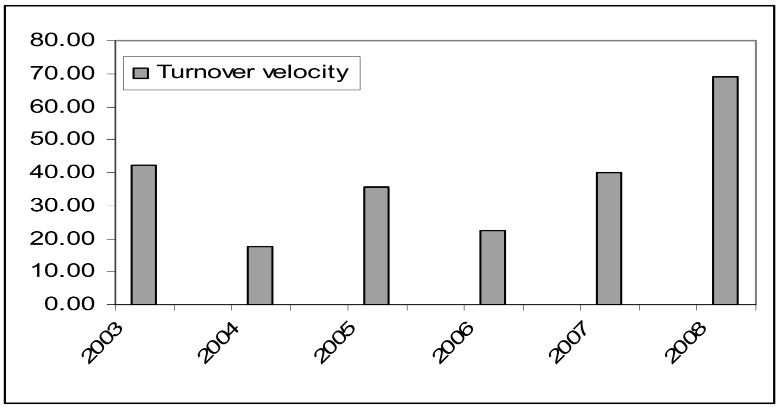
TABLE 1.24

PERFORMANCE OF THE CAPITAL MARKET IN EMERGING AND DEVELOPED COUNTRIES, 2006

Country	Market capitalisation as a percentage of GDP
Philippines	56
Singapore	291
Malaysia	156
Thailand	68
Indonesia	38
Korea	94
China	34
Japan	108
UK	160
Germany	57
USA	146
Bangladesh	26 (in 2008)

Source: McKinsey, IMF, World Federation of Exchanges.

Figure 1.8: Market Liquidity in terms of Turnover Velocity



Note: Turnover velocity is calculated as a ratio of turnover over market capitalisation. Data are taken from *Economic Trends*, Bangladesh Bank.

A comparison with emerging and developed countries (other than SAARC countries) reveals that Bangladesh's capital market is less liquid compared to East Asian countries, however, better placed among SAARC countries (Tables 1.25 and 1.26).

TABLE 1.25

INTERNATIONAL COMPARISON OF MARKET LIQUIDITY, 2006

Country	Market capitalisation (USD billion)	Value of trade (USD billion)	Turnover velocity (%)
Philippines	68	11	16
Singapore	384	180	47
Malaysia	236	75	32
Thailand	140	101	72
Indonesia	139	49	35
Korea	834	1,342	161
China	918	736	80
Japan	4,614	5,823	126
UK	3,794	7,572	200
Germany	1,638	2,737	167
USA	19,286	33,598	174
Bangladesh	30	7	23.3

Source: McKinsey, IMF, World Federation of Exchanges, Bangladesh Bank.

TABLE 1.26

CAPITAL MARKET INDICATORS OF SELECTED SAARC COUNTRIES

Name of the Capital Markets	Indices Name	Indices Year ending 2008	Indices Current Jun 2009	Listed Companies	Market Cap in US$ bn 2008	Turnover in US$ bn 2008	PE Ratio (2008)	Yield % (2008)	% of GDP 2008
Colombo Stock Exchange	CSE Milanka	1631.34	2721.64	235	4.29	1.02	6.53*	4.72*	13.25
Dhaka Stock Exchange	DSE GEN	2795.34	3010.26	276	15.14	9.68	18.42	2.48	17.00
Karachi	KSE 100	5865.01	7177.64	652	23.50	0.35	-	-	16.45
Bombay Stock Exchange	SENSEX	9647.31	14493.84	4921	647.20	309.18	13.77	1.78	54.99

Source: DSE website.

1.6.2 Market Volatility: Risk and Return

The price-earning (P/E) ratio of DSE shares showed an increasing trend in recent months (Table 1.27). Particularly, several sectors, such as service and real estate sector, Jute, Ceramic, investment and engineering, show an increasing trend. From the perspective of the investors, a higher P/E ratio is risky since this may be due to the fact that current prices do not reflect company fundamentals raising the possibility of price fall in future.

The average volatility of DSI (all share price index), as measured by standard deviation, was estimated to be 46.2 in FY08, indicating a significant rise over earlier years (See, *Financial Sector Review,* 3(2), Bangladesh Bank, June 2008**).** Figure 1.9 reports the daily fluctuation of price indexes and turnover at DSE. The dotted lines in Figure 1.10 show the standard deviation of daily price indexes along with monthly average indexes. From both the figures (Figures 1.9 and 1.10), it is evident that volatility was quite high during January-May 2007 with an increasing trend of price indexes. Volatility was substantially high during the second half of FY2007. Despite the fact that volatility increases in bullish market conditions, it appears that volatility is much higher in the market than is expected. As for example, while the average DSI increased by 20.15 per cent, standard deviations increased by 328.76 per cent in May 2007 over December 2006. The substantial increase in volatility during current phase is not a good sign for the development of the market.

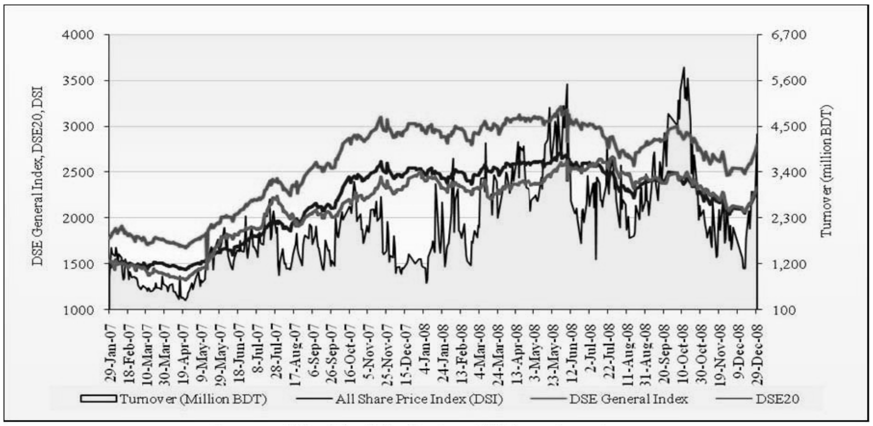
TABLE 1.27

PRICE EARNINGS RATIO OF DIFFERENT SECTORS, MARCH 2010

Sector	Mar-10	Feb-10	Dec-09	Dec-08	Dec-07	Dec-06	Dec-05	Dec-04
Bank	13.35	16.88	18.17	16.62	24.97	15.49	17.90	21.74
Financial Institutions	34.75	38.87	- -	- -	--	--	--	--
Mutual Funds	31.02	37.94	29.06	20.37	20.29	6.13	6.55	8.27
Engineering	39.92	39.55	36.50	30.24	28.57	17.34	14.14	18.62
Food & Allied	20.53	21.70	17.29	16.93	23.28	18.69	9.13	10.11
Fuel & Power	19.13	19.24	17.71	15.83	35.95	18.87	22.32	14.79
Jute	41.28	43.11	27.23	12.15	7.98	6.74	12.55	19.56
Textile	38.92	37.95	32.93	13.85	12.14	12.01	10.08	15.30
Pharmaceuticals	31.01	29.68	27.64	30.96	21.05	11.76	10.84	18.19
Paper & Printing	31.67	24.62	27.59	9.36	6.23	6.62	4.69	1.82
Service & Real estate	60.28	60.86	45.65	22.66	8.82	12.62	8.16	9.61
Cement	56.40	54.76	56.90	10.26	12.61	18.53	16.13	25.23
IT	62.08	60.22	60.71	46.52	15.25	11.12	10.46	25.11
Tannery	16.15	17.25	15.39	16.43	15.38	8.00	10.28	10.51
Ceramic	55.09	52.78	39.97	47.80	29.85	14.88	17.06	25.74
Insurance	31.13	34.06	31.39	21.81	15.59	10.24	20.87	26.92
Telecommunication	147.24	160.79	84.85	- -	--	--	--	--
Miscellaneous	30.50	30.88	28.85	34.43	14.43	11.05	7.83	13.21
Market P/E	27.59	30.58	25.65	18.42	23.58	14.51	13.85	18.40

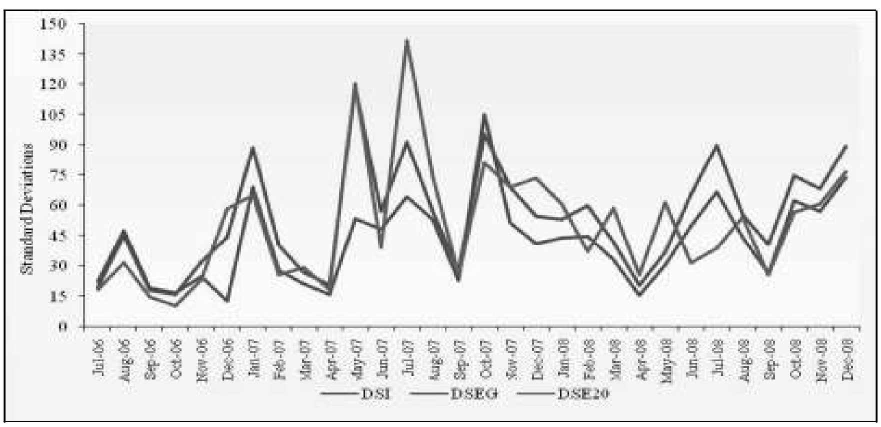
Source: Dhaka Stock Exchange.

Figure 1.9: Daily Movement of Price Indexes and Turnover at DSE



Source: *The Monthly Review,* DSE, various issues.

Figure 1.10: Standard Deviation and Monthly Average of Price Indexes



Source: Data from *Monthly Review*, DSE, various issues; Financial Sector Review, Bangladesh Bank.

1.6.3 Mutual Funds and Their Performance

Mutual funds are the most widely known investment schemes around the world. In Bangladesh, until recently 18 mutual funds were listed among the 446 listed securities in the Dhaka Stock Exchange as of September 2009. The market capitalisation of all the mutual funds stood at Tk. 2,971 million in May 2007, which was 9.47 per cent higher compared to the same period in 2005. The share of mutual funds in total market capitalisation (Tk. 323.4 billion) stood at merely 0.5 per cent. This indicates that mutual funds are not very popular instrument in Bangladesh. This might be due to the fact that the capital market is still diminutive and market significantly lacks sufficient number of quality shares.

Among the 18 mutual funds, 8 are managed by the government owned Investment Corporation of Bangladesh (ICB), 3 are managed by ICB Asset Management Company Ltd (AMCL), one is managed by Bangladesh Shilpa Rin Sangstha (BSRS) and remaining five are privately owned. A few more mutual funds are under active consideration for immediate flotation.

1.6.3.1 Performance of Mutual Funds

Mutual funds play a vital role in bringing transparency and stability in the market. Table 1.28 shows some statistics regarding the performance of the mutual funds in Bangladesh. Total issued capital increased by three times within last 4 years as compared with six times increase in market capitalisation. In 2007 total market capitalisation stood at Tk. 41,154.7 million, which was a nearly 100 per cent increase over the same period. Turnover fluctuated significantly because of the volatile nature of the DSE. From Table 1.29 it is also evident that P/E ratio of the mutual funds has declined over the years. In May 2007, the P/E ratio bounced back and reached to double digit figures by increasing nearly by 100 per cent from its December 2006 figure.

Although still small in size, mutual funds have contributed toward broadening the base of the country's capital market and helped the investors to gain high and relatively secure returns. However, the mutual funds have not yet emerged as a preferred saving mode because of lack of availability of quality shares and the underdeveloped state of the capital market. Mutual funds offer investors the advantages of portfolio diversification and professional management at low cost. These advantages are particularly important in the case of equity funds where both diversification and professional management have the potential to add value. For bond and money market mutual funds, the main advantage is transactional efficiency through professional management. In fact, as argued below, tax incentives and regulatory factors have played a big part in stimulating the development of bond and money market funds. One of the distinguishing features of mutual funds is a high level of operational transparency relative to other financial institutions, such as banks, thrifts, insurance companies and pension funds that also cater to the needs of households. Unlike banks and insurance companies, mutual funds do not assume credit and insurance risks and thus do not need to make subjective provisions against non-performing loans or to create actuarial reserves against future insurance claims. Mutual funds invest in marketable instruments and are able to follow a "mark-to-market" valuation for their assets. But the investment risk is borne by investors who, especially in the case of equity funds, participate in the upside potential of corporate equities but are also exposed to substantial losses when markets are falling.

TABLE 1.28

KEY STATISTICS OF MUTUAL FUNDS

	No. of mutual funds	Total issued capital (in million BDT)	Total market capitalisation (in million BDT)	Turnover (in million BDT)	P/E Ratio
June, 03	10	295	512	--	--
December, 03	11	395	664	27.86	8.48
June, 04	11	395	835	34.52	8.43
December, 04	11	395	1046	55.98	8.27
June, 05	12	495	1247	180	8.37
December, 05	13	735	1521	61.48	6.55
June, 06	13	735	1185	14.03	6.32
December, 06	13	735	1537	378.24	6.13
May, 07	14	835	2971	954.94	11.83
September, 09	18	4316	2371	--	--

Source: *The Monthly Review*, various issues, Dhaka Stock Exchange Ltd.

TABLE 1.29

PERFORMANCE OF DIFFERENT MUTUAL FUNDS (In TK.)

Name	Earning per share Jun 07	Net asset value (NAV) per share	Closing price (end Dec 08)	Price Earning ratio (end Dec 08)*	Closing price/NAV Ratio
1st ICB MF	240.82	4755.61	5000.00	20.76	1.05
2nd ICB MF	76.15	1106.68	2000.00	26.26	1.80
3rd ICB MF	69.11	896.21	1032.50	14.94	1.15
4th ICB MF	63.00	940.59	1007.75	16.00	1.07
5th ICB MF	41.00	952.03	1000.75	24.41	1.05
6th ICB MF	26.05	342.89	515.00	19.77	1.50
7th ICB MF	27.52	490.49	585.00	21.26	1.19
8th ICB MF	22.13	395.72	475.50	21.49	1.20
1st BSRS	13.10	590.12	826.25	63.07	1.40
AIMS 1st MF	0.36	2.79	14.07	39.08	5.04
ICB AMCL 1st MF	24.93	271.75	374.75	15.03	1.38
ICB AMCL Islamic MF	14.94	205.59	276.75	18.52	1.35
Grameen MF One	3.52	29.51	87.40	24.83	2.96
ICB AMCL NRB MF	5.02	196.25	279.25	55.63	1.42
ICB AMCL 2nd NRB MF	na	105.68	197.25	-	-
Grameen One: Scheme Two	na	10.82	56.90	-	-

Source: *The Monthly Review,* Dhaka Stock Exchange, various issues.

* Earning per share calculated on the basis of data during end June 2007.

For their successful operation and development, mutual funds require a robust and effective regulatory framework. As in all cases of agency contracts, investors need to be protected from fraudulent behaviour on the part of mutual fund managers and the diversion of funds into projects or assets that benefit fund managers (agents) at the expense of fund investors (principals). Fund investors bear the investment risk, but they rely on the advertised investment strategies of mutual fund managers for making their selections. It is therefore essential that fund managers should abide by their advertised strategies and should not deviate from their declared objectives without proper prior authorisation. Accounting and auditing rules as well as information disclosure and transparency requirements are of paramount importance.

Mutual funds also require well-developed securities markets with a high level of market integrity and liquidity. Market integrity implies that insiders are barred from taking advantage of privileged information, while large shareholders and market intermediaries are prevented from engaging in market manipulation. Market integrity also requires that officers of listed corporations observe high standards of corporate governance and honesty and do not engage in extensive fraud and theft. Market liquidity ensures that transaction costs are low and investors do not suffer from large adverse price movements when they initiate transactions in individual securities.

1.6.3.2 Regulatory Frameworks

Dhaka Stock Exchange (DSE) has formulated several guidelines and regulatory framework over time in order to ensure discipline and efficiency of the capital market. The DSE regulates under the following rules and guidelines:

-Membership rules

-Listing Rules

-Corporate Governance Guidelines

-Settlement of Stock Exchange TR-1999

-Automated Trading Regulation-1999

-Margin Rules, 1999

-Member's Margin Regulation, 2000

- DSE Board and Admin Reg., 2000

The details of these rules and regulations are available in the website of DSE, and can be reached through: http://www.dsebd.org

1.6.4 Capital Market Development: Recent Initiatives

The Securities and Exchange Commission (SEC) continues to carry out its regulatory reform activities in a bid to develop and protect investors' interest by establishing transparency in the capital market. A brief description of the major reforms undertaken in the capital market during FY2007-08 is given below:

1.6.4.1 Central Depository Systems (CDS)

Up to December 2008, a total of 1,428,548 BO accounts were opened and 170 companies came under CDS. After introduction of CDS, transparency in securities issuance, trading and settlement has increased significantly and settlement period of securities transactions has also reduced.

1.6.4.2 Training Programme

The Commission, in association with the Dhaka and Chittagong Stock Exchanges, arranged training for 746 authorised representatives of the members of the stock exchanges. The Securities and SEC conducts, on regular basis, Investors' Education Programme at SEC premise throughout the year for creating awareness among the general investors of capital and securities markets. During July 2008-December 2008, a total of 341 investors participated in the education programme.

1.6.4.3 Enforcement Actions

The Commission took 84 enforcement actions against the issuers and other market intermediaries during July 2008 to December 2008 who failed to comply with the securities related rules. These enforcement actions are continuing.

1.6.4.4 Improvement of Capital Market Governance Programme Project

To strengthen surveillance system and to improve the governance of Bangladesh capital market, a project named "Improvement of Capital Market Governance Program" funded by Asian Development Bank (ADB) and Government of Bangladesh has been launched from July 2006.

1.6.4.5 Formation of FRC and BICM

Government has established an oversight body named "Financial Reporting Council (FRC)" to ensure timely preparation of financial statements by the issuers reflecting true state of financial affairs of issuer companies and also to ensure objective auditing of the same by statutory auditors in adherence to International Standard on Auditing. Besides, to educate the investors, intermediary institutions and to improve the corporate governance in the listed companies, the Commission, in association with other stakeholders, has established a securities training institute named "Bangladesh Institute of Capital Market (BICM)."

1.6.4.6 Secondary Bond Market

Considering the prime importance of the capital market in ensuring the stability and efficiency of the country's financial system, measures have been taken in recent years to develop and strengthen the capital market. For activating the country's secondary bond market through revamping the trading of government approved securities in the stock exchanges, Bangladesh Bank (BB) has created an alternative platform exclusively for the PDs to promote transaction of government bonds. The SEC provides guidance and encourages selected brokerage firms to participate in activating trade in government bonds. The BB has issued guidelines regarding revaluation of treasury bills and bonds on the basis of marking to market in order to encourage transaction of government securities after issuance and establish a more effective secondary market. For ensuring more competitive secondary trading of government securities, liquidity facility is provided to PDs against government treasury bills and bonds devolved to them for specified periods (maximum one month), which can be extended for well-performing PDs on the basis of auctions and secondary turnover.

1.6.5 Policy Recommendations for the SFYP

A fair degree of consensus now exists recognising the need to develop the capital market, especially for financing the country's long term capital investments. For developing the capital market, several weaknesses need priority action which include weak regulatory framework, constraints on the supply side including lack of benchmark bonds and benchmark yield curve, limited interest of financial intermediaries and businesses in launching new debt products, demand side constraints including limited investor base, intermediaries with limited expertise in dealing with debt products, low confidence in corporate borrowers; and market distortions like the ones caused by above market returns offered by the national savings scheme (NSS).

1.6.5.1 Low Cost Financing of Big Public Projects

In the backdrop of the global financial meltdown, Bangladesh is facing the declining foreign direct investment and foreign grants. Subsequently, public sector financing especially the infrastructure financing will be at stake. Bangladesh is going through a severe power crisis and needs to establish numerous power plants to add electricity to the national grid. Capital market can be a good avenue for the government also to obtain lower cost financing to establish the new power plants. The same source could be used to construct bridges on the river, develop port, establish oil refinery, etc. Even government can take help of capital market to pay up its existing foreign debt by issuing bonds.

More merchant banks can help increase specialised portfolio managers. The capital market of Bangladesh yet lacks higher degree of professional portfolio management, asset allocation opportunities and proper institutional practices. In the domestic financial sector, only NBFIs have the expertise on the long term asset management. They are experienced in handling diversified financial instruments. In this ground, more NBFIs should be awarded merchant banking license to bring more specialised portfolio managers in the capital market. It will increase institutional investments in the capital market which will reduce the price volatility in the market and eliminate the dominance of the junk shares in the index determinacy. But they should concentrate on portfolio management and not only margin lending as they are doing now

The demand for a secondary bond market is increasing. For asset allocation and risk reduction in investment, the existence of an effective secondary bond market is very important. In Bangladesh, the bond market is accounted for only 30 per cent of the domestic savings and highly dominated by the government securities which are sold over the counters (Mujeri and Rahman 2008). In comparison to the other regional bond market and the size of the economy, the bond market in Bangladesh is very tiny and operating in its incipient stage.

A total of 17 debentures were issued since 1987 through public offering out of which 8 are outstanding at present. However, the liquidity of these debentures at the stock exchanges is insignificant and trading is negligible due mainly to their inferior quality. Nevertheless, no new debenture was issued after 1999. Trading of government treasury bonds started in December 2005 at the DSE. Till the end of December 2008, 8 debentures, 111 treasury bonds with different maturities, and 1corporate bond (floated in 2007 by the Islamic Bank Bangladesh Limited (named IBBL Mudaraba Perpetual Bond) are being traded in the market.

Some additional measures are needed to enhance the efficiency of the bond market. These measures include:

(i) Developing *sovereign benchmark yield* curves across the maturity spectrum;

(ii) Develop the *Primary Dealer System* and create *Primary Dealers (PDs)* that are well capitalised with experienced staff in fixed income securities. They should be given the privileges of exclusively in return for meeting specific obligations such as providing two-way quotes. Adequate funding to the PDs through repurchase agreements should be considered.

(iii) *Securities borrowing and lending facility* should be created to enable the institutional investors to earn additional income from their fixed income securities portfolios and provide PDs and other securities dealers to gain access to securities to create more active secondary markets. In this connection, *short sells* for fixed income securities with proper safeguards should be permitted with proper safeguards;

(iv) Further *develop institutional investors* especially *contractual savings* such as insurance companies to increase demand for fixed income securities;

(v) *Develop derivative markets* to enable market participants to hedge against interest, exchange and credit risks; and

(vi) *Improve dissemination of market information* by requiring all the over the counter trades to be reported to a central information system so that market participants will have reliable market information to correctly value their fixed income portfolio, make informed trading and investment decisions. In this context, the establishment of bond pricing company similar to those set up in Korea should be considered to address the valuation issue, i.e. mark to market.

Establishing a commodity exchange in the country to aid in the stability of prices of essential commodities and to shield the end-level consumers from retail market volatility along with the assurance of fair prices for farmers has been a need of time. Such an exchange would assist to assimilate Bangladesh with the price dynamics of international markets effectively and to tackle the vagaries created by local commodity traders who are insensitive and unresponsive to global price fall, but hyperactive to jack-up local prices even after a slender raise in price of any commodity in the international market. The local farmers have no idea about the price differences of commodities at different collection centres countrywide, but this information would ultimately come to the commodity exchange market. Commodity exchange would also aid future trade in farm products and protect farmers and consumers from the volatilities in prices. For a well diversified capital market with different investment opportunities, a structured commodity exchange will open many windows of opportunities.

1.6.5.2 Efficient Portfolio Management and Research

The portfolio management practice in Bangladesh yet remains new and is performed on the basis of very few fundamental indicators. The research based financial asset management is still a "style icon" for the capital market as only a few institutional fund managers conduct true fundamental and technical analysis for the investment purpose. Moreover, extensive industry analysis and macroeconomic analysis are not even in the thought process of the major large industry players to assess the investment environment. "Free of cost" periodic market analysis for investors is supplied by not more than a couple of institutions. As a result, "rumor" remains as one of the investment determinant for the investors. Thus, frenzied market volatility has been a common scenario for the capital market. To create a research friendly environment for the efficient portfolio management, all market stakeholders including the regulator should come forward with effective initiatives. To remove information asymmetry from the market, there is no alternative of "analysed information."

Corporate governance. Corporate governance in industries remains a key issue for years to build-up an efficient and investor friendly capital market. Despite the introduction of some rules, regular monitoring and surveillance by the SEC, establishing corporate governance in the listed companies, brokerage houses and merchant banks are crucial for further development of capital market.

Soundness of the capital market. In the last couple of years, the growth rate of BO accounts and omnibus accounts has been very lofty which indicates a large number of entries of individual investors in the market. But, the awareness and knowledge level of majority investors remain at a very shallow echelon. Regardless of different types of investors' awareness programme and initiatives conducted by SEC, a large number of investors run for the securities with higher price volatility and ultra poor fundamentals. There is a common misconception about capital market that it is a place for generating quick cash flow and supra normal profits. The truth lies here that some securities generate extraordinary profit in some periods but the number of losers from these securities are not negligible. Therefore, a sound-functioning capital market is very important to ensure the interests of investors as well for strengthening overall financial system.

A vibrant and strong regulator. Securities & Exchange Commission (SEC) is the industry watchdog for the bourses of the country, listed companies, mutual funds and asset management companies, merchant banks, brokerage houses, CDBL and credit rating companies in Bangladesh. Since the 1996 crash, SEC has been improvising in observing and governing the capital market with various rules, initiatives and some reformation. Regarding the entertainment of the complaints of the investors, investigating the listed companies about the compliance of rules and regulations and conducting the investors' education and awareness programme, SEC is prompt in action which is much appreciable. But, there is still a long way to go for being a vibrant and strong regulator. Till now, the presence of profitable multinational and large domestic manufacturing companies in the bourses is very trivial. The sluggish and entangled bureaucracy has stood as an impediment to the entrance of large players of different industries to the bourses. Moreover, several decisions concerning various issues have aired to the flame of market volatility and loosened the investors' confidence. There has been late and less responsiveness to the irrational price movements of hyper volatile securities and the non-compliance of some listed companies.

1.6.5.3 Demutualisation

One of the very few issues that make the capital market stakeholders very proud is the subsistence of the two automated and well equipped bourses. In recent periods, both DSE and CSE have been able to bring much up-gradation and sophistication in their automation, administration and management. The managements of the both exchanges have attained significant level of professionalism and efficiency in their operational procedures. Now, a big challenge for these exchanges is the demutualisation.

1.6.5.4 Internet Trading

The escalating interest for initiation of internet trading is still be fully implemented. Although CSE has introduced Internet Trading System (ITS) under "Chittagong Stock Exchange (Internet Trading Regulations) 2002," the trade volume under ITS is very insignificant. In this age of information technology, ITS will be able to reach the intended investors of farthest corner of the country. Likewise, it will decrease the dependency of the investors on the brokerage houses and it will keep the market more active and pulsating.

1.6.5.5 Central Depository System (CDS)

Currently, Central Depository Bangladesh Limited (CDBL) is acting as the lone Central Depository System (CDS) for Electronic Book Entry of the listed shares. The total numbers of securities dematerialised under CDBL are 171 and they accounted for 97.55 per cent of the total market capitalisation. CDBL is also conducting different other investor services as well as providing a platform for the secondary market trading of Treasury Bills and Government Bonds issued by the Bangladesh Bank. Since its commencement of equity market operations in 2004, CDBL has been striving to provide services to the country's capital market. But, the situation is rather challenging to handle the vastly expanded capital market as the market capitalisation of last trading day of December 2004 was $224.16 billion in Dhaka Stock Exchange (DSE) whereas the market capitalisation was $1,043.80 billion in December 31, 2008.

1.6.5.6 Access to High Quality and Credible Corporate Information

The local market is suffering from adequacy of long term capital investment and has a dearth of quality stocks. Access to high quality and credible corporate information and research remains a major challenge in the market. Still it is hoped that Bangladesh as an emerging stock market has immense potential to move forward in coming year. What is essential right now is a coordinated effort and positive attitude of the government, regulators and market players for the development of a vibrant capital market.

Strengthening the capital market is necessary for fulfilling the long term borrowing needs of both the public and private sectors, as well as for a successful private-public partnership. This will make the financial system more competitive through generating market interest rates that would reflect opportunity cost of funds at each maturity and reduce the excess dependence of enterprises on the banking system. For developing an efficient and broader base of the capital market, a robust market of fixed income securities is an essential prerequisite. Despite the marketing of fixed income securities first in 1987 with flotation of debenture by two companies, the market is still shallow playing a marginal role in the development of capital market.

To make the capital market more efficient and developed, and to meet up the long-term financing needs of the economy, it is necessary to address both the structural and operational weaknesses highlighted in this paper during the sixth five year plan period, 2010-1014. To increase the depth of the market, it is necessary to promote effective privatization and encourage private sectors particularly service sectors to be listed in the capital market. In addition, viable public limited companies can be allowed to float their shares in the stock markets.

For efficient functioning of the capital market, it is very urgent to develop secondary bond market as well as streamlining the IPO approval process. Moreover, further financial liberalisation with deregulated interest rates, effective inter-bank market can have a positive impact on the development of the capital market. A detailed list of specific measures is given in Annex 1 that can be considered for the development of the capital market of Bangladesh.

1.7 ISSUES IN EXCHANGE RATE MANAGEMENT

Exchange rate management is one of the central issues of macroeconomic policies. Bangladesh adopted floating exchange rate regime by abandoning intermediate exchange rate regimes in May 30, 2003.[10] It is a crucial question whether Bangladesh should float freely as it is officially committed to do so. While the advantages of freely floating regime are well known, it is still debated whether this regime is suitable for less developed countries. The problem of destabilising

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[10] Historically, Bangladesh had been maintaining various pegged exchange rate regimes, such as pegged to the British pound sterling (1972–1979), pegged to a basket of major trading partners' currencies with pound sterling as the intervening currency (1980–1982), pegged to a basket of major trading partners' currencies with US dollar as the intervening currency (1983–1999), and an adjustable pegged system (2000-2003). In May 31, 2003, Bangladesh switched to floating exchange rate system by abandoning the adjustable pegged system.

speculation and consequent excessive exchange rate volatility appears to be exacerbated in developing countries, making a floating regime especially unviable/unsuitable, particularly in the absence of a resilient and developed financial system (Hossain 2009, Grenville and Gruen 1999). After the Asian and Latin American crises in the 1990s, there has been a growing tendency among countries to adopt a corner regime—either a fixed or a floating regime. However, many studies document that the way developing countries float is not consistent with the characteristics of clean floats (Hausmann *et al.* 2001, Hernandez and Montiel 2003).

There are a number of reasons for which exchange rate management may be necessary for developing countries like Bangladesh. *Firstly*, high degrees of exchange rate flexibility have led to an increased volatility of the nominal exchange rate because of the inability of policymakers to respond effectively to frequent terms-of-trade or capital inflow/outflow shocks. Containment of such shocks is an additional reason for reinstating some form of exchange rate management. Exchange rate volatility is particularly troublesome for the macroeconomic stability. *Secondly*, when exchange rate flexibility is combined with inflexible inflation-targeting, the results can be destabilising. *Thirdly*, managing the exchange rate may allow countries to achieve—over the medium term—a rate that can foster broad-based export competitiveness and can thereby lead to greater structural diversification of the economy.

From the recent trends of exchange rate movements, it does not seem that Bangladesh's exchange rate is fully freely floating. Now the question is how Bangladesh manages its exchange rate and why such management is necessary? Exchange rate in Bangladesh remains fairly stable for last two years or more. Is this stability warranted by economic fundamentals or the result of intervention in the foreign exchange market? Bangladesh Bank in its monetary policy statement recently admitted that they intervene in the foreign exchange market on a regular basis to maintain undervalued exchange rate so that exports can gain competitiveness.[11] Occasional intervention in the foreign exchange market brings some positive benefits, particularly for developing countries like Bangladesh, if the intervention is targeted to achieve some economic objectives such as stable inflation or trade competitiveness.

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[11] Bangladesh bank purchased 1.48 billion US dollar from the inter-bank market in 2008-09, most of which remained unsterilised.

However, a word of caution is in order if nominal exchange rate moves along a continuum for long time—it may create distortions in the market, such as macroeconomic symptoms of *irrational exuberance*, which include strong growth, accelerating inflation, rising international reserves, and gradual overvaluation (the loss of international price competitiveness). This is a troublesome situation and if it continues for long time, there might have the risk of possibility of crisis. In this context, the concern is whether Bangladesh Taka is overvalued and to what extent. At the same time, it is of policy concern as to how the *real effective exchange rates* (REER) are managed. On top of this, it is necessary to analyse whether "managed exchange rate policy" is desirable for Bangladesh?

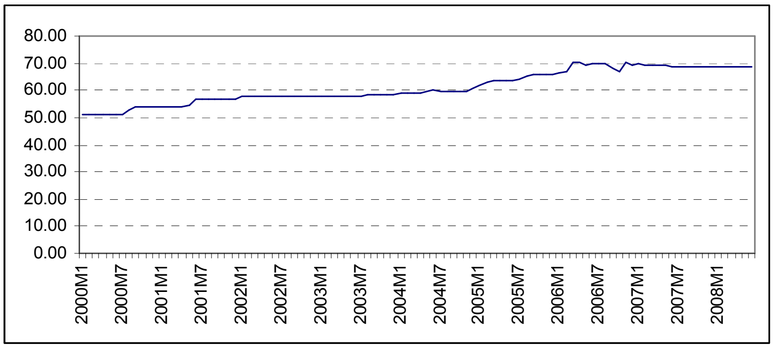
This background paper attempts to highlight necessary implications of exchange rate management from the perspective of macroeconomic stability and external sector development during the Sixth Five Year Plan, 2011-2015. In this context, to assess the exchange rate management policy, three approaches are adopted: (i) macroeconomic Balance Approach; (ii) External sustainability approach; and (iii) Behavioral Equilibrium Exchange Rate (BEER) approach. In addition to that this study assesses the implication of exchange rate movements in a "demand-determined" economy like Bangladesh by estimating (i) exchange rate pass-through and (ii) exchange rate market pressure.

1.7.1 Recent Developments in the Foreign Exchange Market

The transition to a floating regime (June 1, 2003) was smooth as the exchange rate remained fairly stable experiencing a depreciation of less than 1 per cent from June 2003 to April 2004. Exchange rate kept on rising gradually from mid-2004 and it reached its peak at Tk. 70/USD in 2006 from Tk. 58/USD, accounting for 20 per cent depreciation. Since then, it remains fairly stable and has been fluctuating between Taka 68 and 69 (2007-2009). The floating regime in Bangladesh is therefore characterised by both volatility and stability.

Figure 1.11 plots nominal exchange rate movements (level) and Table 1.30 presents estimates of volatility of nominal exchange rate. The figure shows that during intermediate regime (adjustable pegged regime; 2000-2003), nominal exchange rate moves occasionally because of official devaluation and for the first six months of the floating regime (June-December, 2003), the nominal exchange rate remained almost fixed. It is seen that from April 2004, nominal exchange rate exhibited volatility, but remained fairly stable after March 2006.

Figure 1.11: Nominal Exchange Rate Movement



Source: Bangladesh Bank.

To what extent Bangladesh attempts to stabilise exchange rates by intervening in the foreign exchange market? To answer this question, relative volatilities of the exchange rate, reserves and interest rates are estimated. Table 1.30 presents the volatility of reserves, exchange rates as well as volatility of market (call money) interest rate. From these estimates of volatilities, two relative volatilities, such as relative volatility of exchange rate over international reserves and relative volatility of exchange rate over interest rate, are estimated.

TABLE 1.30

RELATIVE VOLATILITIES OF THE NOMINAL EXCHANGE RATE, INTERNATIONAL RESERVE AND CALL MONEY RATE

	Volatility of nominal exchange rate (Tk./$)			Volatility of reserve	Volatility of interest rate			Rel. Vol (ER/Res)	Rel. Vol (ER/IR)
	Std. Dev.	Max.	Min.	Std. Dev.	Std. Dev.	Max.	Min.		
Pre-Floating Regime (Jan 2000-May 2003) N=41	2.65	57.9	51.0	0.052	2.97	16.75	4.25	50.96	0.89
Floating Regime (Jun 2003-Feb 2006) N=33	3.03	67.13	57.9	0.046	3.30	15.97	4.95	65.57	0.92
Floating Regime (Mar 2006-June 2008) N=28	0.71	70.27	67.11	0.061	3.62	21.54	6.9	11.64	0.20

Source: Bangladesh Bank, IFS.

Table 1.30 shows that the nominal exchange rate remained very stable after March 2006, while it was highly volatile during earlier periods of the floating regime (April 2004 to February 2006). Table 1.30 also shows that the behaviour of reserves and call money interest rate in pre-floating regime and in floating regime after March 2006 was higher than the so-called turbulent period, 2004:4 to 2006:2. Estimates also indicate that relative volatilities were very low during 2006:3 to 2008:5, providing an evidence of certain amount of intervention in the foreign exchange market after March 2006.

The comparison of volatility of nominal exchange rates against major trading partner currencies is made in Table 1.31 using the coefficient of variation. It shows that Bangladeshi Taka remained stable against all of our trading partners' currencies except the US dollar.

TABLE 1.31

COMPARISON OF VOLATILITY OF EXCHANGE RATES (COEFFICIENT OF VARIATION)

	Taka/ US dollar	Taka/ Rupee	Taka/ RMB	Taka/ Pound	Taka/ Yen	Taka/ Euro	Taka/ Sing $
Pre-Floating Regime (Jan 2000-May 2003) N=41	0.047	0.019	0.050	0.066	0.039	0.101	0.039
Floating Regime (Jun 2003-Feb 2006) N=33	0.50	0.065	0.057	0.075	0.055	0.069	0.065
Floating Regime (Mar 2006-Nov 2008) N=33	0.11	0.063	0.055	0.058	0.064	0.076	0.050

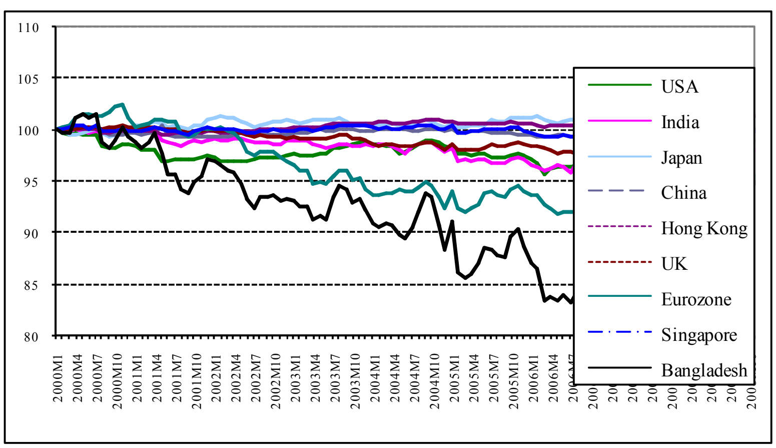
1.7.2 REER and the NEER

Real effective exchange rate (REER) is a popular index of overall trade competitiveness, which is a trade-weighted and inflation-adjusted index. To see the trends of the REER, following Bangladesh Bank's procedure, the REER is calculated considering the year 2000 as base and using trade-weights of eight major trading partners, namely USA, UK, Japan, EU, China, India, Hong Kong and Singapore.

Figure 1.12 plots the REER and bilateral real exchange rates (RERs). It shows that the REER depreciated around 20 per cent over the years in an unstable fashion. During the fixed regime, 2000-2003, the REER moved in tandem with the price differential and the movement of US Dollar vis-à-vis major currencies. The Taka gained competitiveness during 2000-2003 because of the continued lower inflation differential as well as occasional devaluations. However, during the turbulent period of the floating regime (2004-2006), the taka remained competitive because of high depreciation as well as US dollar depreciation vis-à-vis major currencies despite high inflation differentials (with high domestic inflation). From 2006, the REER shows an appreciating trend, but for a brief period. With almost a stable nominal exchange rate of the dollar in the period 2006-2008, the REER shows slightly upward trend because of high inflation differentials and US dollar depreciation vis-à-vis major currencies. It is also observed from the trend of the REER that some periodic adjustments of taka/dollar exchange rate might have contributed to the overall trend of depreciation. Since there appears to be a long term trend in the REER movement, the REER might have been overvalued to some extent.

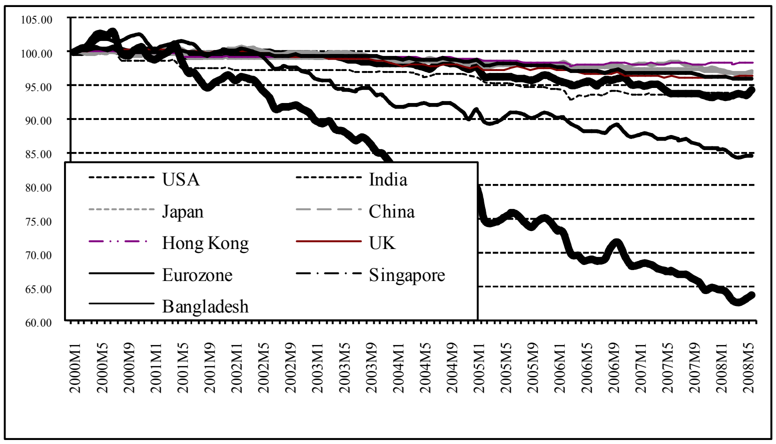
Figure 1.12 also shows that the bilateral real exchange rate against the euro exhibits higher volatility with an overall depreciating trend. However, all other trading partners' real exchange rates remained stable. It appears that Bangladesh competitiveness vis-à-vis the European Union is particularly unstable. The behaviour of the nominal effective exchange rate (NEER) also shows the same depreciating but unstable trend (Figure 1.13). The NEER is a trade-weighted index without being adjusted for inflation. This index has particular importance in stabilising the pace of competitiveness, especially when the currencies of the trading partners are more volatile.

Figure 1.12: Bangladesh's Aggregate and Bilateral REERs based on CPI (2000 = 100) (rise indicates real appreciation)



Source: Hossain and Ahmed (2009).

Figure 1.13: Bangladesh's Aggregate and Bilateral NEERs
(rise indicates appreciation)



Source: Hossain and Ahmed (2009).

1.7.3 Market Intervention

The estimated volatility of the nominal exchange rate suggests that, by and large, exchange rate policy in Bangladesh is not consistent with the characteristics of freely floating exchange rate regime. Evidence suggests that Bangladesh Bank often intervenes in the foreign exchange market in order to keep the nominal exchange rate almost fixed or to allow it to move within a very narrow range (also see Table 1.32).

TABLE 1.32

SALE AND PURCHASE OF FOREIGN EXCHANGE BY BANGLADESH BANK (IN MILLION USD)

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09 (Jul-Apr)
Sale	0	459	413.1	0	735.5	70
Purchase	313.95	147.1	0	649.5	202.5	1480
Net Injection	-313.95	311.9	413.1	-649.5	533	-1408.0

Source: Forex Reserve and Treasury Management Department (FRTMD), Bangladesh Bank.

In a recent study, Hossain and Ahmed (2009) analysed the de facto exchange rate regime in Bangladesh. According to their classification, the period 2004:5 to

2006:12 is classified as *dirty float*, and the period 2007:1-2008:6 as a fixed (pegged) exchange rate system. From this discussion, it may be concluded that Bangladesh's exchange rate policy is not consistent with a freely floating regime. Rather, it can be broadly defined as a managed floating regime.

1.7.4 Is Managed Floating Regime Desirable?

As already mentioned, flexible exchange rate brings many difficulties for developing countries. Flexible exchange rates are subject to high volatility, thereby contributing to high inflation, currency shocks and loss of competitiveness. This section thus examines whether Bangladesh is susceptible to these problems. These issues are investigated in this section through estimating *exchange rate pass-through effect, exchange rate market pressure and export competitiveness.*

1.7.4.1 Exchange Rate Pass–Through Effect

Exchange rate pass-through is an important aspect of exchange rate management, particularly under a managed floating regime. The coefficient of pass-through indicates the extent at which international price changes translates into domestic inflation. Using a simple methodology applied for Australia by de Brower and Ericsson (1995), for Mexico by Garces Diaz (1999) and for a cross-country analysis by Hausmann *et al.* (2001), exchange rate pass-through coefficients are estimated for Bangladesh for the period 2000-2008.

Considering a simple model of domestic prices using a mark-up equation as follows:

$$P = \alpha W^{\theta} F^{\gamma} \qquad (7.1)$$

Where P is domestic price, W wages, F international prices in domestic currency (obtained by multiplying the exchange rate with an index of international prices) and α, θ, and γ are three parameters representing mark up and the long run elasticities of wages and external prices. By taking the natural logarithm of the above equation it is possible to estimate the long run relationship among wages, international prices and local prices. Since we do not have monthly data for wages, we estimate the following long-run equation:

$$p = ln(\alpha) + \gamma f \ , \qquad (7.2)$$

Where lower case letters represent the log of the corresponding upper case variables defined above. All the series we use are monthly and have a unit root process. Hence, the long-run relationship between internal and external prices is examined through the co-integration analysis.

Two different definitions of *f* are used. In the first definition, the log of the US dollar exchange rate is added to the log of an index of international non-fuel commodity prices (from IFS). In the second definition, the commodity price index is substituted by the Indian CPI. Table 1.33 reports the results.

TABLE 1.33
ESTIMATES OF INFLATION PASS-THROUGH (2000-2008)

	Changes in internal prices	Changes in Indian prices
γ	0.87 (0.14)***	0.95 (0.09)***
Constant	2.96	3.61
ECT (Error correction term)	-0.02 (0.005)**	-0.04 (0.02)**

*** and ** indicate significance at 10 per cent and 5 per cent level respectively.

Table 1.33 shows that the long run pass-through coefficient is very high and significant for Bangladesh. It is 0.87 for international price, 1.26 for the US price and 0.95 for the Indian prices, which indicates that a change in international or US or Indian prices will almost completely translate into a change in domestic prices. The estimated error correction term is negative and significant—the speed of adjustment to equilibrium is 2 per cent for international prices and 3 per cent for US prices, while it is 4 per cent for Indian prices. Therefore, exchange rate pass-through appears to have some role in explaining the current stability of exchange rate in Bangladesh, particularly after March 2006 when the World was facing high inflationary episodes.

1.7.4.2 Exchange Market Pressure

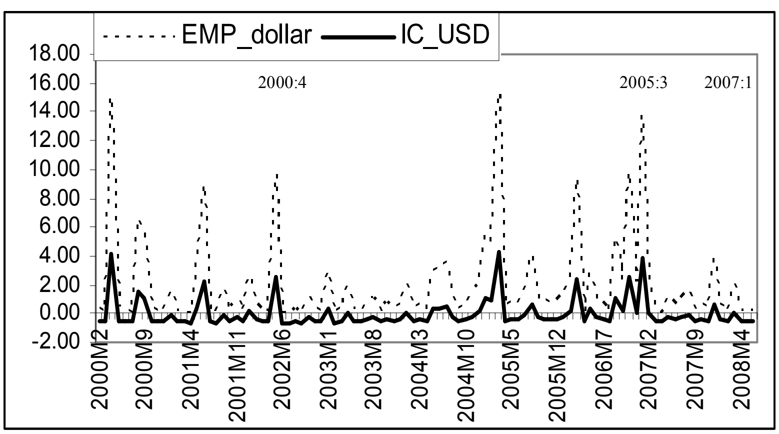
Exchange Market Pressure (EMP) represents disequilibrium in the foreign exchange market, which may occur due to changes in international reserves or changes in exchange rates or combination of both. In a managed floating regime, combination of both changes in reserves and changes in exchange rate may contribute to exchange market pressure. Therefore, following Girton and Roper (1977), an EMP index is calculated by taking the weighted sum of monthly changes in nominal exchange rate and monthly changes in the stock of international reserves scaled by monetary base the period 2000:1 to 2008:9. The weights are inversely proportional to the relative variances of nominal exchange rate changes and international reserve changes. As proposed by Eichengreen, Rose and Wyplosz (1994), a standardised indicator of crisis (IC) is calculated based on EMP as: IC = $\frac{EMP - \mu_{EMP}}{\sigma_{EMP}}$. According to them, a crisis is signaled if IC > 1.5, while Kaminsky and

Reinhart (1999) set a critical value of 3 for the IC. Both EMP and IC indices are plotted in Figure 1.14.

Figure 1.14 shows that EMP is positive in Bangladesh during the period under consideration; however, during 2005-2006 the extent of imbalance in the foreign exchange market was severe. It appears from the index IC that shocks were more frequent and several times it crosses the crisis threshold during the period 2005-2006, which was characterised as turbulent period. However, for the period 2007-08 the EMP is found to be very low, indicating a restoration of equilibrium in the foreign exchange rate market.

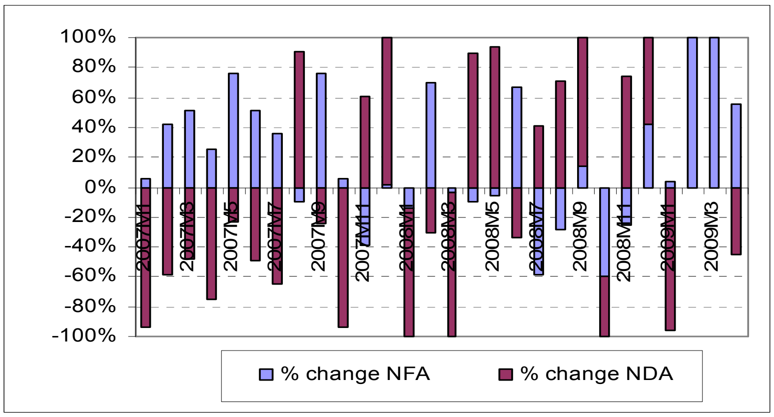
What are the reasons of exchange market pressure? There is a positive and contemporaneous impact of shock to domestic credit growth upon exchange market pressure—an increase in domestic credit causes the exchange rate to depreciate or the foreign exchange reserves to deplete or some combination of the two. This has been investigated in Figure 1.15 by plotting the percentage change in net foreign asset and net domestic asset. It may be concluded that intervention was almost sterilised for the period 2005:8 to 2007:9. Comparing Figures 1.14 and 1.15, a positive relationship between domestic credit growth (or growth of money supply) and exchange market shock is observed. That is, when Bangladesh bank chooses to increase domestic money supply, some combination of reserve depletion or currency depreciation occurs.

Figure 1.14: Exchange Market Pressure Index



Source: Authors' estimate.

Figure 1.15: Percentage Changes in Net Foreign Assets (NFA) and Net Domestic Assets (NDA)



Therefore, it may be concluded that with high aggregate demand in the country sterilised intervention causes extra pressure on the foreign exchange market. However, an incomplete sterilised intervention as is seen from 2007:9 onwards, also contributed to an increase in inflation.[12] *Thus, if there is a likelihood of exchange market pressure, it would be a good option for Bangladesh Bank to tighten the money supply through high interest rates*. In what follows, Bangladesh Bank should work hard on making the financial sector more competitive in order to ensure smooth transmission of monetary policy stimuli through the interest rate channel, and only then, can they enjoy the "low inflation benefit" of non-sterilised interventions. At the same time, tight monetary policy must be accompanied by fiscal adjustments; otherwise, it might increase the burden on the inter-temporal budget and may thus be counterproductive.

1.7.5 REER Volatility and Export Competitiveness

This section examines the effect of real exchange rate volatility on exports. There are two primary determinants of export demand (Dornbusch 1988, Hooper and Marquez 1993). First, is the foreign income variable which measures the economic activity and the purchasing power of the trading partner country ("income effect"). Second, is the relative price or the terms to trade variable ("price effect").

[12] In a recent monetary policy statement (July 19, 2009), Bangladesh Bank admitted that they purchased 1.48 billion dollar in 2008-09 from the currency market, most of which remains unsterilised.

Since real exchange rate volatility might have affected exports, exchange rate volatility is an additional factor that needs to be explicitly taken into account ("volatility effect"). Incorporating these determinants, a simple export demand function is derived as follows:

$$x_t = \alpha_0 + \alpha_1 \, y_t^{world} + \alpha_2 \, p_t^{world} + \alpha_3 V_t + \varepsilon_t \qquad (7.3)$$

where x_t is the natural logarithm of real export (total export is deflated by the export price index) of Bangladesh, y_t^{world} is the natural logarithm of the trade-weighted sum of the real GDP of eight key trading partners, p_t^{world} is the trade-weighted sum of terms of trade of key trade partners, V_t is the real exchange rate volatility measured as the two-quarter moving average standard deviation and ε_t is an error term.

As apparels (Knitwear and Woven garments) constitute major share of Bangladesh's export, separate cointegrating equations for Knitwear and Woven for their main destinations, such as the USA and the EU, are estimated. Signs of the coefficients are consistent with the theoretical predictions. The volume of exports (imports) to a foreign country ought to increase as the real income of the trade partner (domestic country) rises, and vice-versa. So we expect $\alpha_1>0$. A rise (fall) in the terms of trade of a trade partner will cause the domestic goods to become less (more) competitive than foreign goods, therefore exports will fall (increase) and imports will rise (fall). So we expect $\alpha_2 < 0$.

Table 1.34 shows that overall exports from Bangladesh are inversely related to international prices and statistically significant, implying that price support is crucial for the export sector. Export of Knitwear and Woven garments constituted around 70 per cent of total exports in 2007, of which 70 per cent are exported to the US (23 per cent) and EU market (47 per cent). Estimating demand functions for knitwear and woven garments in the US and the EU market show significant impact of price and income on woven and knitwear exports respectively. As a result, woven exports have experienced sharper decline than knitwear in these markets in the second half of 2008 in the face of global economic recession. Although income is also found to be significant for export demand of the USA and EU for knitwear and woven, exports of these items are expected to be less affected by the current global recession due to low income elasticity.

Although REER volatility has significantly positive effect on overall exports, the impact is very low (Table 1.34). The low magnitude of the coefficient of volatility indicates that the less the REER volatility, the more will be the positive impact on overall exports. This finding calls for the stabilisation of the REER.

TABLE 1.34

ESTIMATED EXPORT DEMAND EQUATIONS (2000Q1-2008Q4)

	Total Export	EURO AREA			USA		
		Knit wear	Woven	Total export to EU	Knit wear	Woven	Total export to USA
World income	1.69	0.009+	0.002+	0.014+	0.03+	0.01+	0.02+
World price	-13.32+	0.012	-0.06+	-0.057+	-0.012	-0.02+	-0.016
Constant	49.91	-0.067	-0.22	0.225	-0.32	0.05	-0.07
Short-term factors:							
Vol_reer Vol_rer_USA Vol_rer_EU	0.11 (0.04)**	0.00007 (0.0001)	-0.0001 (0.0001)	0.0003 (0.0002)**	0.000006 (0.0005)	0.0002 (0.0002)	0.0003 (0.0002)
Error Correction Term	-0.19 (0.22)	-0.80 (0.33)**	-0.91 (0.24)***	-0.7 (0.30)**	-2.17 (0.43)***	-1.71 (0.26)***	-1.54 (0.27)***

Notes: 1. At most 1 cointegarting equation is significant at both 1% and 5 % level.
2. *, **, *** indicate 10%, 5% and 1% level of significance.
+ significant at 1% level based on chi-square values obtained by imposing cointegrating restrictions on coefficients (Chi-square critical values: at 1 per cent = 6.63; at 5 per cent = 3.84; at 10 per cent = 2.70).

1.7.6 Assessment of Exchange Rate Policy

To assess the exchange rate in the perspective of macroeconomic stability and external growth, the REER is assessed in this section under three conventional techniques such as macroeconomic balance, external sustainability and the behavioural equilibrium exchange rate (BEER) based on some recent studies.

1.7.6.1 Macroeconomic Balance (MB) Approach

The MB approach calculates the difference between an estimated equilibrium current account balance and its projected value. The exchange rate adjustment that would eliminate the difference between this estimated norm and projected current account over the medium term at prevailing exchange rates is then obtained using country-specific elasticities of the current account with respect to the real exchange rates. A recent IMF study shows that fiscal balance, output growth and private transfers (e.g. remittances) are positive and significant and NFA is negative and significant to the current account balance. According to the IMF projection, the underlying medium-term current account for Bangladesh remains close to its estimated equilibrium level requiring only small movements in the real exchange rate to close the gap between the norm and projected current account (Table 1.35).

TABLE 1.35

EXCHANGE RATE ASSESSMENT BASED ON MB APPROACH

Year	CA/GDP Norm	Projected CA/GDP	Elasticity of CA to REER	RER gap
2008	0.12	0.57	0.1352	3.37
2009	0.40	0.66	0.1352	1.96
2010	0.50	0.81	0.1352	2.33
2011	0.47	0.84	0.1352	2.72
2012	0.53	0.63	0.1352	0.78
2013	0.55	0.57	0.1352	0.16

Source: IMF (2008). * All figures are in per cent except elasticities.

1.7.6.2 External Sustainability (ES) Approach

The ES approach calculates the difference between the actual current account balance and the balance that would stabilise the NFA position of the country at some benchmark level. Given the benchmark NFA/GDP ratio (*nfa*), the NFA-stabilising current account/GDP ratio (*ca*) is calculated as:

$$ca = \frac{g+\pi}{1+g+\pi} nfa$$

where g is the growth rate of real GDP and π is the inflation rate. For Bangladesh, this approach suggests that a larger current account deficit than currently projected would be consistent with a stable NFA position. To stabilise NFA at the current level (around 26 per cent of GDP), and assuming growth in real GDP of 7 per cent and inflation of 4 per cent, Bangladesh could run a current account deficit of around 2.5 per cent of GDP, compared to a projected current account surplus of 0.5 per cent of GDP (Table 1.36). By applying a calculated 0.14 elasticity of the current account to the real exchange rate, this would imply that a taka appreciation in real terms by about 16 per cent over the medium term would be consistent with meeting the estimated current account deficit that would stabilise NFA at its current level (IMF, October 2008).

TABLE 1.36

EXCHANGE RATE ASSESSMENT THROUGH ES APPROACH

End-2006 NFA/GDP	Nominal GDP growth rate	NFA-stabilizing CA/GDP	Projected CA/GDP	Elasticity of CA to REER	RER gap
-26.09	11	-2.59	-0.39	0.14	-16.21

Source: IMF.

1.7.6.3 BEER Approach

The behavioural equilibrium exchange rate (BEER) approach is employed to estimate the long-run equilibrium real effective exchange rate with a view to estimating the actual over- or under valuation of exchange rate in terms of the macroeconomic fundamentals and to assess the appropriateness of current managed floating exchange rate regime in Bangladesh.[13] Hossain and Ahmed (2009) used a single equation approach to estimate the equilibrium REER in terms of fundamentals such as terms of trade, fiscal balance, net foreign assets, and interest rate differential using quarterly data for the period 2000Q1 to 2008Q2. The results are discussed below (Table 1.37).

Terms of trade: Any improvements in terms of trade will have depreciating effect on the real effective exchange rate. A 1 percentage point increase in terms of trade is associated with 1.94 percentage point depreciation of the REER in the long-run.

Net Foreign Asset: Increased net foreign assets will put pressure on the currency to appreciate and one percentage point increase in net foreign assets will cause 0.04 percentage point appreciation in the REER in the long-run.

Real Interest Rate Differential: Real interest rate differential will worsen the exchange rate and 0.012 percentage point depreciation of REER will be associated with one per centage point improvement in real interest rate differential.

Fiscal balance: As expected, Bangladesh's fiscal deficit as a ratio of GDP leads to depreciation of the REER and the magnitude of the depreciation in REER is 0.023 per centage point due to one percentage enhancement of budget deficit.

Balassa-Samuelson Effect: As Montiel (1997) suggested, a time-trend is used to capture the impact of productivity growth, that is, the Balassa-Samuelson effect.[14] The effect contends that productivity improvements will generally concentrated in the tradable sector and thus lead to an appreciation. The sign of *t* is negative and significant, that is the productivity differential is negative, which implies a higher productivity for tradable sectors that may contribute to the real appreciation. This confirms the Balassa-Samuelson effect.

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[13] Following Clark and MacDonald (1998) and Baffes, Elbadawi and O'Connel (1999).

[14] The Balassa-Samuelson effect can come from two sources: (1) Productivity differential between the domestic tradable and non-tradable sectors, and (ii) productivity growth differentials relative to trading partners.

The estimated error correction term is found to be negative (-0.70) and significant. This implies that the speed of adjustment to the equilibrium is very high for each quarter, which is 70 per cent.

TABLE 1.37

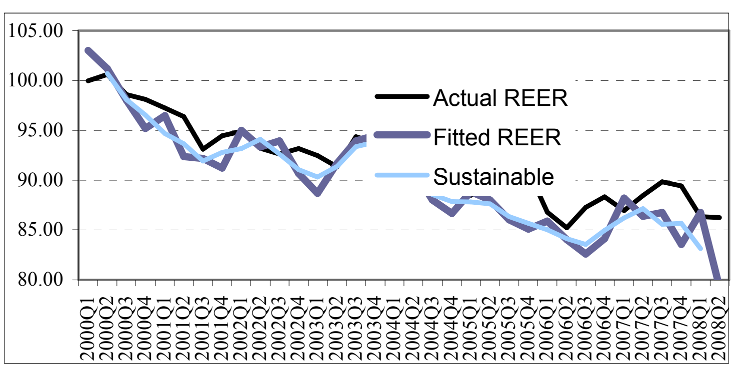
EQUILIBRIUM REER AND ITS DETERMINANTS

	Coeff	Std. Error
LTOT	-1.94	0.18
LNFA	0.04	0.01
RIRD	-0.012	0.001
BD	-0.023	0.002
T	-0.006	
Constant	13.19	

Exchange Rate Misalignment

The overvaluation or undervaluation of the exchange rate can be assessed by deriving the equilibrium "sustainable" real effective exchange rate and subtracting it from the actual real effective exchange rate. As sharp fluctuation in macroeconomic fundamentals is usual, equilibrium REER based on the actual values of macroeconomic fundamentals will also show sharp fluctuation. This leads to estimate a "sustainable" equilibrium REER, which gives an estimate of departure from actual REER in the medium-term framework, that is, the misalignment. Sustainable values of the fundamentals have been derived through three quarterly moving averages.

Figure 1.16: Actual and Equilibrium REER



Source: Hossain and Ahmed (2009).

Following Hossain and Ahmed (2009), estimated REERs are plotted in Figure 1.16. Figure 1.16 depicts these real exchange rate and overvaluation of the taka. The observed real exchange rate seems to have been overvalued since 2004:Q2. For last two years from 2006, it appears that the REER remains overvalued on an average 3 per cent. This indicates that the exchange rate remains very close to the equilibrium as warranted by the economic fundamentals. However, there were some scopes for depreciating the taka at around 3 per cent.

Trade and Exchange Rate Regimes

Over the years, improvement in trade balance in Bangladesh has primarily taken place due to increasing exports rather than decline in imports. Since exchange rate movements are an important dimension of the traders' business environment, a properly aligned exchange rate would be of significant importance in supporting competitiveness of priority export sectors. For the purpose, a pro-active foreign exchange rate policy is required. Since the major export-oriented sectors (such as RMGs) are also employment-intensive, improvements in net export position would support an employment-intensive growth of the economy. A competitive real exchange rate, along with improvement in net trade balance, would therefore support the growth of domestic production activities creating better employment opportunities. In this context, two structural features of the country's trade regime pose important challenges: *first,* limited export base; and *second,* high reliance on imported raw materials and capital goods. The first limitation implies that other factors (such as shift in commodity prices) could be more important in determining export success than the real exchange rate. On the other hand, the second feature means that a weaker Taka would raise the cost of production for import-dependent sectors. For exporters who rely on imported intermediate goods, the net impact depends on several factors, such as exchange rate spread (e.g. the difference in the buying and selling price of Taka) and its volatility between the time when the inputs are purchased and the final products are exported. This shows that measures to keep the exchange rate competitive should be balanced with the potential negative consequences of such actions. Moreover, there are institutional factors in the export sector that are equally important for domestic production and export relative to the real exchange rate. Imported food items, intermediate inputs, and capital goods are important in the economy and thus raise important issues relating to structural aspects and complementary production policies to encourage the development of a more diverse array of exports and promote the growth of import competing activities to transform the economy in such a way as to make the exchange rate policy a more powerful instrument for development.

1.7.7 Summary of the Findings

1. For the first six months of the floating regime, the nominal exchange rate remained almost stable. But from April 2004, nominal exchange rate was somewhat volatile, but remained fairly stable after March 2006. Estimates also indicate that relative volatility of exchange rate over international reserves and relative volatility of exchange rate over interest rate were very low during 2006:3 to 2008:5, providing an evidence of certain amount of intervention in the foreign exchange market.
2. The REER depreciated around 20 per cent over the years in an unstable fashion. However, during the turbulent period of the floating regime (2004-2006), the taka remained competitive because of high depreciation as well as US dollar depreciation vis-à-vis major currencies despite high inflation differentials (with high domestic inflation). From the third quarter of 2008, the REER shows an appreciating trend.
3. The long run pass-through coefficient is found to be very high and significant for Bangladesh. It is 0.87 for international price and 0.95 for the Indian prices, which indicates that a change in international or US or Indian prices will almost completely translate into a change in domestic prices.
4. Exchange market pressure (EMP) is positive in Bangladesh during the period under consideration; however, during 2005-2006 the extent of imbalance in the foreign exchange market was severe (Figure 1.14). It appears that shocks were more frequent and several times it crosses the crisis threshold during the period 2005-2006. However, for the period 2007-08 the EMP is found to be very low, indicating a restoration of equilibrium in the foreign exchange rate market.
5. According to the IMF projection, the underlying medium-term current account for Bangladesh remains close to its estimated equilibrium level requiring only small movements in the real exchange rate to close the gap between the norm and projected current account. Using the MB approach, the current account elasticity to REER is found to be 0.14.
6. For Bangladesh, External sustainability approach suggests that a larger current account deficit than currently projected would be consistent with a stable NFA position. To stabilise NFA at the current level (around -26% of GDP), and assuming growth in real GDP of 7 per cent and inflation of 4 per cent, Bangladesh could run a current account deficit of around 2.5 per cent of GDP, compared to a projected current account surplus of 0.5 per cent of GDP. By applying a calculated 0.14 elasticity of the current account to the real exchange rate, this would imply that a taka appreciation in real terms

by about 16 per cent over the medium term would be consistent with meeting the estimated current account deficit that would stabilise NFA at its current level.

7. The observed real exchange rate seems to have been overvalued since 2004:Q2. From 2006, it appears that the REER remains overvalued on an average 3 per cent. This indicates that the exchange rate remains very close to the equilibrium as warranted by the economic fundamentals.
8. Overall exports from Bangladesh are inversely related to international prices and statistically significant, implying that price support is crucial for the export sector. Estimates of export demand functions for knitwear and woven garments in the US and the EU market show significant impact of price and income on woven and knitwear exports respectively. As a result, woven exports have experienced sharper decline than knitwear in these markets in the later half of 2008 in the face of global economic recession. Although income is also found to be significant for export demand of the USA and EU for knitwear and woven, exports of these items are expected to be less affected by the current global recession due to low income elasticity.
9. REER volatility has significant and positive effect on overall exports; however, the impact is very low. *The low magnitude of the coefficient of volatility indicates that the less the REER volatility, the more will be the positive impact on overall exports. This finding calls for the stabilisation of the REER.*

1.7.8 Sources of Exchange Rate Instability and Challenges for the Sixth Plan

There are at least three channels identified in this study by which exchange rate instability is transmitted to the domestic economy.

(i) Pass-through (inflation) effect: A high pass-through coefficient is estimated for Bangladesh Taka. A one per cent change in international prices translates almost 100 per cent of that change into domestic prices. Since Bangladesh's trade is dominated by imports, a depreciation of taka easily translates inflation into the domestic economy. This high exchange rate pass-through is also likely to increase external debt burden.

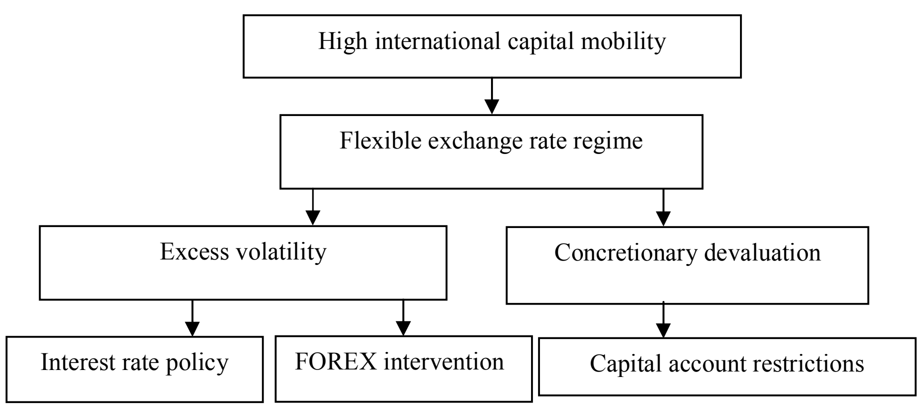
(ii) Competitiveness effect: Although Bangladesh achieved average competitiveness during the period 2000-2008, it is not stable. Competitiveness against European markets is unstable, and since the overall REER moves in tandem with the real Euro, it is very likely that it would destabilise trade relations with other countries. Unstable euro already hurt exports to the European Union, particularly in 2007/08. Regarding the long-term determinants of the REER, an increase in net foreign assets leads to REER appreciation, that is, the loss of international price competitiveness. An improvement of terms of trade works in favour of REER depreciation because of the substitution effect due to increase in import prices.

(iii) Domestic credit effect: This is an indirect channel through which exchange rate is affected in Bangladesh. An increase in domestic credit causes the exchange rate to depreciate or the foreign reserves to deplete or some combination of the two, leading to exchange market pressure. In that situation sterilised intervention would create extra pressure in the foreign exchange market.

1.7.8.1 Challenges Ahead

International Reserve Management

Bangladesh is maintaining current account surplus for last several years particularly due to huge inflows of remittances. Recent trend of capital inflows is optimistic and the reserve has exceeded 10 billion dollar. However, the challenge lies in the management of international reserves. It is likely that huge inflows of capital will lead to appreciation of the exchange rate, thereby loosing export competitiveness. Moreover, with the target of achieving high growth during the Sixth Five Year Plan, the choice of proper instruments in managing exchange rates would be crucial. The following diagram depicts the policy constraints and problems and approaches in managing flexible exchange rates.



Capital Account Openness

Another challenge for Bangladesh whether it would continue with capital account restriction or it will open up capital account. Within the next five year period, Bangladesh can consider easing restrictions on capital outflows in a limited manner. Easing restrictions on capital outflows is expected to generate some capital inflows. However, this policy will be required if there is a need to reduce the size of net capital inflows, and hence mitigate the upward pressure on exchange rates. This is the policy that used to be pursued by many East Asian economies like Japan, Korea, Taipei, and China during the periods of large balance of payments surpluses. It has been adopted by the Peoples Republic of China (PRC) in recent years. Thus, to be effective, these measures need to be combined with other measures mentioned above, such as strengthening financial sector supervision.

Fiscal Deficit

In its election manifesto, the current government envisaged to undertake various big infrastructure projects such as electricity generation projects, roads and highway projects, Padma multipurpose bridge projects, etc. In addition, pay hike for government employees is under way. These projects and initiatives will likely to broaden the fiscal deficit. Such a deficit may create downward pressure on the nominal exchange rate. In such situations, fiscal consolidation as well as market intervention would be required to stabilise the exchange rate.

Natural Disaster and Currency Crisis

Bangladesh very often faces natural disasters which might have effect on the real exchange rates. Maintaining a more flexible regime would be appropriate during a disaster period to absorb shocks automatically. As is evident, Bangladesh Taka has not been overvalued seriously. It is not likely to have any currency crisis in Bangladesh in the near future as capital market restriction is in place and domestic demand for investment is not high. It is necessary to be aware of competitive devaluation and overvaluation of Taka. Constant monitoring of different indicators could be helpful to avoid any crisis. An early warning system can be developed.

1.7.9 Policy Recommendations

Note that there is no simple formula for exchange rate management to achieve two important goals of exchange rate management, such as *competitiveness* and *price stability* simultaneously. In the absence of a solid consensus on the proper target of exchange rate management, we propose to adopt the following pragmatic policies:

1.7.9.1 Stabilisation of REER

In normal times the exchange rate should be managed so as to stabilise overall competitiveness. For this purpose, the REER index, properly constructed to measure the average competitiveness of the tradable sectors, should be constantly monitored. Bilateral real exchange rate of Euro must be stabilised. To stabilise the REER as well as the RER of Euro, adjustments must be made against movements of other currencies as well as of inflation differentials. *This can be accomplished either by a prescribed formula or more informally through timely corrections*.

1.7.9.2 REER Basket

Currently, there are eight currencies in the REER basket. Since Bangladesh's commodity trade is dollar-denominated, *we propose to create a REER basket of four major currencies including the US dollar, the euro, the UK pound sterling and the Japanese yen with proper weights.* This kind of basket would be easier to manage and monitor. Although trade with Japan is not significant, Japanese yen should be included because it matters for debt burden, official development assistance (ODA) and grants.

1.7.9.3 Crisis Management

Bangladesh has not yet been faced any currency crisis, and therefore the capacity of exchange rate management has not been tested yet. With gradual economic development, shocks such as sudden shifts in FDI, export demand or the terms of trade, large business swings, significant resource discovery (or loss), major natural disasters, etc. may occur. In that case *a trigger mechanism needs to be adopted for additional adjustments*. On the other hand, in the face of a currency attack or other severe financial turmoil in the region or in the global economy, REER stabilisation policy may be suspended temporarily to minimise contagion, credit crunch, reversal of capital flows, etc. However, *during a crisis or global economic meltdown, it is better to stabilise the NEER instead of the REER when other trading partner currencies are fluctuating against each other*.

1.7.9.4 Accumulation of Reserves

To maintain managed floats, Bangladesh needs to accumulate a sufficiently large stock of reserves. Has reserve accumulation already proceeded beyond the optimal point? The stock of international reserves stood at 7.48 billion US dollar in 2009, which can afford hardly 3.5 months' import payments. Since the standard practice is to maintain international reserve for 3-months import payments, current reserve position has met the necessary condition, but it is not sufficient. For maintaining stability in the foreign exchange market, it is necessary to accumulate additional reserves. In this context, the management of capital inflows is very important for avoiding any crisis. Since maintenance of large stocks of reserves is a costly activity, *exchange rate stabilisation policies should be based on frequent and small adjustments rather than large and rare ones*.

1.7.9.5 Institutional Development

The foreign exchange market of Bangladesh is in an embryonic stage and thin in terms of daily transactions, which is US$20 million on average. Currency forward market and other derivatives are absent. Bangladesh Bank still controls the market by following net open dollar position of commercial banks as well as by telephonic orders. However, if the economy embarks on a middle-income growth path, the market will need to expand and forward transactions will need to be entertained. Therefore, to reap the maximum benefits of the managed floating regime, there is no alternative other than building institutions and bringing efficiency and depth to the foreign exchange market. In particular, it is necessary to develop inter-bank bond markets as well as capital markets with further financial liberalisation.

1.7.9.6 Monetary and Fiscal Policy Response

It is observed that with high domestic demand, the likelihood of exchange market pressure is high which cannot be addressed only by market intervention. In such situation, *it would be a good option for Bangladesh Bank to tighten the money supply through high interest rates*. In what follows, Bangladesh Bank should work hard on making the financial sector more competitive in order to ensure smooth transmission of monetary policy stimuli through the interest rate channel, and only then, can they enjoy the "low inflation benefit" of non-sterilised interventions. *At the same time, tight monetary policy must be accompanied by fiscal adjustments; otherwise, it might increase the burden on the inter-temporal budget and may thus be counterproductive*.

1.7.10 Concluding Remarks

This study analyses exchange rate policies of Bangladesh under a floating rate regime in a comprehensive manner. It analyses both the behaviour of the nominal exchange rate and the real exchange rate. Although Bangladesh was committed to maintaining a freely floating regime, our findings suggest that its exchange rate policies were not consistent with the characteristics of freely floating regime. Generally speaking, Bangladesh pursues a managed floating rate regime. Given the *thin* foreign exchange market, high exchange rate pass-through and exchange rate shocks (exchange market pressure), it appears to be difficult for Bangladesh to maintain a freely floating regime.

Current managed floating can be viewed as "learning to float" because, with the adoption of a managed floating, policymakers can learn how to conduct optimal monetary policies under a floating regime. It may take time, for example, for the central bank to refine the new internal procedures and communication strategies involved in inflation targeting. However, more importantly, authorities and market agents should take the opportunity of this period of managed floating to become comfortable with exchange rate flexibility. In particular, learning is a process that requires reforms and building institutions that may reduce the risks associated with freely floating exchange rate regime. The East Asian countries underwent massive financial liberalisation during the 1980s and 1990s and recently they are working toward establishing an Asian (ASEAN+3) bond market that could help them reduce "liability dollarization" through borrowing abroad in their own currencies. Therefore, given the vulnerable financial system, this study suggests that it is better for Bangladesh to continue a managed floating regime with frequent and small interventions. Simultaneously, Bangladesh Bank needs to work on developing mechanisms for inflation targeting policies, ensuring efficiency in the financial system, and building necessary institutions in order to manage exchange rates efficiently. Maintaining stability in the short-run and flexibility in the medium-to-long term should be the primary objective of exchange rate management policy of Bangladesh.

1.8 POLICY IMPLICATIONS FOR THE SIXTH PLAN

Over the last ten years, Bangladesh has reversed its past slow and volatile economic growth and, between 2006 and 2008, the average growth rate was close to six-and-a-half per cent, which is among the peaks in the country's post-independence history. Yet the experience shows that such levels of growth alone would not be adequate to improve employment opportunities and reduce poverty at desired rates. The type of growth that matters for Bangladesh is the one that creates more productive employment opportunities especially for the poor and ensures more equal sharing of the benefits of growth so that the country's development objectives are achieved and economic aspirations are fulfilled. For this, a two-pronged strategy is required. *First,* aim at increasing employment and improving its quality that would widen the opportunities to share the benefits of growth. *Second,* adopt policies that develop the labour force and improve the functioning of the labour market so that the labourers can realise higher returns to their labour and take advantage of better opportunities when they arise.

In Bangladesh, monetary policy can create better employment opportunities with a well functioning financial sector having capability to ensure adequate resource flows to socially productive uses. This, however, would also require labour market reforms to mobilise and develop the country's human resources for development. In view of the supply-side nature of the current price dynamics and the weak relationship that exists between the growth of monetary aggregates and inflation, the pursuit of a monetary policy attempting to achieve low inflation by targeting the growth rate of monetary aggregates is not likely to be much effective. On the contrary, such a monetary regime may contribute to high real interest rates impeding the realisation of stipulated growth and poverty reduction.

In order to channel resources to employment generating activities and improve the efficiency of monetary interventions, reforms are needed to enhance the access to credit of small-scale enterprises and the self-employed. For the purpose, a coordinated set of policies is needed such that the employment-intensive activities can increase productivity and reduce business risks. Examples of such policies include providing incentives for extending credit to priority activities, developing credit guarantee schemes to lower risk premiums, creating better credit information systems to generate dependable information on creditworthiness of underserved borrowers, and fostering linkages between commercial banks and informal credit institutions.

Industrial policies need to target sectors having better potential of employment creation such as agro-processing, horticulture, fisheries, and ICT. The policy interventions may need to cover a wide array of activities ranging from fiscal incentives to priority credit allocations for investment and provision of infrastructure. The aim would be to create new employment opportunities and raise the average quality of existing jobs. For the government, it would be useful to monitor employment generation capacity, job quality, and upgrading of productive activities of the targeted beneficiaries.

For success in reducing poverty, complementary policies to increase the economic mobility of the poor and raise their average returns to labour are also crucial. For the purpose, skill development and training policies need to enhance "employability" through providing skills in short supply and training having potential demand. In this context, it is important to keep in view that self-employment is an important source of income for a majority of the labour force. In the short term, this requires improved support to own account workers and small-scale enterprises partly through improving their access to credit. In order to be effective, this also requires provision of technical support to micro and small-businesses. Special programmes may be devised for the purpose of covering these as well as medium enterprises which are also constrained in their access to formal finance. Such support should include skill building, extension services, market facilitation, and building financial/credit management capacity.

For speedy growth of the SME sector, the country's industrial strategy needs anchoring in multi-layered subcontracting arrangements between the large enterprises and the SMEs and among the SMEs themselves, especially among SMEs of different booster sectors. Innovation and searching for new markets are also important for sustaining the growth of existing SMEs and flourishing of new SMEs. For the purpose, Bangladesh needs to adopt its own model of creating support mechanisms for SMEs covering government, private, and NGO sectors. In addition to finance, this should involve direct technical support system to the SMEs based on targeting strategies, such as using a system of "special designation" to select SMEs that would receive priority in allocation of technical extension services and support programmes.[15] The overall thrust should be to provide a comprehensive set of assistance to facilitate the SMEs to upgrade themselves, increase productivity, and improve competitiveness. In this context, efforts could be organised and administered using a network approach to providing assistance covering relevant financial, professional, and technical institutions in both public and private sectors. Similarly, a local SME upgrading programme could be taken up through developing tripartite partnerships among multinational corporations, local SMEs, and the government under which multinationals would provide focused assistance to their suppliers to improve quality and operational efficiency. The need is to set a vision and adopt a pro-active SME promotion policy facilitating rapid transition from traditional to relatively modern product categories to help up-scale existing low productivity informal SMEs and deepen their links with mainstream growth seeking activities. Along with laying the foundation of a robust and competitive industrial sector and furthering economic growth, developing a vibrant SME sector would expand productive and remunerative employment opportunities, especially in the rural areas.

Migrant labour is an important issue for Bangladesh. Migrant workers provide useful support to economic growth and employment creation in the country. The regulatory environment, however, needs to be improved so that benefits of migrant labour are better realised and associated costs are minimised. As a labuor exporting country, Bangladesh can influence the inflow of remittances through adopting appropriate policies such as building hassle free remittance sending infrastructure, exploring new overseas markets, improving the formal channels of fund transfer, establishing specialised banks, and creating more effective investment avenues and providing ownership in social development projects for non-resident Bangladeshis.

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[15] The special designations could include several categories, such as promising SMEs programme, technically advancing SMEs programme and the like. If necessary, SME sanctuaries could be established.

The financial sector can facilitate higher remittance inflows through improving transaction efficiency by introducing automation of rural bank branches, encouraging private banks to open branches in rural areas, and allowing well-established NGOs and MFIs to receive and disburse remittances through their vast rural network. The adoption of a national migration policy can go a long way in ensuring sustained increase in inflow of remittances along with guaranteeing the welfare of the remitters.

With the urgent need to increase domestic resource mobilisation, it is important for Bangladesh to explore the implications of financial sector reforms on saving mobilisation by the liberalised financial system. Although gross domestic savings as a share of GDP increased from 12 per cent in the early 1980s to more than 20 per cent in recent years, it is still low.[16] For the majority of the rural households, ensuring two characteristics of the saving asset is important to fit with their economic environment. *First,* saving assets should be secure; and *second,* these should allow for small but multiple transactions. The currently liberalised financial sector is unlikely to tailor-made their saving assets to such characteristics. As a result, a large part of the country's small savings, especially in the rural areas, goes into non-financial assets (e.g. land, jewellery, and similar assets) and into informal financial sector activities rather than financing productive investments. The preference for informal financial assets arises from a number of their advantages, such as small deposits with intervals, flexibility in operation, and easy access at the community level.

The present structure of the formal financial system has a number of weaknesses to cater to the needs of these income groups, such as limited outreach focusing on more profitable urban activities, limited exposure in rural areas, banking culture not favourable to small depositors, inflexibility in operation, and more time and effort needed to complete transactions. This highlights the importance of taking measures, along with pursuing reforms to create a liberalised financial sector, to improve access, adequacy, and reliability of financial assets especially to small and rural savers. A number of options may be explored, such as

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[16] India, for example, had a domestic savings-GDP ratio of more than 32 per cent in 2006. Although external savings partially plug the savings-investment gap, substantially larger domestic resources are required through proper use of the dynamos created under the financial sector reform programme in Bangladesh. Available evidence from household surveys shows that most households hold some savings as a precaution against low and uncertain incomes. The savings pattern of different groups of households is, however, different with the poorer groups involved in both saving and dissaving depending on the nature of economic activities and income situation over different periods of the year.

encouraging the banks to provide more outlets for household savings in rural and remote areas; promoting technological innovations (e.g. ATMs, mobile banks, mobile phone banking, and other avenues) to redress remoteness, cost of access, and other constraints inhibiting savings with the formal financial system; exploring the scope of developing partnerships between MFIs and the formal financial system in mobilising and pooling small savings and other financial resources; and vitalising public mechanisms (e.g. post offices) to mobilise small savings. Despite the fact that public financial institutions have not performed well in the past, this should not be taken as an excuse for not allowing them to play a useful role in complementing the liberalised financial system through adopting innovative and viable models of mobilising small savings to sustain increased investments in priority sectors.

In Bangladesh, the rate of poverty reduction through economic growth depends largely on its capacity to create productive and decent employment opportunities so that workers of every level of skill, education, and training can get remunerative jobs. Thus, employment is the key link between economic growth and poverty making it the major tool of poverty reduction in Bangladesh. . Since the realisation of the job-led growth depends on employment-friendly growth of the private sector, the government action requires focus on bringing positive changes in the quantity and quality of employment through appropriate labour market and complementary policies. In view of the structural characteristics, expansion of productive employment requires measures covering several areas, such as expanding both wage and self-employment, increasing productivity of and returns to employment, and ensuring a better terms of exchange of the outputs of self-employment activities. This requires public actions through appropriate orientation of fiscal policy and annual development programme (ADP) within the poverty reduction strategy (PRS) framework to ensure provision of social services that improve the quality and capability of the labour force

In this context, public action does not mean state action only. It includes not merely what is done for the public by the state, but also encompasses the role of NGOs, and other social, political, and humanitarian institutions. While it is true that the need for state action partly arises from the failure of the market to provide adequate protection and promotion by generating required employment opportunities in the economy, it does not follow that state action for ensuring economic security must dispense altogether with reliance on the market. Insofar as the market mechanism contributes to economic expansion, provides effective means of matching supplies with demands, and yields widespread entitlement generation (through employment creation), it can be a significant ally in providing economic security through public action. Under existing situation, the need is for integration that is there should not be over-reliance on or neglect of markets in promoting employment generation and poverty reduction agendas.

Finally, one of the important constraints in promoting employment-led growth in the country is the poor availability of information on employment and labour market situation. The promotion of effective employment policies requires reliable labour market information with which to evaluate success and identify the problems and potential solutions. Bangladesh needs to develop an annual employment information system that generates employment related data on a sectoral basis. In short, a coordinated approach to policy is called for in order to improve employment opportunities on a sustainable basis.

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Chapter 2

A Review of Fiscal and Other Macro Incentives in the Manufacturing Sector: Implications for Future Policies

Zaid Bakht
Nazneen Ahmed

2.1 INTRODUCTION

Industry is a broad category including, in addition to manufacturing, ancillary activities such as construction, mining, and utilities (electricity, gas and water). Manufacturing is the dominant component of industry with critical backward and forward linkages with the rest of the economy. It is important, therefore, to ascertain both the extent and nature of growth experienced by the manufacturing sector, particularly with regard to employment intensity as it would have implications for poverty alleviation aspect of growth. In that context, role of various macro and fiscal incentives towards the development of manufacturing is of interest to scrutinise.

After the political change in 1975, Bangladesh abandoned the strategy of public sector led industrialisation adopted at inception in 1971. In the following years, a policy of mixed economy was pursued whereby attempts were made to create more room for the private sector side by side with the existing parastatal bodies. The political change of 1981 marked further shift in the strategy and the New Industrial Policy of 1982 put private sector in the lead role in industrialisation. This was followed by quick privatisation of a large number of public enterprises and strengthening of policy support for private sector development.

All subsequent governments and the respective industrial policies announced by them adhered to the private sector led industrialisation strategy. However, the modalities of private sector promotion varied from regime to regime and the pace of privatisation of public enterprises went through significant changes along with changing political regime.

The present study attempts to make a critical review of the range of macro and fiscal incentives that have been provided from time to time since the early 1980s to promote private sector led industrialisation, and suggest policy imperatives on the basis of lessons learnt.

The paper is organised in the following manner. After the introductory remarks in section 2.1, section 2.2 provides an overview of the performance of manufacturing sector, while section 2.3 discusses important macro set up critical to the manufacturing sector operates. Section 2.4 discusses various fiscal incentives affecting the performance of the manufacturing sector and finally section 2.5 provides conclusions and necessary steps for future development.

2.2 PERFORMANCE OF MANUFACTURING SECTOR

2.2.1 Share in GDP and Growth

Bangladesh economy experienced sluggish growth and moderate structural transformation during the first two decades of independence. Following the recovery phase of the 1970s, average annual GDP growth during the 1980s hovered slightly below 4 per cent level. Until early the 1990s, the economy remained mostly agrarian with agriculture accounting for nearly 37 per cent of GDP in 1989-90. The average annual GDP growth jumped to 4.4 per cent during the first half of the 1990s and along with that the economy began to show signs of significant structural transformation. The year 1995-96 marked the watershed when agriculture and industry each contributed about a quarter of GDP. During the 1990s, compound growth rate of GDP was 4.9 per cent. GDP growth accelerated in the following years and on an average remained 6 per cent during the current decade. Since the early 1990s, growth in industrial GDP dominated the overall GDP growth performance. At the same time, the share of industry in GDP steadily increased and stood at 28.6 per cent in 2008-09 against agriculture's share of 19.8 per cent. During this period service sector's share in GDP experienced ups and downs between 46 per cent and 51 per cent. Thus, in terms of composition of GDP, the structural transformation of Bangladesh's economy since the early 1990s seems like a transition from agriculture to industry rather than to service.

GDP share of manufacturing sector alone, which is a part of industry,[1] has increased from 12.52 per cent in 1989-90 to 17.78 per cent in 2008-09. During this period, share of agriculture (agriculture and forestry without fisheries) in GDP has declined from 25.15 per cent in 1989-90 to 16 per cent in 2008-09. Large industry has been the dominant component of the manufacturing sector in Bangladesh in terms of value addition as 70 per cent of manufacturing GDP comes from large enterprises. However, over the last two decades, the share of large industry has declined marginally and that of small industry has increased.

[1] Broadly, industry includes mining and quarrying, manufacturing, electricity, gas and water and construction.

TABLE 2.1

COMPOUND GROWTH RATES OF GDP AND BROAD SECTORS

Year	Total GDP	Agriculture	Industry	Service
1972-73 to 1979-80	3.68	1.86	5.26	5.17
1980-81 to 1989-90	3.90	1.84	3.16	5.43
1990-91 to 1999-00	4.90	3.03	7.37	4.56
2000-01 to 2008-09	6.02	3.52	7.86	7.48

Source: Calculated on the basis of data from *National Accounts Statistics (various Issues), Twenty Years of National Accounts of Bangladesh, 1993 and Bangladesh Economic Review* (various issues); Base year is 1984-85 for data from 1972-73 to 1989-90; for others, data base year is 1995-96.

TABLE 2.2

SHARE IN GDP AND GROWTH OF MANUFACTURING SECTOR

Year	Manufacturing GDP (million Taka)	Share of manufacturing in GDP (%)	Share of large industry in manufacturing GDP (%)	Share of small industry in manufacturing GDP (%)
1989-90	156,163	12.52	71.16	28.84
1994-95	231,517	15.15	71.83	28.17
1999-2000	303,680	15.40	71.49	28.51
2004-05	422,690	16.51	70.64	29.36
2008-09	583,393	17.78	70.91	29.09
Yearly compound growth rate of manufacturing GDP				
1989-90 to 1994-95			8.17	
1994-95 to 1999-2000			5.66	
1999-2000 to 2004-05			6.73	
2004-05 to 2008-09			8.40	

Source: Based on annex Table A.1.

Table 2.2 shows that yearly compound growth rate of manufacturing during 2004-05 to 2008-09 was higher than yearly compound growth rate in the last two decades. Annex Table A.1, however, shows that the growth rate has been declining since 2007-08 and continued in 2008-09, which may be attributed partly to domestic political situation and partly to the global economic meltdown.

2.2.2 Employment and Real Wage

Employment in industry, which is dominated by manufacturing sector, has been increasing steadily since 1995-96. As a result, share of manufacturing in total employment increased from 10 per cent in 1995-96 to 11 per cent in 2005-06 though its share in industrial employment declined from 76.09 per cent to 75.36 per cent during this period (Table 2.3).

TABLE 2.3

SECTORAL COMPOSITION (%) OF EMPLOYMENT 1995 – 2006

Year	Total employment (In Million)	Employment in industry (In Million)	Employment in manufacturing (In Million)	Share of manufacturing in total employment	Share of manufacturing in industrial employment
1995-96	34.8	4.6	3.5	10.06	76.09
1999-2000	39.0	5.1	3.7	9.49	72.55
2002-03	44.3	6.0	4.3	9.71	71.67
2005-06	47.4	6.9	5.2	11.00	75.36

Source: BBS Labour Force Surveys.
*Industry includes manufacturing, mining, utilities and construction.

Real wage in manufacturing has also increased over time. The average annual growth rates were even higher than growth rates in labour productivity during 1999-2000 to 2002-03 and 2002-03 to 2005-06. Manufacturing wage indices in different years appear to be higher than general wage indices of the country. Moreover, the growth rates of real wage in manufacturing are higher than growth rates in general real wage rates. This trend indicates increased labour demand from manufacturing due to growth in this sector.

TABLE 2.4

LABOUR PRODUCTIVITY AND REAL WAGE INDICES IN MANUFACTURING

Year	Mfg. GDP (million Taka in 1995-96 price)	Mfg. employ-ment (million)	Labour Productivity (annual)	Annual average growth rate of labour productivity (%)	Real wage indices in Mfg. (1969-70 =100)	Annual average growth rate of real wage in Mfg. (%)	General real wage indices (1969-70 =100)	Annual average growth rate of general real wage (%)
1995-96	246351	3.5	70386	--	123	--	114	--
1999-00	303680	3.7	82076	3.92	137	2.73	121	1.50
2002-03	364810	4.3	84840	1.11	169	7.25	141	5.23
2005-06	468197	5.2	90038	2.00	183	2.69	149	1.86

Source: Based on data from *Statistical Yearbook*, Bangladesh Bureau of Statistics (different issues).
Note: Years are chosen on the basis of availability of the Labour Force Survey.

2.2.3 Trend in Investment and the Manufacturing Sector

According to the *Doing Business Report of 2009*, Bangladesh secured the position of 110th in the Ease of Doing Business among 181 countries. However, with respect to several other performance indicators of doing business, Bangladesh ranked well. For example, Bangladesh ranked 18th in terms of protecting investors, 59th in getting credit and 90th in starting a business and paying taxes. As a result, entrepreneurs from Far East, ASEAN, EU, North America and other Asian countries have shown their interest to invest in Bangladesh. The government is undertaking different investment friendly policies to stimulate this trend.[2]

2.2.4 Local Investment

As a result of various reforms under the structural adjustment initiative since the mid-1980s, total investment in the economy registered a steady growth throughout the 1990s. The average growth rate in investment as a proportion of GDP during FY1997–FY2009 was about 1.2 per cent per year. While public sector investment declined by 3.1 per cent, private sector investment increased by 2.8 per cent. The growth thus came mainly from increased private sector investment, which resulted in increase in the private investment-GDP ratio from 13.7 per cent in FY1997 to 18.3 per cent in FY2005 and to 19.5 per cent in FY2009. The share of private sector investment in overall investment increased consistently during the period, rising from 66 per cent in FY1997 to 74.7 per cent in FY2005 and to 81 per cent in FY2009. The local investment, whether private or public, mainly goes to the manufacturing sector. Table 2.6 presents sectoral share in local investment, which reveals that around 90 per cent of local investment goes to the manufacturing sector with the dominance of textile sub-sector, followed by engineering and chemical products. However, the dominance of textile sector is declining overtime.

Small and medium enterprises (SMEs) play a major role in generating employment. Box 2.1 presents a brief on employment scenario in the SMEs.

Though current level of investment is in the rising trend, the level of national savings is inadequate to finance the level of investment that will be required to achieve higher growth rates in the economy as a whole, let alone manufacturing

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[2] Government of Bangladesh, Ministry of Finance, *Bangladesh Economic Review*, 2009.

sector. The poverty reduction strategy[3] of the Government had targeted that the GDP growth rate would have to increase to 8 per cent per annum by 2013 in order to achieve the MDG target of halving poverty by 2015 and to 10 per cent by 2017 to fulfill the election manifesto of the present government. The higher growth rate will require an overall investment-GDP ratio of 30.40 per cent by 2011-13.[4]

TABLE 2.5

PUBLIC AND PRIVATE INVESTMENT BETWEEN FY1997 AND FY2009

Year	Total investment (as % of GDP)	Public investment (as % of GDP)	Private investment (as % of GDP)	Share of public investment (%)	Share of private investment (%)
1996-97	20.72	7.03	13.70	33.91	66.09
1997-98	21.63	6.37	15.27	29.45	70.58
1998-99	22.19	6.72	15.47	30.27	69.71
1999-00	23.03	7.41	15.61	32.19	67.80
2000-01	23.09	7.25	15.84	31.40	68.59
2001-02	23.15	6.37	16.78	27.51	72.49
2002-03	23.40	6.20	17.21	26.48	73.52
2003-04	24.02	6.19	17.83	25.78	74.22
2004-05	24.53	6.21	18.32	25.31	74.70
2005-06	24.65	6.00	18.65	24.33	75.67
2006-07	24.46	5.45	19.02	22.26	77.74
2007-08	24.21	4.95	19.25	20.46	79.54
2008-09P	24.18	4.63	19.55	19.16	80.84

Sources: Bangladesh Bureau of Statistics, *National Accounts Statistics, 2008* and *Bangladesh Economic Review, 2009*.

Note: Figures for 2008-09 are provisional estimates.

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[3] Government of Bangladesh, Planning Commission. *Steps Towards Change – National Strategy for Accelerated Poverty Reduction II*. Dhaka, December, 2009.

[4] Government of Bangladesh, Ministry of Finance, *Bangladesh Economic Review*, 2009

TABLE 2.6

SECTORAL SHARE IN LOCAL INVESTMENT (%)

Sectors	2006-07	2007-08	2008-09
Textile	74.29	56.3	46.42
Food & Allied	2.33	2.24	2.35
Agro-based	4.46	4.86	4.08
Services	8.39	12.05	8.56
Engineering products	5.25	9.50	16.13
Glass & ceramics	0.53	0.90	2.37
Chemical	0.83	11.44	17.85
Leather	0.40	0.10	0.19
Printing	3.16	1.88	1.05
Misc.	0.35	0.73	0.27
Total	100.00	100.00	100.00

Source: *Bangladesh Economic Review*, Various Years.
Note: Manufacturing sectors are highlighted.

Box 2.1: Employment in Small and Medium Enterprises (SMEs)

According to Small Enterprise Development Fund (SEDF) (2003, noted in Bangladesh Bank (2006), SMEs constitute the dominant source of industrial employment in Bangladesh (80 per cent). However, differences in the definitions of SMEs in various sources of statistics make it difficult to present the real picture of employment in these enterprises. The criteria used to define different sizes of industries in the industrial policies of Bangladesh are different from those used by the Bangladesh Bureau of Statistics (BBS). In the industrial policies, industries are divided into various groups according to their fixed capital and number of workers. However, BBS divides industries in different sizes according to the number of employees. Even different census reports of BBS use different definitions. The annual *Census of Manufacturing Industries* (CMI) conducted by the BBS defines enterprises having 10-49 workers as “Medium” industries, while those having 50 or more workers are identified as “Large” industries. For industrial GDP data of BBS, medium and large industries are summed together under “Large” category, while the rest of the industrial enterprises including cottage industries are defined as “Small” category. Again, *the National Report on the Census of Non-farm Economic Activities* by BBS in 2005, enterprises with less than 10 workers are referred to as “Micro” enterprises while “Small” and “Medium” enterprises, are defined to have 10–49 workers and 50–99 workers respectively. The enterprises with 100 or more workers have been defined as “Large” enterprises.

Any rigorous analysis of employment performance of SMEs under different definitions is beyond the scope of the present paper. To get an idea about the importance of SMEs in employment generation, one may look into the latest information given in the *Census of Non-farm Economic Activities of 2005*. According to this census, there are around 3.6 million establishments engaging nearly 12 million people in non-farm economic activities in Bangladesh. Around 98 per cent of all establishments are micro enterprises (having fewer than 10 workers) while their employment share is about 68 per cent. There are 80 thousand enterprises under the small and medium (SME) categories (having 10–99 workers) with an employment share of 14 per cent. About 38 per cent of this employment in SMEs is generated by manufacturing enterprises under these categories.

The funds for investment could come from four sources: domestic savings, foreign savings (private unrequited transfers, primarily remittances of Bangladeshis living abroad), foreign aid, and foreign borrowing. Gross domestic saving (both public and private saving) in Bangladesh is low at 20.0 per cent of GDP. Surge of overseas remittances in recent years compliments the insufficiency of domestic saving, as a result of which the gross national saving stood at 32.4 per cent in FY2009. Reducing losses of state owned enterprises (SOEs) through privatisation may also release resources for productive investment in the private sector. But much of the incremental investment will have to come from FDI for the development of the manufacturing sector as remittances are mostly used for repaying loans and current business environment does not encourage utilising savings.[5]

TABLE 2.7

REQUIRED INVESTMENT FOR ATTAINING TARGET GROWTH RATE AND INVESTMENT DEFICIT

(OPTIMISTIC SCENARIO)

	2009-10	2010-11	2011-12	2012-13	2013-14
GDP Growth %	6.00	6.80	7.50	8.00	8.00
Required Investment (Billion US$)	24.59	30.63	37.18	43.82	49.69
Investment (% of GDP)	24.00	27.02	29.25	30.40	30.40
Required Investment MTMF (Billion US$)	23.55	27.10	31.36	35.54	40.29
Investment Deficit (Billion US$)	1.04	3.53	5.82	8.27	9.40

Source: Bangladesh Economic Review, 2009.

2.2.5 Foreign Direct Investment (FDI)

FDI inflow in the Bangladesh economy has increased since the early 1990s, but the growth has not been steady. FDI outside the export processing zones was virtually nil during the 1980s. However, after the liberalisation measures of the early 1990s, particularly with the opening up of power, gas, telecommunications and infrastructure sub-sectors to foreign investment, there has been an upsurge of FDI inflow into Bangladesh since the mid-1990s. Bulk of these investments went into gas and power sub-sector, while investment in manufacturing was negligible

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[5] Yunus (2010).

with the lone exception of cement industry. The limited size of the domestic market appears to be the main factor discouraging inflow of FDI into manufacturing industries in Bangladesh outside the export processing zones (EPZs). In 2001, FDI inflow was registered at $174 million, which climbed to $ 1.09 billion in 2008. These figures are based on inflow of new investment. Since 1995, Bangladesh Bank has been conducting enterprise surveys to get a comprehensive idea about FDI flows. These surveys include new investment inflow (equity), intra-company loan, re-investment and non-cash equity flow.[6] The survey estimates, presented in Table 2.8, indicate that the share of equity capital to total FDI decreased from 64 per cent in 2006 to 60 per cent in 2007 but increased to 74 per cent in 2008. While reinvested earnings accounted for one third of the total FDI inflow in 2006 and 2007, it decreased to less than a quarter of the total flow in 2008; only a small per cent constituted the inter-company borrowing. Thus, equity capital and re-investment are quite significant components of FDI flows in Bangladesh.

TABLE 2.8

FOREIGN DIRECT INVESTMENT BY TYPE AND YEAR (IN MILLION US$)

FDI components	2006			2007			2008			2009
	Jan-Jun	Jul-Dec	Total	Jan-Jun	Jul-Dec	Total	Jan-Jun	Jul-Dec	Total	Jan-Jun
Equity capital	273.98	229.67	503.65	234.83	166.78	401.61	378.91	430.34	809.25	105.08
Reinvested earnings	95.28	169.46	264.74	111.54	101.70	213.24	96.01	149.72	245.73	186.89
Intra-company loans	11.81	12.29	24.09	34.96	16.55	51.51	8.74	22.59	31.33	65.97
Total	381.07	411.41	792.48	381.34	285.03	666.37	483.66	602.65	1086.31	357.94

Source: FDI Survey Report, January-June, 2009, Bangladesh Bank.

FDI mostly comes in basic industries, though domination of telecommunication is notable during the last couple of years (Table 2.9). Among the manufacturing sectors, textiles and wearing apparel attract bulk of the FDI.

[6] Bangladesh Bank, Foreign Direct Investment in Bangladesh, Survey Report, (January-June), 2009.

TABLE 2.9

MAJOR SECTOR-WISE FDI INFLOWS (MILLION US$)

Sector	2006			2007			2008		
	Jan-Jun	Jul-Dec	Total	Jan-Jun	Jul-Dec	Total	Jan-Jun	Jul-Dec	Total
Telecommunication	154.45	192.05	346.50	112.66	89.24	201.90	210.68	430.71	641.39
Textiles & Wearing	29.00	41.11	70.11	64.34	38.01	102.35	55.41	70.95	126.36
Banking	68.59	49.09	117.68	42.74	37.23	79.96	119.58	22.18	141.76
Food Products	5.27	3.71	8.98	3.49	6.35	9.84	4.92	17.97	22.89
Agriculture & Fishing	0.68	0.58	1.26	3.99	3.34	7.33	0.31	14.12	14.43
Others	123.1	124.87	247.98	154.13	110.88	264.99	92.77	46.71	139.5
Total FDI Inflows	381.07	411.41	792.48	381.34	285.03	666.37	483.66	602.65	1086.31

Source: FDI survey report, July-December, 2008, Bangladesh Bank.
Note: Manufacturing sectors are highlighted.

TABLE 2.10

INVESTMENT AND EMPLOYMENT IN EPZS (UP TO JUNE 2009)

Products	Number of enterprises	Investment (million US$)	Share in total FDI in EPZs	Employment
Garments	70	449.79	28.42	132,512
Textile	33	359.5	22.70	19,017
Terry towel	16	54.52	3.45	6,878
Knitting & other textile products	33	159.90	10.11	29,146
Garments accessories	43	171.52	10.84	10,414
Caps	7	43.47	2.75	6,475
Tent	6	34.87	2.20	5,847
Electronics & electrical goods	15	66.51	4.20	2,617
Footwear & leather goods	13	63.29	4.00	9,548
Metal products	12	24.16	1.53	1,427
Plastic goods	14	22.55	1.43	2,245
Cover items	2	0.85	0.05	116
Fishing reel & golf equipment	1	32.01	2.02	411
Ropes	2	6.26	0.40	468
Service oriented industries	3	6.95	0.44	652
Agro products	7	2.72	0.17	219
Miscellaneous	23	83.87	5.30	6,701
Total	300	1582.47	100.00	234,693

Source: BEPZA, quoted in *Bangladesh Economic Review 2009*.

A total of 8 EPZs[7] of Bangladesh are major destinations of FDI flows. Total investment in the EPZs up to March 2009 amounted to US$ 1.4 billion (Table 2.10). A substantial part of this investment has gone into garments, textile, terry towel, knit and other textiles, garments accessories, cap making, electronics and tent.

2.3 MACRO ENVIRONMENT FOR MANUFACTURING SECTOR

2.3.1 Background

The pattern of industrial development largely depends on the policy and regulatory framework within which industries operate. This framework encompasses a number of policies, such as industrial policy, trade policy, including export, import and exchange rate policies, and fiscal and monetary measures that influence ownership pattern, investment decision and trade decision of various industries.

Immediately after the independence, policies were targeted towards public sector development with nationalisation of industries including insurance, banking and export trade. As a result, 10 public sector corporations emerged controlling 92 per cent of the fixed assets of manufacturing sector (Rahman 1994). Private sector investment ceiling was increased from Tk 2.5 million to Tk 3.5 million in 1973 and again to Tk 30 million in 1974. After 1975, the strategy of private sector led industrialisation overtook the public sector led industrialisation. Even though the attempt was initially slow, accelerated privatisation process was observed since the initiation of the New Industrial Policy (NIP) of 1982. The Revised Industrial Policy (RIP) of 1986, devised in association with the structural adjustment facility (SAF) of the World Bank and the International Monetary Fund (IMF), further strengthened the privatisation measures. Massive lending was made available to the private sector through public sector development finance institutions, which borrowed funds from the international financial institutions at discounted rates. Due to poor governance in the financial sector and political interference in credit allocation, a substantial part of these loans was allocated to unviable projects resulting in huge loan defaults.

With the introduction of the structural adjustment programme (SAP) in 1986, private sector investment started to gain momentum. Periodic revisions of the Industrial Policy, carried out as part of the comprehensive Trade and Industrial Policy reform programme that had begun in 1982, induced growth in private sector investment in manufacturing. Successive industrial policies since the early 1990s have also encouraged a private sector led economic development while upholding the government's role as a facilitator to create a favourable investment-climate.

[7] Adamjee, Chittagong, Comilla, Dhaka, Ishwardi, Mongla, Karnaphuli, and Uttara.

Thus, successive governments gradually changed their stance from the role of a regulator to that of a facilitator and partner.

2.3.2 Investment and Industrial Financing

The public sector led industrialisation policy that was adopted after independence considered opportunity cost of public resources to be high and therefore, the policy objective was not to channel public resources to promote private enterprises. Rather the public resources were targeted to be used in the production of public goods, in projects for low income people and in small and cottage industries. After 1975, public resources were gradually made available towards private sector development. The conduits for channelling public resources to private sector were the development finance institutions (DFIs). The restrictions on FDI and ceiling on private investment were relaxed. In the late 1980s, sanctioning requirements for investments financed through credit from private financial institutions were removed. The board of investment (BOI), created in 1990, aimed at taking various measures to attract industrial investment including FDI. As part of the SAP, massive financial sector reforms were undertaken in 1989; the key reforms include replacements of fixed exchange rate policy by flexible exchange rate policy, subsidised refinancing facility by a more general rediscount facility and instituting financial court designed to improve debt recovery (Bakht and Bhattacharya 1994). The Industrial Policy, 1991 further encouraged private investment and FDI for industrial development. This policy also increased the investment sanctioning limits of the DFIs and nationalised commercial banks (NCBs). Instead of 51 per cent share previously allowed, 100 per cent FDI as well as joint ventures were allowed with the exception of few reserved sectors mainly related to national security (such as defence, atomic power production, money printing, purchasing weapons). The industrial policy of 1991 also allowed special credit facilities for the small and cottage industry sector, later termed as small and medium enterprises (SMEs).

The industrial policies of 1999 and 2005 encouraged both domestic and foreign investments and largely eliminated discrimination between foreign and domestic private investors. This notion has also been reflected in the Industrial Policy of 2009. Incentives currently offered to foreign investors in Bangladesh include full ownership in most sectors, lower import duties on capital machineries and spare parts, tax holidays, duty free imports of raw materials for 100 per cent export oriented industries, tax exemptions on foreign loans and on capital gains for portfolio investors and free repatriation of profits. Moreover, Taka was made convertible in the current account in 1994. It was made fully convertible in 2003.

Industrial Policy 2009 has also envisaged achieving a dominant industrial sector by 2021, where industry will account for at least 40 per cent of GDP from the current level of 28 per cent GDP, as such its share in employment generation will increase from the current level of 16 per cent to 25 per cent.

Various policy initiatives have also been undertaken to develop the capital market that serves as an important source of industrial financing. To that end, the Securities and Exchange Commission (SEC) was established in 1993. Other initiatives to improve the capital market include: structural development, modernisation of the programmes related to capital market and adoption and use of international standards and procedures. Further, “Securities and Exchange Commission (Mutual Fund) Regulations, 1997” was adopted to make capital market more efficient and transparent. In addition, the Investment Corporation of Bangladesh (ICB) has been thoroughly reorganised and registered as three subsidiary companies for simplifying institutional investments in order to facilitate asset management, merchant banking and securities broking. As an alternative IPO valuation method, the book building method was introduced in Bangladesh capital market on 11 March 2009. All these are supposed to attract more manufacturing enterprises in the capital market to source capital.

2.3.3 Privatisation of State Owned Enterprises (SoEs)

Immediately after the independence in 1971, all major industries such as jute, textiles, chemicals, etc. were nationalised under a nationalisation programme. Performance of these government owned enterprises was poor and most of the enterprises incurred substantial financial deficits, which had to be financed from the government budget and government-administered credit allocation from the nationalised commercial banks. As early as 1975, government took measures to divest state ownership of these enterprises as part of its long-term programme of privatisation. During the period of 1976-1992, about 500 SOEs were privatised either by selling them or returning them to their former owners. Where immediate privatisation was not possible, government pursued restructuring of some of the statutory corporations or manufacturing entities.

The industrial policies of the 1990s (introduced in 1991 and 1999) were, by and large, extension and refinement of the policies proclaimed in the 1980s. To remove coordination problem among various public agencies with regard to privatisation, the “Privatisation Commission” was established in 1993. It is empowered to perform all necessary formalities regarding privatisation. During March 1993 to June 1996, 12 SOEs were handed over to the private sector although the Privatisation Board had listed 105 enterprises for privatisation in 1993-95. In order to accelerate the privatisation process, government took further institutional measure. As part of those initiatives, the Board as Privatisation Commission was remodeled by the Privatization Act, 2000. This came into effect from February 2002. The law empowers the Commission to adopt alternative means to sell out the SOEs. Related to the provisions of this law, a detailed policy titled as "Privatization Policy 2001" has also been formulated. Subsequently, this policy had been revised to make it more consistent with the widespread economic reform programmes and socio-economic development imperatives of the government.

Since the establishment of the Privatization Board in 1993 and thereafter the Privatization Commission in 2000, 74 SOEs have been privatised till 2009–54 were privatised through outright sale and 20 through offloading of shares.[8] As of January 2010, 22 SOEs have been included in the Commission's current programmes for privatisation. The pace of privatisation has remained slow until now, although in 2003 Government took a drastic measure to close down the largest jute manufacturing enterprise–Adamjee Jute Mills. Privatisation of this Jute Mill was associated with various supportive measures for the works. However, the current government is pondering to revert the privatisation decision of the Adamjee Jute Mills.

2.3.4 Trade Liberalisation

Successive governments pursued gradual and sometimes abrupt trade liberalisation policies using import policies, export policies and exchange rate policies. Throughout the 1970s, pursuance of import substituting industrialisation strategy called for extensive use of quantitative restrictions on imports complemented with high tariff and non-tariff barriers. This strategy was further propelled by fixed exchange rate policy. Since the early 1980s export oriented industrialisation became the motto of industrialisation, though import liberalisation may be considered moderate throughout the 1980s. Liberalisation of the foreign trade regime mainly started in 1982 with the launching of the *Trade and Investment Policy (TIP)* as part of the SAP. Following recommendations of the TIP, Government undertook a series of reform measures to liberalise the protective regime with special attention given to removing non-tariff barriers, reforming tariff structure, and simplifying import procedures. Trade liberalisation policies have also included liberal export and import policies.

A major change during this period is the replacement of import licensing system by import against letters of credit (L/C) introduced in 1984. Import Policy Orders (IPOs) before 1986 contained a positive list (list of importable items). Since 1986,

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[8] See Privatization Commission, Bangladesh at http://www.pc.gov.bd/ accessed in June 2010.

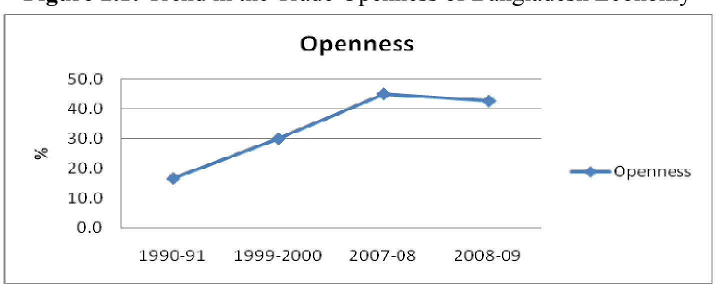
the system introduced a negative list and a restricted list for numerous commodities; commodities not on either of these lists could be imported without any official authorisation. Over time the number of commodities in the negative and restricted list has been reduced. Since 1990, the negative and restricted lists were unified into a "consolidated" list (Ahmed 2001).

Continued reform of the tariff regime has extended significant impact on the openness of the economy. From a mere 17 per cent trade openness[9] in 1990-91, the economy has reached openness level of 43 per cent in 2008-09. Maximum import duty of 150 per cent in 1993 has been gradually reduced to 32.4 per cent in 2003 and 25 per cent in 2009. Tariff slabs have also been reduced from 9 to 5 in 2003 and 4 in 2009.

With the gradual reduction of tariffs the unweighted average and weighted average rates of protection decreased substantially in the past ten years, as shown in Table 2.11 and Table 2.12. During the same period unweighted and weighted average tariffs on types of goods–primary, intermediate, capital and final consumer goods–have been reduced.

The export and import policies during the 1990s aimed at easing import and expanding export for rapid private sector led industrialisation. During this period the tariff structure of the economy went through significant rationalisation and downward adjustment. Between 1991/92 and 2006/07, unweighted average tariff rate declined from high at 70 per cent to low at 12.5 per cent.[10] Both exports and imports grew at two-digit rate during most of the years in the early 1990s. Since 2003-04, export growth has been sustained at a double-digit level.

Figure 2.1: Trend in the Trade Openness of Bangladesh Economy



Source: Based on data from *Bangladesh Economic Review*, various issues.

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[9] Trade openness is measured here as sum of the absolute values of import and export expressed as percentages of respective year's GDP.
[10] Bakht and Ahmed (2010).

TABLE 2.11

IMPACTS OF TARIFF REFORMS ON AVERAGE RATE OF CUSTOMS DUTY

Fiscal Year	Unweighted Average (%)	Weighted Average (%)	M.F.N Unweighted Average (%)
1992-93	47.40	23.60	
2000-01	17.20	12.29	21.39
2001-02	17.13	9.73	21.01
2002-03	16.50	12.42	19.88
2003-04	15.69	9.84	18.85
2004-05	13.54	9.59	16.53
2005-06	13.41	8.44	16.39
2006-07	12.21	6.95	14.87
2007-08	13.44	7.59	17.26
2008-09	12.27	6.89	15.12

Source: National Board of Revenue, quoted in *Bangladesh Economic Review* 2009.

TABLE 2.12

EFFECT OF TARIFF REFORM ON AVERAGE RATE OF CUSTOMS DUTY BY COMMODITY TYPE

FY Classification	FY05		FY06		FY07		FY08		FY09	
	UW Av %	Wt Av %	UW Av %	Wt Av %	UW Av %	Wt Av %	UW Av %	Wt Av %	UW Av %	Wt Av %
Primary goods	17.61	8.99	17.83	6.93	16.58	4.36	17.72	3.59	4.72	10.09
Intermediate goods	12.46	12.72	12.24	9.33	10.55	8.55	12.23	8.85	7.2	11.01
Capital goods	7.28	5.22	7.45	5.16	6.21	4.48	7.72	7.33	5.2	5.85
Final consumer goods	18.22	15.08	18.13	13.44	17.20	12.80	17.78	13.95	9.57	18.43

Source: National Board of Revenue, quoted in *Bangladesh Economic Review 2009*.

Because of trade liberalisation, the number of products under import restriction or ban has gradually dropped from 550 in 1986/87 to 63 in 2003/06. The 2006-09 import policy order declared import control on 25 products only. Complementary to the reduction of tariffs on imported raw materials during the 1990s, the export oriented industrialisation strategy has been rationalised by continuing with and, in some cases, by further deepening of various other incentives and supports for export promotion such as subsidised interest rate on bank loan, cash subsidy, exemption from value added and excise taxes, bonded warehouse facility, duty free import of machineries and inputs, export credit guarantee scheme, income tax rebates for exporters, etc. According to the policy of subsidised interest rate for export, exporters are allowed to borrow from banks at lower bands of interest rates compared to the regular rates for the industry sector in general.

Special facilities are also given to industries in EPZs. The EPZ entrepreneurs can import raw materials, supplies and capital goods free of duty, retain foreign exchange earnings, operate in a working environment where labour unions are allowed in a limited scale and exempt from paying income tax for ten years after setting up of the enterprise (Bakht 2001). The export policy for 2006-09 gave particular attention to export diversification and market development. Various donor–funded projects and programmes are being implemented to provide special business development incentives to prevailing and prospective export sectors.

The export promotion measures initiated in the late 1970s were fortified throughout the 1980s. Such export promotion measures included special credit facilities towards export industries, provision of working capital loan, export credit guarantee scheme, back to back L/C facilities, reduction of import duty on imported raw materials and machinery, provision of bonded warehouse, duty drawback, etc. Moreover, an Export Performance Benefit (XPB) scheme was introduced. This scheme allowed an enterprise to use its foreign exchange earnings from export to import inputs or to sell foreign exchange in the free foreign exchange market.[11] The domestic currency was devalued to a large extent in 1985/86 prior to the initiation of three-year SAF in 1986 (Bakht and Bhattacharya 1994).

2.3.5 Exchange Rate Policy

As a part of its trade liberalisation attempts, Bangladesh implemented various reforms in its exchange rate policy. During the import substitution phase of industrialisation Bangladesh maintained an overvalued and fixed exchange rate system to maintain equilibrium in balance of payments till 1980. This system was replaced by a "managed floating" system in 1980. Taka was pegged to a basket of currencies of the major trading partners of the country. Thus until 1992 the Bangladesh Bank administered a multiple exchange rates regime that in effect became a source of implicit tax on trade causing restrain on export and import.[12] In order to improve to increase trade and openness of the economy, the Bangladesh Bank in 1992 merged the official and secondary exchange rates. However, the government continued with some degree of administrative intervention in the foreign exchange market. The Bank continued to intervene and adjusted the official

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[11] With the unification of exchange rate system in 1992, XPB scheme was abolished.
[12] Yunus (2010).

exchange rate in response to changes in the real effective exchange rate, changes in macroeconomic indicators, and current account deficit. Accordingly, until May 2003, the Bangladesh Bank intervention in the foreign exchange market consisted of a combination of currency basket, pegging and managed flexibility. This policy led to several adjustments in the exchange rate of Taka vis-à-vis US dollar. The exchange rate was Tk.61.39/US$ in FY05; and Tk.69.03/US$ in FY07 and remained sticky around that level since then. The response of the exchange rate to government intervention in the foreign exchange market during the FY01 and FY 09 periods is shown in Table 2.13.

In May 2003, the Bangladesh Bank introduced a floating exchange rate policy. According to Hossain and Ahmed (2009), the government intervention was closed to fixed regime in recent years. If true, it will adversely affect the private sector incentive structures. The pro-export bias in the exchange rate policy together with strict measures in controlling money laundering, supported by the Money Laundering Act, has also contributed to the building of the foreign exchange reserve.

TABLE 2.13

AVERAGE EXCHANGE RATE (TAKA PER US$)

Fiscal Year	Rate (Tk./US$)
2001-02	57.43
2003-04	58.94
2004-05	61.39
2005-06	67.08
2006-07	69.03
2007-08	68.60
2008-09	68.80

Source: Bangladesh Bank, *Economic Trends*, 2010.

2.3.6 Policy towards Small and Medium Enterprises

As a source of decentralised employment and industrialisation in the economy, small, medium and cottage industries have received special attention in recent policy reforms. It may be noted that small and cottage industry was never declared as a priority sector before 1986 and there were lacks in comprehensive policies for overall development of this industry. The RIP of 1986 was the first policy to declare small and cottage industry as a priority sector and set forth various measures for its development. Considering problems faced by small and cottage industries in accessing formal finance, this policy suggested measures to ensure easy access to formal credit for this sector. In this connection, financial institutions and banks were required to keep a certain percentage (5 per cent) of their funds for this group of industries. The Industrial Policy of 1991, however, eliminated the concessionary interest rate and special credit facilities for them in an effort to comply with the financial sector measures which entailed flexible interest rates and various credit reforms. Recent industrial policies have put forward some special measures for the SMEs. One of the prime objectives of the Industrial Policy of 2005 is to expedite the growth of industrial sector through the growth of SMEs and cottage industries. It is expected that growth of SMEs would help generate employment for a large number of poor people.

For development of SMEs, an entrepreneurs' equity fund was established in 2000. It provides equity to SMEs in agro-based industry and ICT sector through commercial banks. Bangladesh Small Industries and Commerce (BASIC) Bank Limited, a specialised public commercial bank, was established in 1988 with the aim of financing small and cottage enterprises and mandated in its Memorandum of Articles that at least 50 per cent of its loanable fund should be invested in small scale industries. Different donor funded projects such as Enterprises, Growth and Bank Modernization Program (EGBMP), Small and Medium Enterprise Sector Development Project (SMESDP) are being implemented for the development of the SME sector.

To provide financial support to the SMEs, especially to remove the inertia of commercial banks and other financial institutions (FIs) in providing *risky* loans to the SMEs, the government has created a Small Enterprise Fund (SEF) and a Tk 1 billion refinancing scheme under the Bangladesh Bank in 2003-04. In addition to the government of Bangladesh, the World Bank (WB) and the Asian Development Bank (ADB) have also contributed to this fund. All the scheduled banks and FIs can avail this fund at bank rate (5 per cent) against their financing of SMEs. The lending institutions then decide on the lending rate towards the SMEs. This scheme allows participating institutions to disburse loans to SMEs without real estate based collateral as their risks are covered through refinancing facility and they can accommodate any additional cost of loan administration through an appropriate spread between the borrowing and the lending rates. Though it is expected that SMEs will get loans at a lower or privileged interest rate under this scheme, reality does not meet that expectation. Therefore, government has asked various banks and financial institutions to keep special desk for SME financing. Up to June 2009, Bangladesh Bank has disbursed Tk.334.25 crore for financing of this programme.

Until 2005, there was no separate policy on small and medium enterprises. Such a policy could define SMEs in clear terms (in terms of assets or employees), general principles supporting SMEs and specific services provided in the form of funding support, technology innovation, expansion of marketing and service systems, and improvement in the enabling environment for SMEs.[13] Government policy toward SMEs is also ambiguous. Programmes have been undertaken without strengthened policy and regulatory framework for SMEs. Accordingly, SME policies were drafted in 2005 and the Small & Medium Enterprise Foundation (SMEF) was formally inaugurated in 2007.

Government industrial policy towards SMEs currently focuses on direct support, such as subsidised industrial estates, direct purchasing of cottage industry products, and subsidised business development services and credit. These policies, while costly to the government, have proven largely ineffective in promoting new activities. Instead, in many cases they have tended to distort the policy environment and create new obstacles to growth for most existing businesses.[14]A more sustainable approach would be to focus on removing distortions and regulatory burden in the economy as a whole. For example, fiscal policy and tax administration should be reviewed to remove provisions that discriminate against sole proprietorships or create vicious incentives for firms to remain small to avoid taxation. Tax rates should be rationalised so that incentives for collusion with tax collectors and under-reporting are mitigated. In this connection, the tax code should be kept simple to understand.

2.3.7 Access to Land

Access to land is considered to be a major constraint of manufacturing sector. Weaknesses in the administration of existing laws and regulations governing the registration and transfer of land impede investment and enterprise level operation. Problems associated with land titling and appropriate legal framework prevent enterprises, especially SMEs, from having access to leased premises. This process requires secured collateral and SMEs often lack such collateral for their business. Also, SMEs do not have easy access to government-administered industrial estates. Mismanagement and corruption in allocation of industrial estate premises have caused serious financial losses to the government. Government is yet to take up any major programme in this area. Government is planning to develop several special economic zones, high-tech parks, etc. to address the crisis of industrial land. However, not much development has been achieved in this regard. In establishing new manufacturing enterprises, government is determined to strictly follow the land zoning policy to be developed by the Land Ministry.

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[13] Yunus (2010).
[14] Yunus (2010).

2.3.8 Legal and Regulatory Framework

The legal and regulatory framework in Bangladesh is characterised by pervasive, archaic, unnecessary laws, vague and discretionary regulations, and flawed and weak enforcement. Amongst these, the following are some of the more critical ones: (a) contract enforcement and dispute resolution, (b) bankruptcy; (c) copyright protection, (d) labour laws, (e) land titling and transfer procedures; and (f) company registration and factory licensing.

Property rights, including over financial assets, are poorly explained and not protected by the law. The sale and mortgage of land is regulated by the Transfer of Property Act of 1882, the Stamp Act of 1882, and the Registration Act of 1908. The three acts, in their present form, are inconsistent. Transfer of land is subject to a complicated registration process on which stamp duties and registration fees must be paid. False title documents make purchase and sale of land and the use of land to access credit difficult. Transparent, efficient land administration system that provides secure property rights through enforceable contracts is an essential requirement for the development of manufacturing sector, especially in enabling enterprises to access finance.

The Bankruptcy Act was introduced in 1997. Its application has been ineffective due to inefficiency of the judiciary system to settle lawsuit cases. It still takes 4 years to go bankrupt, costs of insolvency is 8 per cent of the estate and 23 per cent of the investment can be recovered.[15]

All enterprises operating in the formal economy are required to conduct business after obtaining trade licenses issued by the local government (or city corporations in the six municipalities). Enterprises requiring only trade license to operate business are proprietorship concern and partnership. Enterprises operating as limited liability companies are required to have both trade license and registration with the Registrar of Joint Stock and Companies (RJSC). The process of obtaining licenses is relatively straightforward, but business entrepreneurs are invariably required to pay unofficial fees for securing the licenses and additional fee each year for annual renewal of the trade license. Winding up of companies is subject to a complicated process, requiring a host of legal formalities. To change objectives of a company to respond to some changes in the market becomes extremely difficult. Similarly, mergers and acquisition of companies entail substantial cost and time due to cumbersome documentation requirement and legal processes.

Enterprises are required to obtain a wide range of other licensing requirements from central and local government authorities. These include registration with the

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[15] World Bank. *Doing Business, 2008 (South Asia).*

Board of Investment (BOI) and Bangladesh Export Processing Zone Authority (BEPZA) for foreign and joint-venture companies, inspector of factories, shop and establishment, registration for obtaining import and export licenses, fire protection certificate, environment and sanitation certificate from local authority, tax and VAT registration with the NBR, product registration with Bangladesh Standards and Testing Institution (BSTI), and several others. Enterprises often have to pay substantial amount of unofficial fees for obtaining these licenses and certificates in addition to the administrative burden of obtaining such licenses from multiple institutions. Recently the Federation of Bangladesh Chamber of Commerce and Industry (FBCCI) has opened a window to process trade licenses on behalf of enterprises.

2.3.9 Competition Policy

There is no competition policy in Bangladesh although the government approved a consumer protection law in 2004. Monopolies and Restrictive Trade Practice (Control and Prevention) Ordinance, 1970 has not been implemented but still valid. However, government policy measures increasingly aimed at private sector development are directed at creating an environment for fair competition. Currently, International Finance Corporation (IFC) of the World Bank Group is helping government and the private sectors in drafting a competition law.

Recent investment and business climate surveys have reported that the level of competition in the private segment of the domestic market has improved due largely to changes taking place in the structure of the economy.[16] But the market is becoming more dominated by large firms. However, availability of backward linkage support from local sources is expanding the role of SMEs in a competitive economy.

2.3.10 Environmental Policy and Regulation

Environmental policy and regulations are developed and issued by the Department of Environment of the Ministry of Environment and Forest. A survey of business competitiveness in Bangladesh[17] revealed that Bangladesh does not maintain environmental regulations in a standard which can be compared with other countries. Entrepreneurs are often unaware of government environmental policies and regulations. Further, frequent changes in government environmental regulations and standards have tended to affect businesses and their competitiveness, especially

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[16] Yunus (2010).

[17] Centre for Policy Dialogue (2004a), *Business Competitiveness Environment in Bangladesh 2004*. September 2004.

firms operating for the export market. Non-compliance with environmental concerns is often due to collusive action between enterprise management and government regulatory administrators who benefit from unofficial payments from the former. Environmental compliance has become an important issue for entering the international market. Therefore, future expansion of manufacturing sector needs to undertake various initiatives to comply with environmental requirements. As various manufacturing enterprises consider setting up of effluent treatment plant to be costly, central effluent treatment plant by the government or by private sector may be thought of. A private company is now setting up such a plant in Chittagong EPZ.

2.3.11 Global Economic Crisis and Strategies towards Manufacturing Sector

Since the beginning of FY2010, the external sector experienced a deepening impact of the global economic crisis.[18] The FY2010 budget announced several measures to tackle the short run impact of the crisis on export industries as well as medium to long term social impacts e.g. on employment, education, health, and social protection. These measures include:

- Stimulus package including increased cash incentives to heavily affected sectors and special incentives for readymade garments sector;
- Reduction of bank interest rate to 12-13 per cent;
- Rescheduling facilities for loan reimbursement
- Expansion of the export development fund;
- Withdrawal of license renewal fees payable by the captive power users;
- Measures to solve problems of sick enterprises including garment units;
- Rehabilitation of retrenched workers from abroad and provide them with skill development training;
- Diplomatic initiatives to prevent retrenchment of workers and explore new labour markets abroad;
- Emphasis on public-private partnership for employment generation, infrastructure development, increased investment and strengthening private sector.

[18] The year 2009 experienced the first contraction of the global economy in the post World War II era. The global economic activity, which grew by 3.1 per cent in 2008, is estimated to have declined by 1.4 per cent in 2009 and is expected to rise modestly by 2.5 per cent in 2010. The volume of world trade grew by 2.9 per cent in 2008, but contracted by 12.2 per cent in 2009.

2.3.12 Stimulus Packages

In order to address the adverse impacts, especially on the real economy, the government set up a high powered task force and took up fiscal stimulus packages covering a variety of measures including support to agriculture and small and medium enterprises, expansion of safety nets, employment generation, strategic industries support, and others. The first stimulus package worth US$ 500 million was announced in April 2009, of which 13 per cent was allocated for cash subsidy to selected export industries, 44 per cent for agriculture, 18 per cent for energy, 15 per cent for agricultural credit, and 11 per cent for social safety nets. The cash subsidy from this package was allocated mainly to provide support to three worst-hit sectors–jute and jute goods, frozen food, and leather and leather products. Cash subsidy rate for each of these sectors was increased by 2.5 per cent. Of the total export incentive, 70 per cent was released immediately.

In the FY10 budget, the government provided another US$ 725 million as a means to offset the adverse impact of contraction in external demand and rebalance growth toward domestic demand. While the intent to boost spending is clear, the challenge, however, is to determine where and how to increase spending and ensure the capacity to plan and implement effective spending programmes. However, none of the first two packages provided direct allocation to the RMG sector.

In November 2009, the third stimulus package was announced, which made special provisions for the RMG sector. This package included provisions of cash incentives for the exporters to new markets (markets other than the US, Canada and EU), special incentives for SMEs in RMG sector those have exported up to US$3.5 million, subsidy on electricity usage (of 10 per cent usage) until 30 June 2010 for SMEs who do not have own captive or diesel run generator, L/C amendment and transfer fees, etc. The limit of the Export Development Fund (EDF) is planned to be raised by combining the resources of three commercial banks, while the government will create a Contributory Fund with Tk. 300 crore (US$ 42.9 million) as seed money. In addition to supports for the RMG sector, the third package also included cash incentives for export-oriented yarn sector and for shipbuilding and crust leather sectors. Besides, arrangements were made for additional subsidy on export income related to export of new commodities and export to new markets in textile sector. Later, some of the incentives of this stimulus package were readjusted. One of them is to provide an extra 5 per cent export incentive to small and medium textile industries in FY2009-10 based on the level of export income of the preceding year.

In the budget of 2010-11, the government has declared to continue with the support to export sector through stimulus package. Taka 2,000 crore has been allocated for this purpose.

2.3.13 Infrastructure

Infrastructure constitutes one of the major impediments to industrial development in Bangladesh. It is widely acknowledged that greater investment and/or better performance from existing infrastructure facilities would have high returns in terms of reduced costs of doing business. In a recent perception survey of a sample of exporters, it was found that exporters considered electricity and port facilities to be the most serious infrastructure related bottlenecks encountered by them. Bangladesh faces serious problems of power shortages. A picture is presented in Table 2.14, which also expresses that electricity production on quick rental basis will generate more surpluses in future.

The opening of the power generation activities to the private sector has been a positive development. But pouring more power into the system is not the only way of coming to grips with problems in this sector. Much more needs to be done with regard to outdated transmission and distribution lines, load management and above all huge system, transmission and distribution losses.

Electricity, gas and water connection charges and security deposit costs are significantly high in Bangladesh than in the neighbouring and other Asian countries. Until recently telephone connection charges in Bangladesh were among the highest in the world. The official cost including security deposit plus unofficial payments for obtaining a telephone line connection from the erstwhile government monopoly, BTTB, amounted to US$400 to US$500, which is among the highest in the Asian countries. However, with the advent of the mobile, the BTCL is currently offering landline connection free of charge.

TABLE 2.14

YEAR-WISE POSSIBLE POWER DEMAND AND SUPPLY

(Considering sufficient supply of energy according to demand)

	2009	2010	2011	2012	2013	2014	2015
Probable demand (MW)*	5,566	5,808	6,298	6,832	7,709	8,699	9,812
Capacity retired (MW)*	-	48	-	-	448	378	-
Expected supply excluding quick rental (MW)*	4,289	4,956	5,177	7,029	8,326	9,545	11,625
Expected supply including quick rental (MW)*	4,289	5,109	6,363	8,683	9,764	10,527	12,601
Deficit/surplus excluding quick rental (MW)*	-1,277	-852	-1,121	197	617	846	1,813
Deficit/surplus including quick rental (MW)*	-1,277	-699	65	1,851	2,055	1,822	2,789

Source: Towards Revamping Power and Energy Sector: A Road Map, Ministry of Finance 2010.

Bangladeshi enterprises pay high service cost in accessing services of port facilities. The cost incidence is higher when unofficial payment and demurrages charges are imposed on enterprises in negotiating with port/land customs management. Further, enterprises also incur undue operational costs because of interruption in utility services. For instance, enterprises in Bangladesh lose about 3.4 per cent of their sales due to power outages. Large enterprises have to run their own generators that increase their capital and operational costs. SMEs do not have adequate resources to purchase generators and thus they struggle to stay in business despite the disruption to their operations due to interruption in availability of utility services in addition to the high cost of these services.

2.4 FISCAL INCENTIVES DIRECTED TOWARDS MANUFACTURING SECTOR: EVOLUTION OF CORPORATE TAX REGIME IN BANGLADESH

Corporate income tax is the income tax levied on corporate entities like private and public limited companies, incorporated under law, on their total income including profits and gains from business. In developed countries, corporate income tax constitutes a dominant component of tax revenue earned by the government, and in many cases, revenue from this source exceeds revenue earned from personal income tax. With economic growth, the corporate segment of the economy is expected to grow and, therefore, corporate income tax remains a potential source to tap as the government strives towards raising the tax-GDP ratio in Bangladesh.

The corporate tax is generally levied at a flat rate and is applied to net profit calculated as the excess of receipts over admissible costs. Unlike personal income tax, there is no basic exemption limit in the case of corporate tax.

There are two main controversies surrounding the concept of corporate tax. The first relates to the issue of double taxation. Income from individual proprietorship is covered under personal income tax and hence is taxed only once. In contrast, income of the corporate sector gets taxed twice–once as corporate income tax on the income of the company and again on the same income when distributed as dividend to the shareholders. This leads to a bias against incorporation of business and in favour of individual ownership or partnership, thus being discriminatory. This would also encourage companies to retain their equity earnings rather than distribute them.

The second issue relates to the difference in the treatment of interest income and dividend income. In calculating company's net profit, interest payment on debt finance is deducted but dividend payment is not. This creates bias in favour of debt-finance as opposed to equity finance and encourages business to take loan from the banking system or through debentures rather than raising equity, thus burdening the business with more risk.

Ideally, a neutral tax regime would require an integrated tax system in which a company is not taxed on its profit but only its shareholders are taxed on the distributed or retained profits. However, a number of practical difficulties render such a system operationally infeasible. First, the system would require all the profits of the company to be distributed to the shareholders, which is usually not the case. To the extent that the company retains part or whole of the profit, it will remain untaxed. It would also be difficult to tax by notionally attributing the retained profits to the equity holders. Second, in terms of administration, it would be a gigantic task to attribute dividends to a great number of individual shareholders who might have held it for only a part of the year.

Because of these practical problems, Bangladesh like most countries in the world opted in favour of taxing the companies as independent entities. However, historically, the rate of corporate tax has been high and quite differentiated in Bangladesh. As shown in Table 2.15, in 1991-92, the tax rate was 40 per cent in the case of publicly traded industrial companies, 45 per cent in the case of non-publicly traded companies and 55 per cent in the case of banks, insurance companies and financial institutions. During the 1980s, the rate of corporate tax on the last category was as high as 60 per cent. In recent years, the rate has been reduced for all categories, albeit by a greater extent in the case of publicly traded companies.

TABLE 2.15

TREND IN THE RATES OF CORPORATE TAX IN BANGLADESH (%)

Income tax year	Publicly traded companies	Non-publicly traded companies	Banks, insurance companies & financial institutions	Mobile phone operator company
1991-92	40.0	45.0	55.0	-
1998-99	35.0	40.0	40.0	-
2002-03	30.0	35.0	40.0	-
2003-04	30.0	37.5	45.0	-
2006-07	30.0	40.0	45.0	-
2007-08	30.0	40.0	45.0	45.0
2008-09	27.5	37.5	45.0	45.0
2009-10	27.5	37.5	45.0	45.0

Source: National Board of Revenue.

In a bid to provide support to the share market, the actual applicable rate of corporate tax in the case of publicly traded companies has been linked to dividend payment. Thus, during 2000-2001 and 2001-02, the stipulated 35 per cent corporate tax for publicly traded companies allowed 10 per cent rebate on tax if more than 25 per cent dividend was declared. In 2002-03, the rate of corporate tax was brought down to 30 per cent and 10 per cent rebate was allowed if more than 20 per cent dividend was declared. The system of tax rebate continued in 2003-04 but the budget 2003-04 raised the tax rate for non-publicly traded companies from 35 per cent to 37.5 per cent and included the provision that the publicly traded company will have to pay the same corporate tax as a non-publicly traded company at 37.5 per cent if it declares less than 10 per cent dividend or if it does not pay the dividend within the time limit set down by the SEC. The same provision has been continued till date. In the case of mobile phone operators, the budget 2009-10 allows a lower tax rate of 35 per cent if the company gets listed by transferring a minimum of 10 per cent of its paid up capital in the share market.

The linking of tax rate with dividend payment has been useful in strengthening the share market. A logical follow up of these measures would be to have the provision of graduated higher tax rebate given to the companies declaring even higher dividends, which was also recommended by the Revenue Commission of 2003, but so far has not been implemented by the NBR.

Despite significant reductions, the rate of corporate tax still remains misaligned with the rate of personal income tax in Bangladesh and, therefore, continues to favour individual proprietorship over incorporation. It stands to reason that the rate of tax on companies should be so harmonised that it should not exceed the marginal tax rate on individuals, which in Bangladesh currently stands at 25 per cent for the highest income slab. As the report of the last Revenue Commission of 2003 stated "there is no justification for taxation of company profits at a rate higher than the highest marginal tax rate for individuals, because had these profits been taxed in the hands of the shareholders, who are the real owners of the company, these could not have been taxed at a higher rate than the highest marginal tax for individuals."

A gap of 10 per cent difference in the corporate tax rate between listed and unlisted companies is understandable for encouraging companies to go public. However, in practice, this did not yield expected result partly because of the high tax rate that applied to the listed companies. Therefore, the attempt to bring unlisted companies in the share market will have a better chance of success if the base rate applicable in the case of listed companies gets harmonised with the marginal tax rate for individuals.

The rate of corporate tax on financial institutions has been historically high in Bangladesh. In 1998-99, it was reduced significantly from 55 per cent to 40 per cent, only to be jacked up again to 45 per cent in 2003-04, at which level it has remained till date. In 2007-08, the mobile phone operator companies were included in this group of the highest corporate tax rate.

The logic behind high rate of corporate tax on banks and financial institutions is presumably the high rate of profit, which these service industries enjoy. However, such a perception ignores the fact that in Bangladesh, cost of fund has persisted at a very high level despite repeated government attempts to bring down the interest rate. The existing high rate of corporate tax on financial institutions seems to be a crucial factor in this context. Lowering the tax rate for these companies would not only contribute towards reduced rate of interest and thereby stimulate investment but it would also have a favourable impact on the overall capital market. Similarly, the sharply falling call-rates in the face of intense competition amongst the mobile phone operators needs to be reciprocated with downward adjustment in their corporate tax rate in order to facilitate rapid growth of connectivity in the country, which would be crucial for achieving the objective of digital Bangladesh by the target period.

2.4.1 Tax on Dividend Income

As mentioned earlier, a system of corporate tax along with tax on dividend income amounts to double taxation and thus discourages large investments that cannot be undertaken under individual proprietorship or partnership. We explained earlier why an integrated system of taxation in which a company is not taxed on its profit but only the shareholders are taxed on dividend received is not feasible from the point of view of implementation.

Until 1999-2000, the shareholders were liable to pay tax on the dividends received by them from the distributed profits of the company by adding the amount received as dividend to their other incomes and paying income tax at the rate applicable. In a bid to address this issue of double taxation, attempts were made to give some form of relief or credit in the case of taxation of dividends.

Thus, in 1999-2000, dividend income up to Tk. 30,000 was exempted from tax and the exemption limit was raised to Tk. 100,000 subsequently. But in 2002-03, the limit was brought down to Tk. 25,000 with the condition that such dividend income was fully liable to tax if the amount exceeded Tk. 25,000.

In a bold move in the following year, the budget 2003-04 eliminated tax on dividend income at shareholder's hand but introduced the new system of dividend distribution tax at the rate of 10 per cent on the companies declaring dividends when individuals are dividend recipients. This amounted to a system of tax withholding. When the recipient of dividend is a company, tax has to be paid at the rate of 15 per cent of dividend income.

Making dividend income tax free in the hands of the shareholders has been helpful in reducing the total tax liability of the shareholders and in easing the process of tax administration and, thus, is considered a step in the right direction. But in the interest of completely eliminating double taxation and thereby creating a favourable impact on investment, abolition of dividend distribution tax merits strong consideration, especially at the current stage of development in Bangladesh. Incidentally, this was also one of the recommendations of the Revenue Commission 2003 that has not been implemented by NBR.

2.4.2 Tax Holiday and Accelerated Depreciation Allowance (ADA)

2.4.2.1 Tax Holiday

Tax holiday is a fiscal incentive for investment, which provides exemption from payment of corporate tax during the "holiday" period. Tax holiday has been in force since the Pakistan days and has continued till today. Although its abolition has been talked about many times but there has always been a strong resistance from the private sector against abolition of tax holiday and ultimately the government yielded to the pressure, which extended the life of the tax holiday period. Thus, the Finance Act of 1991 indicated the duration of the facility up to June 30, 1995. Later this was extended up to June 30, 2000. The Finance Act, 2000 extended the facility up to June 30, 2005. The latest extension has allowed continuation of the system up to June 30, 2011. In the budget speech for 2009-10, the Finance Minister has announced that the system will be discontinued after the expiry of the stipulated period.

Tax holiday applies to private/public limited companies in selected industries. The list of these industries got enlarged over time. According to the budget 2009-10, investment in the following industries is eligible for tax holiday benefit.

- Textiles
- Textile machinery
- Jute goods
- High value garments
- Pharmaceutical
- Melamine
- Plastic products
- Ceramics
- Sanitary ware
- Steel from iron ore
- M.S. Rod
- C.I. Sheet

- Insecticide and pesticide
- Computer hardware
- Petrochemicals
- Agricultural machinery
- Boilers
- Compressors
- Basic raw materials of drugs, chemicals and pharmaceuticals
- Agro processing
- Ship building
- Diamond cutting

Currently, the tax holiday facility also includes production of a number of physical infrastructure, such as sea or river port, container terminals, internal container depot, container freight station, LNG terminal and transmission line, gas pipeline, fly over, mono rail, underground rail, telecommunication infrastructure other than mobile phone, large water treatment plant and supply through pipeline, waste treatment plant, solar energy plant and export processing zone.

Activities under tourism industry, which are now eligible for tax holiday, include residential hotels having facility of three-star or more.

Until 2002, tax holidays were provided for 5 years, 7 years, 9 years, 10 years and 12 years according to the location and/or nature of industries as noted below.

TABLE 2.16

DURATION OF TAX HOLIDAY PERIOD BY LOCATION PRIOR TO 2002

Location/Nature of industry	Applicable tax holiday period (years)
Developed areas	5
Less developed area	7
Least developed area	9
Export Processing Zone (pioneering industries specified by NBR)	10
Special economic zones	12

Source: National Board of Revenue.

Developed areas consisted of the metropolitan areas of the cities of Dhaka, Chittagong and Khulna and the municipality of Narayanganj and included areas within a 10-mile radius from the outer limits of these cities. Only Rangamati area was treated as special economic zone. Higher tax holidays were provided to less and least developed areas and special economic zones for dispersal of industries while 10-year tax holiday for pioneering industries located in the EPZs was for providing special encouragement to investments in those zones where foreign investments are particularly involved. The duration of the tax holiday was shortened after 2002 to 5-7 years—5 years for developed areas and 7 years for other areas.

One of the main conditions of eligibility for tax holiday is that the company while enjoying tax exemption during the holiday period must invest specified proportion of profit/exempted income in government approved bond or securities, which also included the stocks of public limited companies. The required proportion has varied over time from a low of 15 per cent in 1989-90 to a high of 50 per cent in 1990-91.

Until 2007-08, tax holiday allowed 100 per cent exemption from payment of corporate tax irrespective of the type of industrial units or their location. In the budget 2008-09, this was modified in the following manner and was made applicable for newly set up industries between 1 July 2008 and 30 June 2011.

TABLE 2.17

MODIFIED TAX HOLIDAY SCHEME APPLICABLE DURING JULY 2008 – JUNE 2011

Location of the industry	Provision of tax exemption
Dhaka and Chittagong Divisions except three hilly districts	• 100 per cent of income for first 2 years • 50 per cent of income for next 2 years • 25 per cent of income for next 1 year
Rajshahi, Khulna, Sylhet and Barisal Divisions and three hilly districts	• 100 per cent of income for first 3 years • 50 per cent of income for next 3 years • 25 per cent of income for next 1 year

During the tax holiday period the companies are required to submit income tax returns to the tax department and the department makes assessment of taxable profit. In this assessment normal depreciation allowances are allowed and losses incurred during the tax holiday period can be adjusted against profits earned during the same period but cannot be carried forward after the tax holiday period.

Although tax holiday facility was allowed only for newly established companies during specified periods, there was a tendency to abuse the facility by showing extensions of existing company as new entity. There were also attempts at taking undue advantage of the location criteria by setting up peripheral units in less developed areas while the principal unit remained located in developed area. In practice, the coverage of tax holiday was quite liberal. Although there was always a list of approved industries, an initial omnibus clause that allowed NBR to prescribe any industry eligible for tax holiday gave considerable flexibility in the system and resulted in the coverage of tax holiday to be quite wide.

By far the most serious adverse impact of the tax holiday was that it created impediment towards tax paying culture. A long period without taxes combined with the prospect of relatively high taxes at the end of holiday encouraged tax avoidance behaviour when the holiday was over. A common observed practice was for the company to report lower profits or even losses towards the end of the tax holiday period aimed at establishing a lower base of assessment when income became taxable.

2.4.2.2 Accelerated Depreciation Allowance (ADA)

ADA is an alternative fiscal incentive for investment. Investors who are not entitled to tax holiday can avail ADA. Those who are eligible for tax holiday also have the option of availing ADA as an alternative to tax holiday.

The rate at which ADA are allowed varied over time. The Finance Act of 2002 allowed 100 per cent depreciation allowance in the very first year of industrial units irrespective of their location. Currently, ADA is allowed on the cost of machinery for new industrial undertaking at the rate of 50 per cent in the first year of commercial production, 30 per cent in the second year and 20 per cent in the third year. ADA incorporates a loss carry forward provision for indefinite period making it more generous as an incentive.

It is advantageous for firms to opt for ADA rather than for tax holiday when they can perceive that the returns are likely to be low or negative in the initial years. In that case the tax holiday does not give them much relief. ADA, on the other hand, helps in such cases since these are carried forward for an indefinite future period when current profit does not cover such allowances fully. From the government revenue point of view, ADA are also a better form of tax incentive than a tax holiday, since the latter system causes loss of tax revenue for the full period of tax holiday, while the former postpones tax payment until the allowance is adjusted fully.

However, empirical evidence suggests that most firms eligible for tax holiday avail that facility instead of opting for ADA. This presumably is a reflection of the tax avoidance attitude that is induced by the tax holiday system.

The Revenue Commission of 2003 recommended abolition of tax holiday facility and its replacement by a uniform reduced tax rate for newly established companies. The suggested reduced tax rate was 10 per cent in the first two years, 15 per cent in the third and the fourth year and 20 per cent in the fifth year.

The Finance Minister in his budget speech for 2009-10 has indicated the following reduced tax structure after the discontinuity of tax holiday facility as of July 1, 2011.

Empirical evidence supports the notion that tax holiday facility contributed significantly towards tax evasion practices. While the system has been helpful in inducing investment, it has not been to the extent that could not be achieved with an arrangement of moderate an undifferentiated corporate tax system with provision for significantly reduced tax rates in the initial years of investment, as has been suggested by the Finance Minister. Hence, most reviewers have rightly concluded that tax holidays are poor instruments for promoting new investment and should be eliminated in tandem with reduction in corporate tax rates. However, the general recommendation is for continuation of ADA as an alternative scheme for fixed capital investment so as to provide incentives that are linked to actual investments. It may be mentioned here that a system of reduced tax is already in place for selected industries, particularly the export industries. The Finance Act of 2002 also provided for a reduced corporate tax rate of 20 per cent for industries set up between July 1, 2002 and June 30, 2005.

TABLE 2.18

SUGGESTED SCHEME OF REDUCED TAX RATE APPLICABLE AFTER ABOLITION OF TAX HOLIDAY

Location of the industry	Provision of tax exemption
Dhaka and Chittagong Divisions except three hilly districts (Rangamati, Bandarban and Khagrachari)	• 5 per cent of income for first 2 years • 10 per cent of income for next 2 years • 15 per cent of income for next 1 year
Rajshahi, Khulna, Sylhet and Barisal Divisions and three hilly districts	• 5 per cent of income for first 3 years • 10 per cent of income for next 3 years • 15 per cent of income for next 1 year

2.4.3 Bonded Warehouse

Bonded warehouse is a fairly old concept in customs law. The Sea Customs Act of 1878 provided for bonded warehouse. This was further broadened in scope by the Customs Act of 1969.

In relation to industrial enterprises, bonded warehouse can be put under two broad categories. The first relates to selected export industries in which an exporter can import raw materials, manufacture goods and export–all outside the tax net. It is a tool to facilitate production by enabling an export industry to import raw material duty free for being competitive in the world market. This is referred as the Special Bonded Warehouse for exports. Initially, the special bonded warehouse facility was extended to a handful of export industries including readymade garments, specialised textiles, leather, ceramics, and packaging industry. The Export Policy of 1997-2002 extended this to all industries recognised as 100 per cent export oriented industries.

The second category is the General Bonded Warehouse for industrial raw materials, which provides legal cover for temporary storage of non-duty paid goods that can be cleared subsequently at a convenient time on payment of duty and taxes. Thus, the producer is spared of paying the whole amount of duty at a time at an earlier date enabling him to build stock of raw materials and plan for a longer time. Thus, it amounts to a system of deferred payment of duty and taxes.

Bonded warehouse facility has contributed significantly towards industrial investment, particularly in the export sector. However, the procedure for setting up bonded warehouse has remained very lengthy and corruption prone. There is urgent need for revamping the system so that bonded warehouse can be set up in a simplified and transparent manner.

The main problem of bonded warehouse is that custom controls over the warehouse are insufficient and ineffective. This results in a large leakage of duty free imported goods into the domestic market and consequent loss of revenue and erosion of protection to domestic industry. To address these problems, the Revenue Commission of 2003 presented a set of recommendations, which do not seem to have been implemented so far. The highlights of these recommendations were as follows:

- The bonded warehouse should be required to maintain records to an approved standard to be audited periodically by customs auditors. There should be a comprehensive record of transaction showing all goods entered, stored, manufactured, destroyed or removed from the warehouse along with Bill of Entry number. Inventory adjustment made for other reasons will have to be supported by a document approved by customs.
- There must be annual reconciliation of physical inventory to Bill of Entry records. The reconciliation report must contain a description of goods for each Bill of Entry, quantity on hand at the beginning of the year, transfers to production and withdrawals during the year and quantity on hand at the end of the year.
- Audit, inspection and spot check will have to be carried out periodically by authorised customs officers to supervise transactions and procedures. Bonder's records, quantity counts in the inventory, spot checks of selected

transaction and procedure, review of conditions of record keeping, security and storage will all come under scrutiny in such occasions.

- There should be a system of bank guarantee ensuring realisation of import taxes if it is found that revenue is due. Such policies are common for bonded warehouse operations internationally.

2.4.4 Duty Drawback

Duty drawback is an arrangement whereby an exporter gets refund of duties and taxes paid on imported inputs used in the production of exported goods. Although the system is widely prevalent in the world, it suffers from some inherent disadvantages compared to other systems such as bonded warehouse. The main disadvantage is that it raises the cost of doing business. The exporter has to pay up-front and get the reimbursement after considerable delay following submission of documents and verifications, which adds to financial overheads.

To minimise the effect of this disadvantage, a dedicated Duty Exemption and Drawback office (DEDO) was established in Bangladesh in 1987. The objective was to ensure prompt and hassle free draw back. But the objectives remained largely unfulfilled as DEDO became quite prone to corruption and forgery.

To streamline the activities of DEDO and guard against forgery, DEDO should be fully automated with links with the automated systems of the NBR and the field customs offices and there should a comprehensive scheme of registration of all duty drawback recipients.

One of the main limitations of the existing duty drawback system in Bangladesh is that it provides partial refund to the extent of customs duty and VAT paid. Other para-tariffs such as infrastructure development surcharge, supplementary duty, etc. are not refunded. Because of this, the exporter does not get access to imported raw materials at international price, which erodes the competitiveness of his exports, particularly in view of the fact that most competing countries allow 100 per cent duty free access to imported inputs. This would also put the exporter at a relative disadvantage against compatriot exporter who has availed the bonded warehouse facility. For the sake of symmetric treatment of all exporters and retention of their competitive edge in the global market, the duty drawback system in Bangladesh needs to be modified to ensure full draw back covering all duties and taxes paid at the input import stage. The system should also be modified to cover deemed exporters who are currently left out of the benefits of duty drawback facilities.

One reason behind delay in getting the duty drawback arises from the fact that the exporter claiming drawback has to produce certificate of export-proceed realisation. This delay could be easily avoided if drawback was provisionally allowed based on evidence of export, which is the system in most other countries.

At present, there are two types of drawback rates in vogue–flat rate and actual rate. Flat rate is a rate on an unit of an export item predetermined by NBR. Actual drawback rate, on the other hand, is determined by DEDO and confirmed by NBR every time an item is exported. In the interest of quick disposition of the drawback claim, the coverage of flat rate should be regularly increased. Once the actual rate of an item has been determined by DEDO and drawback is granted on that basis, it should become a flat rate for that item for all subsequent exports made by any exporter.

2.4.5 Cash Incentive

Cash incentive is a provision to encourage backward linkages in export industries and stimulate non-traditional export sectors to become competitive. This was first introduced in the export policy of 1986-87 as an alternative incentive system for the readymade garment (RMG) sector to encourage the exporters to use local fabrics and to simplify the then existing incentive realisation procedure. The programme started with a cash assistance of 15% of the f.o.b price value of export of those garment industries, which will not avail bonded warehouse or duty drawback facilities. However, they were allowed to enjoy all other export incentives in force. According to the *F.E circulars 68 and 80* of the Bangladesh Bank, only those RMG enterprises will be eligible for this benefit, which use locally manufactured fabrics, where the fabric manufacturer has not availed of bonded warehouse facility for raw materials, nor has applied for duty drawback. Gradually, this incentive system has been expanded for other sectors and the rate was increased to 25 per cent of the f.o.b. price for some sectors.

Currently, cash incentive rates vary for different export industries and requirement of local raw material share also varies for different industries. For some sectors cash incentive is provided even when imported raw materials are used up to certain limit. Table 2.19 presents a picture of cash incentive provided for different sectors in recent years.

Table 2.20 presents the amount of cash incentives provided to different export industries for 3 years. It is noted that in all cases, the subsidy is fully disbursed. However, entrepreneurs usually complain that the procedure to receive the cash incentive is very cumbersome.

Cash incentive to various export industries is mostly perceived to have positive impact on export performance of the respective industries and also in creating domestic value addition. It is widely known that cash incentive to the RMG sector contributed to the growth of backward linkage industries in RMG, which helped to meet the rules of origin (RoO) requirement of many export markets of Bangladesh RMG. Thus the cash incentive scheme worked as a subsidy to the respective export industries and enabled them to enhance export competitiveness. However, there have been complains regarding the management of the cash incentive scheme. In 1998 the scheme was temporarily put on hold as it was discovered that large sums of money was misappropriated through submission of over invoiced papers by some exporters of *Jamdani Saree* to India. Another problem of cash incentive is the slow disbursement of the money to the entrepreneurs. While cash incentive may be a welcoming measure to enhance export competitiveness, its duration needs to be considered with care. The performance of the sectors which are receiving the incentive for a long period needs to be assessed to decide whether the incentive should be continued or not.

TABLE 2.19

CASH INCENTIVES TO DIFFERENT INDUSTRIES

Commodities receiving cash incentives	Rate of incentive				
	FY05-06	FY06-07	FY07-08	FY08-09	FY09-10
Local fabrics	---	5%	5%	5%	5%
Frozen shrimp and other fish	10%	10%	10%	10% (July-March) 12.5% (April- June)	12.5%
Leather products	15%	15%	15%	15%	17.50%
Products made of Hoogla, Straw. Coir of sugar Cane					
a) *If local raw material use is more than 80%*	a)20%	a)20%	a)20%	a)20%	a)20%
b) *If local raw material use is more than 50%*	b)15%	b)15%	b)15%	b)15%	b)15%
Agri and ago-processed products including vegetables and fruits	---	---	20%	20%	20%
Tobacco	10%	10%	10%	---	10%
Potato	20%	10%	10%	10%	10%
Bicycle	15%	15%	15%	15%	15%
Crushed bone	15%	15%	15%	15%	15%
Jute products	7.5%	7.5%	7.5%	7.5%	10%
Hatching eggs and day old chicks	---	15%	15%	15%	15%
Light engineering products	---	10%	10%	10%	10%
Liquid glucose (only for EPZ area)	---	---	20%	20%	20%
Halal Meat	---	---	20%	20%	20%

Source: Export Promotion Bureau.

TABLE 2.20

CASH INCENTIVE TO DIFFERENT EXPORT SECTORS (IN CRORE TAKA)

Sectors	2006-07		2007-08		2008-09	
	Allocation in Budget	Disburse-ment	Allocation in Budget	Disburse-ment	Allocation in Budget	Disburse-ment
Local fabrics	336.5	336.5	526.3	526.3	667.5	667.5
Leather products	45.4	45.4	100.9	100.9	146.8	146.8
Frozen shrimp and other fish	225.4	225.4	360.9	360.9	292.9	292.9
Agricultural products including vegetables and fruits	41.2	41.2	64.6	64.6	47.9	47.9
ago-processed products	13.7	13.7	27.7	27.7	43.0	43.0
Tobacco	8.6	8.6	14.8	14.8	5.1	5.1
Products made of Hoogla, Straw. Coir of sugar Cane	2.3	2.3	2.7	2.7	4.5	4.5
Crushed bone	0.5	0.5	1.2	1.2	1.0	1.0
Potato	1.2	1.2	0.9	0.9	0.6	0.6
Light engineering products	0.3	0.2	-	-	-	-
Hatching eggs and day old chicks	-	-	-	-	0.0	0.0
Halal Meat	-	-	-	-	0.5	0.5
Jute products, of which	125.0	125.0	170.0	170.0	290.6	290.6
Government	36.5	36.5	34.5	34.5	39.2	39.2
Private	88.6	88.6	135.5	135.5	251.5	251.5
Total	**800**	**799.99**	**1,270**	**1,270**	**1,500.3**	**1,500.3**

Source: Bangladesh Bank.

2.5 SUMMARY AND FUTURE STEPS

2.5.1 Proper Pacing and Sequencing of Trade Policy Reform

Rapid trade liberalisation carried out by Bangladesh does not seem to have contributed to broad based growth of export industries. The impact on domestic market oriented industries seems to have been mixed. An important shortcoming of Bangladesh's approach to trade liberalisation has been the failure to announce in advance the timetable of planned changes in the trade policy. The other major limitation of the past trade liberalisation measure in Bangladesh is that it has not been accompanied by complementary reforms in other areas to facilitate adequate supply response to the liberalisation measures. Future trade liberalisation measures, therefore, should correct for these two limitations. Planned changes in trade policy should be announced well in advance, and adequate steps should be taken to relax various supply-side bottlenecks.

As part of the trade reform measures, government pursued policies for export to enable entrepreneurs to take advantage of the expanding global market, especially under the WTO agreement. Government has also designed specific incentives to boost exports, such as duty drawback scheme, bonded warehouse for garment exporters, to boost exports.[19]

The government's poverty reduction strategy emphasises the need for diversifying the country's export base, especially in view of the uncertainty that clouds over Bangladesh's textile and garment export scenario under the post-MFA period.[20] However, the RMG sector in Bangladesh seemed to have coped well with post-MFA onslaught.[21] Development programmes designed to induce private sector investments into other exportable products have thus far had limited success. The key factors that will determine export diversification are those which relate to harnessing growth of the "thrust" industries identified in government's industrial policy, improving the country's investment climate by relieving the numerous administrative and governance related constraints, and enabling the private sector to have cost-effective access to infrastructure services and finance.

2.5.2 Streamlining Legal and Regulatory Framework

The legal and regulatory framework needs to be streamlined, particularly with regard to contract enforcement and dispute resolution, bankruptcy, labour laws, copyright protection, land titling and transfer procedures, etc. The backlog of cases in the courts needs to be cleared and legal procedures have to be modified to deter delaying tactics. Labour laws should be appropriately amended to discourage politicisation of labour relations and maintenance of peaceful environment in the industrial areas. The labour laws should ensure compliance with the newly emerging requirements of the buyers and various conventions on labour. Wage legislations should be responsive to productivity growth in the industrial sector. Land titling transfer procedure will have to be simplified and made corruption free. The regulatory requirements will have to be streamlined through coordination amongst different agencies so that the One-Stop Service of the BoI may help complete all the formalities within a short period. Streamlining of red tape,

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[19] See Bakht and Ahmed (2010).

[20] Yunus (2010)

[21] See Bakht, Yamagata and Yunus (2009).

improvements in law and order situation and legal environment are essential to assure prospective investor–both domestic and foreign–that there is adequate legal protection to legitimate business.

2.5.3 Resolution of the Problem of Industrial Finance

The virtual demise of the DFIs and stricter control on term lending by the NCBs have nearly starved the industrial sector of Bangladesh of institutional credit in recent years. The experience of the 1990s has proved the point that commercial banks in Bangladesh are inappropriate replacement of the DFIs for meeting the country's potential demand for term loan financing. A number of investment companies that came into existence to cater to this need totally failed to realise their statutory objective because of their limited capacity to mobilise funds and their conscious choice to operate as quasi-commercial banks. The contribution of non-banking financial institutions including the leasing companies has so far been limited in attending this concern. The growth of the stock market and the inflow of FDI have also been grossly inadequate to make up for the shortfall in institutional finance. Bangladesh has not done well compared to other countries in Asia in attracting FDI in spite of the very favourable policies. This deficiency in industrial finance was largely responsible for the persistence of high interest rate and consequently the slowing down of the industrial sector in the second half of the 1990s. Though government has recently reduced the interest rate, the process must be rationalised further. Clearly, there is urgent need for deep, broad and swift financial sector reform and new institutional initiative to resolve the problem of industrial finance in Bangladesh. The new institution will have to generate funds from a wide range of sources. The main distinguishing feature of the institution will be that it will be run in line with best practice methods of investment financing, which will require highly competent professional staff devoted to identifying investment opportunities and following them through marketing of outputs of supported enterprises.

2.5.4 Up-gradation of Skill and Technology

Deficient skill and technology are major supply-side bottlenecks in Bangladesh that have constrained growth and diversification of the industrial base in general and the export sector in particular. Also, the need for technological improvement has assumed special importance in the light of enhanced health, sanitary and phytosanitary standards being imposed by importing countries as non-tariff measures to retain protection after reducing tariff as part of WTO agreements. Skill and technology upgradations are also necessary for attracting foreign direct investment in high-tech industries and for complementing the efforts of trade liberalisation measures by facilitating adequate supply response. In this respect, the government should enhance investments in vocational training systems and make them more relevant to current needs of the industrial sector. Technical training institutions in the public sector are mostly poorly equipped and staffed. There should also be support to in-factory skill upgradation and training activities through fiscal and other incentives. Technology acquisition, adaptation and upgradation must be given top priority and Bangladesh should be actively involved in global and regional initiatives in support of transfer of technology favouring developing countries and the LDCs.

2.5.5 High Priority for Energy and Infrastructure Development

The government has already given highest priority for infrastructural development, especially towards solving the problem of energy crisis. The plans should be implemented without delay and with utmost sincerity. The opening up of the energy and infrastructure sector for private investment–both private and foreign–has facilitated inflow of considerable foreign investment into these sectors. Further progress in these area will require restructuring and reform of the relevant parastatal bodies such as Power Development Board (PDB), Dhaka Electric Supply Authority (DESA), Bangladesh Telegraph and Telephone Board (BTTB), Chittagong Port Authority (CPA), Bangladesh Biman, etc. to provide more room and efficient support to the private sector, and creating complementary infrastructure facilities such as generation, transmission and distribution of power, optic fiber gateway for telecommunications and information technology. A critical area of action in the next decade will have to be the improvement in the physical facilities and management of the country's major ports to facilitate the growth of trade and commerce. Meanwhile, private investment in competitive services should be encouraged vigorously.

2.5.6 Effective and Speedy Implementation of the Privatisation Programme

Bangladesh’s experience with privatisation clearly shows that the process cannot be hastened unless the government decides to assert political will in favour of privatisation. A number of limitations and constraints are hampering the privatisation process, such as, absence of a clear cut and strategic privatisation policy mandated by various social groups, lack of political determination, absence of an efficient institutional framework, adequate legal back-up, complicated bureaucratic procedures and interferences, inadequate transparency of the procedures, trade union and workers’ opposition, deteriorating law and order situation and lack of potential buyers’ interest, etc. This will mean giving the Privatization Commission the support it needs in the form of leadership, operational autonomy, and staff resources to do its work efficiently. The government will also have to take necessary measures to reduce social cost of labour adjustment through appropriate safety nets and by helping retrenched workers on targeted basis to reintegrate into the labour market. During some recent privatisation the government has exercised special safety-net programmes for the retrenched workers. Government can tie with NGOs to provide services to the retrenched workers.

2.5.7 Improving Industrial Statistics

The state of industrial statistics in Bangladesh is dreadful. Firms preparing to produce or acquire goods can learn very little about potential demand and supply from the official data on existing production. There is urgent need for revamping the industrial statistics wing of the Bangladesh Bureau of Statistics (BBS). Coordination between different registration authorities should also be sought to obtain consistent set of information on industrial investment, output and employment. Also, data storing and disbursement method of BBS should be improved.

2.5.8 Rationalising Various Fiscal Incentives

The following steps may be taken to rationalise various fiscal incentives.

a. Historically, the rate of corporate tax has been high and differentiated in Bangladesh. There seems to be no justification for taxation of company profit at a rate higher than the highest marginal tax rate on individual.
b. The differentiated rate of tax on financial institutions, presumably on the ground of high rate of profit, needs to reviewed in the light of persistent high rate of interest and consequent adverse effect on investment in Bangladesh.
c. The sharp fall in call-rate due to intense competition amongst the mobile phone operators needs to be reciprocated by reducing the spread in tax rate between these and other companies in order to facilitate rapid growth of connectivity in the country, which would be crucial for achieving the objective of digital Bangladesh by the target period.
d. The linking of tax rate with dividend payment has been useful in strengthening the share market. A logical follow up of these measures would be to have the provision of graduated higher tax rebate given to the companies declaring even higher dividends.
e. In the interest of avoiding double taxation and encouraging investment, the existing system of dividend distribution tax should be abolished.
f. Empirical evidence supports the notion that tax holiday facility contributed significantly towards tax evasion practices. A long period without taxes

combined with the prospect of relatively high taxes at the end of holiday encouraged tax evasion behaviour when the holiday was over. The tax holiday system should, therefore, be abolished in tandem with reduction in corporate tax, as has been suggested by the Finance Minister in his last budget speech.

g. The system of accelerated depreciation allowance along with its carry over facility should be continued after abolition of tax holiday to provide incentives that are linked to actual investment.

h. Measures should be undertaken to minimise the scope of abuse of the bonded warehouse facility by requiring maintenance of records to an approved standard to be periodically audited by customs auditors. In line with the practice in other countries, there should also be a system of bank guarantee ensuring realisation of import taxes if found due.

i. DEDO should be fully automated and there should be a comprehensive scheme to register all recipients of duty drawback to minimise the scope of corruption and forgery.

j. The scope of duty drawback should be extended to cover all duties and taxes paid on inputs at import stage. The deemed exporters should also be brought within the fold of duty drawback facility.

k. The requirement of producing certificate of export proceed realisation should be eased by allowing provisional payment of drawback on evidence of export. The coverage of flat rate of drawback should be increased to facilitate quick settlement of claims.

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Annex

ANNEX TABLE 2.A1

SHARE IN GDP AND GROWTH OF MANUFACTURING SECTOR

Year	Manufac-turing all industry*	Share of manufac-turing sector in GDP	Growth in manufac-turing sector	Share of large industry in Mfg. GDP (%)	Share of Small industry in Mfg. GDP (%)	Yearly compound rate of Growth of Large Industry (%)	Yearly compound rate of Growth of small Industry (%)
1989-90	156163	12.52	1989-90 up to	71.16	28.84	1989-90 up to	1989-90 up to
1990-91	166133	12.9	6.38	70.92	29.08	6.02	7.28
1991-92	178391	13.28	6.88	70.89	29.11	6.68	7.38
1992-93	193771	13.82	7.45	71.14	28.86	8.17	7.59
1993-94	209554	14.35	7.70	71.21	28.79	8.63	7.79
1994-95	231517	15.15	8.17	71.83	28.17	9.84	7.99
			1994-95 up to			1994-95 up to	1994-95 up to
1995-96	246351	15.43	6.41	71.33	28.67	5.67	8.28
1996-97	258795	15.41	5.73	70.60	29.40	4.82	8.01
1997-98	280910	15.88	6.50	71.08	28.92	6.59	7.26
1998-99	289880	15.6	5.98	71.76	28.24	6.71	3.72
1999-2000	303680	15.4	5.66	71.49	28.51	4.27	3.24
			1999-2000 up to			1999-2000 up to	1999-2000 up to
2000-01	323980	15.59	6.68	71.39	28.60	6.55	7.02
2001-02	341740	15.76	6.08	70.80	29.20	5.57	7.36
2002-03	364810	15.97	6.22	70.67	29.33	5.58	7.45
2003-04	390690	16.16	6.42	70.57	29.43	6.75	7.33
2004-05	422690	16.51	6.73	70.64	29.36	7.62	7.69
			2004-05 up to			2004-05 up to	2004-05 up to
2005-06	468197	17.08	10.77	71.06	28.94	11.41	9.21
2006-07	513722	17.55	10.24	71.06	28.94	10.57	9.45
2007-08	550772	17.77	9.27	71.10	28.90	8.49	8.39
2008-09	583393	17.78	8.40	70.91	29.09	6.45	6.84

Source: Based on data from *Bangladesh Economic Review*, various issues and *Statistical Yearbook Bangladesh*, various issues.

Note: * million taka in 1995-96 prices.

Chapter 3

A Study on Alternative Modes of Financing

Selim Raihan
Bazlul Haque Khondker

3.1 INTRODUCTION

Bangladesh is going to reintroduce the five-year development plan, beginning in the next fiscal period, replacing the Poverty Reduction Strategy Papers (PRSPs), aiming to meet the basic need of the nation. Bangladesh adopted the PRSP in 2003, through a participatory process involving civil society and development partners, which will be continued up to 2010.

Bangladesh's First Five Year Plan (1973–78) aimed to increase economic growth by 5.5 per cent annually, but actual growth averaged only 4 per cent per year. A special two-year plan (1978–80), stressing rural development, also fell short of its projected growth target, as did the Second Five Year Plan (1980–85), which targeted 7.2 per cent annual growth. The Third Five Year Plan (1985–90) had a 5.4 per cent annual growth target though only 3.8 per cent was actually achieved.

In 1991, with the reinstitution of elected government, a new economic programme was initiated that included financial sector reform and liberalisation measures to encourage investment, government revenue improvement efforts (realised largely through implementation of a value added tax), and tight monetary policy. Income transfer measures, Food-for-Work, and other programmes were also implemented to help protect the poorest segments of the population from the transitional effects of structural reform. Political turmoil from 1994 to 1996 helped reduce the final average annual growth rate under the Fourth Five Year Plan (1990–1995) to 4.15 per cent (short of the 5 per cent target). From 1995-1997 development administration proceeded on an *ad hoc* basis. Then the Fifth Five Year Plan was launched on July 1997.

Due to criticism from different quarters on the shortfalls in the ongoing PRSP, that is, the PRSP, not a home-grown document, has failed to ensure an inclusive and sustainable development of the country, as it has no well-organised long-term goals, to be achieved within a certain period the newly elected government has taken the initiative to change the nation's public investment policy and re-introduction of Five Year Plan after a gap of seven years.

TABLE 3.1
SUMMARY OF PLANNED DEVELOPMENT EFFORTS IN BANGLADESH

Plan	Plan Size (in million taka)			GDP Growth rate (per cent)	
	Total	Public	Private	Target	Actual
First Five Year Plan (1973-78)	44,550	39,520	5,030	5.5	4.0
Two-Year Plan (1978-80)	38,610	32,610	6,000	5.6	3.5
Second Five Year Plan (1980-85)	172,000	111,000	61,000	5.4	3.8
Third Five Year Plan (1985-90)	386,000	250,000	136,000	5.4	3.8
Fourth Five Year Plan (1990-95)	620,000	347,000	273,000	5.0	4.15
Fifth Five Year Plan (1997-2002)	1959,521	858,939	1100,582	7.0	5.5

Source: Compiled from various Plan Documents.

The critical concern of the Sixth Five Year Plan would be to achieve higher growth and make the growth pro-poor such that the poorer sections get a proportionately greater share of the benefits of growth that can lead them to move out of poverty (bringing down poverty level to 15 per cent and ensuring housing for all by 2015).

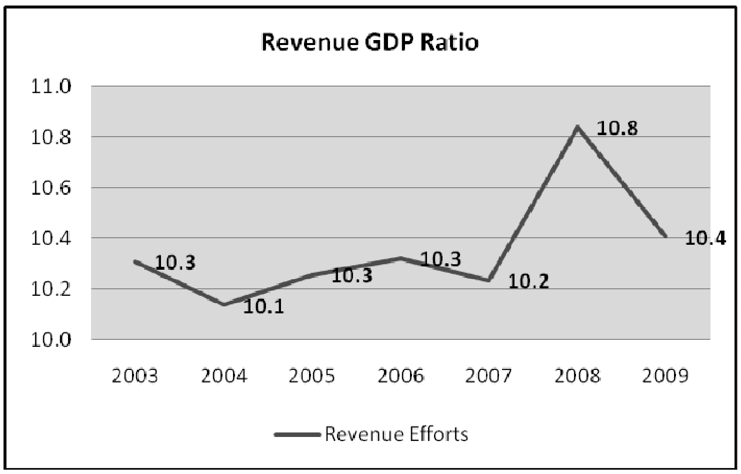
The Five Year Plan will also focus on remittance, manpower export, export diversification, population control, foreign investment, capacity building of the country's economy and ensure business friendly environment. In this context, this paper discusses the alternative modes of financing for the Sixth Five Year Plan.

The broad objective of this paper is to explore alternative ways of financing public and private investments under the Sixth Plan. The paper recommends measures for enhanced revenue generation by the government and greater inflow of development assistance from multilateral and bilateral development partners. Modalities of domestic borrowing and safe limits to such borrowings are examined keeping in view the need for ensuring stable macroeconomic policy. The paper recommends measures towards raising the efficiency of the financing and capital markets in meeting the resource needs of the private sector. The paper also recommends guidelines for Public-Private Partnership (PPP) for investment in infrastructure and other priority sectors.

3.2 PAST REVENUE EFFORTS

Revenue system is inefficient in Bangladesh failing to mobilise adequate resources needed to undertake projects and programmes in line with the desired development goals/targets. Problems and prospects of revenue system are assessed in terms of two measures–(i) revenue efforts; and (ii) revenue productivity.

Figure 3.1: Revenue Efforts 2003-2009



Source: Ministry of Finance, Bangladesh.

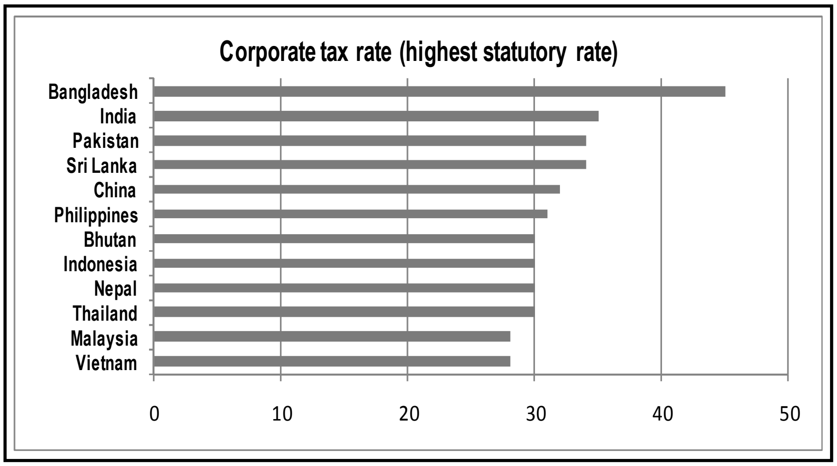
The "revenue effort" of a country is defined as the total revenue (tax plus non-tax revenue) as a share of GDP. The levels of revenue efforts have historically been low in Bangladesh. Figure 1 shows the revenue efforts in Bangladesh between 2003 and 2009. The revenue effort has been low hovering around 10 per cent between 2003 and 2009. Low revenue effort in Bangladesh is due to the combined effects of serious base erosion owing to incentives, deficient tax design, weak tax administration and low compliance.

Furthermore, an analysis of the revenue productivity of Bangladesh tax system with comparable developing nations clearly reflects inefficiency of our tax system. Revenue productivity is a measurement of how much tax revenue expressed in per cent of GDP that each percentage point of the nominal rate is able to raise. In other words it is expressed as the tax/GDP ratio divided by the applicable nominal tax rate.[1] Revenue productivity thus suggests that, given an efficient revenue administration, the higher the tax rate, the higher would be the revenue productivity.

[1] Revenue Productivity = (Tax Effort/Nominal Tax Rate) where Tax Effort = Tax Revenue/ GDP.

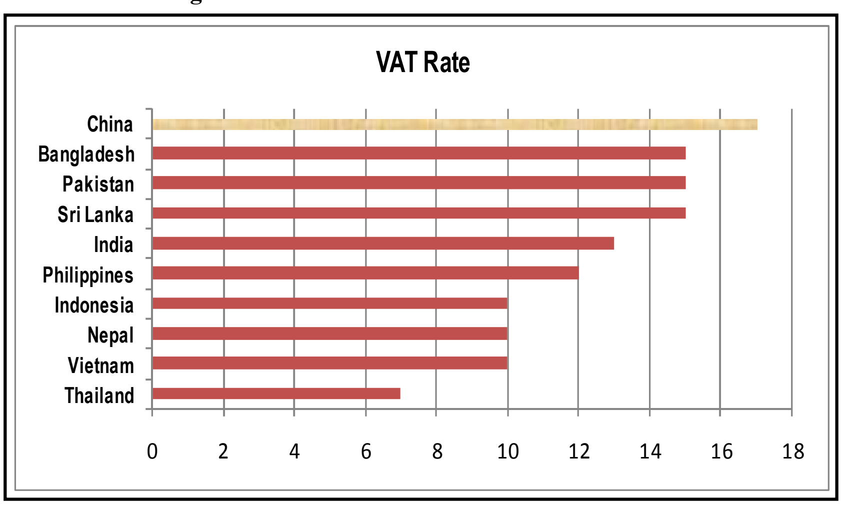
Rates of taxes and revenue productivity estimates for selected countries are shown in Figures 3.2, 3.3, 3.4 and 3.5.

Figure 3.2: Corporate Income Tax Rate in Selected Asian Countries



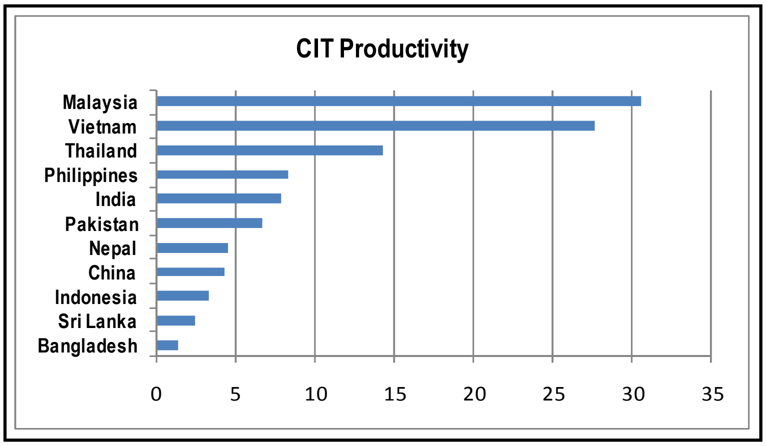
Source: International Bureau of Fiscal Documentation (IBFD); and IMF Country Documents.

Figure 3.3: VAT Rates in Selected Asian Countries



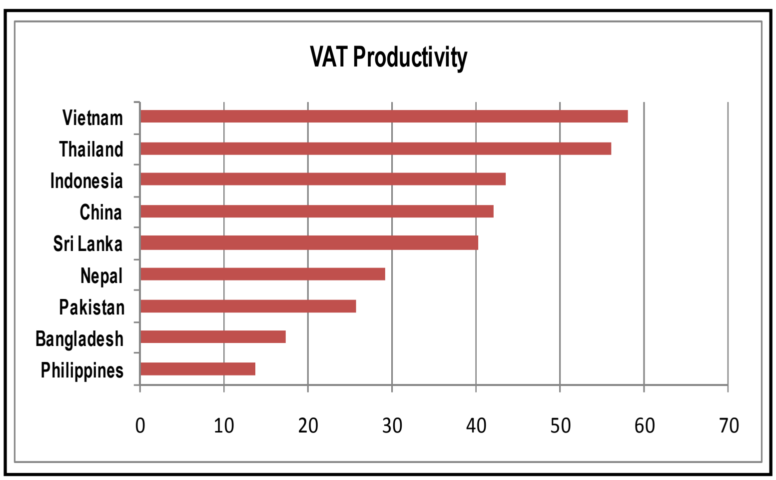
Source: International Bureau of Fiscal Documentation (IBFD); and IMF Country Documents.

Figure 3.4: CIT Revenue Productivity in Selected Asian Countries



Source: International Monetary Fund; Fiscal Affairs Department, and VAT Productivity Data Base of IMF.

Figure 3.5: VAT Revenue Productivity in Selected Asian Countries



Source: International Monetary Fund; Fiscal Affairs Department, and VAT Productivity Data Base of IMF.

It is observed that the statutory nominal tax rates in Bangladesh are generally high among the comparators. Except for China, the value added tax (VAT) rate (15 per cent) in Bangladesh is higher than the VAT rates in other countries in the Asia and Pacific region. The corporate income tax (CIT) rate for publicly-listed companies (30 per cent) is more or less at a comparable level. However, the higher corporate income tax rates applied to non-listed companies (40 per cent) and financial institutions (45 per cent) are significantly above the CIT rates in the comparator countries.

With comparatively high nominal tax rates, one would expect that revenue productivity in Bangladesh should be much higher than the revenue productivity of countries with lower nominal tax rates. Despite having higher nominal tax rate, due to low revenue yields, Bangladesh's revenue productivity for CIT and VAT is much lower than its comparators. As the IMF (2007) study argues, the low efficiency in revenue collection is due both to narrow tax bases—reflecting base erosion from incentives, structural deficiencies in tax design, and poor compliance and weak tax administration.

Above analysis envisages that although Bangladesh collects only 10 per cent of GDP as revenue, the revenue potential is likely to be in the range of 14-15 per cent. The gap between this potential and actual collection is an indication of poor tax administration in Bangladesh which needs to be addressed. For widening of tax base, tax authority would need measures to phase-out tax incentives, improve structural tax characteristics, administration and compliance. It is assumed that current initiatives to reform the VAT and income tax system within FY2011 will help raise the revenue effort substantially.

Reforms aimed at strengthening tax administration and improving taxpayer services during the period FY2010-12 should focus on the following measures:

- Improved monitoring of tax collection and the impact of measures to expand the tax net.
- Delinking tax collection from tax officials by allowing payments through banks and/or online rather than through tax offices.
- Improved procedures for ensuring the timely deposit of tax revenues at the point of collection.
- Establishment of a special tribunal to prioritise the resolution of long-standing tax payment cases.
- Improved publicity and information to encourage individuals and firms to register and pay tax.
- Action to fill vacant positions in NBR, improved on-the-job training and other capacity building measures.
- Development of one-stop service centres to provide information and advice to taxpayers and contribute to a more positive tax compliant environment.

- Further simplification of the tax forms and improved tax payment procedures such as payment through mobile phones.
- Implementation of an integrated automation strategy covering taxpayer submissions, assessment, permissions and approvals, and payments.

3.3 GLOBAL RECESSION AND CLIMATE CHANGE AND AID

Budget for FY2009-10 highlighted the concerns related to tackling global economic crisis and also, at the same time, fulfilling the promises and targets set out in the election manifesto "Vision 2021" of the government.

- Budget formulated keeping in view the election manifesto of the government.
- Some new programmes/projects included for implementation to fulfil the pledges of election manifesto.
- The main challenge will be to sustain development even in the face of economic slump.
- Special emphasis has been given on PPP for employment generation, infrastructure development, increased investment and strengthening private sector. To facilitate that –
    - ADP has been scaled up by 32.6 per cent to Tk. 30,500 crore over last year's ADP of Tk. 23,000 crore.
    - Due to limited public sector resources, more emphasis has been placed on private sector investment in infrastructure development.
    - With a view to implement investment project under PPP, an allocation of Tk. 2,500 crore has been made in the budget.
    - Income Tax, Customs, VAT procedures have been simplified; duties of industrial raw materials have been reduced to 5 per cent from 7 per cent, customs duty on capital machineries reclassified and rationalised.
- To empower women and secure their rights, around 30 per cent of the total budget (4.93 per cent of GDP) has been allocated.
    - For the first time, separate reports have been prepared on the allocation of resources for empowering women for the Ministries of Education, Health, Social Welfare and Food and Disaster Management.
- Around 60 per cent of the total budget (9.95 per cent of GDP) has been allocated for poverty reduction.

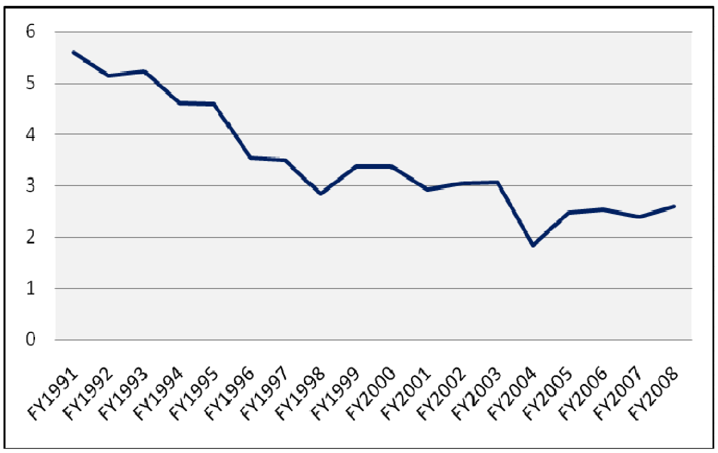
Although Bangladesh contributes insignificantly to the global green house gas emission (one-fifth of one per cent of world's total), it is one of the front line victims of the adverse consequences of climate change through increasing temperature and rainfall, sea level rise, salt water intrusion and increasing natural disasters such as cyclones and floods. Fourth Assessment carried out by the Intergovernmental Panel on Climate Change (IPCC) (2007) reported evidence to the effect that adverse impacts are already visible in the case of Bangladesh. The adverse impacts of climate change are of cross-cutting nature and are likely to affect a wide array of sectors including agriculture and food security, water resource, coastal resource, livelihood security, health and infrastructure. Bangladesh has already taken a number of initiatives including Bangladesh Climate Change Strategy and Action Plan (2008 and 2009), a National Climate Change Fund and a Comprehensive Action Plan for 2009-2018. The proposed activities included some immediate actions such as strengthening disaster management, research and knowledge management, capacity building and public awareness programmes, and urgent investments such as cyclone shelters and selected drainage programmes. Bangladesh must press the international community to ensure an equitable system in allocation of funds for adaptation needs. Bangladesh went to Copenhagen, leading the voices of the most vulnerable countries, demanding compensation from the developed countries for the damage they have done. United Nations Framework Convention on Climate Change (UNFCCC) estimated that a fund of US$ 200 billion was necessary for the adaptation of 100 million climate victims of the world. Though no final document emerged was signed in Copenhagen, in the Copenhagen Accord, developed countries have made commitment to create a US$ 30 billion fund for the years 2010–2012 and mobilise US$ 100 billion a year by 2020. Having been recognised as one of the most vulnerable countries, Bangladesh has demanded a sizeable (15 per cent) share in this proposed fund (in proportion to its population). However, no tangible commitment has been received yet. In the run up to the next conference in Mexico in 2010, Bangladesh now faces the challenge of preparing a comprehensive strategy to mobilise and make use of this fund. Since the country's absorption capacity could become an issue, it was important that Bangladesh takes appropriate measures to enhance its ability to spend the envisaged funds.

3.3.1 Declining Aid

In spite of the less than optimal levels of Official Development Assistance (ODA) inflows and its status of least developed country (LDC), Bangladesh's dependence on ODA has declined significantly since independence. The country was heavily dependent on aid during the first two decades of independence when

ODA comprised between 5 and 7 per cent of GDP. Since then, however, due to sustained growth in national income, ODA as a share of GDP has followed a downward trajectory. ODA inflows in 2007-08 comprised about $2 billion or 2.6 per cent of GDP, recovering to some extent, from only 1.8 per cent in 2003-04 (Figure 3.6).

Figure 3.6: ODA Disbursements as per cent of GDP



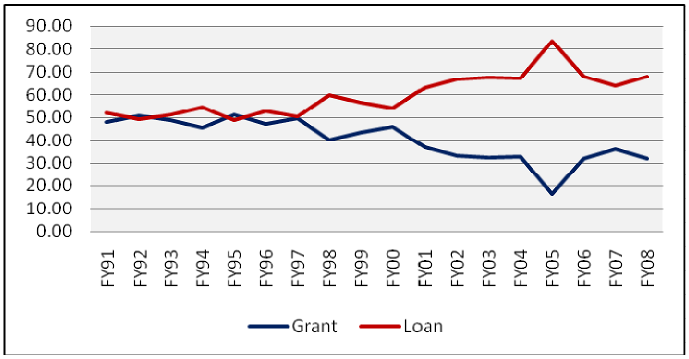
Source: Based on External Relations Divisions (ERD) data.

Although ODA as a share of GDP has declined, per capita ODA has remained almost constant between FY1991 ($15.6) and FY2008 ($14.5) despite considerable fluctuations and despite reaching a low of $7.6 during FY2004. More interesting, however, are the trends in per capita loans and grants. While grants per person have declined from $7.5 to $4.6 during the aggregate period, loans per person have actually risen from $8.1 to $9.85.

3.3.2 Concessional vs. Non-Concessional Aid

The rising non-concessional element of ODA is further corroborated by Figure 3.7. For the most part of the 1990s, ODA was equally divided between grants and loans. There was a sudden break from this pattern in the late 1990s with ODA being increasingly dispensed as loans rather than grants. This dichotomy was most pronounced in 2004-05 when the loan component of ODA was as high as 84 per cent. In general, during the first decade of the millennium about two-thirds of ODA has comprised loans and the remaining one-third grants.

Figure 3.7: Grants and Loans as per cent of Total ODA

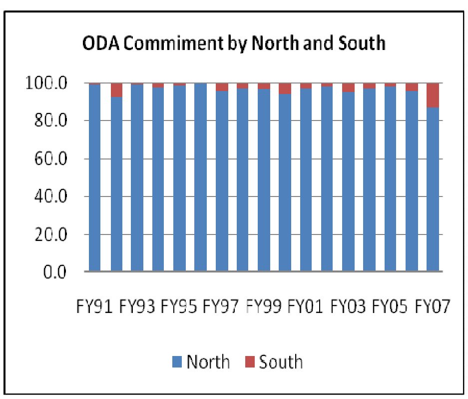


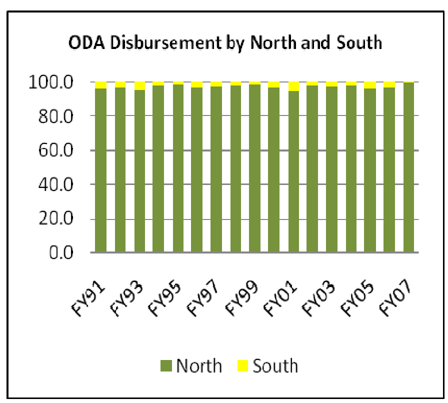
Source: Based on External Relations Divisions (ERD) Data.

3.3.3 Sources of ODA

ODA inflows are overwhelmingly from developed (Northern) countries. Recently, however, Southern (emerging) countries have also become important donors.[2] In FY2007, about 12 per cent of aid commitments were from the South (Figure 3.8), albeit this commitment is yet to be reflected as disbursements. In the short to medium term, therefore, the countries of the North will continue to be the major source of foreign assistance to Bangladesh.

Figure 3.8: Sources of ODA



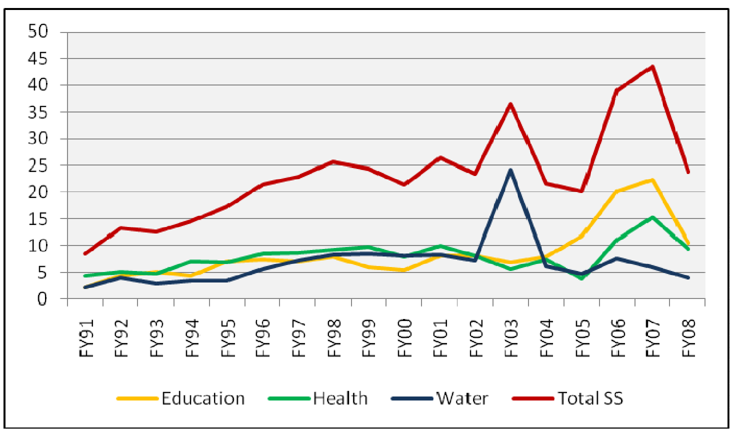


[2] Southern/emerging donors include China, India, Kuwait, Pakistan, Saudi Arabia, South Korea and the UAE. All other donors are included in the Northern/developed group.

3.3.4 Sectoral Allocation of ODA

Examining the sectoral allocation of ODA, it is observed that development assistance to education and health (Figure 3.9), on average, increased between FY1991 and FY2008, albeit there was a sharp increase during FY2006 and FY2007, followed by a steep decline in allocation. Spending on water supply, physical planning and housing, however, has experienced a declining trend despite the sudden spurt in FY2003. Almost 45 per cent of ODA was allocated to social sectors in FY2007. Figure 3.9 indicates that ODA allocations have been pro-MDGs in the second half of the present decade, as there have been increasing allocations to social sectors like education, health and water. However, allocations have not been uniform, as spending has come in spurts. It is recommended that ODA to these sectors be more stable, as such uneven spending could result in setbacks in the achievement of MDG goals.

Figure 3.9: Allocation to Social Sectors (per cent of Total ODA Disbursements)

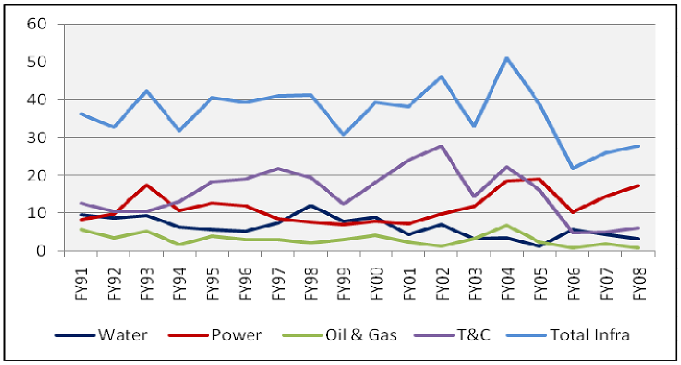


Source: Based on External Relations Divisions (ERD) Data.

Notes: Education: education and religion, Health: health, population and welfare, Water: Physical planning, water supply and housing. Total SS: total spending on social sectors – education, health and water.

Foreign aid allocations to physical infrastructure have been declining and the decline has been very pronounced since FY2004 (Figure 3.10) in contrast to the steep increase in allocations to social sectors. The only sector that has witnessed rising allocations over the period under consideration is the power sector; a welcome aberration from the general trend in light of the acute power shortage in the country.

Figure 3.10: Allocations to Physical Infrastructure (per cent of Total ODA Disbursements)



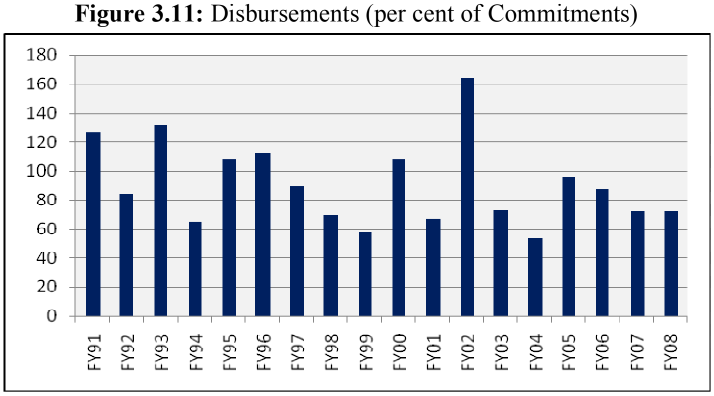
Source: Based on External Relations Divisions (ERD) Data.

Notes: Water: water resources, Oil & Gas: oil, gas and mineral resources, T&C: transport and communication, Total Infra: total spending on water, power, oil & gas and T&C.

3.3.5 Mismatch between Commitments and Disbursements

A disturbing feature in the aid architecture of Bangladesh has been the consistently wide gap between disbursements and commitments/planned spending of donors. In just six of the 18 years under consideration have disbursements exceeded planned spending (Figure 3.11). Since FY2003, disbursements as a share of commitments have consistently been well below 100 per cent. Such prolonged under-disbursement of committed aid is indicative of several issues which have been a deterrent to higher disbursement of planned assistance.

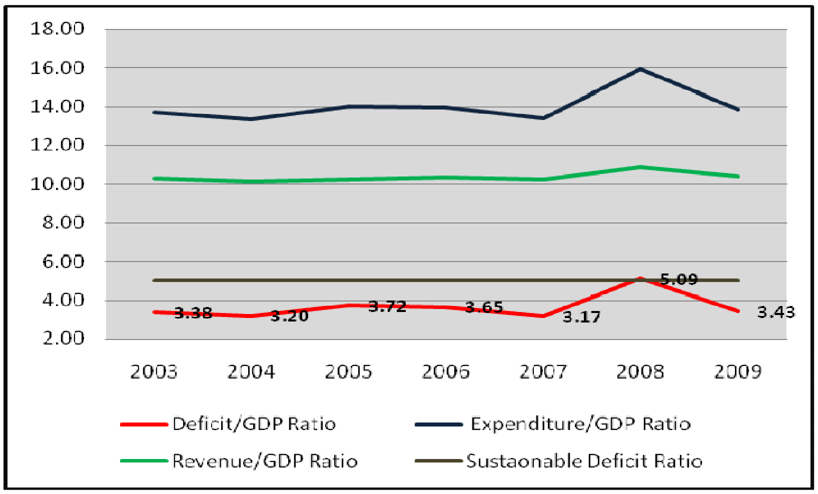
Figure 3.11: Disbursements (per cent of Commitments)



3.4 DEFICIT FINANCING

In Bangladesh, total expenditures are higher than the resources mobilised through tax and non-tax revenue sources. The implied resource gaps, or deficits, are bridged by inflows from domestic and external sources.

Figure 3.12: Budget Deficit (2003-2009)



Source: *Bangladesh Economic Review 2009*, Ministry of Finance, Bangladesh.

As noted earlier, government expenditure accounts for about 13 per cent to 14 per cent of GDP, of which current expenditure accounts for about 11 per cent and the remaining 4 per cent is attributed to capital expenditure. Furthermore, the total revenue as a ratio of GDP has remained stable at around 10 per cent between 2003 and 2009. Resultant deficits have also been low at around 3.5 per cent of GDP. On the basis of sustainable fiscal deficit limit (usually 5 per cent of GDP), it is argued that the deficit-GDP ratios have remained within the "sustainable" level (Figure 3.12).[3]

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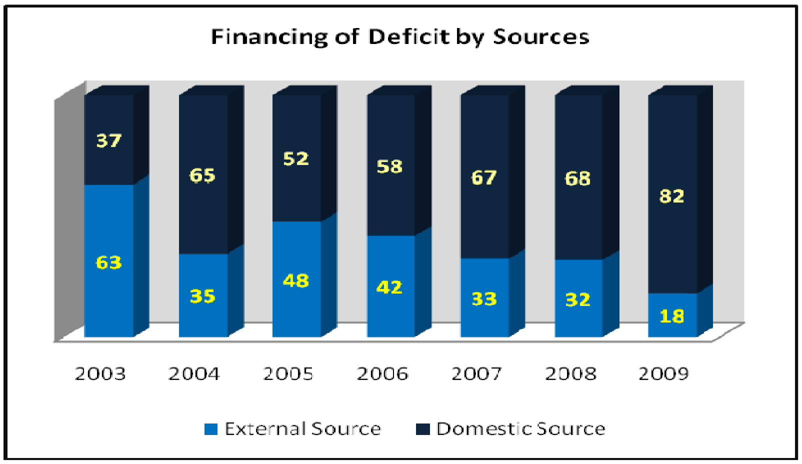
[3] The measurement of sustainable budget deficit was developed by Buiter (1983) and van Wijnbergen (1989). The sustainable condition for external borrowing is estimated by $f_{row}(t) \leq [r_{row}(t) - g(t)] \cdot Debt_{row}(t_{-1})$ where f_{row} is non-interest current foreign deficit to GDP ratio, r_{row} is real foreign interest rate and $Debt_{row}$ refers to initial foreign debt-GDP ratio. For domestic borrowing the condition is $dom^{use}(t) \leq [r_{dom}(t) - g(t)] \cdot Debt_{dom}(t_{-1})$

Budget deficits are usually covered by resources drawn from external and domestic sources. Significant variations have observed in the composition of financing of budget deficits in Bangladesh between 2003 and 2009.

Figure 3.13: Composition of Deficit Financing (2003-2009)



Source: External Resource Division (ERD), Ministry of Finance, Bangladesh.

Figure 3.13 shows the composition of deficit financing in Bangladesh between 2003 and 2009. The share of deficit financing from external sources (i.e. in the form of loan and grants) declined from 63 per cent in 2003 to only 18 per cent in 2009. During the same period, share of foreign grants in total external financing has also declined. On the other hand, share of domestic financing–predominantly non-bank financing, increased to 82 per cent in 2009 from 37 per cent in 2003. Average interest rates (i.e. 10 per cent and more) on domestic debts are significantly higher than the cost of fund of external debts. Shifts in composition of deficit financing in Bangladesh suggest that the country has been allocating higher amount of resources to pay interest perhaps narrowing the scope of financing for items desirable from the perspective of development targets/goals realisation.

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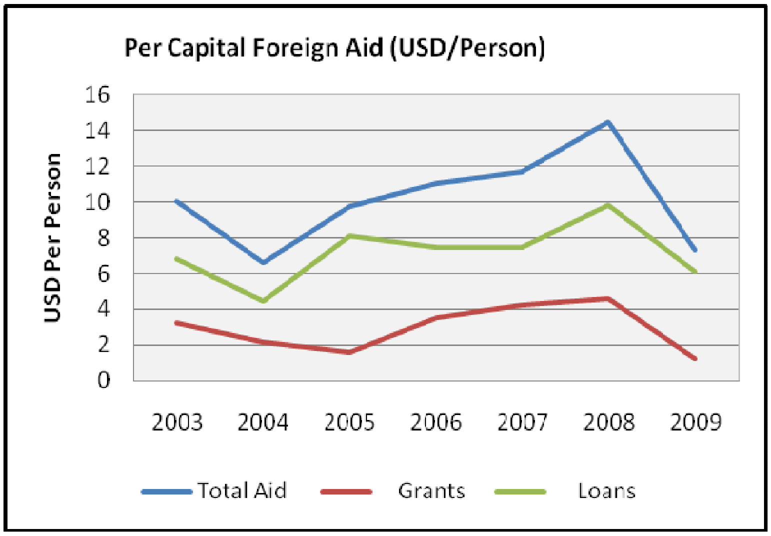
where dom^{use} is non-interest current deficit to GDP ratio is, r_{dom} is real domestic interest rate and $Debt_{dom}$ refers to initial domestic debt-GDP ratio (see World Bank 1997).

Figure 3.14: Per Capital Foreign Aid (2003-2009)



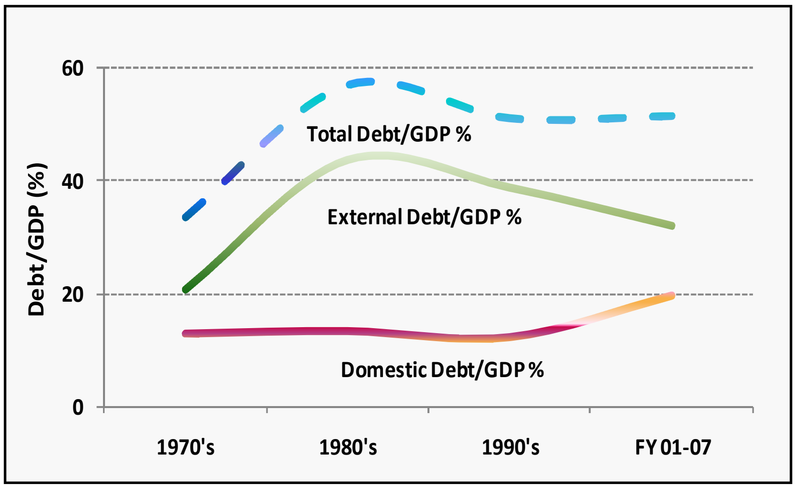
Source: *World Development Indicators* (WDI), World Bank.

Except for the year 2004, Bangladesh has been receiving foreign aid in the range of US$ 10 to US$ 15 between 2003 and 2008 on per capita basis (Figure 3.14). In FY2009, per capital aid flow dropped to US$ 7, the level recorded for 2004. Average per capita loan receipt during this period is US$ 7, more than doubled than the flow of grants (i.e. US$ 3 per capita) on a per capita basis. Such low aid flows on per capital basis appear inconsistent with development perspective of Bangladesh.

3.4.1 Public Debt Trends and Sustainability

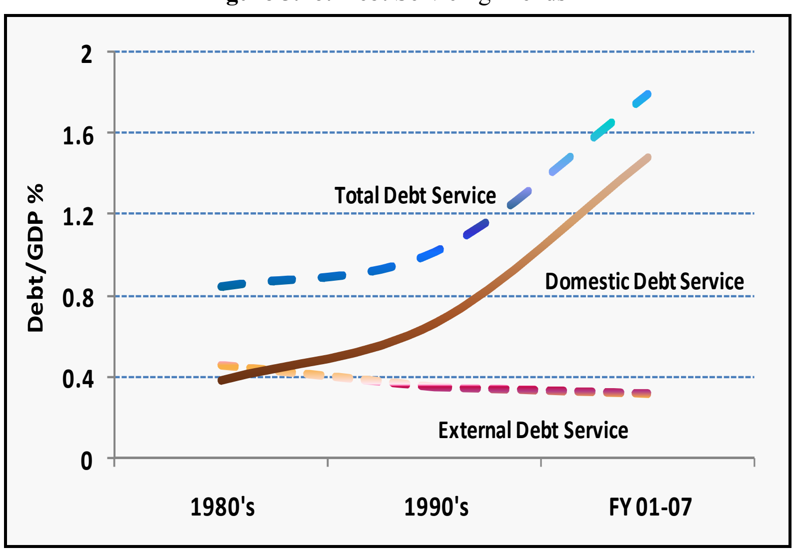
Trends in public debt and debt servicing are shown in Figure 3.15 and Figure 3.16. The public debt-GDP ratio, which was around 60 per cent in the 1980s, fell to 50 per cent during the 1990s and remained at that level during FY2001-07. These measures suggest that Bangladesh is a low debt country. However, there has been a significant change in debt composition during the 1990s in favour of domestic debt. The domestic debt to GDP ratio, which was stable around 12 per cent during the last three decades, rose to about 17 per cent over the FY2001-07 period. On the other hand, external debt to GDP ratio declined from 45 per cent in the 1980s to approximately 35 per cent during FY2001-07.

Figure 3.15: Debt Trends



Source: Based on Finance Division Data, Ministry of Finance, Bangladesh.

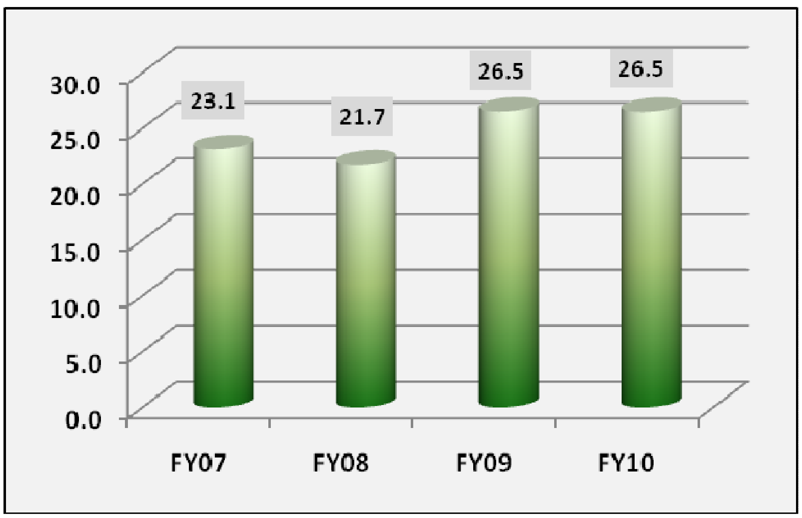
Figure 3.16: Debt Servicing Trends



Source: Based on Finance Division Data, Ministry of Finance, Bangladesh.

Debt servicing as per cent of GDP has been rising. Total debt servicing was less than 1 per cent of GDP during the 1980s and crossed the 1 per cent level in 1990. Since then it has increased relentlessly to its current level (FY2001-07) of around 1.8 per cent. Such a sharp increase has occurred because of high interest rates on domestic debt and the progressive shift in debt composition towards domestic debt. More specifically, the average interest rate on domestic debt is 7.75 per cent compared to 1 per cent on external debt[4] rendering domestic debt 7 times more expensive than external debt. Figure 3.17 summarises interest payments made by the government during FY2007-11.

Figure 3.17: Interest Payments (per cent of Recurrent Expenditure)



Source: Based on Finance Division Data, Ministry of Finance, Bangladesh.

Greater reliance on more expensive domestic debt for deficit financing has resulted in rising allocations to interest payments under the recurrent expenditure budget. The adverse fallout of this has been the reduction in the available of fiscal space to finance development programmes.

[4] This refers to a report on "Govt's interest payment rises", published in Star Business, April 9, 2010. The report stated that "according to a Finance Division report, the rate of interest is on average 1 per cent in the case of foreign loan. On the other hand, the rate of interest on loans from local banks is 7.75 per cent, while the savings instrument interest rate is 11.75 per cent."

3.4.2 Public Debt Sustainability

Bangladesh's external debt service ratio is low at less than 4 per cent of export and remittance receipts. Domestic debt has been relatively stable over the past five years. Gross domestic debt has remained at around 17 per cent of GDP during the period end-June 2002 through end-2008. The majority of the domestic debt is in the form of treasury bills and savings certificates held by nonbanks, and just a quarter is held by the central bank. The above indicators suggest that Bangladesh does not have a debt sustainability problem. Projections carried out by IMF/World Bank and other agencies also envisage that Bangladesh is unlikely to face debt sustainability problem in future.

IMF/World Bank projected that Bangladesh's external debt burden indicators did not breach the relevant indicative thresholds established under the IMF-World Bank debt sustainability analysis (DSA) framework. Table 3.2 summarises Bangladesh's indicative thresholds, actual 2009 ratios, and average debt service ratios under the baseline scenario prepared by the IMF-World Bank staff in 2008.

TABLE 3.2
POLICY-BASED EXTERNAL DEBT BURDEN THRESHOLDS FOR BANGLADESH

PV of external debt in per cent of	Threshold		Bangladesh's Ratio	
		In 2009	In 2009*	In 2009**
GDP	40	19.5	16	17
Export	150	100.1	95	97
Revenue	250	185.1	97	99
External debt in per cent of				
Export	20	8.2	3.8	3.9
Revenue	30	13.2	7.1	7.5

Source: Article IV Consultation Report-2009, IMF.
*Average period of the base line scenario (5 per cent fiscal deficit).
**Average period (FY11-15) of the shock scenario (7.5 per cent fiscal deficit, on an average).

Debt sustainability analysis carried out by IMF also suggests, on the basis of baseline projection, that Bangladesh does not have a debt sustainability problem. According to the analysis, all external debt indicators remain well below the policy-dependent debt burden threshold under the baseline scenario. Given the growing dependence on domestic debt over time and the fiscal deficit at its historical level of about 4 per cent of GDP (excluding grants), external debt in relation to GDP would tend to fall very rapidly (Table 3.3). Given the buoyant trend in export projected in the DSA analysis, external debt service in relation to exports will decline to around 2.3 per cent by 2030 (IMF 2009).

TABLE 3.3

BANGLADESH'S DEBT SUSTAINABILITY BASE LINE SCENARIO (2007-2030)

Year	Total Govt. Debt Outstanding as per cent of GDP	External Debt as per cent of GDP	Total external debt service as per cent of export
2007	46.8	27.3	5.2
2008	46.8	26.6	4.9
2009	45.3	24.3	4.5
2010	43.8	22.6	6.0
2011	44	22.0	6.0
2012	43.7	21.0	6.4
2013	43.3	20.1	6.0
2014	43.1	19.3	5.2
2015	42.8	18.6	4.8
2020	41.8	15.5	4.2
2030	40.0	12.0	2.3

Source: Article IV Consultation Report-2009, IMF.

The baseline scenario entails a steady decline in the public debt-to-GDP ratio, with external debt declining but domestic debt increasing in relation to GDP. This is the natural outcome of the trend observed in the last two decades with growing reliance on domestic financing of the budget deficit. As a result of this change in debt composition, total public debt in relation to GDP will also fall, albeit at a much slower pace, by 7 percentage points to 40 per cent of GDP by 2030.

Although Bangladesh has been increasingly financing its budget deficit from domestic resources, this has not had a deleterious impact on private sector investment activity. In order to examine whether public borrowing from domestic sources crowds out private investment in Bangladesh, Majumder (2007) carried out a study using consistent data for 31 years (1976-2006). A multivariate regression model involving private investment as dependent variable and public borrowing, GDP and interest rate as independent variables was estimated. A long run relationship was established by using time series econometric tools such as unit root test, cointegration test and error correction model. The study concluded that *there is* *no crowding out effect rather there is a crowding in effect* for the country. This has important policy implications for fiscal management because *as long as there is excess liquidity in the financial system, government can rely on domestic sources for meeting the deficit without causing any upward pressure in the interest rate and consequently hampering the flow of private investment*. This is also supported by the experience of Pakistan. Hussain *et al.* (2009) show that non-development expenditures (such as debt servicing and defense) crowd out private investment, while development expenditures (such as infrastructure, health, education and social welfare) serve to crowd in private investment.

3.5 EFFICIENCY OF THE FINANCIAL AND THE CAPITAL MARKETS

Table 3.4 shows the size of Bangladesh stock market. Market capitalisation ratio has increased from 1.4 per cent in 1990-91 to 10.2 per cent in 2005-06 with a sudden increase to 29.0 per cent in 2006-07 .Total market capitalisation reached Tk. 1366.53 billion in 2006-07 from Tk. 11.485 billion in 1990-91.This shows a remarkable cumulative increase of 117.98 times. Mean market capitalisation ratio of 0.077 with a standard deviation of 0.073 points to high level of volatility in market capitalisation.

TABLE 3.4

STOCK MARKET SIZE OF BANGLADESH, 1990-91 TO 2006-07

Year	GDP (billion Taka)	Market capitalisation (billion Taka)	Market capitalisation to GDP	Year	GDP (billion Taka)	Market capitalisation (billion Taka)	Market capitalisation to GDP
1990-91	834.39	11.485	0.014	1999-00	2370.86	120.69	0.051
1991-92	906.5	10.397	0.011	2000-01	2535.46	121.586	0.048
1992-93	948.07	12.29	0.013	2001-02	2732.01	131.73	0.048
1993-94	1354.12	18.098	0.018	2002-03	3005.80	182.899	0.061
1994-95	1525.18	80.657	0.051	2003-04	3329.73	439.934	0.132
1995-96	1663.24	315.149	0.189	2004-05	3707.07	453.018	0.122
1996-97	1807.01	124.134	0.069	2005-06	4157.28	420.850	0.102
1997-98	2001.77	91.637	0.046	2006-07	4674.97	1366.53	0.290
1998-99	2196.97	81.324	0.037				
Descriptive statistics of Market capitalisation to GDP ratio		Mean	Standard deviation	Kurtosis	Skewness	Minimum	Maximum
		0.077	0.073	3.745	1.864	0.011	0.290

Source: *Bangladesh Economic Review*, *Statistical Yearbook of Bangladesh*, Dhaka stock Exchange (main board) and Securities and Exchange Commission (Annual report and quarterly review).

Table 3.5 shows that during the period under study, number of listed companies has grown from 149 to 273 with an average annual growth rate of 4.421 per cent and a standard deviation of 39.006.

TABLE 3.5
NUMBER OF LISTED COMPANIES IN DHAKA STOCK EXCHANGE

Year	Number of listed Companies	Growth (in per cent)	Year	Number of listed Companies	Growth (in per cent)
1990-91	149		1999-00	229	4.566
1991-92	153	2.685	2000-01	234	2.183
1992-93	166	8.497	2001-02	248	5.983
1993-94	201	21.084	2002-03	251	1.210
1994-95	192	-4.478	2003-04	259	3.187
1995-96	192	6.771	2004-05	251	-3.089
1996-97	203	5.729	2005-06	269	7.171
1997-98	213	4.926	2006-07	273	1.487
1998-99	219	2.817			
Descriptive statistics of number of listed companies	Mean	Standard deviation	Minimum	Maximum	Average growth rate
	217.765	39.006	149.000	273.000	4.421 per cent

Source: Compiled from different issues of *Monthly Review*, DSE.

Table 3.5 shows the liquidity situation of Bangladesh stock market in terms of total value traded to GDP ratio. The ratio has increased from an insignificant number (0.000228) in 1990-91 to 4.05 per cent in 2006-07. Mean value of 0.015 with a standard deviation of 0.011 for the ratio implies that the increase is not even smooth; there is a marked fluctuation in the value traded to GDP ratio over the years.

Turnover equals the value of total shares traded divided by market capitalisation. High turnover is often used as an indicator of high level of liquidity. Turnover also complements total value traded ratio. While total value traded /GDP captures trading compared with the size of the economy, turnover measures trading relative to the size of the stock market. Put it differently, a small, liquid market will have a high turnover ratio but a small total value traded/GDP ratio. During the study period it increased from 1.1 per cent to 17.5 per cent. The turnover ratio peaked at 62.1 per cent during the year 1998-99, showing a declining trend afterwards. Minimum and maximum ratio of 0.012 and 0.621 during the study period with a mean ratio of 0.215 and standard deviation of 0.192 (Table 3.6) indicate marked fluctuations in the turnover ratio.

TABLE 3.6

LIQUIDITY MEASURE—TOTAL VALUE TRADED TO GDP, 1990-91 TO 2006-07

Year	GDP (billion Taka)	Total value traded (billion Taka)	Value traded/GDP	Year	GDP (billion Taka)	Total value traded (billion Taka)	Value traded/GDP
1990-91	834.39	0.19	0.000	1999-00	2370.85	53.2986	0.022
1991-92	906.5	0.12	0.000	2000-01	2535.46	54.6645	0.022
1992-93	948.07	0.44	0.001	2001-02	2732.01	48.571	0.018
1993-94	1030.36	0.58	0.001	2002-03	3005.8	25.8407	0.009
1994-95	1589.76	6.3997	0.004	2003-04	3329.73	70.7324	0.021
1995-96	1663.24	36.222	0.022	2004-05	3707.07	78.8775	0.021
1996-97	1807.07	25.9485	0.014	2005-06	4157.28	57.4001	0.014
1997-98	2001.76	48.4044	0.024	2006-07	4674.97	189.7104	0.041
1998-99	2196.95	50.5023	0.023				
Descriptive statistics		Mean	Standard deviation	Kurtosis	Skewness	Minimum	Maximum
Value traded to GDP ratio		0.015	0.011	0.024	0.264	0.000	0.041
Turnover ratio		0.215	0.192	-0.384	0.923	0.012	0.621

Source: Computed from data of various issues of *Statistical Yearbook of Bangladesh*, SEC *Quarterly Review* and *DSE Monthly Review*.

Table 3.7 depicts the volatility in the Dhaka Stock Exchange. The range, standard deviation, coefficient of variation and composite volatility ranking for each year during the study period indicate that the market was highly volatile during the study period. Table 3.7 also shows that the market was the most volatile during the period 1995-96 (rank 1) and 1996-97 (rank 2) which is congruent with the fact that during the year 1996 the capital market of Bangladesh experienced a sudden on-set of boom and a subsequent burst. However, the decreasing volatility ranks (with volatility index increasing) over the years may be interpreted to mean increasing volatility in stock markets.

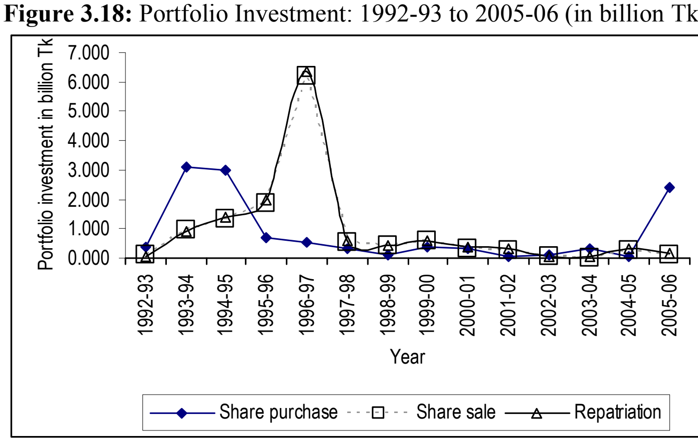
Foreign portfolio investment in equity and debt securities indicates the level of integration of a stock market with stock market of other countries. It also indicates growth level of a stock market. Bangladesh stock market is showing a declining trend in terms of foreign portfolio investment in equity and debt securities. Figure 18 depicts the foreign portfolio investment situation in Bangladesh stock market for the period of 1992-93 to 2005-06. From 1992 to 1994-95, purchase of shares by foreign investors exceeded the amount of share sale and repatriation. After 1995-96, the trend reversed and share sale and repatriation exceeded the share purchase for most of the years. During the period of 1995-96 and 1996-97, Bangladesh experienced a massive outflow of foreign investment evidenced by Tk. 6.332 billion repatriation and Tk. 6.187 billion sales as against Tk. 0.518 billion share purchase by foreign investors in 1996-97. The declining trend of portfolio investment, evidenced by average annual sales and repatriation of portfolio investment amounting to Tk. 0.995 billion and 1.036 billion per year with standard deviation of 1.603 and 1.636 exceeding the average annual purchase by portfolio investors of Tk. 0.718 billion with a standard deviation of 1.106 during the study period, may be interpreted to mean that Bangladesh stock markets remain non-attractive to foreign portfolio investors.

TABLE 3.7
VOLATILITY IN THE STOCK MARKET- RANGE AND STANDARD DEVIATION AND COEFFICIENT OF VARIATION

Year	Standard deviation	Range	CV	Volatility index	Volatility ranking	Year	Standard deviation	Range	CV	Volatility index	Volatility ranking
1990-91	25.383	60.9	0.068	-0.740	15	1999-00	66.557	176.49	0.115	-0.453	9
1991-92	37.628	100.95	0.111	-0.582	12	2000-01	73.273	222.18	0.108	-0.421	8
1992-93	24.849	76.61	0.063	-0.741	16	2001-02	49.392	125.46	0.061	-0.655	14
1993-94	103.587	346.28	0.145	-0.175	5	2002-03	61.364	217.04	0.075	-0.528	11
1994-95	48.571	185.03	0.06	-0.615	13	2003-04	360.654	1017.5	0.262	1.165	3
1995-96	860.964	2289.34	0.592	3.986	1	2004-05	122.742	409.14	0.072	-0.257	6
1996-97	377.758	1212.47	0.344	1.540	2	2005-06	98.097	254.34	0.083	-0.400	7
1997-98	58.270	201.61	0.093	-0.504	10	2006-07	180.645	649.21	0.128	0.181	4
1998-99	21.980	66.24	0.043	-0.802	17						

Source: Computed from month end index of DSE from 1990-91 to 2006-07 (DSE main board –Monthly review and Graphs).

Figure 3.18: Portfolio Investment: 1992-93 to 2005-06 (in billion Tk.)



Source: SEC, Bangladesh, *Annual Report 2005-06.*

3.6 PUBLIC-PRIVATE PARTNERSHIPS

The number one constraint limiting the growth potential of the Bangladesh economy is insufficient capacity in infrastructure–power, transport and ports. Over the years, Bangladesh's population, work force, and the size of the economy have expanded significantly. The total GDP of the country will reach almost $100 billion by the end of the next fiscal year. Per capita income has already crossed $600 in 2008/09. This increased income per head and rapidly growing economic activity are contributing to a substantial increase in demand for power and transport infrastructure. In a well-managed economy, such demands create opportunities for investment, jobs and more domestic demand contributing to a further acceleration of growth. However, a secular decline in public sector investment in infrastructure over a number of years and the absence of supportive government policies to encourage private investment in infrastructure have contributed to severe infrastructure bottlenecks that threaten the growth potential of the Bangladesh economy.

The current process of project selection and implementation, based on the Annual Development Plan (ADP) framework, has proved to be increasingly ineffective in meeting today's challenges. While the ADP model for providing public infrastructure investment worked during the 1970s and the 1980s, when the domestic resource base was small and the country was largely dependent on foreign multilateral and bilateral assistance to carry out its public sector investment programme, it is increasingly apparent that it is no longer an adequate mechanism. Today the government's dependence on foreign financing of its ADP has declined significantly and public sector resource availability has become inadequate in meeting the rapidly growing demand for physical infrastructure in the economy. Moreover, the demonstrated failure of the ADP-based execution of projects essentially implies that the traditional way of financing and implementing infrastructure projects will not be able to cope with the burgeoning needs of an economy that should grow at an annual rate of 8 per cent or more over the medium-term. To top it all, a number of mega infrastructure projects e.g. deep sea port, Chittagong–Dhaka expressway, Dhaka metro rail, two bridges over the river Padma, and several large power plants including the Ruppur nuclear power project are already part of the Government's vision in the medium- to long-term. A new innovative strategy needs to be found to meet the massive capital requirements of such projects and it is self-evident that it cannot be met by government funds alone.

The newly elected government is committed to a rapid reduction of poverty, which can only be achieved through a further significant acceleration of real economic growth from the current rate of 6 per cent per annum. But increasing the productive potential of the economy in a sustainable manner will require investment on a massive scale in the key sectors of the economy. Resources, from both domestic and foreign public and private sources, have to be mobilised to finance such investment. And the policy environment has to be supportive of facilitating private and public participation, separately and jointly.

Many countries in the region have been very successful in adopting the right framework for accelerating investment in the critical infrastructure sectors. The examples of China, East Asia, Middle East and India are particularly noteworthy. In the oil producing Gulf Cooperation Council (GCC) countries, the massive $2 trillion investment plan, currently underway, is largely being implemented under various PPP arrangements. Infrastructure investment in India under PPP arrangements is projected to increase to $500 billion under the current Five-year plan.

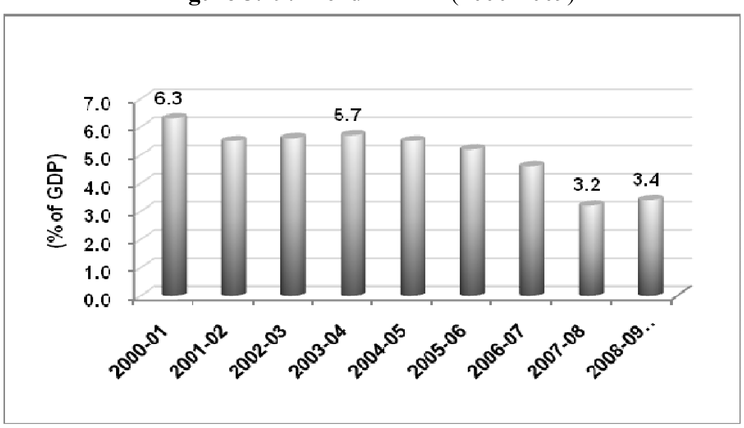
The Government of Bangladesh had also adopted a "Private Sector Infrastructure Guideline" in 2004 with a view to promote infrastructure projects through the private sector. Limited progress has also been made in a number of areas. Following the adoption of Private Power Generation Policy of 1996, private participation in the sector has increased. With a installed capacity of 1474 MW, Independent Power Producers (IPPs) account for about 25 per cent of total installed capacity. PPP arrangement is also working well in the gas sector. International Oil Companies (IOCs) accounting for 45 per cent of the total gas produced in Bangladesh in 2007/08. However, PPP activities were primarily limited to power and gas sectors and total amount of investments under PPP arrangements in these two areas was also only a fraction of what would have been needed to meet the country's growing infrastructure needs.

Bangladesh has to learn from the experience of those countries which have been successful in meeting their rapidly growing infrastructure demand and to design its own framework for developing the needed infrastructure in the country. PPP framework in its various forms has been found to be both feasible and effective in fulfilling the broad-ranging demands in emerging market economies. The timid and limited recourse to PPP-based infrastructure development needs to be replaced by a renewed and bold initiative.

For Bangladesh to achieve the cherished medium- and long-term GDP growth target of 8-10 per cent per annum, investment in the domestic economy must increase significantly. Currently, Bangladesh invests about 24-25 per cent of GDP and stabilised at that level over the last five years. With this level of domestic investment. Bangladesh can only sustain its GDP growth at about 6 per cent, which is a rate at which our growth has indeed stabilised in recent years. Boosting economic growth to a higher trajectory of 8-10 per cent will require additional investments of about 12 percentage points to 37 per cent of GDP by 2021. While domestic investment in relation to GDP may not reach the level of China, it must get closer to that. A large part of that additional investment should also go to the infrastructure sector, given Bangladesh's huge investment gap in the infrastructure sector.

Bangladesh lags behind its most regional comparators in terms of provision of basic infrastructure services. While significant gains have been made in penetration of telecommunications in recent years due to the dominant role of private sector telecom providers, no significant progress was made in other important areas. In particular, generation of power, access to better roads, and improved sanitary and sewerage systems call for immediate attention. This dismal record in infrastructure provision is primarily attributable to: (i) the government's reliance on ADP-based public sector investment programme which has declined steadily in relation to GDP in recent years; and (ii) the government's failure to attract private investment in the infrastructure sector. ADP spending has declined almost every year and now accounts for only 3.4 per cent of GDP in 2008/09 (Figure 3.19). The secular decline in ADP spending over the years is attributable to two factors. First, government's limited administrative capacity in implementing the ADP projects even when resources are made available. Second, limited availability of public sector domestic resources, coupled with declining foreign financing for projects, also constrained the size of the ADP in the budget.

Figure 3.19: Trend in ADP (2000-2009)



Source: *Bangladesh Economic Review*, Ministry of Finance, Bangladesh.

To attain a sustained growth rate of 8-10 per cent per annum over the next decade, Bangladesh will have to raise its investment rate closes to levels attained by India and China today, i.e. 37-40 per cent of GDP. The challenge lies not only in mobilising sufficient resources to finance that investment but also to develop effective institutional arrangements to implement large infrastructure projects, including some mega projects. One approach that has been successfully done in China, and is being pursued in India with vigour, is the PPP approach.

A rough assessment of the magnitude and composition of investment that will be required over the next decade, until 2021, could be instructive. Assuming GDP growth to accelerate and rise to 8 per cent by 2015, the cumulative gross domestic investment over that period would be about $200 billion in current dollars. Another $600 billion would be invested up until 2021 as GDP growth is to increase to the desirable rate of 10 per cent per annum. To fill the huge current gap in the country's infrastructure–power, ports, transport (road, rail, air, urban transport)–a good chunk of this investment would have to be physical infrastructure. We have noted earlier that the ADP framework has proved, by and large, ineffective. It will also be inadequate to address the enormous challenge that our economy faces in building adequate infrastructure.

Bangladesh's private sector, which currently bears the major burden of investment (19 per cent out of 24 per cent) but has played only a small role in building infrastructure, will have to be mobilised to share a larger portion of the future investment in power, port, and transport infrastructure. They could be involved in various PPP modes, such as Build, Own and Operate (BOO) or Build, Own and Transfer (BOT) basis. Whatever may be the form of private sector involvement, FDI will also have to be mobilised by creating a supportive policy environment since the prospect of any significant augmentation of ODA flows appears bleak. In the Bangladesh context, it would not be reasonable to expect ODA inflows of more than $2.5 billion a year over the long-term. In this scenario, PPP format holds the best prospect both as an effective institution and for mobilising adequate resources for implementing large or small infrastructure projects of the future. Indeed, as PPP framework evolves into an acceptable mode of project implementation in Bangladesh, it would create the right policy environment and financing mix by attracting increasing amounts of FDI.

Bangladesh governments have initiated moves to encourage PPP projects in the infrastructure sector since the mid-1990s. Well before the PPP term was popularised, the government went into production sharing arrangements with International Oil Companies (IOCs) under the Bangladesh Petroleum Act, enacted in 1974 to facilitate participation of IOCs under production sharing contract (PSC) blocks in the gas sector. Despite its early start, PPP initiatives in Bangladesh have had only limited success in a few sectors. Success in telecom sector, driven particularly by the foreign telecom companies with strengthened policy framework, is particularly noteworthy. In contrast to this success in telecom, PPP arrangements did not gain momentum contributing to severe infrastructure gap Bangladesh is experiencing today. The remainder of the sector provides an overview of where we stand today in terms of investment in various infrastructure sectors and the current regulatory and institutional frameworks guiding the process

Private Sector Infrastructure Guidelines (PSIG) provides the framework for private sector infrastructure investments in Bangladesh. The Government of Bangladesh (GoB) approved the guidelines in 2004. The objectives of this guideline are:

- to establish, within the government, procedures to identify private infrastructure projects;
- to document a set of guidelines, for both the private sector investors and government, enabling the procurement and implementation of private infrastructure projects; and
- to establish institutional arrangements to monitor and expedite the implementation of such projects at a national level.

Under the existing Guidelines, infrastructure projects from the following sectors or sub sectors may be implemented as Private Infrastructure Projects:

a) Telecommunication systems, networks and services including information and communication technology (ICT);
b) Power generation, transmission, distribution and services;
c) Port development (sea, river and land) including inland container terminals, inland container depot and other services;
d) Highways and expressways including mass-transit, bridges, tunnels, flyovers, interchanges, city roads, bus terminals, commercial car parking, etc.;
e) Exploration, production, transmission and distribution of oil and gas;
f) Airports, terminals and related aviation facilities;
g) Tourism industry;
h) Water supply and distribution, sewerage and drainage;
i) Industrial estates and parks, city and property development, including services to support commercial and non-commercial activities;
j) Land reclamation, dredging of rivers, canals, wetlands, lakes and other related facilities;

k) Service sectors e.g. health and educational facilities, carried out by the government through the private sector;
l) Environmental, industrial and solid waste management projects;
m) Railway systems, rolling stock, equipment and facilities;
n) Other urban, municipal and rural infrastructure that the government views as priority areas for development so as to support economic development activities; and
o) Any other infrastructure project of similar nature.

Under the current institutional framework, the private sector can participate in the infrastructure projects in two ways: bidding for the projects solicited by the government, and developing a project and submitting an unsolicited proposal. Projects prepared by the line ministries (LMs) for possible private sector participation or unsolicited bids for the private sector are examined by PICOM. After the PICOM approved, the approved projects are sent to Cabinet Committee on Economic Affairs ((CCEA) for approval. Once the projects approved by the CCEA, LMs and PICOM ensure implementation of the project as per the government guidelines.

3.7 SIXTH PLAN INVESTMENT SIZE AND FINANCING SOURCES

The macroeconomic framework underpinning the Sixth Five Year Plan (SFYP) is consistent with the objectives of government's Perspective Plan for 2021. In line with the government's objectives of achieving 10 per cent GDP growth by 2021 and reduction of the per cent of population living below the poverty line to [15 per cent], the SFYP aims at increasing real GDP growth to 8 per cent by FY2015 and reducing the level of poverty by 10-15 percentage points to 25 per cent.

Based on recent performance of the economy, Bangladesh's growth potential has been stunted by infrastructural bottlenecks. During the 5-year period preceding the SFYP period, economic growth has been stuck in the range of 5.5 to 6 per cent. More importantly, combined with the impact of the global economic meltdown, economic growth in the two most recent years has been on a declining trend. While external economic environment has adversely impacted domestic growth potential through lower demand for Bangladesh exports, it is also widely understood that stagnant overall investment (in relation to GDP) in the economy, and in particular the declining level of public investment in infrastructure over a prolong period, is undermining seriously Bangladesh's growth potential.

In this background, achieving the average growth target of 7 per cent for the SFYP period (FY2011-FY2015) would involve accelerating GDP growth from 5.5

per cent in FY2010, the base year for the purpose of the Plan, to 8 per cent by the end of the Plan period (Table 3.8). The target is certainly ambitious and would entail adopting bold strategies to break away from the recent lacklustre moderate growth steady state situation.

TABLE 3.8
MACROECONOMIC SCENARIO UNDER SIXTH PLAN

Macro Indicators	FY10	FY11	FY12	FY13	FY14	FY15
Growth: Real GDP %	5.5	6.7	6.9	7.2	7.6	8.0
CPI Inflation (%)	7.0	6.5	6.4	6.3	6.2	6.0
Gross Domestic Investment (% of GDP)	24.2	26.5	28.4	29.6	31.0	32.5
Private Investment (% of GDP)	19.1	20.9	22.2	23.0	24.0	25.0
Infrastructure Investment (% of GDP)		2.0	3.5	4.5	5.0	6.0
Public Investment (% of GDP)	5.0	5.6	6.2	6.6	7.0	7.5
National Savings (% of GDP)	27.3	28.8	29.9	30.8	31.8	32.9
Consumption (% of GDP)	83.7	82.4	81.3	80.4	79.4	78.9

Source: Macroeconomic Framework for SFYP.

Exemplary economic performance of Bangladesh's neighbouring countries like India and China, recording growth rates of 9 per cent and more than 10 per cent respectively in recent years, indicates that with strong economic reforms leading to higher investment Bangladesh should also be able to achieve its economic objectives.

The higher growth rate in the SFYP is predicated upon a substantial increase in the investment rate in the economy from the current level of 24.5 per cent of GDP to 32.5 per cent by the end of the Plan. The entire increase in investment could be financed through higher utilisation of domestic savings, with the current account surplus steadily declining to less than one per cent of GDP by the end of the Plan. The incremental Capital Output Ratio (ICOR) is expected to improve due to increased competitiveness engendered through expected improvements in infrastructure and greater economic openness.

Achieving the higher growth target will require total investment under the Plan to increase steadily by 8 percentage points in relation to GDP to 32 per cent of GDP by FY2015. It is stipulated that both the public and private sectors will play important roles in raising the investment rate to the required levels during the SFYP period. The prerequisite would be that public investments and policies shall create necessary investment climate and heighten investors' (both national and foreign) confidence to undertake the required investments. Some key areas of improvement in this respect would be: energy supply including electricity and gas; (ii) infrastructure including roads, railways, bridges, embankments and dykes; (iii) telecommunications; (iv) ports; (v) legal and administrative systems including property rights issues; (vi) socioeconomic environment including law and order situation; and (vii) sound monetary policy and sustainable management of public finances.

It has also become clear that the past practice of relying solely on the ADP for providing the required infrastructure must give way to the adoption of PPP arrangements in delivering large infrastructure projects. Thus in addition to launching a bigger ADP in relation to GDP during the Plan period, the Plan also envisages bigger public sector investment in infrastructure programmes under the newly approved PPP framework. The government has also announced a major initiative for boosting power generation and expand power distribution network to alleviate the ongoing energy crisis in the country.

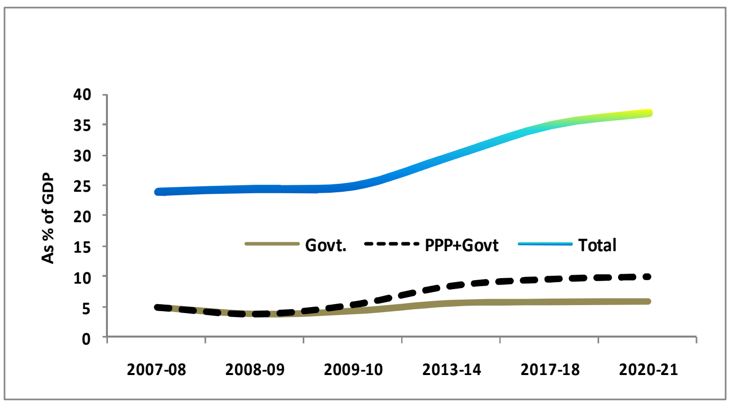
Efforts to reverse the declining trend in ADP was launched with the FY2010 budget and intensified in FY2011 budget, the first year of SFYP. The government established a very ambitious target for ADP in FY2010 by setting the ADP target at Tk. 305 billion, which was about 55 per cent higher than the outturn of the preceding year. In the event, although the ambitious target of 55 per cent increase in nominal term did not materialise, ADP spending increased by 35 per cent, which was a major improvement over the implementation rate recorded in recent years. After many years of steady decline, ADP spending in relation to GDP increased by 0.5 per cent in FY2010. Building on this gain, the target for ADP in FY2015 has been set at 2 percentage points higher at 6.9 per cent of GDP. The Plan objective is to sustain this momentum by increasing the ADP size by 2.5 percentage points to 7.5 per cent of GDP. Special emphasis has also been given to infrastructure and power sectors in the ADP. Implementing this larger ADP, while maintain quality of spending, will certainly be a major challenge. To ensure quality of spending and ensure better project implementation, all ministries are being brought under the Medium Term Budget Framework (MTBF).

As part of its strategy to allow the private sector a greater role, the Plan underscores the importance of PPP in infrastructure projects and other areas. Under the new PPP initiative and the associated investment guideline, the procedures for

PPP investment have been streamlined and a new PPP Office has been established to promote PPP projects in Bangladesh based on transparent investment and approval criteria. PPP investment is now being allowed in a wide range of projects under streamlined approval criteria.

The Plan envisages a sizable increase in infrastructure investment under the PPP initiative during the Plan period. Although infrastructural bottlenecks are severe, it will take time for the PPP initiative to gain momentum and reach its full potential. However, since a number of power generation and infrastructure projects are already in the pipeline, the Plan targets about 2 per cent of GDP in PPP related investment in the first year, and reaching a peak of 6 per cent of GDP by the end of the Plan (Figure 3.20).

Figure 3.20: Infrastructure Investment-Project Composition (2008-2021)



Source: Macroeconomic Framework and Projection of SFYP.

In order to ensure financing of PPP projects by playing a catalysing role, the government has established the Bangladesh Infrastructure Financing Facility (BIFF). As designed, BIIF will help finance infrastructure projects by using its own resources, augmenting its resources by issuing infrastructure binds, allowing other institutional investors of international and domestic origin to invest in BIIF as minority shareholders, and allowing the government to increase the capital base of BIIF through budgetary subventions in future.

At its inception in 2010, BIIF has been established with an initial capital of TK 16 billion (equivalent to $230 million). The ultimate objective of BIIF will be to help finance PPP infrastructure projects by taking direct equity participation in financially viable projects.

TABLE 3.9

PLAN SIZE AND FINANCING

	FY10	FY11	FY12	FY13	FY14	FY15	Total for plan period
Nominal GDP growth		12.2	13.3	13.5	13.8	14.0	
Nominal GDP	6,872	7,711	8,736	9,916	11,284	12,864	
GDP Deflator (per cent)		6.5	6.4	6.3	6.2	6.0	
GDP Deflator (2010-11 as the base)		100.0	106.40	113.10	120.12	127.32	
Real GDP (Billion Taka at 2010-11 prices)		7,711	8,211	8,767	9,394	10,103	
Gross Domestic Investment (per cent of GDP)		26.5	28.4	29.6	31.0	32.5	
Real Total Investment (Billion Taka at 2010-11 prices)		2,043	2332	2,595	2,912	3,284	13,166
Private Investment (per cent of GDP)		20.9	22.2	23.0	24.0	25.0	
Real Private Investment (Billion Taka at 2010-11 prices)		1,612	1,823	2,016	2,255	2,526	10,231
Public Investment (per cent of GDP)		5.6	6.2	6.6	7.0	7.5	
Real Public Investment (Billion Taka at 2010-11 prices)		432	509	579	658	758	2,935
Total revenue (per cent of GDP)		16.7	19.5	21.7	21.7	24.4	
Total expenditure (per cent of GDP)		16.9	18.1	19.0	19.9	21.2	
Government savings (per cent of GDP)		-0.2	1.4	2.7	1.8	3.2	
Government savings (Billion Taka at 2010-11 prices)		-15	115	237	169	323	829
Domestic Borrowing (per cent of GDP)		3.3	3.3	3.4	3.4	3.5	
Domestic borrowing (Billion Taka at 2010-11 prices)		254	271	298	319	354	1,497
FDI (per cent of GDP)		0.64	0.67	0.76	0.83	0.94	
FDI (Billion Taka at 2010-11 prices)		49	55	67	78	95	344

Source: Macroeconomic Framework and Projection of SFYP.

Table 3.10 shows total size of the Sixth Plan and sources of financing from domestic and external sources. Total plan size would be Taka 13,166 billion at 2010-11 prices. Private investment is estimated to be 78 per cent of the total plan. Remaining 22 per cent of the resources would need to be supplied by government. The composition of resources of domestic and external sources is reported below.

TABLE 3.10

PLAN SIZE AND FINANCING

Items	Total	Share (per cent)	Public	Share (per cent)	Private	Share (per cent)
Plan Size (investment)	13,166	100	2,935	100	10,231	100
Domestic Resources	12,212	93	2,325	79	9,887	97
External Resources (net)	954	7	610	21	344	3

Source: Macroeconomic Framework and Projection of SFYP.

3.8 CONCLUSION

This study examines the investment requirements from different sources to achieve the goals and targets set out in the Sixth Five Year Plan. While estimating the requirements, the study focused on a number of related issues and trends. Low levels of revenue and expenditure in Bangladesh resulted in low budget deficits at around 4 per cent of GDP. The low level of budget deficit does not reflect fiscal prudence rather it epitomises the features of a typical Bangladesh budget: setting a high revenue target and a high ADP target and a fiscal deficit in the rage of 3.5-5 per cent of GDP. In the event, a large revenue shortfall is generally offset by a large ADP implementation shortfall, thereby achieving the target for the overall budget deficit.

The share of deficit financing from external sources (i.e. in the form of loan and grants) declined from 63 per cent in 2003 to only 18 per cent in 2009. During the same period, share of foreign grants in total external financing has also declined. On the other hand, share of domestic financing—predominantly non-bank financing—increased to 82 per cent in 2009 from 37 per cent in 2003. Average interest rates (i.e. 10 per cent and more) on domestic debts are significantly higher than the cost of fund of external debts. Shifts in composition of deficit financing in Bangladesh suggest that the country has been allocating higher amount of resources to pay interest perhaps narrowing the scope of financing for items desirable from the perspective of development targets/goals realisation.

ODA inflows to Bangladesh as per cent of GDP have dropped from 5.6 per cent in FY1991 to 2.5 per cent in FY2008. Falling ODA has also been accompanied by rising non-concessional element of ODA.

The implementation of ADP has always been much lower than its budget targets. Moreover, the size of the ADP has declined by half as a ratio of GDP over the years from 6.3 per cent in FY2001 to 3.4 per cent in FY2009. It has also become clear that the past practice of relying solely on the annual development programme (ADP) for providing the required infrastructure must give way to the adoption of Public-Private Partnership arrangements in delivering large infrastructure projects. Thus in addition to launching a bigger ADP in relation to GDP during the Plan period, the Plan also envisages bigger public sector investment in infrastructure programmes under the newly approved PPP framework.

Achieving the higher growth target will require total investment under the Plan to increase steadily by 8 percentage points in relation to GDP to 32 per cent of GDP by FY2015. It is stipulated that both the public and private sectors will play important roles in raising the investment rate to the required levels during the SFYP period. The prerequisite would be that public investments and policies shall create necessary investment climate and heighten investors' (both national and foreign) confidence to undertake the required investments. Total plan size would be Taka 13,166 billion at 2010-11 prices. Private investment is estimated to be Taka or 78 per cent of the total plan. Remaining 22 per cent of the resources would need to be supplied by government.

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ANNEX TABLE 3.A1

SECTOR WISE REVENUE COLLECTION

(In Billion Taka)

Fiscal Year	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Total Revenue	1.71	2.92	5.05	8.48	9.23	11.53	14.19	16.95	22.95	23.45	24.71	27.90	35.76	40.83	46.85	52.03	57.72	67.12	80.26
Tax Revenue	1.70	2.89	4.30	7.13	7.70	9.98	12.17	14.59	18.31	19.79	21.34	23.72	29.67	33.03	38.66	44.24	48.45	57.15	65.87
NBR tax	1.66	2.78	4.10	6.74	7.26	9.40	11.47	13.78	17.23	18.54	20.00	22.31	27.24	30.54	35.76	40.69	44.91	52.92	61.52
Custom duty	0.70	1.26	1.51	2.82	2.78	3.98	4.97	6.25	7.48	7.83	8.70	9.34	11.83	13.39	15.42	16.54	18.45	21.37	23.74
VAT Import																			
Supp.Import																			
Sales tax	0.21	0.43	0.62	1.20	1.25	1.72	2.43	2.84	3.52	3.25	2.98	3.50	4.46	4.60	5.39	5.43	5.04	6.32	7.98
Import- based	**0.91**	**1.68**	**2.12**	**4.02**	**4.03**	**5.71**	**7.41**	**9.09**	**10.99**	**11.08**	**11.68**	**12.84**	**16.29**	**18.00**	**20.80**	**21.97**	**23.49**	**27.69**	**31.72**
Income tax	0.10	0.19	0.48	0.86	1.15	1.33	1.49	1.82	2.27	2.80	3.26	3.39	3.86	4.62	5.53	6.64	7.06	7.82	11.27
VAT Domestic																			
Supp.Domestic																			
Others tax	0.65	0.90	1.50	1.86	2.09	2.36	2.57	2.87	3.97	4.66	5.06	6.08	7.10	7.92	9.43	12.08	14.36	17.40	18.54
Domestic-based	**0.75**	**1.10**	**1.98**	**2.72**	**3.23**	**3.69**	**4.06**	**4.69**	**6.24**	**7.46**	**8.32**	**9.47**	**10.96**	**12.54**	**14.96**	**18.72**	**21.42**	**25.23**	**29.81**
Non-NBR tax	0.035	0.11	0.20	0.40	0.44	0.59	0.70	0.81	1.09	1.25	1.35	1.41	2.43	2.49	2.90	3.55	3.55	4.23	4.35
Non-Tax Revenue	0.014	0.034	0.75	1.35	1.53	1.55	2.02	2.37	4.64	3.67	3.36	4.17	6.09	7.80	8.19	7.79	9.26	9.97	14.39

(Cont. Table 3.A1)

Fiscal Year	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Total Revenue	**99.60**	**115.02**	**126.35**	**143.03**	**153.81**	**165.71**	**184.24**	**193.46**	**200.92**	**243.38**	**279.58**	**309.91**	**343.71**	**386.34**	**439.29**	**491.79**	**622.75**	**687.86**
Tax Revenue	**79.00**	**91.52**	**97.25**	**113.53**	**121.71**	**134.51**	**147.94**	**157.46**	**160.92**	**197.78**	**213.98**	**248.21**	**272.71**	**313.84**	**352.39**	**389.59**	**497.45**	**551.36**
NBR tax	**73.47**	**85.35**	**89.96**	**105.20**	**113.67**	**125.02**	**138.03**	**148.66**	**151.34**	**187.75**	**202.90**	**237.55**	**260.34**	**299.63**	**337.13**	**371.05**	**474.36**	**524.83**
Custom duty	27.46	28.75	29.83	36.76	37.72	40.13	45.39	47.38	42.5	51.0	53.9	66.9	70.8	79.0	78.4	81.7	96.0	93.4
VAT Import	12.69	17.31	17.13	22.15	25.55	27.88	29.09	30.47	30.6	36.8	37.6	41.1	44.0	53.5	58.5	63.1	84.9	91.9
Supp.Import	0.26	0.31	0.74	1.87	3.59	4.52	5.62	7.67	9.5	12.6	13.3	12.7	16.9	18.5	15.7	11.9	17.5	23.4
Sales tax																		
Import- based	**40.41**	**46.37**	**47.70**	**60.78**	**66.86**	**72.53**	**80.10**	**85.52**	**82.65**	**100.36**	**104.85**	**120.72**	**131.73**	**151.01**	**152.63**	**156.74**	**198.47**	**208.66**
Income tax	12.94	16.13	17.04	14.91	15.33	16.64	19.69	23.61	26.05	35.01	38.83	43.72	46.10	56.72	71.48	86.69	117.45	138.64
VAT Domestic	4.65	8.31	10.32	12.48	13.04	15.51	16.87	18.12	21.1	27.0	32.0	36.2	42.5	50.8	63.2	74.5	91.8	109.3
Supp.Domestic	0.26	9.81	11.82	13.44	14.64	16.18	17.16	17.09	17.2	21.14	22.75	31.48	35.43	37.14	43.90	48.17	60.01	61.63
Others tax	15.21	4.73	3.08	3.59	3.80	4.16	4.21	4.32	4.35	4.24	4.44	5.40	4.54	3.94	5.91	4.93	6.58	6.56
Domestic-based	**33.06**	**38.98**	**42.26**	**44.42**	**46.81**	**52.49**	**57.93**	**63.14**	**68.68**	**87.39**	**98.05**	**116.83**	**128.61**	**148.62**	**184.50**	**214.31**	**275.89**	**316.17**
Non-NBR tax	5.53	6.17	7.29	8.33	8.04	9.49	9.91	8.80	9.58	10.03	11.08	10.66	12.37	14.21	15.26	18.54	23.09	26.53
Non-Tax Revenue	20.60	23.50	29.1	29.5	32.1	31.20	36.30	36.00	40.00	45.60	65.60	61.70	71.00	72.50	86.90	102.20	125.30	136.50

Source: Different Issues of *Bangladesh Economic Review*, Ministry of Finance, Bangladesh.

ANNEX TABLE 3.A2

REVENUE COMPONENTS AS PERCENTAGE OF TOTAL REVENUE

Fiscal Year	1972-73	1973-74	1974-75	1975-76	1976-77	1977-78	1978-79	1979-80	1980-81	1981-82	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89	1989-90	1990-91
Tax Revenue	99.16	98.84	85.17	84.10	83.44	86.58	85.75	86.04	79.79	84.36	86.38	85.05	82.97	80.89	82.52	85.03	83.95	85.15	82.07
NBR tax	97.12	95.14	81.17	79.41	78.66	81.50	80.83	81.29	75.05	79.03	80.94	79.99	76.18	74.80	76.33	78.21	77.81	78.85	76.65
Custom duty	40.86	42.96	29.80	33.20	30.07	34.55	35.05	36.89	32.56	33.37	35.21	33.48	33.08	32.80	32.91	31.80	31.97	31.84	29.58
VAT Import	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Supp.Import	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Sales tax	12.26	14.64	12.18	14.14	13.57	14.95	17.15	16.73	15.32	13.86	12.05	12.56	12.46	11.28	11.49	10.43	8.72	9.42	9.94
Import- based	53.12	57.60	41.98	47.35	43.64	49.50	52.20	53.62	47.89	47.23	47.26	46.04	45.54	44.08	44.40	42.23	40.69	41.26	39.52
Income tax	6.05	6.58	9.47	10.09	12.42	11.51	10.50	10.72	9.88	11.95	13.18	12.15	10.79	11.32	11.81	12.77	12.23	11.65	14.04
VAT Domestic	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Supp.Domestic	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Others tax	37.95	30.96	29.72	21.97	22.59	20.50	18.13	16.94	17.29	19.85	20.50	21.80	19.85	19.40	20.12	23.21	24.89	25.93	23.09
Domestic-based	44.01	37.54	39.19	32.06	35.01	32.00	28.63	27.67	27.17	31.80	33.68	33.95	30.64	30.72	31.93	35.98	37.12	37.59	37.14
Non-NBR tax	2.04	3.70	4.00	4.69	4.78	5.08	4.92	4.76	4.73	5.33	5.44	5.06	6.79	6.09	6.19	6.82	6.14	6.30	5.42
Non-Tax Revenue	0.84	1.16	14.83	15.90	16.56	13.42	14.25	13.96	20.21	15.64	13.62	14.95	17.03	19.11	17.48	14.97	16.05	14.85	17.93

(Cont. Table 3.A2)

Fiscal Year	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Tax Revenue	79.32	79.57	76.97	79.37	79.13	81.17	80.30	81.39	80.09	81.26	76.54	80.09	79.34	81.23	80.22	79.22	79.88	80.16
NBR tax	73.76	74.20	71.20	73.55	73.90	75.44	74.92	76.84	75.32	77.14	72.57	76.65	75.74	77.56	76.74	75.45	76.17	76.30
Custom duty	27.57	25.00	23.61	25.70	24.52	24.22	24.64	24.49	21.17	20.96	19.30	21.58	20.61	20.44	17.84	16.62	15.42	13.58
VAT Import	12.74	15.05	13.56	15.49	16.61	16.82	15.79	15.75	15.25	15.12	13.43	13.27	12.80	13.84	13.32	12.83	13.64	13.36
Supp.Import	0.26	0.27	0.59	1.31	2.33	2.73	3.05	3.96	4.71	5.16	4.77	4.10	4.92	4.80	3.58	2.42	2.82	3.40
Sales tax	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Import- based	40.57	40.32	37.75	42.50	43.47	43.77	43.48	44.20	41.14	41.24	37.50	38.95	38.32	39.09	34.75	31.87	31.87	30.33
Income tax	12.99	14.02	13.49	10.42	9.97	10.04	10.69	12.20	12.97	14.38	13.89	14.11	13.41	14.68	16.27	17.63	18.86	20.16
VAT Domestic	4.67	7.22	8.17	8.73	8.48	9.36	9.16	9.37	10.49	11.10	11.46	11.69	12.38	13.15	14.39	15.15	14.75	15.90
Supp.Domestic	0.26	8.53	9.35	9.40	9.52	9.76	9.31	8.83	8.56	8.69	8.14	10.16	10.31	9.61	9.99	9.80	9.64	8.96
Others tax	15.27	4.11	2.44	2.51	2.47	2.51	2.28	2.23	2.17	1.74	1.59	1.74	1.32	1.02	1.35	1.00	1.06	0.95
Domestic-based	33.19	33.89	33.45	31.06	30.43	31.67	31.44	32.64	34.18	35.91	35.07	37.70	37.42	38.47	42.00	43.58	44.30	45.96
Non-NBR tax	5.55	5.36	5.77	5.82	5.23	5.73	5.38	4.55	4.77	4.12	3.96	3.44	3.60	3.68	3.47	3.77	3.71	3.86
Non-Tax Revenue	20.68	20.43	23.03	20.63	20.87	18.83	19.70	18.61	19.91	18.74	23.46	19.91	20.66	18.77	19.78	20.78	20.12	19.84

Source: Different Issues of *Bangladesh Economic Review*, Ministry of Finance, Bangladesh.

ANNEX TABLE 3.A3

DEFICIT FINANCING AS PERCENTAGE OF GDP

Fiscal Year	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09
Total Revenue	8.3	9.2	9.3	9.4	9.2	9.2	9.2	8.8	8.5	9.6	10.2	10.3	10.3	10.4	10.6	10.4	11.4	11.2
Tax Revenue	6.6	7.3	7.2	7.4	7.3	7.4	7.4	7.2	6.8	7.8	7.8	8.3	8.2	8.5	8.5	8.2	9.1	9.0
Non-Tax Revenue	1.7	1.9	2.1	1.9	1.9	1.7	1.8	1.6	1.7	1.8	2.4	2.1	2.1	2.0	2.1	2.2	2.3	2.2
Total Expenditure	13.0	13.0	15.0	14.4	13.9	13.3	12.9	13.6	14.5	14.8	14.9	14.5	14.8	15.0	14.7	14.1	17.2	15.3
Revenue expenditure	8.3	7.9	8.6	7.8	8.0	7.3	7.5	7.9	8.1	8.5	9.4	8.9	9.1	9.5	9.5	10.4	13.0	11.6
ADP expenditure	4.7	5.0	6.5	6.6	5.9	6.0	5.4	5.6	6.4	6.3	5.5	5.6	5.7	5.5	5.2	3.8	4.1	3.7
Overall balance (excluding grant)	4.7	3.8	5.7	5.1	4.7	4.2	3.7	4.7	6.1	5.2	4.7	4.2	4.5	4.6	4.1	3.7	5.7	4.1
Overall balance (including grant)	2.1	1.2	3.6	2.7	3.0	2.4	2.6	3.3	4.5	4.1	3.7	3.2	3.9	4.2	3.3	2.9	4.9	3.9
Primary balance	3.8	3.0	5.0	3.8	3.7	2.7	2.3	3.2	4.6	3.5	3.1	2.3	2.4	2.7	2.1	1.7	3.9	2.0
Financing	6.4	5.6	5.6	4.5	4.7	4.2	3.9	4.6	5.4	4.8	4.8	3.6	4.6	4.2	3.9	3.5	4.4	2.1
External	4.5	4.5	3.8	3.8	2.8	2.8	2.3	2.5	2.5	2.0	2.1	2.3	2.4	2.4	1.7	1.6	1.8	0.4
Grants	2.6	2.6	2.1	2.3	1.7	1.7	1.1	1.5	1.5	1.1	1.0	1.0	0.6	0.4	0.8	0.9	0.8	0.2
Loan	2.5	2.7	2.5	2.2	1.9	1.8	1.7	1.9	1.8	1.8	2.0	2.1	1.2	2.1	1.7	1.5	1.8	1.0
Amortization	0.7	0.7	0.8	0.8	0.8	0.7	0.7	0.8	0.9	0.9	0.9	0.9	0.7	0.7	0.8	0.8	0.7	0.8
Domestic	1.9	1.2	1.8	0.7	2.0	1.5	1.6	2.2	2.9	2.8	2.7	1.3	2.2	1.8	2.2	1.9	2.6	1.6
Bank	1.2	0.2	0.6	0.0	1.1	0.9	0.6	0.9	1.5	1.1	0.9	-0.3	0.8	1.0	1.5	0.9	2.0	1.1
Non- bank	0.7	0.9	1.2	0.7	1.0	0.5	1.0	1.3	1.4	1.7	1.7	1.6	1.4	0.8	0.7	1.0	0.6	0.6

Source: Different Issues of *Bangladesh Economic Review*, Ministry of Finance, Bangladesh.

Chapter 4

Export Promotion and External Issues: Present Status and Future Developments

M Ismail Hossain
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4.1 INTRODUCTION

There has been substantial change in the trade regime of Bangladesh over the last three decades, especially since the early 1990s, resulting in a shift of the regime from an inward-looking one to an outward-looking one and higher integration of the economy in the global economy. During this period, two types of development can be observed (Ahmed and Sattar 2005). First, Bangladesh unilaterally implemented trade liberalisation policies focusing on tariff and non-tariff barriers to trade, exchange rate system and capital flows. Second, the country also participated in multilateral trade liberalisation under the World Trade Organization (WTO) since 1995.[1] The period has witnessed a significant improvement in trade performance. Both the export/GDP ratio and the import/GDP ratio have increased—the former rising faster than the latter, resulting in reduced trade deficit as a proportion of GDP. Foreign remittance has experienced a sustained rapid growth except a few years when demand shock in the host countries caused declines in remittance flow. Foreign direct investment (FDI) has increased several times though the growth rate is much lower than some of our neighbouring countries such as India and Pakistan. Foreign aid has been relatively stagnant and declined as a proportion of GDP. Consequently, the debt servicing capacity of the country has increased. Another interesting development in the external sector in recent years is the emergence of a small surplus in the current account which has been traditionally in deficit.

The change in trade regime and opportunities created in the world market apart these developments have been possible also because of the dynamism of the entrepreneurs who could exploit the opportunities in the international market and deal with the risks. Bangladesh faced significant challenges on several occasions but was able to overcome those. For example, the phasing out of Multifibre Arrangement (MFA) on 31 December 2004 did not result in any decline in exports

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[1]Bangladesh has also been, to a small degree, engaged in liberalisation under regional trading arrangements.

of readymade garment (RMG) as was apprehended by many researchers (e.g. Mlachila and Yang 2004). Similarly, exports and remittance sustained the current global economic slowdown marked by rapid deceleration in global trade, industrial production and financial flows which began in the last quarter of 2008 and has been still continuing. However, exports experienced some decline in December 2009, indicating a lagged effect of the global recession on the Bangladesh economy. The depth and duration of this negative impact on exports in the near future remains uncertain.

The external sector thus faces both opportunities and challenges from an increasingly globalised world. The trade strategy of the country during the Sixth Five Year Plan should be directed at meeting the challenges and exploit the opportunities within its broad development strategy which seeks to achieve accelerated poverty reduction and Millennium Development Goals (MDGs) by 2015 and transform Bangladesh into a middle-income country by 2021.

4.2 OBJECTIVES OF THE STUDY

In this context, the broad objective of the study is to assess the opportunities, challenges, and the risks facing the external sector of Bangladesh, especially in increasing export earnings and remittance in the face of changing global economic environment and WTO rules and make appropriate recommendations for export promotion during the Sixth Five Year Plan (2011-15) period. The study identifies factors that have caused the export sector to remain narrowly based despite a significant increase in the degree of openness in the economy during the past two decades. Potential export industries are identified and policy support needed to promote these industries is spelled out. The ongoing process of trade liberalisation is examined critically from the perspective of right pace and sequence and required policy modifications are suggested for the plan period. The study also examines Bangladesh's experience with multilateral and bi-lateral trade negotiations and suggests strategies for the future. Policies for promoting FDI (foreign direct investment) and increased remittance flow are also reviewed under the study. The specific objectives of the study are to:

- Review growth and structural change in the export and import of goods and services and the role of trade policy in influencing external trade of Bangladesh;
- Assess the impact of past trade liberalisation measures and recommend appropriate export policies for the Sixth Plan period;
- Identify potential export industries and recommend policy measures for export diversification and promotion of potential export industries;

- Make a critical assessment of South Asian Free Trade Area (SAFTA) and the scope of reducing Bangladesh's trade imbalance with its neighbours through bilateral Free Trade Arrangement (FTA);
- Suggest negotiation strategies for securing quota-free and duty-free access for Bangladesh's exports in the developed country markets;
- Make a critical assessment of past policies towards FDI and recommend necessary improvements;
- Recommend measures for enhancing inflow of foreign remittances and ensuring productive use of these resources; and
- Examine any other issues related to export promotion.

4.3 GROWTH AND STRUCTURAL CHANGE IN EXTERNAL TRADE AND THE ROLE OF TRADE POLICY

4.3.1 Growth and Structural Change

This section examines the growth and structural change that took place in Bangladesh over the last three decades and the role of trade policy in influencing the exports and imports of goods and services. First, a descriptive analysis of the changes in trade and trade policy is presented and then an empirical analysis of structural change in exports and imports and the role of trade policy in influencing trade are presented.

4.3.1.1 Growth of Exports

Exports grew at an average annual rate of 9.1 per cent in the 1980s (Annex Table 4.A.1). Rapid increase in the trade deficit resulting from slow export growth and rapid import growth led the government to implement trade liberalisation policies in the 1980s as a part of the structural adjustment policies in the economy. These policies were implemented to enhance the supply response of the economy, especially the exportables. The trade liberalisation policy was intensified in FY91-92 following the coming of a new democratic government into power. In the 1990s, exports grew at an average annual rate of 14.7 per cent which was much higher than that achieved in the 1980s. Trade liberalisation policies that reduced the anti-export bias and buoyant world demand underlie the rapid growth of exports. Exports grew at an annual average rate of 11.8 per cent during the FY2001-FY2009 period. Export growth in the latest period though lower than that achieved in the preceding decade should be considered as reasonably satisfactory in the context of the challenges facing the export market. Firstly, the world recession of FY2002, which led to decline in exports. Secondly, the complete phase out of the MFA on 31 December 2004 which was apprehended to reduce RMG export. Thirdly, recent world recession beginning in the last quarter of 2008, which have negatively affected exports of many developing countries. Fourthly, the US lifted quota on certain Chinese apparel items competing with Bangladeshi products. The double digit growth of exports in the face of several consecutive shocks as a matter of fact demonstrates resilience of the export sector.[2]

4.3.1.2 Structural Change of Exports

An important feature of the export basket has been its concentration on a few commodities during the period under study (Annex Table 4.A1). Jute and jute goods, tea, leather and leather products, and frozen foods were the major exports up to the late 1980s. Since FY1988 woven and knit garments, frozen foods, leather and leather products and jute and jute goods have been the major exports. The most remarkable feature of the export basket is the emergence of RMG in the late 1970s as export and its increasing dominance in the export basket over the years. RMG has replaced jute and jute goods in importance. Thus while the contribution of jute and jute goods declined from about 69 per cent in FY1981 to about 3 per cent in FY2009, readymade garment–an unknown item in the early 1970s constitutes more than 75 per cent of total exports in recent years. There has been structural change within RMG itself. While woven garment completely dominated RMG export in the beginning, the share of knit garment in RMG has gradually increased and exceeded that of woven garment in FY2008.

There has also been some change in the case of other minor exports. Newsprint, naptha, furnace oil and bitumen, urea, molasses, wheat and rice bran, and handicrafts constituted important minor exports in the 1970s and 1980s. While naptha, furnace oil and bitumen and handicrafts continue to be present in the export basket, some new items have been added to the basket. These include agricultural products, other primary products, shoe, chemicals, and engineering products. Besides, other manufactured products comprising a variety of small items are gradually becoming important. On the whole, concentration of exports remains an important feature of the external sector. Notwithstanding government efforts to diversify exports through various export incentives, there has been little progress in export diversification.

4.3.1.3 Destinations of Exports

Like exports of commodities, destination of exports is also marked by growing concentration as well as shift in regional composition (Annex Table 4.A2). In the

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[2] Domestic political disturbances during the later part of 2006 also posed a challenge for the sustained growth of the economy including the export sector.

early 1980s about 20 per cent of total exports entered the EU market. Other regions like developing Asia, the Middle East, Africa and North America used to attract 10-15 per cent of total exports. Afterwards increasing percentage of exports has been sent to the EU and North America. In recent years, the EU has become the most important destination followed by North America. These two markets absorbed about 73 per cent of total exports of Bangladesh in FY2008, resulting in marked decline in the share of exports of developing Asia, the Middle East and Africa. The shift in export destination is mainly a consequence of the change in the commodity composition of export. Jute and jute goods were exported to all the regional markets claiming a respectable share of exports. The EU and North America are the dominant buyers of RMG, currently the most important export of the country. It is known that trade in textiles and clothing products was managed from 1974 to 2004 under MFA which allowed developed importing countries like the USA, the EU and Canada to use quota to restrict imports from certain developing countries. Bangladesh could develop its RMG sector taking advantage of the quota system faced by large RMG exporting countries. In the post-MFA period Bangladeshi exports enjoy tariff preferences in these markets giving Bangladesh some price advantage over its competitors. In the last few years increasing wages in China, the dominant RMG exporter in the world, has given rise to some cost advantage for Bangladesh.

4.3.1.4 Growth and Structural Change of Imports

Imports grew at an average annual rate of 5.1 per cent in the 1980s, followed by 8.9 per cent and 12.0 per cent growth in the 1990s and during the FY2001-FY2009 period. The most noticeable change in the composition of imports is the steady decline in the share of foodgrains in total imports that has been made possible by increased domestic production. There have been yearly fluctuations in foodgrains imports depending on domestic production and stock. During the FY1981-FY2009 period, imports grew at a relatively lower (8.6 per cent) than that of exports (11.9 per cent) resulting in declining trade deficit as a proportion of GDP. During this period exports increased from US$ 680.6 million in FY1981 to US$ 15565.2 million in FY2009, while imports increased from US$ 2,533 million to US$ 22,507 million. These developments resulted in an increase in export/import ratio from 0.27 to 0.69 during that period. Thus while a large proportion of import was financed by foreign aid in the earlier period, a larger proportion of import is now being financed by Bangladesh's own export earnings.

The sources of imports have also undergone changes over the years. The share of Japan and the USA in total imports declined from about 18 per cent in FY1985 to about 6 per cent in FY2008. During the same period, the share of imports from a small group of developing countries such as India, China, Singapore, South Korea, Malaysia, Hong Kong and Taiwan increased from 20 per cent to 47 per cent. India and China contributed 16 per cent and 15 per cent of imports respectively in FY2008. Thus while exports are increasingly marketed in developed country markets, imports are sourced from developing country markets. The rising prominence of developing countries as sources of imports can be attributed to emergence of the countries as sources of relatively cheaper capital goods and a wide range of consumer products as well as raw materials and intermediate goods for the export oriented textile and RMG industry.

4.3.2 External Trade Policy

As indicated above, Bangladesh underwent substantial changes in economic policies since the early 1980s experienced an increased degree of integration with the global economy (Salim 2003, Hossain and Karunaratne 2004, Jenkins and Sen 2006). The liberalisation attempts can be divided into several phases in terms of the coverage and the degree of implementation of the programme: phase I (FY1982-FY1986), phase II (FY1987-FY1991), phase III (FY1992-FY1996), phase IV (FY1997-FY2001) and phase V (FY2002 onwards). The first modest attempt at trade liberalisation was made during FY1982-FY1986. The policies led to some reduction in the level of quantitative restrictions on imports, reduction in rates and dispersion of tariff rates and removal of import licensing in FY1984. A few measures were introduced and some old ones were reformed to promote exports. A more heightened attempt at trade liberalisation was made during FY1987-FY1991. The reform package was directed at removing quantitative restrictions on imports, decreasing tariff levels, rationalising the tariff structure and simplifying trade procedures.

The third phase marks significant intensification of the trade liberalisation programme. The programme progressively moved to lower the protectionist nature of the trade regime. The number of goods whose imports were banned or restricted was brought down from 478 in FY1985 to 109 in FY1994.The highest customs duty was brought down from 400 per cent in FY1989 to 60 per cent in FY1995. The number of operative duty slabs was reduced from 18 in FY1991 to 7 in FY1995. As a result of tariff restructuring both unweighted and weighted nominal protection rate (NPR) declined. The import clearance procedure was simplified through complete removal of import license requirements, modification of voluntary Pre-shipment Inspection (PSI) in 1994 and introduction of computerised customs valuation system.

The fourth phase (FY1997-FY2001) shows relative stagnation in some of the indicators and backtracking of trade policy. Trade liberalisation resumed again in FY2002, but the progress has been slow in recent years. The liberalisation programme though moved at different rates and depth over the last three decades has resulted more outward orientation of the economy. In FY2010, the number of tariff slabs stands at four–25 per cent for finished goods, 12 per cent for intermediate raw materials, 5 per cent for basic industrial raw materials and 3 per cent for capital machinery and parts. The average tariff in FY2010 standing at 24 per cent, though significantly lower than that in the earlier periods, is one of the highest in South Asia. The highest tariff rate (25 per cent) has remained unchanged for the last five years.

TABLE 4.1

SELECTED TRADE INDICATORS, 2005-07

Indicators	Value
Trade Policy Ranking (out of 125)[1]	97
TTRI	15.1
MFN applied tariff - simple average (%)	21.8
MFN applied tariff - trade weighted average (%)	18.3
MFN zero-duty imports (% in total imports)	19.2
Applied tariff (including preferences) - trade weighted average (%)	13.5*
Bound tariff frequency ratio (% of total lines)	13.0
Tariff overhang (MFN bound less MFN applied rate %)	153.5
Import duties (% of imports)	15.7*
Non-tariff measures frequency ratio (%)	9.8*
Overall GATS commitment index (0-100, best)	3.4
External Environment Ranking (out of 126)[1]	54
ROW applied tariff (including preferences) - weighted average (%)	4.4
MFN zero-duty exports (% of total exports)	8.6
Preferences (EU+US) utilisation rate (%)	84.6
Preferences (EU+US) actual value (% of exports)	6.6
Institutional Environment Ranking (out of 181)[1]	110
Ease of Doing Business (rank out of 181)	104
WGI - Regulatory Quality (-2.5 to +2.5, best)	-0.81
Trade Facilitation Ranking (out of 151)[1]	87
Efficiency of customs and other border procedures (1 to 5 best)	2.0
Quality of transport and IT infrastructures (1 to 5)	2.3
Timeliness of shipment	3.3
Doing Business - Trading Across Borders (rank out of 181)	104
Trade Outcome Ranking (out of 161)[1]	31
Trade integration (trade as % of GDP)	47.1
FDI inflow (% of GDP)	1.2
Merchandise share in total exports (%)	88.8
Service share in total exports (%)	11.2
Export market concentration index (0 to 100, highest)	40.6*

Source: World Bank (2008).

Note: 1 Data available for the latest year. * indicates that data are available for 2000-04. ROW means the rest of the world.

The progressive dismantling of quantitative restrictions and reduction in tariff rates and dispersion of rates have considerably reduced the anti-export bias of trade policy. On the export side, policies are directed at providing incentives for exports and offsetting the disincentive effects of import barriers. This policy is termed "equalising compensation" i.e. equalisation of incentives for exporters and import substitutors. Due to restrictions on imports through tariff and non-tariff barriers to protect domestic industries, an import substitution industry may be preferred to an export industry. Therefore, profitability considerations require providing equal incentives to exporters and import substitutors, i.e., equalising compensation by offsetting the bias between anti-export and pro-import substitution. Over time, the government has employed different measures to provide incentives to export sector. The current major export incentives include bonded warehouse and back to back letter of credit facility, duty drawback facility and export credit guarantee scheme facility.

In spite of all the policy measures in the external sector, the country is characterised by one of the least liberal trade policy regimes in the world in terms of Trade Tariff Restrictiveness Index (TTRI). The recent Most Favoured Nation (MFN) applied simple tariff average is much higher than that of most of its neighbours.[3] The tariff overhang is very high, which demonstrates its reluctance to bind the trade policy regime at rates close to the MFN applied rates (World Bank 2008).

The economy is also incurring significant loss in terms of its volume and share in the economy due to the existing tariff structure. Kee, Nicita and Olarreagn (2008) demonstrate that the linearly approximated deadweight loss (DWL) associated with the existing tariff structure is 0.47 per cent of the total GDP of Bangladesh (Table 4.2).[4]

TABLE 4.2

DEAD WEIGHT LOSS (DWL) DUE TO THE EXISTING TARIFF REGIME

Total DWL Million US$	DWL due to Tariff			
	% of GDP	Average	Variance	Covariance
263.63** (110.46)	0.47	169.27	67.54	26.81

Source: Kee, Nicita and Olarreaga (2008).

Note: Number in parenthesis is bootstrapped standard errors. ** indicates that the estimated DWL is statistically significant at 5 per cent level.

[3] MFN is the principle of treating imports from a country on the same basis as that given to the most favoured other nation. It is fundamental to GATT. With some exceptions, every country gets the lowest tariff that any country gets, and reductions in tariffs to one country are provided also to others. MFN tariff is the tariff level that a member of the GATT/ WTO charges on a good to other members.

[4] DWL is divided into three components associated with the contributions of import-weighted tariff, tariff variance, and the covariance between tariffs and import demand elasticities. A positive contribution of the covariance indicates that countries impose higher tariffs on more elastic imports.

4.3.3 Analysis of Structural Change in Exports and Imports

In a regression model of Bangladesh's external trade that involves time series data, there may be a structural change in the relationship between the dependent variable and independent variables. Structural change implies that the values of the parameters of the model do not remain the same through the entire period. Sometimes the structural change may be due to external forces (e.g. demand or income elasticity of exportable in destination countries), to domestic policy changes (e.g. tariff reduction, financial sector reforms) or to unobservable factors, which exert individual or combined impact on the country's international trade.

One traditional approach of examining structural change is to adopt Chow test (Chow 1960). This test assesses whether the coefficients in two linear regressions on different data sets are equal. The fundamental problem associated with this test is the arbitrariness in bifurcating the series to examine whether two sets have different intercepts, slopes or both. Recent developments in the literature of structural break suggests that it is important to determine whether there is structural break in the entire series or not taking into account the time series properties of the data and single or multiple breakpoint exists in a series, and to identify the year of the structural break.

4.3.3.1 Existence of the Break

Elliott and Müller (2006) devise a test to examine whether there is a structural break in a series. This test allows for many or relatively few breaks, clustered breaks, regularly occurring breaks, or smooth transitions to changes in the regression coefficients. The test distinguishes the null hypothesis of a stable regression model

$$y_t = X_t'\overline{\beta} + Z_t'\delta + \varepsilon_t \qquad t = 1, \ldots, T \tag{3.1}$$

from the alternative hypothesis of the unstable model

$$y_t = X_t'\beta_t + Z_t'\delta + \varepsilon_t \qquad t = 1, \ldots, T \tag{3.2}$$

with non-constant $\{\beta_t\}$, where y_t is a scalar, X_t, β_t are $k\times1$ vectors, Z_t and δ are $d\times1$, $\{y_t, X_t, Z_t\}$ are observed, $\overline{\beta}$, $\{\beta_t\}$, and δ are unknown, and ε_t is a mean-zero disturbance. That is, this test examines whether the coefficient vector that links the observables X_t to y_t remains stable over time, while allowing for other stable links between y_t and the observables through Z_t. This very general specification nests many of the "structural break" and "time varying parameter" models in the literature, allowing for almost any pattern of variation in the coefficients of the X variables, with good power and size even in a heteroscedastic context.

The tests have been performed for the log of aggregate annual exports and imports from 1980 to 2008 against time period. The calculated test statistics for both exports and imports are significantly higher than 1 per cent critical value. The results indicate that both the series have structural break.

TABLE 4.3

ELLIOTT-MÜLLER TEST FOR TIME VARYING COEFFICIENTS

	Test Statistic	1% Critical Value	5% Critical Value	10% Critical Value
Exports	-24.625	-11.05	-8.36	-7.14
Imports	-24.663			

Source: Own calculation.

4.3.3.2 Optimal Breakpoint

Elliott-Müller test does not identify the optimal year of a break and whether there is one or more than one break year in a series. For examining the optimal breakpoint, we adopt two tests: (i) Zivot-Andrews test, and (ii) Clemente-Montañés-Reyes test.

Zivot and Andrews (1992) proceed with three models to test for a unit root: Model 3.3, which permits a one-time change in the level of the series; Model 3.4, which allows for a one-time change in the slope of the trend function; and Model 3.5, which combines one-time changes in the level and the slope of the trend function of the series. To test for a unit root against the alternative of a one-time structural break, Zivot and Andrews use the following regression equations corresponding to the above three models:

$$\Delta y_t = c + \alpha y_{t-1} + \beta t + \gamma DU_t + \sum_{j=1}^{k} d_j \Delta y_{t-j} + \varepsilon_t \tag{3.3}$$

$$\Delta y_t = c + \alpha y_{t-1} + \beta t + \theta DU_t + \sum_{j=1}^{k} d_j \Delta y_{t-j} + \varepsilon_t \tag{3.4}$$

$$\Delta y_t = c + \alpha y_{t-1} + \beta t + \theta DU_t + \gamma DT_t + \sum_{j=1}^{k} d_j \Delta y_{t-j} + \varepsilon_t \tag{3.5}$$

where DU_t is an indicator dummy variable for a mean shift occurring at each possible break-date (TB) while DT_t is corresponding trend shift variable. Formally,

$$DU_t = \begin{cases} 1 & if \quad t > TB \\ 0 & otherwise \end{cases} \qquad \text{and}$$

$$DT_t = \begin{cases} t - TB & if \quad t > TB \\ 0 & otherwise \end{cases}$$

The null hypothesis in all the three models is α=0, which implies that the series $\{y_t\}$ contains a unit root with a drift that excludes any structural break, while the alternative hypothesis α<0 implies that the series is a trend-stationary process with a one-time break occurring at an unknown point in time. Zivot-Andrews test considers every point as a potential break-date (TB) and runs a regression for every possible break-date sequentially. From amongst all possible break-points (TB), the procedure selects as its choice of break-date ($\overline{TB}$); the date which minimises the one-sided t-statistic for testing $\hat{\alpha}$ =(α-1) =1. According to Zivot and Andrews, the presence of the end points causes the asymptotic distribution of the statistics to diverge towards infinity. Therefore, some region must be chosen such that the end points of the sample are not included. They suggest the "trimming region" be specified as (0.15T, 0.85T).

TABLE 4.4

ZIVOT-ANDREWS ONE-BREAK TEST

Allowing for break in	Imports/Exports	Minimum t-statistic	Break Year
Intercept	Exports	-4.094	1993
	Imports	-3.940	1995
Trend	Exports	-4.287	1985
	Imports	-3.424	2003
Both intercept and trend	Exports	-4.168	1984
	Imports	-3.689	1995

Source: Own calculation.

The results indicate that when allowed for break in intercept only, the optimal break years are 1993 and 1995 for imports and exports. Conversely, allowing for break in trend, the respective years are 1985 and 2003. However, if we allow for both, the optimal year for exports becomes 1984 but for import it is the same as that of Model 3.3.

Now it is imperative to examine whether there are more than one break in exports and imports. As Clemente, Montanes and Reyes (1998) suggest, "… some variables do not show just one break; rather, it is common for them to exhibit the presence of multiple breaks. Thus, it seems advisable to introduce a larger number of breaks in the specifications of the models …." Following their approach, the null hypothesis can be tested as

$$y_t = y_{t-1} + \delta_1 DTB_{1t} + \delta_2 DTB_{2t} + u_t \quad (3.6)$$

against the alternative hypothesis

$$y_t = \mu + d_1 DU_{1t} + d_2 DTB_{2t} + e_t \quad (3.7)$$

where DTB_{it} is a pulse variable that takes the value 1 if $t=TB_i+1$ (i=1, 2) and 0 otherwise, $DU_{it}=1$ if $t>TB$ (i=1, 2) and 0 otherwise. TB_1 and TB_2 are the time periods when the mean is being modified. For simplicity, suppose $TB = \lambda_i T$ (i=1, 2), with $0<\lambda_i<1$ and $\lambda_2 > \lambda_1$. Now, if the two breaks belong to the innovational outlier (IO), the unit-root hypothesis can be tested by

$$y_t = \mu + \rho y_{t-1} + \delta_1 DTB_{1t} + \delta_2 DTB_{2t} + +d_1 DU_{1t} + d_2 DTB_{2t} + \sum_{i=1}^{k} c_i \Delta y_{t-i} + e_t \quad (3.8)$$

Figure 4.1: Optimal Breakpoints of Exports Allowing for Break in Intercept (top left), Trend (top right) and both Intercept and Trend (bottom)

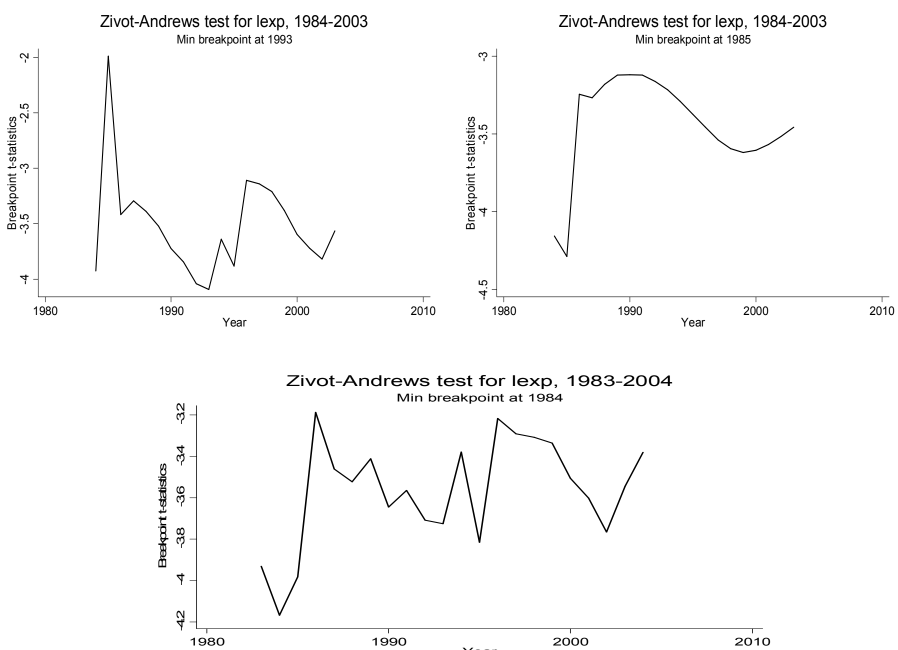


Figure 4.2: Optimal Breakpoints of Imports Allowing for Break in Intercept (top left), Trend (top right) and both Intercept and Trend (bottom)

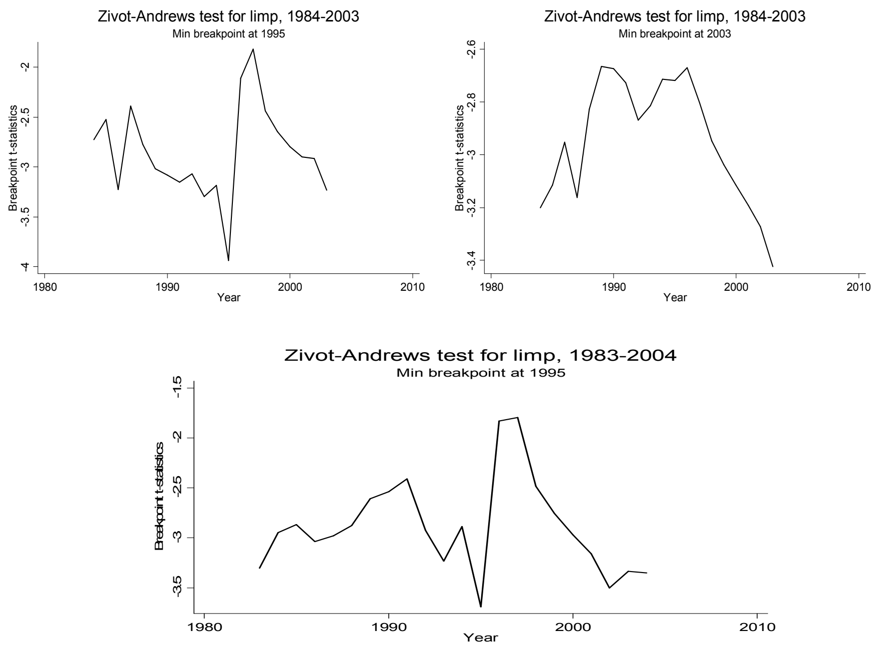


TABLE 4.5

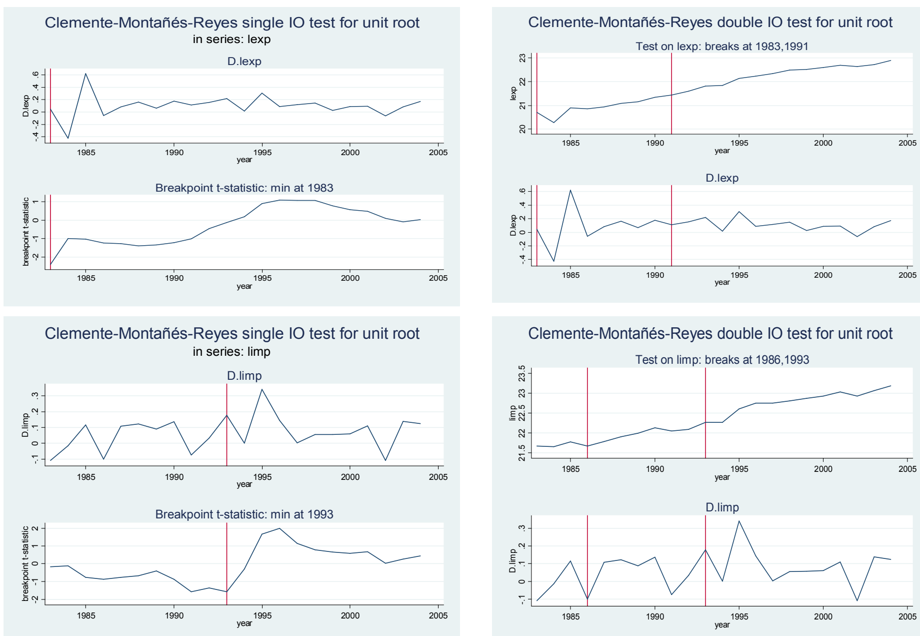
CLEMENTE-MONTAÑÉS-REYES TEST IN IO MODEL

		First Break Year	Second Break Year	DU1	DU2
Single mean shift	Exports	1983		0.279***	
	Imports	1993		0.142	
Double mean shifts	Exports	1983	1991	0.000	0.800**
	Imports	1986	1993	0.146**	0.137

Note: *** and ** indicate that the particular coefficients are significant at 1 and 5 per cent level respectively.

The results indicate that there is one structural break in exports (1983), which is strongly significant (at 1 per cent level), but no break in imports, when allowed for single mean shift. For double mean shift, one structural break is evident for both exports and imports (significant at 5 per cent level); the optimal break years are 1991 and 1986 respectively.

Figure 4.3: Optimal Breakpoints of Exports (top) and Imports (bottom)



4.3.4 Analysis of Role of Trade Policy in External Trade

The role of trade policy in influencing external trade can best be examined by identifying an appropriate trade policy variable and assessing its impact on the trading pattern of a country. Such a variable can be a country's trade openness, which is an outcome of all trade policies. In the context of performance of exports and imports of goods and services, such variables may be the export-GDP ratio and import-GDP ratio respectively, which are used by Ben-David and Papell (1997). The next empirical question would be: how can we measure the trading pattern of a country? The simple way to do is to estimate its export supply and import demand functions and examine the role of export-GDP and import-GDP ratios in these functions respectively.

A body of literature exists on the study of aggregate export supply and import demand function for developing countries (e.g. Ahmed (2000) for export supply function and Senhadji (1998) for import demand function). The aggregate export supply and import demand functions for Bangladesh can be written as:

$$LEQI_t = \alpha_1 + \alpha_2 LEVI_t + \alpha_3 LWPI_t + \alpha_4 LIND_t + \alpha_5 XRER_t + \alpha_6 LXGDP + \varepsilon_t \tag{3.9}$$

$$LIQI_t = \beta_1 + \beta_2 LIVI_t + \beta_3 LWPI_t + \beta_4 LRES_t + \beta_5 LMGDP + e_t \tag{3.10}$$

where

L = natural logarithm
EQI = export quantum index
EVI = export value index
WPI = wholesale price index
XRER = real effective exchange rate
IQI = import quantum index
IVI = import value index
RES = foreign exchange reserve (US dollars)
ε and e = error terms
t = 1, 2, …, n is the time period, from 1980 to 2007.

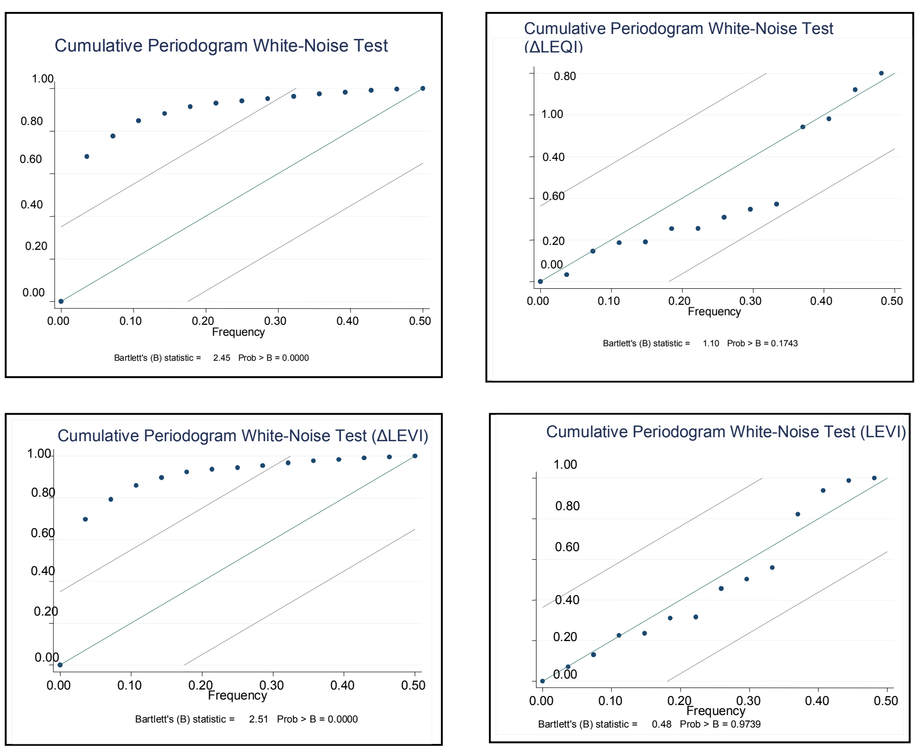
It is a standard practice to begin the analysis by examining the time series properties of the data. The analysis of Cointegration starts with the determination of the univariate properties of the time series. The concept of Cointegration requires that the set of variables should be integrated of the same order and their linear combinations must be stationary. If the series do not follow the same order of integration, then there can be no meaningful relationship among them. If the series are integrated of the same order, we can proceed to the cointegration test.

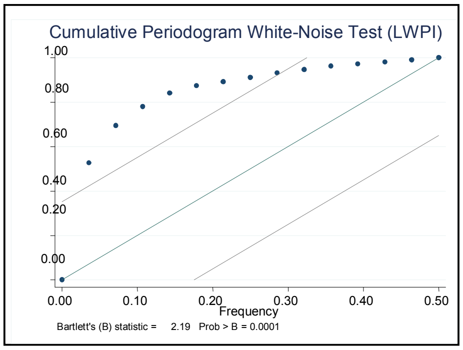
A test for cointegration analysis means looking for stable long-run equilibrium relationships among non-stationary economic variables. If the results indicate the absence of cointegrating vectors between the variables, it means that there does not exist a long-run stable relationship between them. The implementation of cointegration method necessitates the prior check for non-stationarity of data. In time series literature unit root tests like augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) tests are widely used for testing stationarity (nonstationarity) in economic data. If the variables are found to be non-stationary at levels and they are determined to be stationary in their first-differences, they are said to be integrated of order one, I(1). There are two main approaches to test for cointegration: Engle and Granger (1987) two step procedure and the Johansen (1988) and Johansen and Juselius (1990) procedure. To test for cointegration among variables in export supply and import demand functions, we adopt the latter procedure since this method is claimed to be superior to the regression based Engle-Granger procedure. The Johansen and Juselius procedure fully captures the underlying time series properties of the data and provides estimates of all the cointegrating vectors that exist within a set of variables.

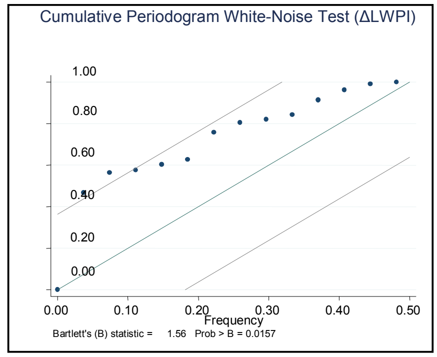
4.3.4.1 Unit Root and Cointegration Tests

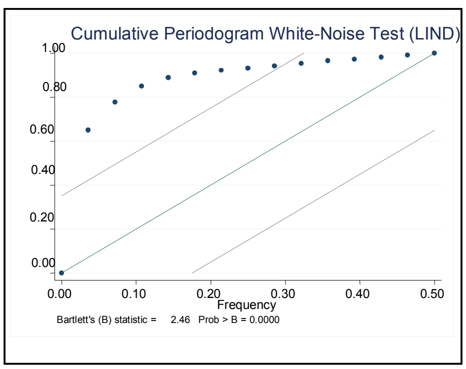
Before applying the cointegration test, we carry out the unit root tests of the time series properties of the variables. For each series, we examine the time series properties of the macro variables using the standard ADF and PP tests (Table 4.6). Results provide strong evidence of non-stationarity in level in both the tests except for LWPI, which is stationary at level. For first difference, the variables turn out to be stationary. Therefore, we conclude that all the series contain a single unit root. Since all the variables appear to have a unit root, testing for cointegration is feasible.

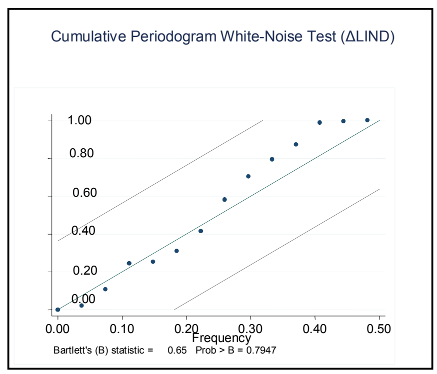
Figure 4.4: White Noise Test of the Variables at Level (Left) and First Difference (Right) in Export Supply Function

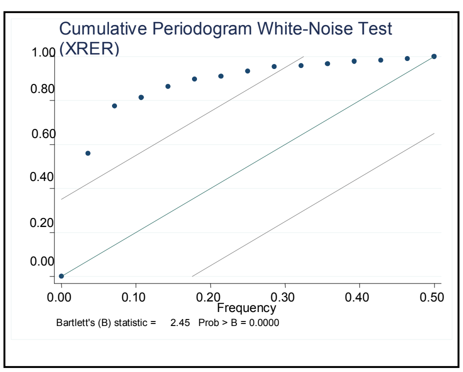


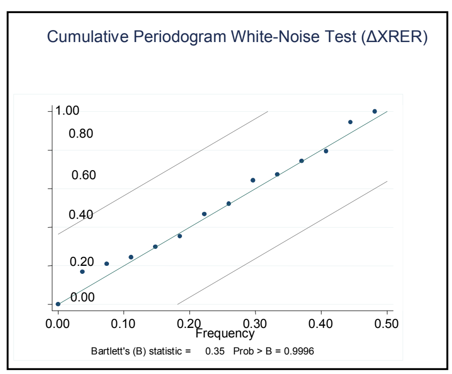

Cumulative Periodogram White-Noise Test (LWPI)
1.00
0.80
0.60
0.40
0.20
0.00
0.00 0.10 0.20 0.30 0.40 0.50
Frequency
Bartlett's (B) statistic = 2.19 Prob > B = 0.0001


Cumulative Periodogram White-Noise Test (ΔLWPI)
1.00
0.80
0.60
0.40
0.20
0.00
0.00 0.10 0.20 0.30 0.40 0.50
Frequency
Bartlett's (B) statistic = 1.56 Prob > B = 0.0157


Cumulative Periodogram White-Noise Test (LIND)
1.00
0.80
0.60
0.40
0.20
0.00
0.00 0.10 0.20 0.30 0.40 0.50
Frequency
Bartlett's (B) statistic = 2.46 Prob > B = 0.0000


Cumulative Periodogram White-Noise Test (ΔLIND)
1.00
0.80
0.60
0.40
0.20
0.00
0.00 0.10 0.20 0.30 0.40 0.50
Frequency
Bartlett's (B) statistic = 0.65 Prob > B = 0.7947


Cumulative Periodogram White-Noise Test (XRER)
1.00
0.80
0.60
0.40
0.20
0.00
0.00 0.10 0.20 0.30 0.40 0.50
Frequency
Bartlett's (B) statistic = 2.45 Prob > B = 0.0000


Cumulative Periodogram White-Noise Test (ΔXRER)
1.00
0.80
0.60
0.40
0.20
0.00
0.00 0.10 0.20 0.30 0.40 0.50
Frequency
Bartlett's (B) statistic = 0.35 Prob > B = 0.9996

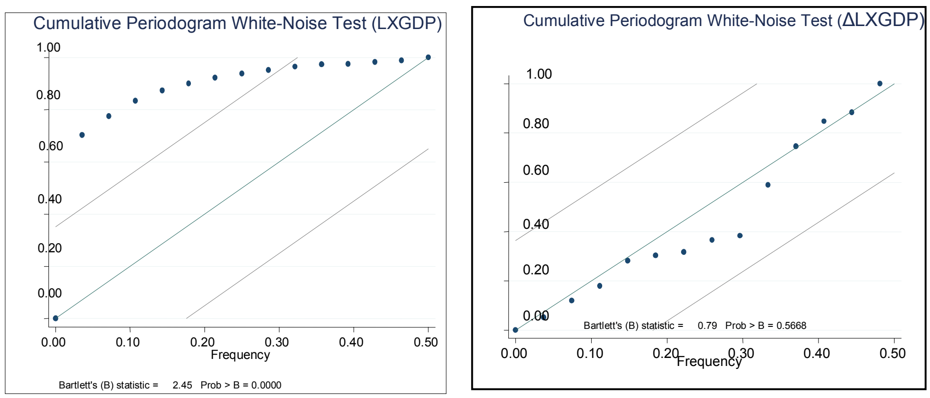
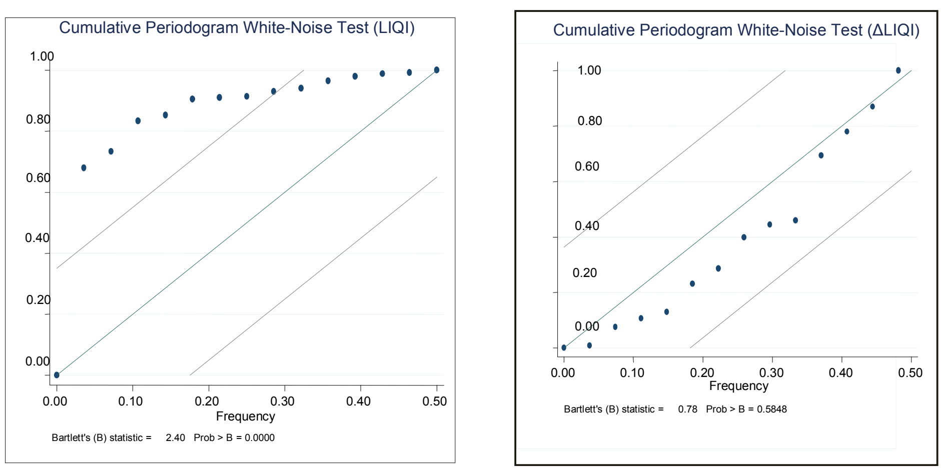
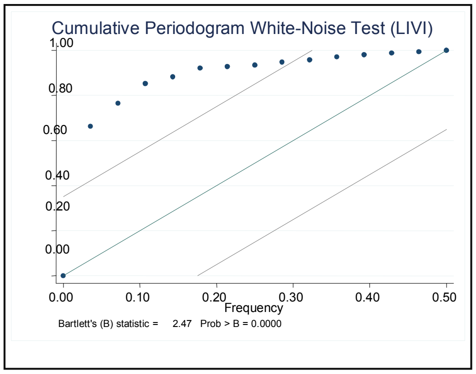
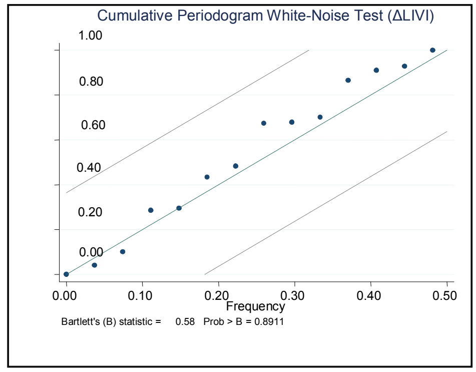
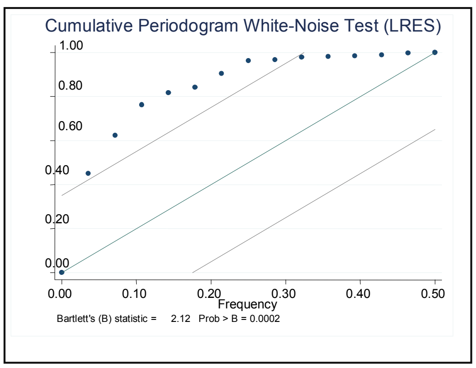


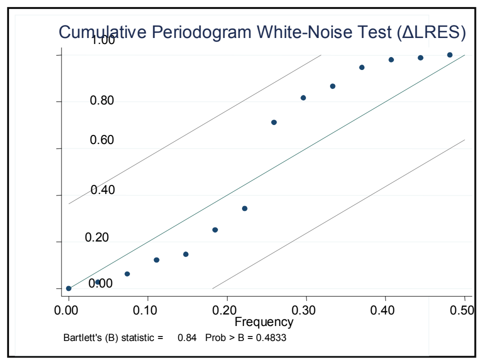
Figure 4.5: White Noise Test of the Variables at Level (Left) and First Difference (Right) in Import Demand Function

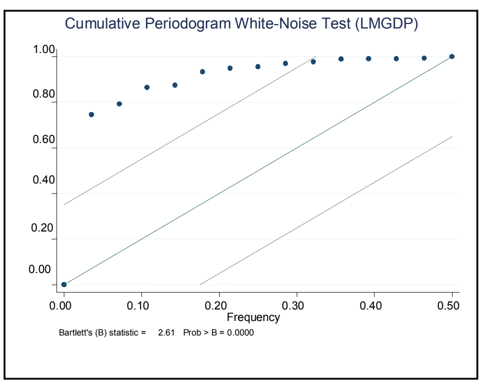



Cumulative Periodogram White-Noise Test (LIVI)
1.00
0.80
0.60
0.40
0.20
0.00
0.00
0.10
0.20
0.30
0.40
0.50
Frequency
Bartlett's (B) statistic = 2.47 Prob > B = 0.0000


Cumulative Periodogram White-Noise Test (ΔLIVI)
1.00
0.80
0.60
0.40
0.20
0.00
0.00
0.10
0.20
0.30
0.40
0.50
Frequency
Bartlett's (B) statistic = 0.58 Prob > B = 0.8911


Cumulative Periodogram White-Noise Test (LRES)
1.00
0.80
0.60
0.40
0.20
0.00
0.00
0.10
0.20
0.30
0.40
0.50
Frequency
Bartlett's (B) statistic = 2.12 Prob > B = 0.0002


Cumulative Periodogram White-Noise Test (ΔLRES)
1.00
0.80
0.60
0.40
0.20
0.00
0.00
0.10
0.20
0.30
0.40
0.50
Frequency
Bartlett's (B) statistic = 0.84 Prob > B = 0.4833


Cumulative Periodogram White-Noise Test (LMGDP)
1.00
0.80
0.60
0.40
0.20
0.00
0.00
0.10
0.20
0.30
0.40
0.50
Frequency
Bartlett's (B) statistic = 2.61 Prob > B = 0.0000

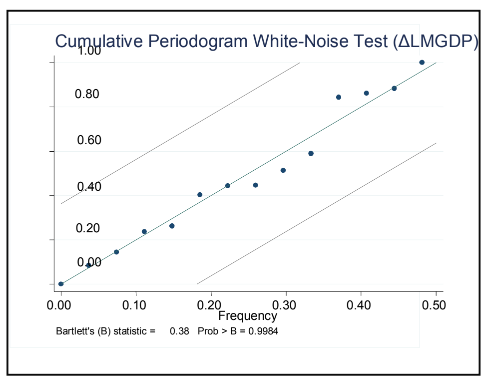

Cumulative Periodogram White-Noise Test (ΔLMGDP)
1.00
0.80
0.60
0.40
0.20
0.00
0.00
0.10
0.20
0.30
0.40
0.50
Frequency
Bartlett's (B) statistic = 0.38 Prob > B = 0.9984

TABLE 4.6

ADF AND PP TESTS FOR VARIABLES IN THE EXPORT SUPPLY FUNCTION

	ADF		PP		Remarks
	Level	First Difference	Level	First Difference	
LEQI	0.262	-6.883^{***}	0.491	-6.806^{***}	I(1)
LEVI	0.522	-5.795^{***}	0.736	-5.855^{***}	I(1)
LWPI	-3.034^{**}	-2.801^{*}	-2.831^{*}	-2.705^{*}	I(0)
LIND	0.687	-5.027^{***}	0.839	-5.030^{***}	I(1)
XRER	1.071	-5.100^{***}	1.408	-5.101^{***}	I(1)
LXGDP	1.112	-6.172^{***}	1.745	-6.141^{***}	I(1)

Note: ***, ** and * indicate that the particular coefficients are significant at 1, 5 and 10 per cent level respectively.

TABLE 4.7

JOHANSEN'S COINTEGRATION TEST FOR LEQI, LEVI, LIND, LWPI, XRER AND XGDP

Maximal Eigenvalue				Trace			
Null	Alternative	Statistic	95% Critical Value	Null	Alternative	Statistic	95% Critical Value
r = 0	r = 1	50.813	39.830	r = 0	r ≥1	121.370	95.870
r ≤ 1	r = 2	31.757	33.640	r ≤ 1	r ≥ 2	70.557	70.490

TABLE 4.8

ADF AND PP TESTS FOR VARIABLES IN THE IMPORT DEMAND FUNCTION

	ADF		PP		Remarks
	Level	First Difference	Level	First Difference	
LIQI	-0.308	-6.844^{***}	0.028	-7.008^{***}	I(1)
LIVI	1.323	-4.633^{***}	1.585	-4.613^{***}	I(1)
LRES	-0.979	-5.187^{***}	-0.789	-5.268^{***}	I(1)
LXGDP	0.623	-5.688^{***}	0.756	-5.628^{***}	I(1)

Note: *** indicates that the particular coefficient is significant at 1 per cent level.

TABLE 4.9
JOHANSEN'S COINTEGRATION TEST FOR LIQI, LEVI, LWPI, XRES AND XGDP

Maximal Eigenvalue				Trace			
Null	Alternative	Statistic	95% Critical Value	Null	Alternative	Statistic	95% Critical Value
r = 0	r = 1	50.911	31.000	r = 0	r ≥1	86.793	58.930
r ≤ 1	r = 2	19.211	24.350	r ≤ 1	r ≥ 2	35.882	39.330

The results of the cointegration tests suggest that there is one cointegrating relationship between the variables used in the export supply function. Now, since the variables are both I(0) and I(1) in this function, we can adopt autoregressive distributed lag (ARDL) model to examine both the short and long run impact of LXGDP and LMGDP on LEQI and LIQI respectively.

4.3.4.2 ARDL Estimates

The present ARDL model follows the approach adopted by Pesaran and Shin (1995), Pesaran, Shin and Smith (1996), Pesaran and Pesaran (1997), Pesaran (1999), Pesaran, Shin and Smith (2001), and Narayan and Narayan (2005). The main advantage of this approach is that it avoids the uncertainty pertaining to unit root pretesting by allowing it irrespective of whether the variables are I(0) or I(1). It yields precise estimates of long-term coefficients and valid t-statistics in the presence of even endogenous variables (Inder 1993). Estimates based on an ARDL model are super-consistent and valid inferences can be drawn using standard tests on long-term parameters by applying standard asymptotic theory (Pesaran and Shin 1995).

The general form of an augmented ARDL(p, q_1, q_2, …, q_k) model can be written as follows (Pesaran and Pesaran 1997):

$$\phi(L,p)y_t = \sum_{i=1}^{k}\beta_i(L,q_i)x_{i,t} + \delta' w_t + u_t \quad ; t = 1, 2, \ldots, 27 \tag{2.11}$$

where, L is the lag operator such that $Ly_t = y_{t-1}$; w_t is s×1 vector of deterministic variables including intercept; p = 0,1,2, …, m; q_i = 0,1,2, …, m; $\phi(L,p)$ =1–

$\phi_1 L - \phi_2 L^2 - ... - \phi_p L^p$; $\beta_i(L, q_i) = 1 - \beta_{i1} L - \beta_{i2} L^2 - ... - \beta_{iq_i} L^{q_i}$. The long-term estimator for the response of y_t to a unit change in $x_{i,t}$ is given by

$$\hat{\theta}_i = [\hat{\beta}_i(1, \hat{q}_i)] / \hat{\phi}(1, \hat{p})]$$

and, the long-term estimator related to the exogenous or deterministic variables with fixed lags can be written as:

$$\hat{\psi} = [\hat{\delta}(\hat{p}, \hat{q}_i)] / [\hat{\phi}(1, \hat{p})]$$

Finally, the error correction representation of the ARDL(p, q_1, q_2, …, q_k) model can be written as:

$$\Delta y_t = -\phi(1, \hat{p}) EC_{t-1} + \sum_{i=1}^{k} \beta_{i0} \Delta x_{i,t} + \hat{\delta} \Delta w_t - \sum_{j=1}^{\hat{p}-1} \phi_j^* \Delta y_{t-j} - \sum_{i=1}^{k} \sum_{j=1}^{\hat{p}-1} \beta_{ij}^* \Delta x_{i,t-j} + u_t \qquad (2.12)$$

where the error correction term, EC_t, corresponding to the long-term estimators, is defined by

$$EC_t = y_t - \sum_{i=1}^{k} \hat{\theta}_i x_{i,t} - \hat{\psi}' w_t$$

In Equation (2.12), $\phi(1, \hat{p})$ measures the significance of the error correction term. The coefficients ϕ_j^* and β_{ij}^* transmit to the short-run dynamics of the convergence of the model to equilibrium.

The coefficients of the estimated ARDL model are presented in Tables 4.10 and 4.11, where the lag orders of ARDL are based on the SBC. Since Tables 4.7 and 4.9 confirm the existence of cointegrating relationship among the variables, there is no need for carrying out the bounds test.[5] The coefficient of LMGDP is positive and significant at 1 per cent level in both the long and short run estimates. However, the estimated coefficient of LXGDP is significant at 5 per cent level in ECM representation of ARDL model but significant at 1 per cent level for long run estimate. The results indicate that external trade policies, represented by the share of exports and imports in GDP, had positive and significant influence on the growth of exports and imports of goods and services of Bangladesh in both short and long run.

[5] Chen (2008) notes that the approach of the bounds testing is adopted to determine whether a single long run relationship exists between the explained and explanatory variables.

TABLE 4.10

ARDL (1,1,0,0,1,1) ESTIMATES OF EXPORT SUPPLY FUNCTION

Long Run		Short Run (ECM)	
Regresor	Coefficients	Repressor	Coefficients
LEVI	0.398*** (0.121)	ΔLEVI	0.840*** (0.055)
LWPI	0.230*** (0.097)	ΔLWPI	0.169*** (0.050)
LIND	-0.0065 (0.011)	ΔLIND	-0.004 (0.008)
XRER	0.170*** (0.058)	ΔXRER	-0.025 (0.080)
LXGDP	0.635*** (0.172)	ΔLXGDP	0.159** (0.057)
		ECM(-1)	-0.733*** (0.133)
Diagnostic Tests			
R-sq		0.957	
Adj R-sq		0.938	
F		80.879***	

Note: *** and ** indicate that the particular coefficients are significant at 1 and 5 per cent level respectively.

TABLE 4.11

ARDL (1,1,1,0,1) ESTIMATES OF IMPORT DEMAND FUNCTION

Long Run		Short Run (ECM)	
Repressor	Coefficients	Repressor	Coefficients
LIVI	-0.242*** (0.062)	ΔLIVI	0.471*** (0.152)
LWPI	0.477*** (0.093)	ΔLWPI	0.289** (0.108)
LRES	0.040 (0.048)	ΔLRES	-0.046* (0.023)
LMGDP	1.079*** (0.099)	ΔLMGDP	0.480*** (0.154)
		ECM(-1)	-0.605*** (0.187)
Diagnostic Tests			
R-sq		0.889	
Adj R-sq		0.848	
F		38.070***	

Note: ***, ** and * indicate that the particular coefficients are significant at 1, 5 and 10 per cent level respectively.

4.3.5 Summary

Both descriptive and quantitative analyses reveal that there has been a structural change in both exports and imports of Bangladesh. Quantitative analysis of the role of trade policy in Bangladesh's external trade performance reveals that external sector policies exerted positive and statistically significant impact on imports and exports, both in the short and long run.

4.4 POTENTIAL EXPORT INDUSTRIES, EXPORT DIVERSIFICATION AND PROMOTION OF POTENTIAL INDUSTRIES

4.4.1 Introduction

The exports of Bangladesh have been determined mainly by its comparative advantage, domestic trade policy promoting exports and access to international market. Jute goods export, which along with raw jute was the dominant export up to the late 1980s, was a labour-intensive product. It enjoyed generous government support during its prosperity (and also during its decline). With a few competitors in the international market it also enjoyed relatively easy access to market. Similarly, RMG, currently the dominant export commodity, is a labour-intensive manufactured good. It has benefited from government policy support such as the duty free bonded warehouse system and duty drawback system. Bangladesh was able to exploit the opportunities provided by the international market under MFA and latter ATC and presently the GSP. In both the cases, the entrepreneurial talents of the country were concentrated in the respective industries. An interesting phenomenon common to both the industries has been their complete unfamiliarity proceeding the period of their establishment. Thus manufactured exports, which are labour intensive and enjoy stable international market, can be regarded as potential exports of the country irrespective of their sources of raw materials.

4.4.2 Trade Policies Influencing Export Industries

As indicated earlier, the reforms of the trade regime initiated in the early 1980s continued to be undertaken by successive governments for greater outward-orientation. These measures led to remarkable decline in quantitative restrictions, opening up of trade in many restricted items, significant rationalisation and diminution of import tariffs and complete liberalisation of the foreign exchange regime on current account. Generous promotional measures were also taken for exports–export promotion schemes were adopted to provide exporters with an environment in which the previous anti-export bias could be reduced significantly. Important export incentive schemes include subsidised rates of interest on bank loans, duty free import of machinery and intermediate inputs, cash subsidies, and exemption from value-added and excise taxes. However, although the export sector has flourished, the momentum in export has been dominated by RMG. Other export items failed to replicate the impressive success of this sector. All other non-RMG major export items have had only a modest growth since the late 1980s. Though some new items have been added to the export basket the country's export base remains narrow and undiversified (Razzaque and Raihan 2006).

An explanation for undiversified nature of the export basket can be traced to the trade policies followed by the country. As the government has been implementing measures to liberalise the trade regime, it also took measures which were at odds with trade liberalisation. The Government has used para-tariffs for protection as well as for raising revenue. Currently, they include Infrastructure Development Surcharge, Value Added Tax (VAT), and Supplementary Duty (SD). A World Bank study (2007) shows that para-tariffs covered 20 per cent of tariff lines in 2006 and accounted for 40 per cent of total nominal protection provided by statutory customs duty as opposed to 10 per cent in 1996. Furthermore, rate of customs duty increases with the degree of processing with highest rates on finished goods. This implies that the industries benefitting from these measures enjoy higher effective rate of protection than implied by the nominal rates. Furthermore, the anti-export bias which came down sharply in the first half of the 1990s remained unchanged at a high level in the latter years. The structure of incentives created by the trade policy favours the production of domestic import substitutes and creates barriers for emergence of new export industries and expansion of export industries not benefitting from special measures such as duty free bonded warehouse system and duty drawback system (World Bank 2007).

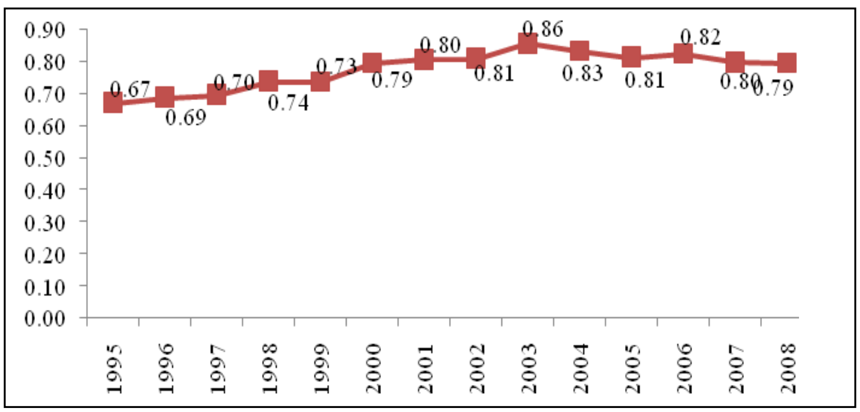
In light of the preceding discussion identification of industries with export potential needs to focus both on industries which already export but their potentials are not fully realised and on new industries. In the latter case, the industry may already exist but do not export or may be a new industry which does not exist yet.

4.4.3 Export Diversification

Diversification refers to the spreading of operations over dissimilar economic activities and takes place in order to mitigate the effect of cyclical instability, to come closer to a full utilisation of resources, and to expand the export share. Diversification makes countries less vulnerable to trade shocks by stabilising their export revenues. It has also spillover effects in the economy–it creates learning opportunities that lead to new forms of comparative advantage.

Over the last two decades, RMG emerged as the overwhelmingly dominant product in the export basket of Bangladesh. The share of RMG products was 77.1 per cent of the total export basket in the fiscal year 2009-10, which was slightly lower than that of the preceding fiscal year (79.33 per cent). In the RMG exports, knitwear has a slightly higher contribution than woven garment products (40 per cent and 37.1 per cent of total exports respectively). This indicates that Bangladesh embraced lower diversification in its export items over the years. It means that the country's exports continue to remain susceptible to greater shocks in exports. Bangladesh's RMG is over-dependent on a limited number of markets in North America and Europe. Exports to the rest of the world are negligible and increasing at a very slow pace. RMG depends on a limited number of export products, and the country lags behind major competitors such as China and Vietnam in terms of product diversification. Apparel exports from Bangladesh are also below the world average unit value, which reflects the dominance of low quality apparel exports from the country. With reference point or world average relative unit value 1, Bangladesh exports at 0.8, China at 1.2, India at 1.4 and Italy at 2.5.

Figure 4.6: Trend of Diversification Index of Bangladesh's Exports (1 indicates that the country is completely specialised in its exports)



Source: UNCTAD (2009).

While deepening relationships with existing markets is key for export growth, geographical diversification is found to be of great significance for low-income countries such as Bangladesh. East Asian Tigers achieved well over 300 per cent gains in this area between 1974 and 2003 (Besedeš and Prusa 2007). Therefore, opportunities for Bangladesh to further exploit geographical diversification are enormous.

4.4.4 Other Factors Influencing Exports

A number of factors inhibit the growth and realising the potentials of the country's export. Domestic "behind the border" or supply–side constraints like infrastructure, communications, ports, capacity in implementing export incentive regime, functioning of export related institutions, and governance of the external sector, coupled with "beyond the border" constraints, such as inadequate market access, have contributed to the highly concentrated export basket.

Liberalisation has opened up export opportunities for the country. However, it has also increased the level of competition and the number of non-trade barriers deterring the export in some markets in the form of stringent rules of origin, environmental conditions, labour regulations, compliance, various anti-competitive measures and product quality. Razzaque and Raihan (2006) identified four categories of factors that constrain export performance of the country. These are:

a. Internal constraints
  - Lack of fund for investment and working capital
  - High rate of interest charged by financial institutions
  - Shortage of skilled manpower
  - Stringent regulatory regime
  - Low standards and quality of products
  - Lack of entrepreneurial and managerial skills
  - Occasional labour unrest in export oriented firms

b. External constraints
  - High transport costs
  - Trade policy of important partner countries (e.g. rules of origin)
  - Lack of trade/market information
  - Difficulties in market access
  - Unstable demand

c. Institutional constraints
  - Institutional weakness/inefficiency
  - Poor law and order situation
  - Bribing
  - Centralised decision making

d. Infrastructural constraints
  - Power problems
  - Inefficient ports
  - Inefficient customs
  - Low access to telecommunication

Despite the existence of these negative factors, Bangladesh could achieve significant growth of exports during the last two decades. Bangladeshi entrepreneurs were able to overcome or mitigate the effects of the negative effects and exploit the opportunities provided by the world trading system. In the absence of these constraining factors a higher rate of growth of exports could have been achieved with greater effects on income and employment.

4.4.5 Identifying Potential Export Items and Sectors

4.4.5.1 Potential Exports from Existing Export Items

The straightforward way of identifying potential export items is to consider their export performance over time. In terms of performance, 33 items out of top 40 commodities belong to RMG sector. The other important items are leather, jute products, fertiliser and apparatus for mobile phone according to COMTRADE data.

TABLE 4.12

SHARE OF TOP COMMODITIES IN TOTAL EXPORTS (PER CENT)

1996	2001	2007	1996	2001	2007	1996	2001	2007	1996	2001	2007
TOP 20 EXPORT ITEMS											
	610910			620342			611090			030613	
5.20	8.30	14.92	4.27	7.42	10.30	2.64	3.94	5.28	8.12	4.90	4.59
	620462			620520			620590			611030	
1.17	3.16	3.96	9.12	6.87	3.52	10.10	6.08	2.45	0.74	3.47	2.08
	610510			610899			611020			410439	
0.38	0.89	1.86	0.01	0.01	1.82	0.98	2.36	1.80	..	0.54	1.69
	620349			271000			530310			530710	
1.79	2.53	1.68	..	0.16	1.59	2.05	0.74	1.45	1.01	1.12	1.41
	620341			620333			620469			520100	
0.01	0.02	1.34	0.96	2.57	1.24	0.24	0.81	1.23	0.01	0.00	1.09
NEXT 20 EXPORT ITEMS											
	620343			610990			630231			611010	
0.08	2.007	0.966	2.68	0.916	0.959	0.02	0.235	0.827	0.01	0.337	0.734
	620690			580219			630510			610590	
1.15	1.684	0.729	1.07	0.351	0.658	3.03	1.138	0.626	0.31	0.470	0.597
	620630			310210			650590			610342	
1.30	1.666	0.542	2.00	0.703	0.534	..	0.436	0.508	0.08	0.109	0.485
	620461			610610			610821			852520	
..	0.011	0.482	0.08	0.346	0.482	0.30	0.381	0.480	..	0.001	0.426
	620463			610469			610711			620339	
0.28	0.868	0.423	0.49	0.554	0.418	0.18	0.004	0.404	2.66	1.988	0.403

TABLE 4.13
TOP EXPORT ITEMS AT HS6 LEVEL

Top 20 Commodities		Next 20 Commodities	
HS Code	Description	HS Code	Description
610910	T-shirts, singlets and vests, of cotton, knit	620343	Men's, boys trousers shorts, synthetic fibre, not knit
620342	Men's, boys' trousers & shorts, of cotton, not knit	610990	T-shirts, singlets etc, of material nes, knit
611090	Pullovers, cardigans etc of material nes knit	630231	Bed linen, table linen, toilet linen and kitchen linen
611010	Pullovers, cardigans etc of wool or hair, knit	611010	Pullovers, cardigans etc of wool or hair, knit
620462	Women's, girls' trousers & shorts, of cotton, not knit	620690	Women's, girls blouses & shirts, material nes, not kni
620520	Men's, boys' shirts, of cotton, not knit	580219	Terry toweling, etc. of cotton nes, width >30cm
620590	Men's, boys shirts, of material nes, not knit	630510	Sacks and bags, used for packing goods, of jute, etc.
611030	Pullovers, cardigans, etc. of manmade fibres, knit	610590	Men's, boys shirts, of materials nes, knit
610510	Men's or boys' shirts of cotton, knitted or crocheted	620630	Women's, girls blouses & shirts, of cotton, not knit
610899	Women's, girls bathrobe, dressing gowns, nes, knit	310210	Urea, whether or not in aqueous solution
611020	Pullovers, cardigans, etc. of cotton, knit	650590	Hats and other headgear, knitted or crocheted, or made from lace, etc.
410439	Bovine and equine leather, nes	610342	Men's, boys trousers & shorts, of cotton, knit
620349	Men's, boys trousers & shorts, material nes, not knit	620461	Women's, girls trousers, shorts, wool or hair, not knit
271000	Motor spirit	610610	Women's/girls blouses and shirts, of cotton, knitted
530310	Jute, other bast fibre, raw or processed, not spun	610821	Women's/girls briefs and panties, of cotton, knitted
530710	Yarn of jute or textile bast fibres nes, single	852520	Apparatus for cellular mobile telephones
620341	Men's, boys trousers & shorts, wool or hair, not knit	620463	Women's/girls trousers and shorts, of synthetic fibres, not knitted
620333	Men's/boys jackets and blazers, of synthetic fibres, not knitted	610469	Women's/girls trousers and shorts, of other textile materials, knitted
620469	Women's/girls trousers & shorts, of other textile materials, not knitted	610711	Men's or boys' underpants and briefs of cotton, knitted or crocheted
520100	Cotton, not carded or combed	620339	Men's/boys jackets and blazers, of other textile materials, not knitted

Source: Calculated from UN COMTRADE database.

If we aggregate the sector-specific export performance in HS2 level, the RMG still remains the highest performing sector. However, the fish and related products appear to be important in terms of value of exports (rank 3), leather (rank 6), cotton (rank 7), mineral fuel (rank 8), footwear (rank 9) and electronic products (rank 10), which have the share of more than 1 per cent of export value in 2007. Amongst these, although fish and leather demonstrate decreasing share over time, their export values have increased. The other four sectors demonstrate increase in both magnitude and share, thereby indicating their importance as potential sectors. The other potential sectors are fertiliser, headgear and parts, copper and articles, edible vegetables, printed books and newspapers, and plastic products (Table 4.14).

TABLE 4.14

POTENTIAL EXPORT SECTORS

Rank	HS2 Digit	Description	1996		2007	
			Exports ('000'US$)	% of Total	Exports ('000'US$)	% of Total
1	61	Articles of apparel, accessories, knit or crochet	559,439.64	15.81	4,733,886.75	36.02
2	62	Articles of apparel, accessories, not knit or crochet	1,658,742.32	46.88	4,588,550.37	34.91
3	3	Fish, crustaceans, molluscs, aquatic invertebrates	323,634.47	9.15	694,625.88	5.29
4	53	Vegetable textile fibres nes, paper yarn, woven fabrics	219,550.94	6.20	475,131.26	3.62
5	63	Other made textile articles, sets, worn clothing, etc.	160,489.16	4.54	402,225.75	3.06
6	41	Raw hides and skins (other than fur skins) and leather	149,590.54	4.23	290,954.00	2.21
7	52	Cotton	8,778.68	0.25	225,596.66	1.72
8	27	Mineral fuels, oils, distillation products, etc.	9,492.13	0.27	213,287.31	1.62
9	64	Footwear, gaiters and the like, parts thereof	28,895.97	0.82	137,487.00	1.05
10	85	Electrical machinery and equipment and parts thereof	15,187.33	0.43	135,017.99	1.03

(Cont. Table 4.14)

Rank	HS2 Digit	Description	1996		2007	
			Exports ('000'US$)	% of Total	Exports ('000'US$)	% of Total
11	58	Special woven or tufted fabric, lace, tapestry, etc.	39,075.63	1.10	98,585.57	0.75
12	31	Fertilizers	101,444.64	2.87	70,152.43	0.53
13	65	Headgear and parts thereof	24.51	0.00	67,439.37	0.51
14	74	Copper and articles thereof	10.49	0.00	60,463.22	0.46
15	7	Edible vegetables and certain roots and tubers	5.52	0.00	56,774.53	0.43
16	49	Printed books, newspapers, etc.	73.79	0.00	55,932.64	0.43
17	39	Plastics and articles thereof	10,040.13	0.28	49,145.31	0.37
18	56	Wadding, felt, nonwovens, yarns, twine, cordage, etc.	54,482.53	1.54	47,780.26	0.36

Source: Calculated from UN COMTRADE database.

4.4.5.2 Potential New Exports

In some cases new exports can be accidental. The most notable example is that of RMG which was established though unknown as a fully export oriented industry. Most recently shipbuilding has emerged as a potential export industry (See Box 4.1). In other cases industries might have gained experience in serving the domestic market and later on can enter the export market. Many small exports of Bangladesh are of this type.

There are some export sectors that have higher export potential but it could not be realised owing to various reasons. The sectors can achieve higher success if adequate support is given. The Export Policy 2009-2012 has identified these "highest priority sectors":

i. agro-products and agro-processing products
ii. light engineering products (including auto parts and bicycles)
iii. footwear and leather products
iv. pharmaceutical products
v. software and ICT products
vi. home textiles
vii. shipping industry

The Policy has identified some "special development sectors" as well, which have export potential but they do not have sufficient production, supply and export base. In order to strengthen supply base, special development schemes will be adopted for these sectors. These are as follows:

i. production of crashed and finished leather
ii. production and processing of frozen fish
iii. handicrafts
iv. electronic goods
v. fresh flower and follies
vi. jute goods
vii. handloom textiles of hilly people
viii. unpolished diamond
ix. herbal medicine and medicinal plants
x. ceramic products
xi. plastic products

4.4.6 Policy Recommendations

To raise the export growth an array of policies/measures will need to be undertaken. The following policies/measures are recommended to reduce the anti-export bias of the trade regime, remove domestic supply-side constraints, take advantage of preferences extended by the EU and get preferences from the USA and improve functioning of government institutions dealing with exports:

- Move to a low and uniform tariff regime replacing the existing four slabs cascading tariff rates in a phased manner. The highest tariff rate can be gradually brought down to 15 per cent with reduction in the dispersion of rates.[6]
- Move to unify all para-tariffs and merge them with existing customs duty.
- Remove quantitative restrictions/bans that are used for protective purposes and replace them with equivalent tariffs.
- Undertake appropriate measures to take advantage of the preferences given by EU to LDCs under its GSP/"everything but arms" programme. The "regional cumulation," allowed by the EU to meet its rules of origin requirement, may be used in the RMG sector to expand export of woven garments.

[6] India has brought down the highest non-agricultural tariff rate to 10 per cent.

- While garments exports from African, Caribbean and some other countries enjoy duty-free access to the USA, RMG exports from Bangladesh do not yet qualify for such preference. Bangladesh will need to continue to lobby hard in the USA for duty-free access of RMG exports (See Section 8).
- Remove supply constraints/inefficiencies in ports, transportation, power, finance and skilled manpower all of which affect competitiveness of exports. In particular, the problem of shortage of electricity and gas which poses a major constraint on production will need to be solved on a priority and sustainable basis.
- Improve governance and reduce inefficiencies in all government institutions dealing with exports, especially customs and Duty Exemption and Drawback Office (DEDO), to reduce delays in customs clearance and payments of tariffs and duty drawbacks.

BOX 4.1: Potential of Ship Building Industry

Bangladesh ship building industry suddenly emerged in the export. Convenient geographical advantage together with availability of technically knowledgeable personnel, skilled and semi-skilled workers and long tradition of the ship building industry of Bangladesh has started its journey towards export. This industry is manufacturing row ferries, tug boats, fishing trawlers, inland oil tankers, etc. catering to the local demand. Recently Bangladesh has successfully exported its first ocean going ship to a high end market like Denmark by competing with Chinese and Vietnamese shipbuilders. Cost-effective human resource in comparison with other shipbuilding countries and comparative advantages such as simple importation facility of raw materials, duty-free market access for Bangladeshi ship to other countries, etc. have encouraged the Bangladeshi entrepreneurs of this sector to come forward in export business. Bangladesh Government has taken initiatives to promote this sector with a view to including a new item in the export basket and considering its huge capability to develop the country's multi-dimensional production base as linkage industries, which market this nation as the next cost effective destination for global buyers dealing in ships, ship machineries, fittings and marine technology.

4.5 AN ASSESSMENT OF SAFTA AND PROSPECTS OF BILATERAL FTAs WITH NEIGHBOURS

4.5.1 A Prelude to SAFTA

Regional trading agreements (RTAs) have emerged as an alternative to achieve trade liberalisation as multilateral efforts under GATT and currently WTO has faced political and economic obstacles. RTAs present advantages as well as limitations for its members. By reducing number of participants in the negotiation they can help expand the discussion to include more dimensions of economic integration. Compared with unilateral liberalisation, political support for RTAs also seems to be greater, given the perception of reciprocity from other member countries.

The principal motivation behind the regional economic integration in South Asia was that it would generate significant intraregional trade and welfare gains for the countries of the region through removal of tariff and non-tariff barriers and thereby to enjoy the gains of regional integration and at the same time to become more competitive in the global market. Critics argue that potential benefits from a Free Trade Agreement (FTA) in South Asia are little because major trading partners of the individual South Asian countries are located in the West (as can be perceived from Table 4.15A), there are limited complementarities in the region, etc. (Pitigala 2005, Hossain and Selim 2007). It is also alleged that an RTA in South Asia will lead to substantial trade diversion than trade creation and it may work as a "stumbling bloc" to multilateral trade liberalisation.

The South Asian Association for Regional Cooperation (SAARC) was formed in 1985 with the objective of exploiting accelerated economic growth, social progress and cultural development in South Asia. In recent years, an important concern in the economic policy arena amongst South Asian countries is whether the creation of South Asian Free Trade Area (SAFTA) would bring about desired benefits or not. Eight years after forming the SAARC to promote regional economic cooperation, South Asian Preferential Trading Arrangement (SAPTA) was launched in 1995 in order to enhance regional trade. Later on, the SAPTA was transformed to SAFTA in 2006 with a view to fully implement the trade liberalisation scheme within the eight member countries by 2016. Pakistan and India will eliminate all tariffs by 2012, Sri Lanka by 2013 and Bangladesh, Bhutan, Maldives and Nepal by 2015. Also, there have been other initiatives for regional integration or bilateral preferential trading arrangements involving the South Asian countries, especially Bangladesh (Raihan and Razzaque 2007).

The SAFTA Agreement has seven core elements, which are: (i) trade liberalisation programme; (ii) rules of origin; (iii) institutional arrangements; (iv) compensation mechanism of revenue loss; (v) technical assistance for LDCs; (vi) safeguard measures; and (vii) consultations and dispute settlement procedures.

TABLE 4.15A

INTRA-SAARC TRADE, 2008 (MILLION US$)

IMPORTS									
From / To	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	SAARC
Afghanistan	--	2.55		394.55			2,051.49		2,448.59
Bangladesh	1.44	--	15.06	3,498.15		87.41	296.50	17.03	3,915.59
Bhutan			--						
India	123.90	295.52	160.76	--	3.96	523.26	343.75	420.23	1,871.38
Maldives				130.51	--	0.01	5.03	63.91	199.46
Nepal		6.61		1,697.72		--	3.75	0.23	1,708.31
Pakistan	93.15	86.35	1.01	1,704.32	6.03	4.01	--	69.63	1,964.50
Sri Lanka		12.16		2,731.93	17.65	0.09	203.27	--	2,965.10
SAARC	218.49	403.19	176.83	10,157.18	27.64	614.78	2,903.79	571.03	15,072.93
EXPORTS									
To / From	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	SAARC
Afghanistan	--	1.31		112.64			84.68		198.63
Bangladesh	2.32	--	3.16	318.82		6.01	78.50	11.05	419.86
Bhutan			--						
India	358.68	2,574.66	104.71	--	118.65	1,543.39	1,549.38	2,483.58	8,733.05
Maldives					--			16.05	16.05
Nepal		79.47		475.69		--	3.648	0.08	558.89
Pakistan	1,864.99	269.55	0.42	312.50	5.14	3.41	--	184.79	2,640.80
Sri Lanka		15.48		382.02	58.10	0.21	63.29		519.10
SAARC	2,225.99	2,940.47	108.29	1,601.67	181.89	1,553.02	1,779.50	2,695.55	13,086.38

Source: IMF's *Direction of Trade Statistics* (online).

TABLE 4.51B

SAARC'S TRADE WITH THE WORLD (MILLION US$)

IMPORTS								
From To	Advanced Economies	Euro Area	Emerging & Dev. Economies	Developing Asia	Central & Eastern Europe	Middle East	Western Hemisphere	World
Afghanistan	1,694.91	679.58	3,949.32	2,765.93	257.48	18.39	9.14	5,644.23
Bangladesh	8,219.81	1,361.38	14,005.00	9,253.32	157.98	3,158.87	346.08	23,820.60
Bhutan								
India	114,123.00	30,998.20	165,861.00	49,800.90	3,377.14	77,442.00	8,937.82	281,467.00
Maldives	650.71	134.48	764.34	468.05	3.73	273.09	12.84	1,417.00
Nepal	375.10	89.36	2,320.05	2,213.46	3.89	93.87	1.75	3,073.97
Pakistan	13,895.50	4,338.90	32,220.70	13,503.80	761.43	15,219.90	570.59	46,144.40
Sri Lanka	6,106.15	1,484.16	8,226.90	6,000.96	103.56	1,865.68	70.71	14,421.30
SAARC	145,065.18	39,086.06	227,347.31	84,006.42	4,665.21	98,071.80	9,948.93	375,988.50
EXPORTS								
To From	Advanced Economies	Euro Area	Emerging & Dev. Economies	Developing Asia	Central & Eastern Europe	Middle East	Western Hemisphere	World
Afghanistan	143.37	56.08	335.065	202.60	8.14	31.22	11.39	478.44
Bangladesh	10,212.60	4,956.21	1,445.12	608.07	346.88	195.94	131.89	13,627.60
Bhutan								
India	85,513.00	28,472.10	87,876.70	28,791.50	3,333.21	35,275.40	5,829.13	177,700.00
Maldives	92.08	53.08	95.95	88.80	0.10	0.24	0.06	188.02
Nepal	244.75	95.23	594.44	570.55	15.72	4.62	1.01	867.60
Pakistan	10,236.40	3,511.46	11,368.20	4,161.99	769.03	4,420.50	536.42	21,624.20
Sri Lanka	5,878.89	2,119.52	2,209.62	720.27	157.41	732.02	190.96	8,520.84
SAARC	112,321.09	39,263.68	103,925.10	35,143.78	4,630.49	40,659.94	6,700.86	223,006.70

Source: IMF's *Direction of Trade Statistics* (online).

4.5.1.1 Trade Liberalisation Programme

As per Article 7 of the Agreement, tariffs on all products except the products under sensitive lists would be reduced to 0-5% within time frames agreed for LDC and non-LDC members. The Agreement stipulates that SAFTA Committee of Experts would review non-tariff barriers in its regular meeting with a view to eliminating them or making them non-restrictive. The Agreement provides different timeframe for tariff reduction by LDCs and non-LDC state parties. Furthermore, non-LDC members are required to reduce their tariffs for the products of LDC members within shorter period. Non-LDC members were required to reduce their tariffs, applied on 1 January 2006, to 0-5% among themselves within seven years (with one extra year for Sri Lanka). The LDC members are required to reduce tariffs on the products other than the products under sensitive lists to 0-05% within 31 December 2015.

The schedule of tariff reduction is as follows. For non-LDCs, the dates of tariff reduction will be (i) 10% MoP in 1 July 2006, (ii) 30% MoP in 31 December 2006, (iii) 30% MoP in 31 December 2007, and (iv) 30% MoP in 31 December 2008. The schedule of tariff reduction by LDCs (others) is a bit different: 33.33% MoP in 1 July 2006, 33.33% MoP in 1 July 2007 and 0-5% (end duty) in 1 July 2008.

TABLE 4.16

PHASES OF TARIFF REDUCTION

Non-LDCs (India, Pakistan and Sri Lanka)	Tariff Line	1 July 2006	31 `December 2006	31 December 2006	31 December 2008 to 31 December 2012[*]
	Lines >20%	(t-20)/4	(t-20)/4	(t-20)/2	0-5% in 5 equal installment
	Lines <20%	5% MoP	10% MoP	10% MoP	
LDCs (Others)	Tariff Line	1 July 2006	31 December 2006	31 December 2006	31 December 2008 to 31 December 2015
	Lines >30%	(t-30)/4	(t-30)/4	(t-30)/2	0-5% in 8 equal installment
	Lines <30%	2.5% MoP	2.5% MoP	5% MoP	

Source: Raihan and Razzaque (2007).

[*] for Sri Lanka the period is 31st December 2008 to 31st December 2013 and number of installment is 6, t= tariff applicable on 1 January 2006, MoP= Margin of preference to be applied on tariff of 1 January 2006.

4.5.1.2 Sensitive Lists

The Agreement provides scope for maintaining of sensitive lists, which would be different for LDC and non-LDC members, only Bangladesh, India and Nepal maintain different sensitive lists for LDCs and Non-LDCs.

TABLE 4.17

SENSITIVE LIST OF SAFTA

	Number of Sensitive List		Coverage of Sensitive List as % of Total HS Lines	
	Non-LDCs	LDCs	Non-LDCs	LDCs
Bangladesh	1,254	1,249	24.0	23.9
Bhutan	157	157	3.0	3.0
India	865	744	16.6	14.2
Maldives	671	671	12.8	12.8
Nepal	1,335	1,299	25.6	24.9
Pakistan	1,191	1,191	22.8	22.8
Sri Lanka	1,079	1,079	20.7	20.7

Source: Hossain and Selim (2007).

4.5.1.3 Non-Tariff and Para-Tariff Barriers

The Agreement requires that all quantitative restrictions, if not permitted under GATT 1994, shall be eliminated. With respect to other non-tariff measures and para-tariff measures the Agreement requires that the countries notify the measures to SAARC Secretariat on an annual basis and SAFTA Committee of Experts review the non-tariff and para-tariff barriers in its regular meeting with a view to making recommendation for their elimination or making them non-restrictive. A sub-group has already been established to address issues related to non-tariff barriers.

4.5.1.4 Rules of Origin

Rules of origin (ROOs) of SAFTA are general in nature, i.e., one criterion for all products. It requires that a product must undergo sufficient processing for changing the tariff heading from the non-originating inputs and for having value at least 40 per cent value addition measures as percentage of fob value in order to enjoy the preference. However, value addition requirement is lower for Sri Lanka and LDCs, which is 35 per cent and 30 per cent respectively. Furthermore, detailed operational certification procedures have been adopted to avoid fraudulent practices.

Under Tariff Rate Quota (TRQ), India agreed to provide Bangladesh duty-free access from 1 July 2006 for RMG products, which are covered by sensitive lists in the following manner:

- 3 million pieces made of fabrics, yarn of Indian origin;
- 3 million pieces made of fabrics either in Bangladesh or India; and

- 2 million pieces by satisfying the AFTA rules of origin.

Moreover, India agreed to remove specific duty on 99 tariff lines of textile sector from the date of implementation and 105 tariff lines of textile sector on which specific duty would be removed within three years of implementation.

4.5.1.5 Institutional Arrangement

SAFTA Ministerial Council (SMC) and Committee of Experts (COE) have been established to monitor the implementation of the Agreement. SMC comprising Commerce or Trade Minister of member countries is the highest decision making body, who meet at least once a year or more often. This Committee is supported by the COE comprising senior trade officials of member countries, which meets once in every six months.

4.5.1.6 Compensation Mechanism

A mechanism has been established to compensate the revenue loss to be incurred by the LDCs due to reduction of tariffs. It will be in cash and partial: maximum 5 per cent of the Customs duty collected from SAARC import in 2005. Compensation will be available for 4 years only. However, compensation will be available for six years for Maldives.

4.5.1.7 Technical Assistance

SAFTA has provisions for technical assistance for LDC members upon request in the following areas: Trade related capacity building; development and improvement of tax policy and instruments; customs procedures related measures; legislative and policy related measures; assistance for improvement of national capacity; studies on trade related physical infrastructure development; improvement of banking sector; and development of export financing.

4.5.1.8 Safeguard Measures

In order to protect domestic industry from possible damage due to increased preferential import, the Agreement provided scope for partial or full withdrawal of preference granted under SAFTA for a period of maximum 3 years. Safeguard measures cannot be applied against the product of LDCs if share of import from an LDC of the product concerned in total import of importing country is less than 5 per cent.

4.5.1.9 Consultations and Dispute Settlement Procedures

Bilateral consultation would be held within 30 days upon a request made by any member. If dispute cannot be settled through bilateral consultation, the matter would be referred to the COE for its recommendation within 60 days. The COE may consult with a panel of experts for peer review. Any decision of the COE can be appealed to SMC for its decision within 60 days. The decision of the SMC would be final.

4.5.2 Critical Aspects of SAFTA

4.5.2.1 Low Intra-Regional Trade

Benefits from regional FTA would be higher amongst the member countries which have high degree of intra-regional trade. Intra-regional trade would depend more on the existence of product complementarities, comparative advantage, degree of concentration, and diversification of trade profiles among regional partners. At present, South Asia combines a low level of regional integration and the presence of relatively high trade barriers. The proportion of intra-regional trade has increased in the last decade but still lags behind neighbouring trade blocs like ASEAN. Except for Nepal and Afghanistan, SAARC countries demonstrate meagre proportion of their intra-bloc exports. The share of intra-regional imports is, however, very small for India and Pakistan.

TABLE 4.18A

SHARE OF REGIONAL TRADE IN SAARC'S TRADE WITH THE WORLD, 2008

(per cent)

IMPORTS

From To	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	SAARC
Afghanistan		0.05	0.00	6.99	0.00	0.00	36.35	0.00	43.38
Bangladesh	0.01		0.06	14.69	0.00	0.37	1.24	0.07	16.44
Bhutan									
India	0.04	0.10	0.06		0.00	0.19	0.12	0.15	0.66
Maldives	0.00	0.00	0.00	9.21		0.00	0.35	4.51	14.08
Nepal	0.00	0.22	0.00	55.25	0.00		0.12	0.01	55.59
Pakistan	0.20	0.19	0.00	3.69	0.01	0.01		0.15	4.26
Sri Lanka	0.00	0.08	0.00	18.94	0.12	0.00	1.41		20.56
SAARC	0.06	0.11	0.05	2.70	0.01	0.16	0.77	0.15	

EXPORTS

To From	Afghanistan	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	SAARC
Afghanistan		0.27	0.00	23.54	0.00	0.00	17.70	0.00	41.52
Bangladesh	0.02		0.02	2.34	0.00	0.04	0.58	0.08	3.08
Bhutan									
India	0.20	1.45	0.06		0.07	0.87	0.87	1.40	4.91
Maldives	0.00	0.00	0.00	0.00		0.00	0.00	8.54	8.54
Nepal	0.00	9.16	0.00	54.83	0.00		0.42	0.01	64.42
Pakistan	8.62	1.25	0.00	1.45	0.02	0.02		0.85	12.21
Sri Lanka	0.00	0.18	0.00	4.48	0.68	0.00	0.74		6.09
SAARC	1.00	1.32	0.05	0.72	0.08	0.70	0.80	1.21	

Source: Calculated from IMF's *Direction of Trade Statistics database* (online).

4.5.2.2 Low Trade Complementarity

Another popular view is that the potential benefits accruing from the SAFTA would be minimal. Most of these critics have pointed their fingers to the limited complementarities in the region. FTAs are likely to succeed if trade structure of members demonstrates strong complementarities. When commodities of one country have considerable demand in the other, the potential benefit of FTA is higher. Pitigala (2005) demonstrates that Trade Complementarity Index (TCI) is very low, only 1.3, in SAFTA as compared to 56.3 for NAFTA, 53.4 for EU and 28.6 for Mercosur.

TABLE 4.18B

TRADE COMPLEMENTARITY IN VARIOUS BLOCS

Trade Blocs	TCI
SAFTA	1.3
NAFTA	56.3
EU	53.4
Andean Pact	7.4
Mercosur	28.6
Canada-US FTA	64.3
Latin American Free Trade Area (LAFTA)	22.3

Source: Pitigala (2005).

4.5.2.3 Low Comparative Advantage

The direction of international trade based on efficiency is governed by comparative advantage and specialisation (Pitigala 2005). Countries having different specialisation among different commodity groups would form a successful FTA. Potential of trade expansion is likely to be weak for countries with comparative advantage in similar products. According to International Revealed Comparative Advantage (IRCA) index, south Asian countries enjoy comparative advantage in narrower range of products except for India and Sri Lanka. Out of 71 commodity groups, Bangladesh, Nepal and Pakistan have revealed comparative advantage only in 7, 5 and 12 commodity groups, while India and Sri Lanka enjoy comparative advantage in 26 and 21 commodity groups respectively. However, none of the countries has comparative advantage in capital-intensive and high value-added commodities.

4.5.2.4 Uneven Gains

Evidence reveals that SAFTA would result in uneven gains for its members from freeing trade. For example, Hossain and Selim (2007) reveal that the welfare effect, measured by equivalent variation (EV) in Global Trade Analysis Project

(GTAP) Model, is negative and substantial for Bangladesh under the assumption of full employment. The other countries enjoy positive welfare effect. When this assumption is relaxed due to the fact that South Asia is a labour-surplus region, positive endowment effect outweighs negative allocative efficiency, terms of trade (ToT) and investment-savings (I-S) effects. Still, Bangladesh's welfare gain turns out to be meagre compared to the other members. SAFTA would also affect adversely on the growth of real GDP of this country.

TABLE 4.19

WELFARE EFFECT (MILLION US$) AND IMPACT ON THE GROWTH OF REAL GDP (PER CENT)

	Allocative Efficiency	Endowment	ToT	I-S	Welfare	Welfare (with Full Employment)	GDP
Bangladesh	-18.1	217.7	-135.2	-17.7	46.6	-171.1	-0.64
India	134.2	521.7	250.7	-3.6	902.9	381.2	0.63
Pakistan	110.5	183	374.3	11.7	679.5	496.5	3.5
Sri Lanka	38.3	128.3	52.3	0.8	219.6	91.3	1.87

Source: Hossain and Selim (2007).

4.5.2.5 Revenue Loss

A significant concern for Bangladesh is the possible loss of revenue due to the implementation of SAFTA. It is worth mentioning that Bangladesh's revenue to GDP ratio remains among the lowest in the world and most of its revenues come from import related taxes. Due to the low revenue collection, public investment in infrastructure and human capital has been inadequate in Bangladesh compared with most countries in the world. Although the concerns of the LDCs in this regard are reflected in the SAFTA agreement, as it includes the mechanism for compensation of revenue loss to be incurred by LDCs, the debate over revenue loss and compensation mechanism has not yet abated.

4.5.2.6 Political Tensions

Political tensions between big members, India and Pakistan have undermined efforts to foster SAARC processes and SAFTA. As long as political tensions are insignificant, it does not create any hindrance to a friendly environment amongst member countries to reach final decisions conveniently. Indo-Pakistan relations have always been a problem for creating a congenial environment for trade cooperation.

4.5.3 Bangladesh's Trade Imbalances with Its Neighbours: Prospects of Bilateral FTA

4.5.3.1 Trade Gap with Immediate and Close Neighbours

Bangladesh's cumulative trade balance is negative with all its neighbours: immediate neighbours Myanmar and India and close neighbours Bhutan, Maldives, Nepal, Pakistan and Sri Lanka. However, the direction of trade balance has been fluctuating over the years for few countries. From 1980 to 1998 and from 2004 to 2008, the trade balance was positive with Maldives, although the magnitude was very small. Also, the country enjoyed some trade surplus with Nepal during 1984-1991, 1993-1995, 1998, and 2004-2005, with Pakistan during the 1980s, and with Sri Lanka during the first half of the 1990s. During 1980-2008, trade gap has been persistently high and negative with India. It has also been negative with Bhutan during this period although the magnitude has not been high.

TABLE 4.20

BANGLADESH'S TRADE GAP WITH SOUTH ASIAN COUNTRIES (Million US$)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989
Bhutan	..	..	..	..	..	..	..	..	..	-2.08
India	-47.58	-43.71	-23.04	-30.97	-31.80	-35.29	-49.5	-63.36	-81.33	-110.04
Maldives	0.00	0.00	0.00	0.00	0.03	0.13	0.03	0.05	0.04	0.03
Myanmar	-4.84	1.31	-3.45	-0.06	-4.06	1.48	-3.06	-3.47	-1.67	-3.04
Nepal	-0.47	-11.54	-0.42	2.76	14.63	5.12	10.11	4.96	4.61	9.32
Pakistan	20.37	-4.22	16.58	34.27	44.77	23.73	9.15	-9.37	-29.10	-2.59
Sri Lanka	-3.83	-4.51	-6.96	-4.75	10.22	-7.93	-3.83	-4.51	-6.96	-4.75

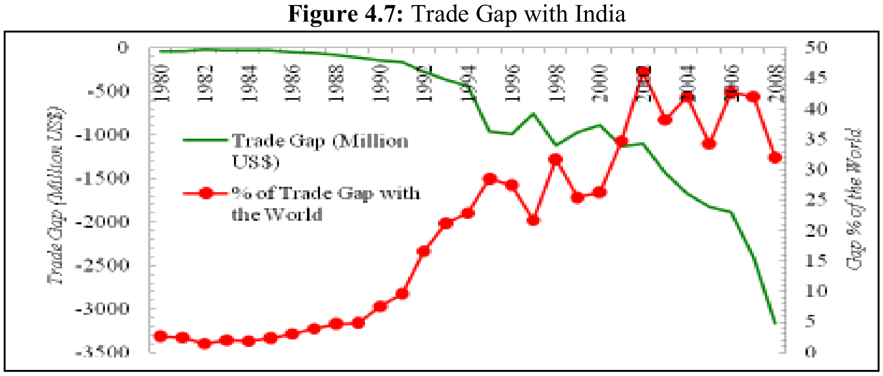
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Bhutan	-7.30	-3.60	-3.82	-2.37	-8.06	-3.30	-4.69	-3.81	-4.41	-3.66
India	-148.59	-166.69	-279.65	-367.68	-442.30	-958.31	-997.31	-758.40	-1123.81	-974.26
Maldives	0.00	0.00	0.00	0.00	0.01	0.02	0.09	0.02	-0.65	-0.54
Myanmar	-0.34	0.11	1.75	6.05	-0.69	-2.80	-2.56	-2.28	-11.81	-12.53
Nepal	5.81	11.41	-0.14	6.66	13.83	6.08	-5.58	-10.05	3.57	-3.70
Pakistan	-46.84	-18.32	-57.48	-64.47	-91.42	-111.22	-52.77	-28.75	-44.61	-60.51
Sri Lanka	0.20	1.10	5.26	1.23	-3.33	0.56	-8.59	-5.33	-5.22	-0.62

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Bhutan	-3.64	-3.59	-1.89	-1.46	-2.41	-7.14	-7.04	-5.57	-11.79
India	-895.32	-1134.69	-1106.50	-1438.88	-1678.91	-1832.36	-1893.60	-2413.65	-3168.46
Maldives	-1.41	-0.66	0.00	-0.40	0.00	0.00	0.00	0.00	0.00
Myanmar	-21.33	-19.04	-22.81	-30.79	-25.41	-30.77	-23.60	-23.89	-78.73
Nepal	-2.67	-2.20	-1.47	-1.88	2.46	0.54	-1.38	-11.19	-81.38
Pakistan	-58.66	-60.04	-32.60	-52.79	-80.73	-91.88	-113.37	-123.38	-217.54
Sri Lanka	-5.80	-5.85	-4.85	-3.44	0.36	-1.24	-9.19	-3.30	-6.15

Source: Calculated from IMF's *Direction of Trade Statistics* database (online).

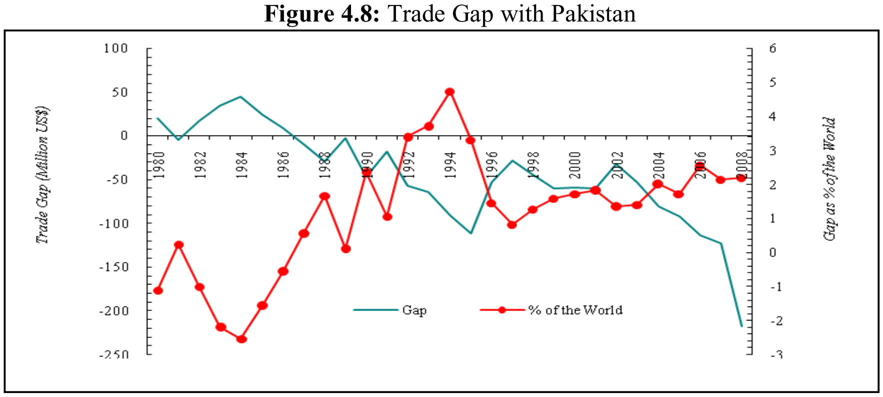
The trade gap with India has been one of the highest of country's trade gap with the world. It reached around 50 per cent of that of the world in 2002; and it fluctuated with the range of 38 to 43 per cent. Conversely, the ratio of trade gap with Pakistan to that with the world ranged from 1 per cent to 5 per cent since 1990, which peaked in 1995 at 5 per cent.

Figure 4.7: Trade Gap with India



Source: IMF DOTS.

Figure 4.8: Trade Gap with Pakistan



Source: IMF DOTS.

4.5.3.2 Possibility of Bilateral FTA in Reducing Trade Imblances

There have been some strong arguments for the regional economic integration in South Asia, as this integration is thought to generate significant intra-regional trade and welfare gains for the South Asian countries. However, as mentioned above, the potential benefits from the SAFTA and other regional trading arrangements in South Asia are little because there are limited complementarities in the region; major trading partners of the individual South Asian countries are located in the West. It is also alleged that an RTA in South Asia will lead to substantial trade diversion than trade creation and it may work as a stumbling bloc to multilateral trade liberalisation. Panagariya (1999) argued that by eliminating tariff preferentially from the SAARC countries and keeping the tariff on the rest of the world (ROW) as it was before, Bangladesh would become net trade diverting. Furthermore, Panagariya (2003, p.1283) notes,

> "Given that South Asia accounts for less than one per cent of world production and that tariffs in the region are high, the risk of trade diversion from preferential trade liberalization is high. With 99 per cent of world production outside the region, the likelihood that the most efficient and competitive producers of the large majority of the products are within the region is very low. This means that the scope for trade diversion is substantial."

Keeping these in mind, it is imperative for Bangladesh to look for some possible alternatives in order to reduce its trade deficit with the neighbours. One of such options would be to go for bilateral FTAs. However, since trade deficit is more prominent with India and Pakistan, the possible impact on trade balance can be examined through creating hypothetical scenarios of FTA with these countries.

Analytical Framework

Drawing on Calfat and Flôres (2006, pp. 940-943), the trade effects of Bangladesh-India Bilateral FTA can be described as follows in a simpler analytical framework since the objective of the present exercise is to examine whether such an arrangement can help reduce Bangladesh's trade gap with its neighbours, particularly India.

Keeping other factors constant, Bangladesh-India FTA will lead to an increase in import demand from within these two countries due to bilateral tariff reduction. In other words, if the tariff of imports of commodity X_1 is eliminated by India or Bangladesh under the FTA, imports of X_1 from within least cost FTA region will increase due to substitution away from costly non-FTA countries. For Bangladesh, this effect can be written as:

$$T1 = M.\eta_M \{\Delta t / (1+t)\} \tag{4.1}$$

where M is the volume of imports of Bangladesh from India (and vice versa), t implies the ad valorem rate of import tariff and Δt its unit change. η_M, the import price elasticity, is expressed as:

$$\eta_M = (\Delta M / M)\left(P_M^d / \Delta P_M^d\right)$$

where P_M^d is the price of imported items in domestic market.

There will be another trade effect in Bangladesh and India, i.e., shifted imports from other countries to Bangladesh and India due to price changes from a preferential tariff reduction. This effect can be expressed as:

$$T2 = \frac{\left[M.\eta_S \{\Delta t / (1+t)\}\right]}{[1+(M/\overline{M})][1+\eta_S \{\Delta t/(1+t)\}]} \tag{4.2}$$

where $\overline{M}$ refers to the imports from the other sources than Bangladesh and India, and η_S is the importer's elasticity of substitution. Here,

$$\eta_S = \frac{\Delta(M/\overline{M})}{M/\overline{M}} \cdot \frac{P_M^{BI} / \overline{P}}{\Delta(P_M^{BI} / \overline{P})} \tag{4.3}$$

where P_M^{BI} and $\overline{P}$ refer to the price of imports from Bangladesh or India and other countries respectively.

The total trade effect will thus be

$$TE = T1 + T2 \tag{4.4}$$

Results and Implications

The trade effects of Bangladesh-India and Bangladesh-Pakistan FTAs have been worked out based on the above simple analytical framework. The base year of the analysis was 2007. The HS6 digit bilateral trade data came from UN COMTRADE, while tariff data were extracted from TRAINS database. The import demand elasticity came from two sources: Kee, Nicita and Olarreaga (2008) for Bangladesh (-3.23) and India (-12.07), and Senhadji (1998) for Pakistan (-0.47). The Armington elasticity (1.5) has been used for the elasticity of substitution. The export supply elasticity has been assumed to be infinite for all the countries.

The trade effect of Bangladesh-India FTA has been portrayed in Table 4.21. It reveals that both the countries would experience substantially increased exports between them, while Bangladesh's imports from the other neighbours would decrease to some extent. However, the gap would still increase against Bangladesh by US$7.4 million in 2007. However, although this FTA would help reduce trade gap with the other neighbours, the proportion would be insignificant (highest with Sri Lanka by 8.15 per cent).

TABLE 4.21

CHANGES IN TRADE THROUGH BANGLADESH-INDIA BILATERAL FTA (MILLION US$), 2007

Effect	Direction of Effect	Change due to FTA	Trade Gap with Bangladesh	Impact on the Gap % Increase (+)/Decrease (-)
TE	Bangladesh's Exports to India	452.416	-2,413.65	0.31 (+)
TE	India's Exports to Bangladesh	459.842		
T1	Others' Exports to Bangladesh			
	Bhutan	..	-5.57	..
	Maldives	..	0.00	..
	Myanmar	-0.189	-23.89	0.79 (-)
	Nepal	-0.556	-11.19	4.97 (-)
	Pakistan	-3.600	-123.38	2.92 (-)
	Sri Lanka	-0.269	-3.30	8.15 (-)

Source: Authors' calculation.

The result would be significantly different for Bangladesh-Pakistan FTA (Table 4.22). The results indicate that the trade gap with Pakistan would, on the one hand, substantially increase by such an FTA, and, on the other hand, the gaps with the other neighbours would decline by meagre proportions as compared to Bangladesh-India FTA. However, one can argue that this result may be due to low import demand elasticity used in the analysis. Therefore, we used import demand elasticity at HS2 digit level estimated by Stern, Francis and Schumacher (1976). The result did not alter substantially—Bangladesh's export effect to Pakistan turned out to be US$7.4 million. Thus, Bangladesh's trade gap would increase by 55 per cent through such an FTA.

TABLE 4.22

CHANGES IN TRADE THROUGH BANGLADESH-PAKISTAN BILATERAL FTA (MILLION US$), 2007

Effect	Direction of Effect	Change due to FTA	Trade Gap with Bangladesh	Impact on the Gap % Increase (+)/Decrease (-)
TE	Bangladesh's Exports to Pakistan	4.034	-123.38	57.71(+)
TE	Pakistan's Exports to Bangladesh	75.235		
T1	Others' Exports to Bangladesh			
	Bhutan	..	-5.57	..
	India	-3.733	-2413.65	0.15 (-)
	Maldives	..	0.00	..
	Myanmar	-0.142	-23.89	0.59 (-)
	Nepal	..	-11.19	..
	Sri Lanka	-0.030	-3.30	0.91 (-)

Source: Authors' calculation.

4.5.4 Summary

This section discusses the basic facts of SAFTA, its drawbacks and Bangladesh's trade imbalances with its immediate and close neighbours. It has been revealed that Bangladesh has been suffering from sustained trade deficit with all the neighbours over nearly three decades. To reduce the gap with the two neighbours, India and Pakistan, the potential of bilateral FTA has been analysed. The exercise demonstrates that none of the hypothetical FTA would help reduce the substantial trade gap with these countries. Indeed, an FTA with Pakistan would substantially increase trade gap with the country. However, since the scenario of Bangladesh-India FTA would increase one's exports to the other's market substantially and India's exports to Bangladesh would increase at a marginally higher amount than that of Bangladesh, the country would opt for such an FTA subject to detailed analysis of impacts according to headings and sub-headings of product categories.

Bangladesh will need to use the SAARC instrumentality to seek cooperation in other areas which promote economic growth as envisaged by SAARC leaders. It can also use bilateral mechanism to achieve the same objectives where appropriate. These areas will include transportation focusing on power and gas and ports, trade facilitation and harmonisation of sanitary and phyto-sanitary measures.

4.6 FOREIGN DIRECT INVESTMENT: ANALYSIS OF PAST POLICIES AND FUTURE OPTIONS

4.6.1 Introduction

The Government has undertaken various policies to attract Foreign Direct Investment (FDI) in the country. The policies have yielded some positive results in terms of attracting FDI. But the flow of FDI has been low when compared with flows in other countries of the region. In this context, a review of the past policies is needed and future options need to be identified to attract a higher level of FDI.

4.6.2 Past Trends in FDI

FDI comprising equity capital, reinvested earnings and intra-company loans shows a rising trend reaching about US$960 million in FY2009. It has also been increasing as a proportion of total domestic investment indicating increasing contribution of FDI to domestic investment. It contributed 3.4 per cent of total domestic investment in FY2008. FDI flows, however, show marked yearly fluctuations. The rising trend is a consequence of the FDI policies of the Government adopted to attract FDI and other measures to improve the investment climate of the country.

TABLE 4.23

FDI IN BANGLADESH, FY1992 – FY2009

(Million US $)

Fiscal Year	FDI
1997	366.85
1998	603.3
1999	394.1
2000	383.22
2001	563.92
2002	393.76
2003	379.18
2004	284.16
2005	803.18
2006	744.16
2007	792.74
2008	768.69
2009	960.59

Source: Bangladesh Bank, unpublished data.

Sectoral distribution of FDI inflows reveals that most FDI are targeted to manufacturing, telecommunications, banking, and power, gas and petroleum. Of these, the later three sectors primarily serve the domestic market, which implies that existence of domestic market has played a key role in attracting FDI. In the manufacturing sector textiles and apparels has also attracted some foreign investment. This sector serves both the domestic and the external market. Investment in EPZs is targeted to serve the export market. The share of FDI in EPZs in total FDI has remained relatively stable around 12 per cent

TABLE 4.24

FDI INFLOWS BY MAJOR SECTORS, FY1997–FY2009

(Million US $)

	FY97	FY00	FY05	FY06	FY07	FY 08	FY09
Agriculture & Fishing	0.26	2.89	2.07	1.37	4.57	3.65	19.14
Power, gas & petroleum	109.08	106.57	198.39	209.31	229.94	157.94	46.88
Manufacturing	135.08	225.80	235.52	120.94	147.47	128.92	183.96
Of which:							
Food products	3.02	11.81	3.74	5.27	7.20	11.27	20.60
Textiles and wearing	44.78	143.72	74.99	73.52	105.45	93.42	130.35
Trade and Commerce	118.39	44.11	101.80	142.20	103.83	171.26	122.53
Of which Banking	115.87	19.62	94.88	129.96	91.83	156.80	110.20
Telecommunication	1.37	0.00	261.89	267.97	304.71	299.91	579.63
Services	2.57	3.32	2.05	1.07	1.82	7.02	7.77
Others	0.01	0.62	2.07	1.78	0.4	0.00	0.68
Total	366.85	383.22	803.79	744.61	792.74	768.69	960.59

4.6.3 FDI Policies in Bangladesh

The government has adopted various policies to protect FDI, allow easy entry and unrestricted repatriation of profits and exit of capital in case the investor decides to close down business. There are also provisions for various fiscal incentives to encourage FDI flows.

4.6.3.1 Evolution of the FDI Policy in Bangladesh

In the late 1980s and 1990s, Bangladesh announced a series of measures and liberalised its FDI policy framework. In recent years, Bangladesh has significantly improved its investment and regulatory environment, including the liberalisation of the industrial policy, abolition of performance requirements and allowance of full foreign-owned joint ventures. Since 1996, new sectors have been opened up for foreign investment, including the telecommunications sector.

4.6.3.2 FDI Policy Framework

FDI is encouraged in all industrial activities in Bangladesh excluding those on the list of reserved industries such as production of arms and ammunitions, forest plantation and mechanised extraction within the bounds of a reserved forest, production of nuclear energy and printing and minting fresh currency notes. Such investments may be undertaken either independently or through joint ventures, either with the local, private or public sector. The capital market also remains open for portfolio investment. The policy framework for foreign investment in Bangladesh is based on the Foreign Private Investment (Promotion and Protection) Act, 1980, which provides measures for the non-discriminatory treatment and protection of foreign investment.

4.6.3.3 Incentives to Foreign Investment

The government has liberalised its industrial and investment policies in recent years by reducing bureaucratic control over private investment and opening up many areas. Some of the major incentives are tax exemptions for power generation, import duty exemptions for export processing, an exemption of import duties for export oriented industries, and tax holidays for different industries. Double taxation can be avoided by foreign investors on the basis of bilateral agreements. Facilities for the full repatriation of invested capital, profit and dividend exist.

4.6.3.4 Concessionary Duty on Imported Capital Machinery

An import duty, at the rate of 5 per cent ad valorem, is payable on capital machinery and spares imported for initial installation. For 100 per cent export oriented industries, no import duty is charged in the case of capital machinery and spares. Duties and taxes on the import of goods that are produced locally are higher than those applicable to imports of raw materials for the production of such goods.

4.6.3.5 Intellectual Property Rights and Investment Protection

The government recognises the importance of intellectual property rights for attracting FDI and is making efforts to update its legislation and improve enforcement. The country has been a member of the World Intellectual Property Organization (WIPO) since 1985 and signed the Paris Convention on Intellectual Property in 1991. The Foreign Private Investment (Promotion and Protection) Act of 1980 guarantees protection against expropriation. If a foreign investor becomes subject to a legal measure that has the effect of expropriation, adequate compensation will be paid to the investor and it can be freely repatriated. It may be noted that no appropriation of any enterprise has occurred since the passing of the Act.

4.6.3.6 Labour Laws

Workers are entitled to elect collective bargaining agents (CBAs) to negotiate their demands with management. A trade union may be formed if 30 per cent of employees support it. All trade unions need to be registered. There are 47 labour laws covering matters such as wages, industrial disputes, working conditions, etc. Foreign nationals can be employed as long as their number does not exceed 15 per cent of the total number of employees.

4.6.4 Future Options

Bangladesh has taken a number of steps to reform and liberalise its FDI regime. There are no restrictions on the entry and exit of foreign investors. Generous fiscal incentives are provided and guaranteed compensation in the case of appropriation, employment of foreign nationals and duty-free import of capital goods are allowed. In terms of policies, Bangladesh has a very liberal FDI regime and not much remains to be done to attract FDI. However, there are factors that affect investment climate in general need improvement.

- An investment promotion agency should undertake image building and policy advocacy and provide investor services. The Board of Investment (BoI) performs some of these functions but it needs to be strengthened through clear mandates, adequate staffing and incentives.
- Bangladesh should show case success stories to allay the bad image of the country.
- Availability of quality physical infrastructure including electricity, roads, and ports should be ensured.

- Legal and procedural difficulties, especially procedural delays in establishing and operating an enterprise, should be minimised.
- Data and information regarding investment policies, investment services, and investment and marketing opportunities should be made available to prospective investors.
- Stability of tariff regime is needed to help make investment decisions.

4.7 REMITTANCE AND ITS UTILISATION

4.7.1 Introduction

Faced with the problem of unemployment, underemployment and low wage at home in contrast with relative higher wages and stable employment abroad, Bangladeshi workers have been seeking foreign employment in increasing numbers. Long term growth of income in advanced countries, causing a shift in the structure of the labour force and rapid growth of some countries, especially the oil rich Middle East countries necessitating additional supply of workers to meet the domestic supply-demand gap, have paved the way for overseas employment for Bangladeshi workers. Annual flow of workers increased from about 6,000 in 1976 to 650,000 in 2009 with a peak in 981,000 in 2008. Annual flow of remittance increased from about US$ 24 million in 1976 to about US$ 9.7 billion in 2009. The importance of remittance in the economy can be appreciated by noting that in FY2009 it comprised about 35 per cent of total foreign exchange earnings and about 11 per cent of GDP of the country. Furthermore, remittance was about four times the combined value of foreign aid and FDI in FY2009.

The rising inflow of remittance has exerted positive effects on the economy at both macro and micro levels. At the macro level, it helped sustain macroeconomic stability by relaxing the foreign exchange constraint as well as the domestic saving constraint, resulting in higher investment. The country has generated current account surplus, built up foreign exchange reserves and achieved enhanced debt service capacity. At the micro level, remittance has increased income of recipient households with positive effects on both consumption and savings. Increased consumption has exerted positive effects on poverty reduction and fulfillment of basic needs like education and health. Household investment has also increased with concentration in residential investment. The increased demand for goods and services resulting from higher income has sustained growth of manufacturing, services and agriculture sectors of the economy and enhanced financial intermediation. There might have been some negative effects of remittance. For example, rapid growth of remittance might cause appreciation of the exchange rate and make workers dependent on remittance discouraging them from taking any employment.

The volume and effects of remittance have naturally drawn widespread attention of researchers as well as policymakers. Two issues have dominated the discussion: first, how to enhance the flow of remittance and second, how to ensure "productive" use of remittance.

4.7.2 Increasing the Flow of Remittance

The flow of remittance depends on two proximate factors. First, the number of migrant workers and their wages and second, remittance sent by the migrant workers to their home country. Annual flow of migrant workers depends both on conditions obtaining in host countries like excess demand for workers of particular skills, employment policy, and preferences of employers for workers of different countries and conditions obtaining in Bangladesh like access to institutions dealing with manpower exports and ability to finance migration costs. Annual remittance flow depends on various factors underlying the motives of workers to remit money to Bangladesh. One main motive is altruistic motive where increased income of recipients increases the utility of the remitter. The alternative motive is that of self interest where the remitter remits to promote his/her self-interest like ensuring family inheritance, investment in residential structure, land improvement and agricultural implements, accumulation of financial and real assets, empowerment and self-esteem. There can be combination of these two motives in various degrees. It should be noted that remittance is sent through two channels–formal channel and informal channel. While the preceding factors influence the decision to remit, the choice between the two channels of remittance is influenced by a separate set of factors like access to formal channel both at remitting point and at receiving point, ease of using formal channel, relative speed of transferring money, relative exchange rate, opportunity to send money on holidays, and legal requirements and its enforcement. The government has adopted various measures to influence the factors determining both flow of migration and remittance.

4.7.2.1 Encouraging Labour Migration

Bangladesh Overseas Employment and Services Ltd. (BOESL) and Bureau of Manpower, Employment and Training (BMET) have been promoting migration of workers and the government has been entering into bilateral agreements with foreign countries. Palli Karma-Sahayak Foundation (PKSF) has started to finance cost of migration of workers from Monga areas.

4.7.2.2 Targeting Remittance Channel to Formalise Method of Remittance

The Bangladesh Bank and commercial banks have undertaken measures to encourage and facilitate the use of official channels for transferring money.

4.7.2.3 Providing Access to Banking Faculties

The Bangladesh Bank is encouraging the commercial banks to link up with foreign banks and exchange houses and set up taka drawing arrangements. The commercial banks are opening new branches and exchange houses abroad.

4.7.2.4 Reforming Official Remittance Channels

Official remittance channels are being reformed and adapted to the needs of the migrants and their families. The measures focused on reduction of transaction time, reduction of transaction costs, making remittance tax free, simplifying formalities, regular monitoring to ensure service, and penalising unauthorised remittance dealers. Some of the important recent initiatives by Bangladesh Bank to facilitate remittance flows include introduction of Bangladesh Automated Clearing House, electronic clearing house facilities, Bangladesh Electronic Funds Transfer Network, and use of mobile phone platforms or creation of own platforms of the banks to facilitate remittance payments.

4.7.2.5 Creating Special Accounts

The Bangladesh Bank allows migrant workers to open different accounts having some special advantages. These accounts include Non-resident Taka Account (NITA), and Non-resident Foreign Currency Account (NFCA).

4.7.2.6 Attracting Investment by Non-residents

The Bangladesh Bank has introduced various bonds to attract foreign exchange from migrants and expatriates. These include Wage Earner Development Bond, US Dollar Premium Bond, and US Investment Bond. Further, tax benefits are offered on interest on the NFCD account and Wage Earners Development Bond.

The private sector has also been trying to promote investment by expatriates. The Investors Forum Sylhet Bangladesh and British Bangladesh Chamber of Commerce organise seminars in Bangladesh and the U.K. to strengthen investors' ties between the U.K. and Sylhet. Besides, the migrant associations WARBE, BOMSA and the NGO SHISUK have been working with the families of the migrant workers and encouraging them to save and invest a portion of remittance.

4.7.3 Improving the Flow of Remittance

4.7.3.1 Increasing Migration of Workers

The government will need to undertake measures to provide training in skills including proficiency in English and computer literacy that are in demand in different markets, make bilateral agreements with host country governments, monitor the performance of labour exporting agencies to ensure better service, and undertake measures to arrange finance for migration, especially from poor areas. Government and NGOs can provide key information in relatively poor areas about prospects of foreign employment as well as requirements of host countries.

Measures need to be strengthened to divert remittance from informal to formal channel. Banking services can be computerised and an electronic money transfer system can be developed. Private banks can open branches in rural areas and banks can create partnership with MFIs, post offices and mobile phone companies for quick transfer of remittance.

The relative attractiveness of informal channel to remitters as well as the demand for foreign exchange to finance illegal transactions has sustained the existence of the channel. The anti-money laundering drive of the government and increasing the access to legal channel have discouraged remittance inflow through informal channel. The effectiveness of these measures should be enhanced and awareness of migrant workers about advantages of sending through formal channel needs to be created and enhanced further.

4.7.4 Promoting Better Utilisation of Remittance

Utilisation of remittance can be viewed from the macro as well as micro perspective. From the macro perspective, remittance adds to national savings and enhances investible resources. For the last few years Bangladesh's investment/GDP ratio falls short of national savings/GDP ratio, which implies that Bangladesh cannot fully utilise its available savings for investment.

Remittance is a private affair and it is managed jointly by the remitter and the recipients to attain household objectives, given the constraints faced by them. Various micro studies show that about 40 per cent of remittance is used for consumption and the rest is saved. Most of the consumption expenditure comprises basic needs like food and shelter; it also includes expenditure on health and education. These expenditures make good sense for the poor families as they contribute to improved nutrition and increased human capital with positive impact on growth.

Savings generated from remittance are put to various uses. It is used to pay off past debt (dissaving), accumulate real assets like land and gold and financial assets like savings deposits and bonds, make fixed business investment (agricultural machinery), residential investment and inventory investment (grocery or cloth stores) and make transfer payments like gifts. Saving is also used to finance lumpy consumption expenditure like marriage expenditure.

While various policies and measures adopted by the government, financial institutions and other stakeholders have focused on increasing the flow of migrant workers and inflow of remittance, not much has been done to influence the utilisation of remittance. It should be noted, however, that remittances are private money flows and policies and measures should aim at enabling the remitters and their families to send and use their remittances in the most effective ways, according to their own preferences and constraints. In this context, the following measures can be adopted:

i. Pre-departure awareness of workers: Pre-departure awareness of workers about remittance channels, risks of using informal channel, utilisation of remittance along with rules, regulations and culture of the host countries has to be provided effectively.

ii. Keeping Bangladeshi bank branches open on weekly holidays in countries with large concentration of Bangladeshi immigrants to enable them to send remittance without taking leave from work.

iii. Making available savings instruments: Savings instruments should be made accessible to remitters and recipients with easy transaction. Banks can organise meetings at local level to persuade remittance receivers to save in various instruments.

iv. Creating opportunity to invest: Certain percentage of shares of companies at initial public offerings can be reserved for migrant workers with online transactions facilities. Projects can be designed by government under public-private partnership scheme and funds can be mobilised from migrant workers. For example, government can mobilise a part of the finance for Padma Bridge Project or Rooppur Atomic Energy Project by selling bonds to remitters issued for this purpose.

4.8 DUTY-FREE AND QUOTA-FREE ACCESS TO DEVELOPED COUNTRY MARKETS

4.8.1 Introduction

Bangladesh has benefitted from the world trading system in the form of trade preferences extended by the developed countries. Expansion of trade fostered by sheltered market and preferences has promoted economic growth and industrialisation of the country. The developed countries undertook a new initiative for the least developed countries to promote export from developing countries to developed countries. In the sixth Ministerial Conference of the WTO Members, held in Hong Kong in December 2005, developed countries made a binding commitment to allow duty-free and quota-free access to products originating from LDCs. Bangladesh being a member of the LDC group qualifies for deriving benefit from this initiative. However, the declaration allows the developing countries to provide duty-free and quota-free access to at least 97 per cent of products in the case of difficulties. This excluded 3 per cent products, which were left for the country concerned to decide, has created problem for Bangladesh and Bangladesh has to devise strategies for getting unrestricted access (100 per cent) to developed country market, especially to the US market.

4.8.2 Market Access Initiative for LDCs in the Doha Development Agenda

The Doha round of multilateral trade negotiations stipulated that the world trading system must improve the access of the least developed countries in the world market. Accordingly, the WTO members agreed at their Hong Kong Ministerial Conference in December 2005 that "developed country Members shall, and developing country members in a position to do so should provide duty-free and quota-free market access on a lasting basis, for all products originating from all LDCs by 2008 or no later than the start of the implementation period in a manner that ensures stability, security and predictability." This ambitious objective, however, was limited by the next paragraph of the declaration "Members facing difficulties at this time to provide market access….shall provide duty-free and quota-free market access for at least 97 per cent of products originating from LDCs defined at the tariff line level…"

Implementation of the duty-free and quota-free initiative provides an opportunity to ensure that LDCs are able to take advantage of the development benefits of trade. If, however, product coverage remains limited and the product most important to LDCs are excluded (under 97 per cent rule), benefits to LDCs will fall far short of their potential. In order to maximise the poverty reduction potential of a duty-free and quota-free initiative, the product coverage should be increased to duty-free access to LDCs though the coverage is not uniform. The EU granted duty-free and quota-free access to LDCs, under EBA in 2000, 100 per cent for all LDCs.

In the post Hong Kong period the developed countries have started to redefine their preference schemes. By 2009, most developing countries have extended, which covers 99 of tariff lines. Japan granted special treatment to LDCs in 2001 and the list has been updated up to 2011. In April 2007, Japan notified expansion of tariff lines to 8,859 products. The coverage of the DFQF access to LDCs is well over 99 per cent of import value. In 2003, Canada extended duty-free and quota-free access to 48 LDCs with the exception of some agricultural products such as dairy, poultry and eggs; the scheme covers 98.9 per cent tariff lines. Australia and New Zealand granted duty-free market access to LDCs in 2003 and 2001 respectively. Both Australia and New Zealand covered 99 plus tariff lines.

The USA has yet to provide duty-free access to substantive part of manufacturing products originating from LDCs. Most of the gains and growth in imports under preference programmes are tied to regional programmes which impose fewer constraints on imports. In 2008, 50 African countries under African Growth and Opportunity Act (AGOA) represented 51.5 per cent of US preference tariffs, Andean countries under Andean Trade Preference Act (ATPA) 15.5 per cent, Caribbean basin countries under Caribbean Basin Initiative (CBI) 2.7 per cent, and Caribbean Basin Trade Partnership Act (CBTPA) 1.5 per cent while GSP represented 28.5 per cent of imports under preference programmes. AGOA, which has less stringent RoO and the widest product coverage, has demonstrated the greatest success of all the US preference programmes. This shows preference margin as well as product coverage matter for growth of imports from developing countries. In contrast, only 0.6 per cent of total US imports from Bangladesh currently receive preference market access putting Bangladesh at a disadvantage in the LDC group. This provides a basis for Bangladesh to strongly argue for DFQF access to the US market.

4.8.3 Recent Legislative Initiatives in the USA

In the post Hong Kong period the USA has undertaken certain legislative initiatives to help LDCs and some developing countries.

4.8.3.1 Trade Relief Assistance for Developing Economies Act (TRADE), 2005, 2009

This bill was first introduced to the American Congress in 2005 and then in 2007. On 21 May 2009, it was re-introduced to the Senate (S. 1141) and it is currently referred to the Committee on Finance for deliberations, investigations, and revisions. TRADE purports to help 14 LDCs and developing countries including Bangladesh, Cambodia and Sri Lanka by giving them duty-free treatment for certain articles that are grown, produced, or manufactured in these countries. The preference includes the RMG sector and envisages duty-free access for apparel assembled in the beneficiary countries and exported to the U.S. over a 10-year period.

4.8.3.2 New Partnership for Trade Development Act of 2009 (NPTDA)

NPTDA of 2009 was introduced on 18 November 2009 for providing duty-free market access to all LDCs and Sub-Saharan African (SSA) Countries. The Bill has been referred to the House Ways and Means Committee for review. Some key provisions of the bill relevant to Bangladesh are:

- It provides limited duty-free treatment to twenty (20) apparel categories from Bangladesh. It would set a cap of 50% for Bangladesh based on its exports of key categories like shirts, pants and coats (based on 2007 volume). Thus half of its key exports of key categories (based on 2007 volume) would get duty free treatment. Other textile and apparel products from Bangladesh would get unlimited duty free benefits (e.g. sweaters).
- The bill includes an "integration incentive" that would increase the quota for Bangladesh by 10 percentage points a year if it uses inputs from any eligible beneficiary developing countries or FTA partner. This lasts for 10 years. After 10 years duty-free apparel trade from Bangladesh would be uncapped.
- It establishes a simple 35 per cent value added rule for all eligible products from all countries under AGOA and GSP. However, fabric qualifies if it is cut and sewn (or knit to shape) in an eligible country (regardless of where the fabric came from), meaning that textile and apparel articles that are both cut (or knit to shape) and sewn or otherwise assembled in one or more beneficiary countries from foreign materials would qualify for preferential treatment regardless of whether the finished article actually complies with the 35 per cent value added requirement.

It is observed that the cap on the major categories of exports will restrict Bangladesh's export to the US with adverse consequences for employment generation and poverty reduction in the country. It is also argued that the 35 per cent value added rule is stringent for Bangladesh. Instead, a uniform 25 per cent value added criterion like the Canadian one can be followed for the LDCs.

4.8.4 Future Strategies for DFQF Access

In order to get unrestricted duty-free and quota-free access to the US, market Bangladesh will need follow three broad strategies[7]:

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[7] This section borrows from M. Humayun Kabir, "In pursuit of Duty and Quota Free Access to US Market: Bangladesh Perspective," a paper presented at a seminar organised by DCCI, Bangladesh.

i Undertake domestic policies to address problems related to exports ,especially that of RMG;

ii Use international diplomacy to counter moves by competitors to obstruct DFQF access; and

iii Use diplomacy and other channels to promote Bangladesh's interest in the US.

i. Undertake domestic policies to address problems related to exports especially that of RMG

- A National Task Force comprising all stakeholders–concerned ministries, representatives of BGMEA, BKMEA and BTMA, think tanks and representatives of workers with the Minister of Commerce as Chairman, should be constituted to formulate, monitor and evaluate implementation of policy on RMG, including progress on effort to get duty-free access.
- Credible measures should be taken to address labour rights issues raised in GSP Review process at the United States Trade Representative (USTR).

ii. Use international diplomacy to counter moves by competitors to obstruct DFQF access

- The AGOA countries have serious concern about possible competition in access to the US market which has brought significant growth of their exports. Naturally, the African lobby will put pressure on any move which threatens AGOA's interest. Already there is pressure not to extend the benefits provided to AGOA to other developing countries. In this context Bangladesh along with other interested countries like Cambodia and Nepal will need to address the concerns of Sub-Saharan countries. Bangladesh missions in these countries should find ways to win their support through diplomacy and exchanging export and import deals.

iii. Use diplomacy and other channels to promote Bangladesh's interest in the US

- Bangladesh will need to continue to Lobby with the US administration and the Congress mainly through Bangladesh Caucus, African-American Caucus.

- Visit of Congressional delegation to Bangladesh should be arranged to acquaint them with the benefit of DFQF access in terms of employment of poor women and poverty reduction, thus ensuring political stability in the country. In a similar vein, visit of congressional staffers who prepare the cases for the Senators and Congressmen can be arranged.
- Special efforts should be made to bring US labour organisations on board to support duty-free access to US market through changes in labour conditions.
- Textile lobby, retail business group and MNCs should be approached to support Bangladesh on this issue.

4.9 SUMMARY AND POLICY RECOMMENDATIONS

The external sector of Bangladesh has undergone significant changes during the last three decades or so. The trade regime has shifted dramatically from inward-looking to outward-oriented one leading to higher integration of the country in the global economy. The reforms underlying the regime shift were mainly unilaterally implemented by Bangladesh. The country also participated in multilateral trade liberalisation under the WTO since 1995. The period has also witnessed a significant improvement in various dimensions of trade performance, especially export-GDP and import-GDP ratios. The economy has been able to maintain high rate of growth of exports, increasingly high rate of remittance flow and modest flow of foreign direct investment in an increasingly globalised world which presents both opportunities and challenges. The trade strategy of the country during the Sixth Five Year Plan will be to enhance the domestic supply capacity and meet the global challenges and exploit the opportunities within its broad development strategy which seeks to achieve accelerated poverty reduction and MDGs by 2015 and transform Bangladesh into a middle income country by 2021.

4.9.1 Potential Export Industries, Export Diversification and Promotion of Potential Industries

The study reveals that comparative advantage, domestic trade policy and access to international market are the main factors that determine exports of Bangladesh over the years. There are significant domestic “behind the border” or supply-side constraints that include infrastructure, communications, ports, capacity in implementing export incentive regime, functioning of export related institutions, and governance of the external sector that limit export. At the same time, “beyond the border” constraints, such as insufficient market access, environmental conditions, labour standard and compliance, various anti-competitive measures and product quality, are responsible for highly concentrated export basket. High anti-export bias maintained by trade policies also gave rise to lower export diversification.

Bangladesh has to realise the potentials of existing exports and also promote new exports. Export Policy 2009-12 identifies some "highly potential sectors", such as agro- and agro-processing, light engineering (including auto parts and bicycles), footwear and leather products, pharmaceuticals, software and ICT products, home textiles and shipbuilding industry. It has identified some "special development sectors" as well, which include production of crashed and finished leather, production and processing of frozen fish, handicrafts, electronic goods, fresh flower and follies, jute goods, handloom textiles of hilly people, unpolished diamond, herbal medicine and medicinal plants, and ceramic and plastic products. Promoting exports of these sectors needs special care by strengthening supply base through special development schemes.

Furthermore, policies and measures should be undertaken to reduce the anti-export bias of the trade regime, remove "behind the border" constraints, utilise advantage of preferences extended by the EU and get further preferences from the USA. Functioning of government institutions that deal with exports should also be improved.

4.9.2 Reducing Bangladesh's Trade Imbalance through FTAs

FTAs can be important means of reducing trade deficit of Bangladesh with its important trading partners. SAFTA would lead to uneven gains for its members. Welfare effect of SAFTA turned out to be negative and considerable for Bangladesh under the assumption of full employment while the other countries enjoy positive welfare effect. However, positive endowment effect outweighs negative allocative efficiency, ToT and I-S effects under the assumption of surplus labour. Even then, Bangladesh's welfare gain becomes very small compared to other SAARC members. SAFTA would also affect adversely the growth of real GDP of Bangladesh.

The present study finds that bilateral FTAs would be weak option for Bangladesh to reduce trade deficits with Pakistan and India. An FTA with Pakistan would worsen the country's bilateral trade deficit. Conversely, a Bangladesh-India FTA would increase one's exports to the other's market substantially. Increase in India's exports to Bangladesh would be marginally higher than that of Bangladesh. Trade deficit with India will continue to increase.

Therefore, Bangladesh will need to use the SAARC to seek cooperation in the areas that promote economic development. The country can also unfold areas of bilateral cooperation that include infrastructure, power, ports, trade facilitation and harmonisation of sanitary and phyto-sanitary measures.

4.9.3 Foreign Direct Investment: Future Policy Options

FDI is an important means to promote growth of the domestic economy and the export sector through technology diffusion and knowledge spillover. Although negligible until the late 1990s, it shows a rising trend afterwards. It has also been increasing as a proportion of total domestic investment. Liberalisation of the FDI regime, fiscal incentives, compensation in the case of appropriation, employment of foreign nationals and duty-free import of capital goods along with improved business environment helped increase FDI in the country.

To attract FDI further, a range of initiatives should to taken. The Board of Investment has to be strengthened to perform the task of an investment promotion agency focusing on image building and policy advocacy as well as providing investor services. The country needs to showcase success stories to allay the bad image of the country. Quality of physical infrastructure should be enhanced. Investment related service delivery should be substantially improved through removing legal and procedural difficulties. Potential investors should be provided with data and information regarding investment policies, investment services, and investment and marketing opportunities through electronic media. Finally, tariff regime should be made predictable to promote better investment decisions.

4.9.4 Promoting Better Utilisation of Remittance

Inflow of remittance witnessed significant increase in the recent past despite global financial meltdown and job loss in the developed world as well as major destinations of manpower export of Bangladesh. Even though remittance is a private affair and it is managed jointly by the remitter and the recipients, it acts as a significant source of foreign currency earnings of the country. Studies reveal that about two-fifths of remittance is used for consumption, most of which is spent to meet up basic needs like food, shelter, education and medical purposes. This contributes positively to the reduction of poverty in the country. The remainder is saved, which is put to various uses, such as to pay off past debt (dissaving), accumulate real assets like land and gold and financial assets like savings deposits and bonds, make fixed business investment (agricultural machinery), residential investment, and inventory investment (grocery or cloth stores). These further contribute to raise income of recipient households, which is likely to generate multiplier effects in the domestic economy.

Keeping these positive aspects in mind, the following measures should be adopted to help maximise benefits of remittance. Pre-departure awareness should be created amongst workers about remittance channels, risks of using informal channel, utilisation of remittance along with rules, regulations and culture of the host countries. Savings instruments should be made available and easily accessible to remitters and recipients with easy transaction and low cost. Banks should be encouraged to organise meetings at local level to persuade remittance recipients to save in various profitable instruments. Furthermore, certain proportion of shares of companies at Initial Public offerings (IPOs) can be reserved for migrant workers with online transaction facilities. Funds can be mobilised from migrant workers for implementing development projects under Public Private Partnership (PPP) subject to offering them attractive benefits.

4.9.5 Duty-Free and Quota-Free Access (DFQF) to Developed Country Markets

Being an LDC, Bangladesh qualifies for deriving benefit from DFQF access of its products to developed country markets, which is a binding commitment of the sixth Ministerial Conference of the WTO Members. It allows the developing countries DFQF access to at least 97 per cent of products in the case of difficulties. However, the excluded 3 per cent products, which were left for the country concerned to decide, has led to problem for Bangladesh, for which the country has to devise strategies to get completely unrestricted access, especially to the US market. For this to happen, Bangladesh needs to undertake domestic policy measures to address problems related to exports, especially that of RMG; use economic diplomacy to counter moves by competitors; and promote Bangladesh's interest through lobbies in the US.

To address problems related to exports especially that of RMG, a comprehensive domestic policy package has to be undertaken. It will include formation of a National Task Force, comprising all stakeholders–concerned ministries, representatives of BGMEA, BKMEA and BTMA, research institutions, and representatives of workers with the Minister of Commerce as Chairman. The Task Force will have the responsibility to formulate, monitor and evaluate implementation of policy concerning RMG, including progress on effort to get duty-free access. Initiatives should be taken to address issues related to labour rights, standard and compliance.

Effective use of international diplomacy should be ensured to counter moves by competitors to obstruct DFQF access for Bangladesh. The AGOA countries have serious concern about possible competition in access to the US market, leading to potential detrimental impact on their exports. Therefore, missions of Bangladesh in African countries should find ways to get support through diplomacy and exchanging trade deals.

Finally, diplomacy and other channels should be used to promote Bangladesh's interest in the US. The country should continue lobby mainly through Bangladesh Caucus in the US Administration, Congress and Senate. Visit of Congressional delegation and staffers to Bangladesh should be organised to explain them the positive impact of DFQF access on poverty reduction through employment of poor women, thereby ensuring political stability that can best serve the US interest in the country. US labour organisations should also be brought on board to support DFQF access to US market. Textiles lobby, retail business group and MNCs should also be approached effectively to support Bangladesh in this regard.

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ANNEX

TABLE 4.A1

EXPORT STRUCTURE

Year	Jute	Manufac. + Specialty Prod.	Tea	Leather & Leather Product	Traditional sub total	Frozen Shrimps, Frog legs, Fish	News prints	Naptha, Furnace Oil	Urea	Garments		Others	Non-traditional subtotal	Total (Traditional + Non-traditional)
										Woven	Knitwear			
1980-81	118.9	352.9	40.7	56.7	569.2	41.9	7.6	49.1	9.6	3.24		0.0	111.44	680.6
1981-82	103.7	291.5	37.9	63.1	496.2	52.8	0.0	41.4	0.0	7.0		0.0	101.2	597.4
1982-83	110.0	317.0	47.0	58.0	532.0	72.0	4.0	27.0	10.0	11.0		0.0	124.0	656.0
1983-84	117.0	357.0	69.0	85.0	628.0	96.0	7.0	23.0	10.0	92.0		-33.5	194.49	822.5
1984-85	151.0	390.0	61.0	70.0	672.0	87.0	9.0	21.0	5.0	116.0		25.0	263.00	935.0
1985-86	124.0	295.0	23.0	61.0	503.0	115.0	7.0	14.0	3.0	131.0		36.4	306.43	809.4
1986-87	104.0	302.0	30.0	135.0	571.0	136.0	8.0	12.0	4.0	299.0		45.5	504.48	1075.5
1987-88	81.0	301.0	39.0	147.0	568.0	140.0	7.0	12.0	25.0	434.0		45.4	663.40	1231.4
1988-89	97.0	280.0	40.0	137.0	554.0	141.0	4.0	16.0	57.0	471.0		47.9	736.94	1290.9
1989-90	125.0	331.0	39.0	179.0	674.0	138.0	3.0	17.0	17.0	609.0		68.7	852.66	1526.7
1990-91	104.0	358.0	43.0	137.0	642.0	182.0	4.0	33.0	36.0	736.0		87.0	1078.00	1720.0
1991-92	85.0	302.0	32.0	149.0	568.0	131.0	1.0	8.0	21.0	1064.0		204.0	1429.00	1997.0
1992-93	74.0	292.0	41.0	151.0	558.0	165.0	1.0	36.0	41.0	1240.0		344.1	1827.14	2385.1
1993-94	57.0	284.0	38.0	168.0	547.0	211.0	0.4	16.0	51.0	1292.0		416.3	1986.74	2533.7
1994-95	80.0	319.0	33.0	202.0	634.0	306.0	0.0	14.0	91.0	1835.0		593.4	2839.43	3473.4
1995-96	91.0	329.0	33.0	212.0	665.0	314.0	0.0	11.0	0.0	1949.0	598.0	536.0	3408.0	4073
1996-97	116.0	318.0	38.0	195.0	667.0	321.0	0.0	16.0	0.0	2238.0	763.0	563.0	3901.0	4568
1997-98	108.0	281.0	47.0	190.0	626.0	294.0	0.0	11.0	0.0	2843.0	940.0	582.0	4670.0	5296
1998-99	72.0	304.0	39.0	168.0	583.0	274.0	0.0	5.0	0.0	2985.0	1035.0	603.0	4902.0	5485
1999-00	72.0	266.0	18.0	195.0	551.0	344.0	0.0	11.0	0.0	3083.0	1270.0	575.0	5283.0	5834
2000-01	67.0	230.0	22.0	254.0	573.0	363.0	0.0	10.0	0.0	3364.0	1496.0	750.0	5983.0	6556
2001-02	61.0	244.0	17.0	207.0	529.0	276.0	0.0	10.0	0.0	3125.0	1459.0	726.0	5596.0	6125
2002-03	82.0	257.0	15.0	191.0	545.0	322.0	0.0	31.0	0.0	3258.0	1654.0	821.0	6086.0	6631
2003-04	80.0	246.0	16.0	211.0	553.0	390.0	0.0	37.0	0.0	3538.0	2148.0	937.0	7050.0	7603
2004-05	96.0	307.0	16.0	221.0	640.0	421.0	0.0	35.0	0.0	3598.0	2819.0	1133.0	8006.0	8646
2005-06	148.0	361.0	12.0	257.0	778.0	459.0	0.0	88.0	0.0	4084.0	3817.0	1305.0	9753.0	10531
2006-07	147.0	321.0	7.0	266.0	741.0	515.0	0.0	84.0	0.0	4658.0	4554.0	1535.0	11346.0	12087
2007-08	165.0	318.0	15.0	284.0	782.0	534.0	0.0	185.0	0.0	5167.0	5533.0	1704.0	13123.0	13905
2008-09	103.0	199.0	12.0	139.0	453.0	356.0	0.0	105.0	0.0	4465.0	4751.0	1305.0	10982.0	11435

TABLE 4.A2

EXPORTS DESTINATION AND VALUE (MILLION US$)

Sl		1980		1990		2000		2008
1	European Union	157.55 (19.94)	European Union	590.25 (35.33)	European Union	2250.55 (40.26)	European Union	6676.28 (47.99)
2	Developing Asia	119.70 (15.15)	North America	538.42 (32.23)	North America	1884.22 (33.71)	North America	3419.55 (24.58)
3	Middle East	101.03 (12.79)	Developing Asia	103.72 (6.21)	Developing Asia	166.05 (2.97)	Developing Asia	620.61 (4.46)
4	Africa	90.28 (11.42)	Middle East	82.52 (4.94)	Middle East	136.23 (2.44)	Middle East	198.18 (1.42)
5	North America	82.28 (10.41)	Africa	55.16 (3.30)	Africa	32.67 (0.58)	Africa	88.80 (0.64)
6	Others	239.38 (30.29)	Others	300.43 (17.98)	Others	1119.87 (20.03)	Others	2907.77 (20.90)
	Total	790.22 (100.00)		1670.50 (100.00)		5589.58 (100.00)		13911.20 (100.00)

Source: Calculated from IMF DOTS.

Note: Figures in the parentheses are percentage of total.

Chapter 5

National Security of Bangladesh: Strategy and Cost Effectiveness

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5.1 INTRODUCTION

Historically, security has been viewed as a core value and final goal of state behaviour and inter-state relations. Security, as defined by the *Oxford Advanced Learner's Dictionary*, means freedom or protection from danger or worry. The same dictionary defines strategy as the art of planning and directing an operation in a war campaign, and skill in planning or managing any affair well. By contrast, it defines policy as plan of action, statement of ideals, etc. proposed or adopted by a government, political party, business. It has generally been held that security is essentially a matter of "threat" perception. This "threat" could be "real" or "imagined," depending on how threats are assessed and how accurate are those assessments. Sources of threat are varied, emanating from the external and internal settings of a given country. The so-called third world countries are plagued more by a set of security problems stemming from the countries' domestic setting. Addressing external security threats requires a national military strategy which in turn presupposes a defence policy. Likewise, addressing internal security threats demands a national strategy and plan as well. Managing the defence affairs is one critical task of a state. But a state has to manage a set of non-defence affairs such as human, political, social, economic, diplomatic and environmental, etc. Comprehensive national security (CNS) entails both military and non-military dimensions calling for an interface between the two. Resource allocation is an integral part of national security. Resource allocation in national security should be planned as such so that its adequacy and effectiveness become tangible in the country's security management. While crafting Bangladesh's national security strategy and policy not only their "cost-effectiveness" should be considered but also their appropriateness to address the nation's security, both externally and internally, ensuring the well-being of its people should be kept in mind. For sure, security has become synonymous of development and vice versa.[1] Hence, national security should be viewed as a prerequisite of a country's development and vice versa. Significantly, the subject of national security has not been dealt with in any Five-Year Plan of Bangladesh's government. The Bangladesh government also does not publish any White Paper (which is in vogue in the West) on defence affairs. Public debate on the defence matter is almost non-existence in Bangladesh.

Against the preceding setting, the objective of this study is to examine the various issues concerning Bangladesh's national security, suggesting strategic measures and policies and their cost-effectiveness and offering short-term, medium-term and long-term recommendations about Bangladesh's national security for the Sixth Five Year Plan (2011-2015) of Bangladesh. The study has been divided into seven sections including the introductory one. Section 5.2 looks at concept and components of CNS, traditional security (TS) and non-traditional security (NTS) issues, evolving CNS in Bangladesh through an interface of TS and NTS and determinants of CNS. Section 5.3 deals with existing national security system (NSS) of Bangladesh, its components, strengths, weaknesses, options available to Bangladesh and identifies areas of change needed in NSS. Section 5.4 examines the following issues: border security and other inter-security issues such as human trafficking, small arms trafficking and illicit drug trade. This section probes into terrorism, piracy and crime as intra-security issues. Section 5.5 focuses on regional and international cooperation and partnership in which South Asian Association for Regional Cooperation (SAARC)-SAARC cooperation and partnership, Association of South East Asian Nations (ASEAN)-SAARC dialogue, partnership and cooperation, the European Union (EU)-SAARC cooperation and partnership, Organisation for Security and Cooperation in Europe (OSCE)-SAARC cooperation and partnership, the United Nations (UN)-Bangladesh cooperation and partnership, South Asia Partnership International (SAPI)-SAARC cooperation and partnership have been discussed. This section further looks at cooperation in security issues at two levels: inter-state and inter-military in which cooperation between Bangladesh and a select countries such as India, Myanmar, the United Kingdom (UK), the United States of America (USA) and China has been examined. Section 5.6 takes up issues such as budgetary allocations for national security, measures of adequacy and effectiveness, dealing with how to ensure better cost-effectiveness and technological

[1] Towards the late 1960s, Robert McNamara (1968) has given the classic expression of the theme in the following words: "Security means development. Security is not military hardware, though it includes it, security is not military force, though it may involve it, security is not traditional military activity, though it may encompass it. Security is development and without development there can be no security."

advancement for defence system and rational and effective use of resources. Section 5.7 highlights on strategic measures and policies, giving a set of recommendations for the Sixth Five Year Plan (2011-2015) of Bangladesh.

Methodologically, the study has adopted a qualitative approach. Sources of information are derived from classified and restricted material, published material and websites. It has undertaken some key informant interviews (KII) to get a better insight on the subject-matter. All these have been carefully scrutinised and analysed and then used as objectively as possible to accomplish the objective of the study. However, the study has its limitation. Although it had access to classified and restricted material, it has not been possible to reveal the sources of material owing to certain policies of material suppliers.

5.2 NATIONAL SECURITY: CONCEPT AND THE DIMENSIONS OF SECURITY THREAT TO BANGLADESH

5.2.1 Concept and Components of CNS

From time immemorial, national sovereignty and security have been considered essential to a viable state. The concept of national security, although as old as nation state itself, came to be widely used and discussed in international relations following the World War II. In today's world nation-state is the basic unit and security of a nation-state is an indispensable element in contemporary international relations. The preservation of its territorial integrity is of utmost importance without which no nation-state can govern itself nor can it guarantee the utilisation of its own resources.

The term security has multiple meanings and people have divergent understanding of it. The phrase national security means protection of a nation's borders and territories against invasion and control by foreign powers (Jordan and Taylor 1984). It is generally viewed in terms of power, avoiding war or is equated with survival, and for some it is the relative freedom from harmful threats (Sheikh 1986). Until the end of Cold War era, the concept of national security has been used more in militaristic sense and this is based on the assumption that the principal threat to security comes from other nations. The western literature on national security is basically dominated by this assumption. It is said that national security is "the ability of a nation to protect its internal values from its external threats."[2] On national security Lippmann (1943) wrote, "a nation is secure to the extent to which

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[2] Encyclopedia of Social Sciences, quoted in Abdul-Momen M. Al-Mashat, *National Security in the Third World,* (London, West View Press: 1985), p.20.

it is not in danger of having to sacrifice core values, if it wishes to avoid war, and is able, if challenged, to maintain them by such victory in such a war." Maniruzzaman (1982) defines security as the "protection and preservation of the minimum core values of any nation: political independence and territorial integrity." Hartman (1967) argues that "security is the sum-total of the vital national interests of the state" amplifying that a "vital national interest is one for which a state is willing to go to war either immediately or ultimately." According to Trager and Samonie, "it is that part of government policy having as its objective the creation of national and international conditions favourable to the protection or extension of vital national values against existing and potential adversaries (quoted in Sheikh 1986)." The more familiar approach to security is conceived in terms of "abstract values" and is concerned mainly with the preservation of independence and sovereignty. Thus national security has traditionally been equated with military strength of a nation state.

During the last decade the global security situation has changed dramatically. While old threats have faded away, new and daunting challenges have taken their places. Security is now considered a multi-dimensional and comprehensive construct, where economic, environmental and other non-military aspects of security are treated as being on the same plane of significance as military security. Economic and technological strength have increased in importance relative to military strength (Easton and Anzim 1995). It is increasingly viewed as an all-encompassing condition in which people and communities live in freedom, peace and safety, participate fully in the governance of their countries, enjoy the protection of fundamental rights, have access to resources and the basic necessities of life, and inhabit an environment which is not detrimental to their health and well-being. One of the recent definitions of National Security provided by International Working Group on National Security (IWGNS) reads:

> "National Security is the first and most important obligation of government. It involves not just the safety and security of the country and its citizens. It is a matter of guarding national values and interests against both internal and external dangers–threats that have the potential to undermine the security of the state, society and citizens. It must include not just freedom from undue fear of attack against their person, communities or sources of their prosperity and sovereignty, but also the preservation of the political, economic and social values - respect for the rule of law, democracy, human rights,

> a market economy and the environment - which are central to the quality of life in a modern state."[3]

There is a growing consensus that the issue of security should be approached in a comprehensive manner by also taking non-military factors into account. Both military and non-military nature of threats have come under academic and policy scrutiny but non-military aspects of security–political, economical, environmental and social–now look like assume greater importance. As regards the advantage and disadvantage of broader security agenda, a parliamentarian handbook states:

> "The advantage of broader security agenda is that it provides a more comprehensive understanding of the threats to security and the responses needed. The disadvantage is that security services, which include all organizations that have the legitimate authority to use force, to order force or to threaten the use of force in order to protect the state and citizens, can become too powerful if they become active in non-military areas of society."[4]

The current definition of security is broad and is related to the ability of the state to perform the function of protecting the well-being of its people. Hence, national security has to encompass the whole gamut of socio-political spectrum. It is about the states as much as it is about their societies. It encompasses their social, cultural and economic developments, social stratification and modes of economic and political organisation. A nation can be said to have assured its own security when it is economically and technologically developed, politically stable and socio-culturally cohesive (Jayaramu 1987). The nations perceive security differently depending on their vulnerability, own peculiar circumstances and priorities. The abstract values of sovereignty and territorial integrity cannot have enduring appeal for hungry people, while the question of development or well-being presupposes sovereign existence of the state. So, however small and poor the country may be the military aspect of security cannot be ignored altogether. But the internal cohesion and strength of the state will be the inevitable precondition for its enduring security. It rests largely on the strong sense of nationhood achieved, among other things, through the well-being of the people.

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[3] http://www.ssronline.org/national_security_index.cfm accessed on 10 December 2009.

[4] Inter Parliamentary Union and Geneva Centre for the Democratic Control of the Armed Forces (2003), *Parliamentary Oversight of the Security Sector: Principles, Mechanisms and Practices*, Geneva, 2003, p. 16.

Security of a developing country is a complicated phenomenon. So it is an imperative for a country like Bangladesh to redefine the concept of security which would reflect the changed reality. Because security is central to people's well-being, it is essential that their views find expression in the nation's security policy. The policy has to incorporate the underlying values and principles relating to security which the state seeks to foster and protect. Security and development are inextricably related concept. A nation must ensure its political independence and territorial integrity. It must also take into account the people and society which constitute a nation. It must develop its economy to sustain a viable social and political system and allocate resources for the defence of its people, society and their political boundary. The predicament of small states with their scarce resource is indeed acute. It has always been difficult to choose between the conflicting requirement of defence and development. A heavy defence budget is a definite strain on small states' exchequer. At the same time, there could not be any true development without adequate internal and external security. Hence, some minimum defence requirements affording the country, at least a deterrent capability, cannot perhaps be overlooked. Therefore, small and poor states are often required to carry out a difficult task of striking a delicate balance between the two. In understanding security we must have a comprehensive approach to evolve a survival strategy. Security is something invisible and cannot be achieved piecemeal. Threat to security anywhere is a threat to security everywhere; hence, achievement of security demands comprehensive approach.

5.2.2 TS and NTS Issues and Interfacing TS and NTS towards Evolving a CNS

5.2.2.1 TS

The traditional concept of national security is concerned with direct i.e. military threats to security that may impinge on the sovereignty or territorial integrity of a state. This may vary from direct military attack to intimidation through the purposeful display of force (Osmany and Ahmad 2003). The TS concerns like border and territoriality, power rivalry and arms race are not died out rather they are very much prevalent in the developing world. As such, the very location of a state can make it vulnerable to external threats originating from its contiguous neighbours. These threats need not always be physical. They could also be economic, environmental and sometimes psychological. Currently, globalisation has heightened interdependence between and among states, including in the area of security. Security threat, posed to a country, can easily spill over to another country, destabilising a region or even the world. This, in turn, can affect the world peace. It needs reflecting that the countries' internal systems are shaped by the realities of international order. While the countries, especially the developing countries, are racing to cope with the post-Cold War global order, the dimension of their internal security at times is becoming more prominent. These are drawing external attention, thereby becoming sources of external influence.

5.2.2.2 NTS

Security problems also arise when the independence or territorial integrity of a state is threatened owing to indirect spill over impacts that leave on a state. These are identified as NTS issues. NTS encompasses "issues and factors that impinge on the security/ stability of the state or individual and has become more noticeable after the demise of the Cold War (Bhaskar 1997)" NTS threats today include alone or combined political threats such as political instability, terrorism, human right abuses; economic threats such as poverty, the impact of an economically powerful or unstable neighbouring state, and piracy; environmental or man-made threats such as natural or man-made disaster, global ecological changes, degradation of land or water, lack of food and other resources; and social threats such as overpopulation, organised crime, transnational drug trafficking, illegal trade, uncontrolled mass immigration and disease. Threats, emanating from the domestic source, are sometimes the most serious and significant of all other threats.

5.2.2.3 Interfacing TS and NTS towards Evolving a CNS

Interfacing implies existence of a place or area (in academic parlance it may mean intellectual space) where two different things meet and have an effect on each other (Osmany 2008). In terms of the nature of the threats (military or non-military) and the instruments to meet them as well as the security actors, security is either traditional or non-traditional (Osmany 2008). Nowadays, TS and NTS aspects have become intertwined and interfaced. These appear true in the case of developing states which suffer, among other things, from poor economy and lack of good governance. Bangladesh is a case in point. The boundary between TS and NTS at certain point becomes blurred as both impinge upon each other. Islam (2009) writes:

> "Bangladesh is one of those countries faced with a wide range of severe challenges in the field of security intertwined by both TS and NTS issues. Threats to its security, as understood from the traditional perspective, never disappeared. Occasionally such threats manifested vividly constrained by poverty, backwardness, underdevelopment, human deprivation, mis-governance, environmental degradation, turbulent process of socio-economic and politico-cultural development etc. Bangladesh faces much more intense threats in the NTS field."

Security is one concept with various referent objects, threats and conditions, victims and providers. A composite picture of national security calls for a study of both external and internal sources of insecurities, and state and non-state actors. It needs to be viewed in a holistic manner, combining both TS and NTS in one single, umbrella concept—comprehensive security. This actually implies a comprehensive approach to national security. The term comprehensive may be used in three senses—inclusion of non-military threats to the state, military threats to non-state security referents and non-military threats to both state and non-state security referents (Osmany 2008).

5.2.3 Determinants of National Security

As stated earlier, national security, which denotes both people's security and state's security, is dependent upon elements of national power. It refers to the requirement to maintain the survival of the nation-state through the use of economic, military and political powers and through the use of diplomacy. Structuring and exercising of the national powers of a state presupposes a study of the various determinants of the national security of the state. Keeping in view various factors and dimensions of security, for the purpose of this study the geographical location and geo-strategic importance of Bangladesh, threats to national security, both external and internal, national interests and economy are discussed in the succeeding paragraphs as the major determinants of national security of Bangladesh.

5.2.3.1 Geographical Location and Geo-Strategic Importance of Bangladesh

Bangladesh is located at the north-eastern part of South Asia. Its geographical location is as such that, it has practically only one neighbour India. Bangladesh is geographically dependent on India in many ways. It shares no less than 54 rivers with India, many of which originate in the Himalayan Ranges. Bangladesh gets 92 per cent of its water flowing through these rivers. Despite its geographical handicap in relation to India, Bangladesh seems to possess some geo-strategic importance in its South Asian setting. Bangladesh being a littoral state commands access to the Indian Ocean through the lanes of the Bay of Bengal. Bangladesh borders on the seven northeast Indian states which are experiencing insurgency. By virtue of its very location, Bangladesh divides northeast Indian states from the rest of the India, thus has the potential to meddle with affairs in eastern India. The possible land link of Indian hinterlands with China and Far East will pass through Bangladesh's territorial boundaries. The futuristic plan of Asian Highway is a manifestation of this significance. Continentally engulfed by India, Bangladesh attains special significance for India and its growing regional concerns. Furthermore, Bangladesh's role in the South Asian sub-system also adds to its geo-political importance.

Chinese strategy in South Asia after the 1962 Sino-Indian War has always been aimed at countering Indian dominance—political, military and economic. The South Asian nations suffering setbacks with India were easily courted by China and vice versa (Nuruzzaman 2003). Regarding these two rising powers relation, Malik (2004) commented, "Neither power is comfortable with the rise of the other. Each perceives the other as pursuing hegemony and entertaining imperial ambitions." Given the fact that China's relations with India constitute an important element of the periphery or neighbourhood policy of the former, such relations cannot go without ramifications for Bangladesh that lies in the same neighbourhood. By now, Bangladesh has developed a workable relationship with China and this has been cemented further through numerous trade and cultural agreements and construction projects. China also became the primary supplier of military equipment and training for Bangladesh. Hence, geo-politically Bangladesh is of quite significance to India. The extra-regional powers' strategic interest in Bangladesh increases its vulnerability to the strategic requirement of India that seeks the exclusion of outside powers' involvement in South Asia.

Lack of territorial depth discourages Bangladesh to opt for national security through military means only. However, Bangladesh's terrain with hundreds of rivers criss-crossing each other provides a good defence potential. This, together with its enormous populations of unique homogeneity along with the nation's experience during the Liberation War in 1971, may compensate for the lack of territorial depth. However, it remains a question as how all these potentialities can be integrated and exploited in the time of need.

5.2.3.2 Threats to National Security of Bangladesh

Security is a concept which does not give any meaning without some identification of threat. It is said that the security of a state is vulnerable to both internal and external threats. "Threat to the state comes in diverse forms which cannot be easily weighed off against each other and which are frequently in a state of constant evolution (Buzan 1983)." External and internal threats posed to a nation are considered to be the most critical determinants of national security. For assessing the security and policy implications for Bangladesh, it is of paramount importance to identify the threats that the nation is facing.

Threats from External Source

Threats to a state from the external source usually emanate from its closest neighbour (s). Due to the geographical location of Bangladesh, it is understood that the TS threats that it may have to confront are likely to come from its contiguous neighbours i.e. India and Myanmar. In addition, there could be also the possibility of Bangladesh facing nuclear threats from external source due to the proximity of the declared nuclear power states in South Asia.

India

Bangladesh is surrounded on three sides on the North, East and West by India and it shares 4,025 kilometres (km) land border with Bangladesh. India, by virtue of its geo-strategic location, size, resources, technological and industrial bases, military capability, occupies a hegemonic position from where it can dictate terms in the subcontinent (Saber 2008). Bangladesh has bilateral disputes with India, and relations between the two countries are marked by several contentious issues that proved too difficult to resolve. These are: (i) water sharing of the common rivers; (ii) implementation of the 1974 Border Agreement; (iii) India's support for insurgency in the Chittagong Hill Tracts (CHT) and the so-called 'Banga Bhumi Andolon' in the southwest; (iv) demarcation of maritime boundaries and the ownership of South Talpatty Island; (v) trade imbalances in favour of India; and (vi) smuggling and illegal cross-border activities and 'push in' of Bengali speaking Indians on the plea of illegal immigrants, etc. (Islam, Ahmed and Bhuyan 2009).

Most of these are long-standing unresolved bilateral issues. The issues of killing of Bangladeshi nationals in the borders by the Indian Border Security Force (BSF) and construction of *Tipaimukh Dam* are the latest addition to this list. As a big neighbour, India's motive and stance of keeping these issues pending seem to pose the actual threat to the security of Bangladesh. From the regional perspective, mistrust and suspicion in the region continue to prevail because of India's pre-dominance as regional power. Therefore, India's ability to manipulate Bangladesh's international image and internal stability and economy also pose threat to Bangladesh.

Myanmar

Bangladesh shares 283 kilometre of land border with Myanmar on the East. Since Bangladesh's independence, the relationship between Myanmar and Bangladesh was considered as a friendly one. However, some political issues such as the influx of Muslim Rohingya refugees, the maritime boundary delimitation and border issues have sometimes worsened the relationship between Bangladesh and Myanmar. Bangladesh probably did not visualise serious military threat from Myanmar until December 1991 when Myanmar Army raided one of Bangladesh Border Out Post (BOP) of Bandarban district (Saber 2008). Subsequently, it mobilised its regular forces along Bangladesh's border to deter an impending retaliation from Bangladesh. After the raid on the BOP, the intentions and the capabilities of Myanmar armed forces have been partly unveiled. Over the years, the Bangladesh-Myanmar maritime boundary dispute continued to remain unresolved because of legal complication and international instruments. The maritime boundary dispute between Bangladesh and Myanmar escalated further in November 2008 when the naval forces of the two countries came face to face in the Bay of Bengal after an oil and gas exploration attempt by Myanmar in a disputed area. Thus, it is clearly evident that Myanmar does pose threat to the security of Bangladesh.

Nuclear Threat

The nuclear environment that prevails in South Asia today is ambiguous as the declared nuclear states, India and Pakistan, are located in this region and there prevails a complex inter-state relation between the two. Past experiences reveal that India-Pakistan relation has the spill over effects over all the South Asian states including Bangladesh (Islam, Ahmed and Bhuyan 2009). Since the independence of these two countries there had been many circumstances in the past from which it can undoubtedly be concluded that the stability in the region is dependant on the degree of tension prevailing between the two. The accidental or potent use of nuclear arsenal against each other and the resultant collateral damage and nuclear fallout remain critical security threats to the whole of South Asia. Thus, it remains a threat to the security of Bangladesh also.

Threats from Internal Source

Internal threats are mostly related to internal disturbances. As stated earlier, these include political dissension and instability, terrorism, human right abuses, poverty, piracy, natural or man-made disaster, global ecological changes, environmental degradation, lack of food and other resources, overpopulation, organised crime, drug trafficking, illegal trade, proliferation of small arms, uncontrolled mass immigration and disease, etc. From the Bangladesh perspective, the list can be made longer by adding corruption, continuous moral degradation and intellectual decay and so on. However, of all these, only few important ones related to management of Bangladesh national security are discussed in the succeeding paragraphs.

Political Dissension and Instability

Since independence Bangladesh had experienced a series of political turmoil. Even now, there are dissensions on various issues which hamper national peace and prosperity. The democratic journey of the country started in 1991. Till then, the country has been ruled either by civil or military or civil-military governments. Politics in Bangladesh during this period has experienced impaired functioning and mostly remained volatile. Among many other causes, such state of politics also arises out of quality or lack of it of the players of the game. Consequently, politics in Bangladesh has been found to be mostly non-delivering. This practice continued even after the taking over of the democratic governments after the 1990s. As a result of unhealthy rivalry and antagonism between the political parties, a type of political culture has grown in the country in which the potentiality of instability is inherently rooted. The opposition parties seem to oppose the government for the sake of opposing. This at times results in serious crisis of governance. The parliament is characterised by frequent walkouts and rendered ineffective as the opposition abstained from joining the parliamentary sessions for months together. This has been the regular phenomenon in the last three democratic governments. The incidence of such politics in the country has multidimensional security implications, both in the short and long run. Frequent *hartals* called by political parties is the worst indicator of volatile politics, which was taking toll on national economy and making enormous suffering for all walks of people. In 2006, the country has witnessed its devastating effect which claimed innocent lives, destroyed public and private properties, thwarted social and economic progress, and created political instability and governance problems. In such a critical situation, the Caretaker Government backed by military got involved in Bangladesh politics on 11 January 2007 declaring a state of emergency and pledged a return to democratic government through organisation of a free and fair election within two years. The Caretaker Government handed over the power to the democratically elected government on 6 January 2009 after having conducted a free, fair and credible election within the timeframe as pledged. However, as the opposition continued to remain abstained from joining the parliamentary sessions repeating the previously practiced phenomenon, a truly institutionalised political stability in the country still remains in question.

Terrorism

The existence of the terrorist groups and evidence of their activities are noticeable in the country. Though Bangladesh has witnessed a sharp rise in religious terrorism since the mid-1990s, anti-state terrorism activities by the ultra-leftist groups were prevailing in the country since the pre-independence period. Ethnic terrorism insurgent groups such as Parbatya Chattagram Jana Sanghati Samity (PCJSS) are seen to be active in the CHT since the early 1970s. Despite the fact that the Peace Accord was signed in 1997, there has been concern and possibility of a return to violence as the renegades still have arms, and some degree of violence does exist. In the recent days the country is experiencing two types of extremism–

the religious extremism by the extremist religious groups and the political extremism by the left-wing political groups. The religion-based extremist groups are operating across the country and the ultra-leftist groups are concentrating mainly in the north and south western districts of the country (Islam 2008). Extremist religious groups have demonstrated their capacity for violence all over Bangladesh in the last few years on many occasions. The terrorist outfits engaged in promoting religious terrorism in Bangladesh include Jaamatul Mujahidin Bangladesh (JMB), Harkat-ul-Jehad-al-Islami Bangladesh (HuJI-B), Jagrata Muslim Janata Bangladesh (JMJB), Hizbut Tauhid, Allah r-Dal, Shahadat al-Hikma, etc. The execution of the extremist group, namely, the JMB's top leaders, in 2007 was a clear demonstration of the government's resolve in dealing with such extremists and can be seen as a significant development in containing extremism in Bangladesh. Subsequently, continuous vigilance and many operational successes by the law enforcement agencies of Bangladesh kept extremist religious groups' activities under tight control. However, few of the terrorist groups have been attempting to regroup and expand their dysfunctional network in different parts of the country. Religious extremists' activities can be said as the outcome of defective education system, political use of religion and the socio-economic backwardness of Bangladesh. These activities generate national security threats, impeding socio-economic and political development. Most of the extremists' activities in Bangladesh were thought to be home grown. However, recent arrests of some of the terrorists of India and Pakistan, operating in Bangladesh, gave rise to an apprehension that these extremists' activities could be linked with international terrorist organisations or groups. If such apprehension is true, the security of Bangladesh would be at stake, giving rise to regional and global implications.

Poverty

Bangladesh is faced with a situation of aggravating poverty. It has been a major challenge to the security and development of Bangladesh. Historically, poverty incidence in Bangladesh is very high. More than 40 per cent of the people live below the poverty line. In Bangladesh, more than 70 per cent of the people reside in the rural areas and a significant number of them are landless peasants. Compared to the urban areas, the poverty depiction is gloomier in the rural areas. These poverty stricken people do not have any belongings and they lack both physical and financial assets to raise their income adequate for them to get out of poverty. Their poor financial condition does not allow them to achieve education in order to increase their human capital. Thus they are tied in vicious circle of poverty. Besides, due to natural disasters like flood, drought, cyclone, riverbank erosion, etc. and accidents, sickness, social injustice and land grabbing, many people become poor and they cannot overcome the situation. In the disaster prone areas and in rural areas, incident of poverty is higher than the urban areas. Again, poverty is higher in the western and southern part of Bangladesh, where development is relatively less than that of northern and eastern part. From the time of independence in 1971 till to-date, the poverty situation in Bangladesh though improving but has not been changed significantly. According to the *Household Income and Expenditure Survey 2005*, Bangladesh has been able to reduce poverty at a rate of 1.8 per cent between 1990 and 2005 (BBS 2006). So the country remains trapped in an unending poverty cycle. According to Nuruzzaman (2003), "This poverty stricken people cannot be expected to contribute to the security of Bangladesh. They are just indifferent to the state structure and do not care for the sovereignty of the country. They rather drag the country backward and increasingly make it unfit to compete with the external world."

Environmental Degradation

Identifying environmental issue as a reckonable threat to national security has been a recent phenomenon. Bangladesh, because of its very geographic location, is a well-identified disaster prone area. The country is facing several major environmental problems like land degradation and depletion of natural resources, degradation of soil condition and fertility, natural disasters like flood, droughts, cyclones and storm surges, climate changes and sea level rise, etc. Because of our poor economy, lack of infrastructure and resource constraints, our inability to face calamities such as flood, storms, tidal surge, drought, etc. increase our vulnerability many fold. Moreover, the apprehended rise of sea level due to Green House effect adds a greater and unmanageable dimension of threat to Bangladesh. As forecasted by the UN Intergovernmental Panel on Climate Change, 17 per cent of Bangladesh total land is likely to be submerged affecting millions of people by the middle of this century. The various negative impacts are being felt severely due to increased food insecurity, hunger, poverty and inequity within the society. It displaces people in many affected ecosystems (coastal zone, river basin and drought prone areas) and enhances rural to urban migration. The poor are the most vulnerable to the impacts of environmental problems because of their lack of capacity and as the impacts are sometimes direct, such as loss of crop yields and food insecurity, water scarcity and growing health risks. Due to lack of resources and technology, land hungry farmers resort to cultivating erosion prone hillsides and moving into tropical forest areas. This will result in rapid loss of forestry to the detriment of environment as a whole. Degradation of soil is caused by reclamation of land for agriculture, over grazing, extensive use of fertiliser and pesticides and expansion of irrigation. Bangladesh with its distracted forest area, rising population growth and ever-increasing trend of impurity of environment is already in hazardous condition. "If a nation's environmental foundations are depleted, the idea goes, its economy may well decline, its social fabric may deteriorate and its political structure may become destabilised. The outcome, all too likely, is conflict, whether in terms of disorder and insurrection within nation or tension and hostilities with other nations (Myers 2003)." Such threat definitely demands concerted efforts and steps at the national as well as regional and global level.

Overpopulation

Bangladesh is one of the overpopulated countries of the world. About 150 million people live in a comparatively small country of 1,44,000 square kilometres of territory. Though the country has a brilliant record of bringing the population growth rate from 2.5 per cent in 1980 to 1.41 per cent in 2008 (Iftekharuzzaman 2010), it is predicted that Bangladesh's current population will reach more than 190 million by the year 2025. Because of overpopulation, per capita share of land in the country is already very low. With the growth of population, pressure on land is also increasing. At about 0.08 hectare per capita, cropland is already desperately scarce, and population growth will reduce the per capita share of cropland into half by 2025 (Chowdhury 2010). Rapid population growth has worsened the mutually reinforcing effects of poverty and environmental degradation. The existing overpopulation has also posed severe strain on economy in the form of poverty, rising unemployment, increasing dependence on foreign aid and so on. According to Mahmud (2009), "the extreme conditions of land scarcity and population density make Bangladesh a test case of development since there is no historical precedence of economic development taking place under such conditions." An ever-increasing number of floating populations with no access to basic amenities of life thus pose a substantial threat to the national security of Bangladesh.

Proliferation of Small Arms

Bangladesh is alleged to be a transit route both through land and sea for weapons movement to conflict zones of South Asia. There are several insurgent groups in the Indian North-Eastern areas. These groups are running their activities near to the Bangladesh-India border. Security problems, arising from their activities, multiply and deepen because of the porous border, the incomplete and disputed demarcation of boundary between Bangladesh and India, the absence of effective border management, the illegal activities around the border, and the lack of mutual trust, etc. An adequate check on illegal crossing from Myanmar and India to Bangladesh cannot be adequately checked owing to the inaccessible hilly terrain that surrounds the south-eastern part of Bangladesh. It is also difficult to keep the maritime borders under complete watch and control. Since independence, Bangladesh witnessed use of arms mainly in political violence, extortion and various other criminal activities. These involved arms which ranged from locally produced crude firearms such as pipe guns and pistols in small scale to modern sophisticated ones. In the last few years, the availability and wide use of illicit small arms and improvised explosive devices (IED) increased greatly. It is said that one of the major factors that led to the recent rise of terrorism in Bangladesh has been the easy availability of small arms and light weapons. As a result, proliferation of small arms, terrorism, illicit trade and drug trafficking are becoming growing concerns for Bangladesh, posing threat to its national security.

Piracy

Piracy has appeared as a threat and challenge for Bangladesh in the recent days. Piracy, robbery of ships at sea includes the acts in the sea like kidnapping of people for ransom, robbery, murder, and seizure of items or the ship, sabotage resulting in the ship subsequently sinking (Islam, Ahmed and Bhuyan 2009). Ships preparing to anchor are also becoming targets of the pirates. In Bangladesh sea area, a typical act of piracy termed as *Asian Piracy* often occurs which involves mere petty theft cases like stealing portable goods and valuables from ships with a negligible amount of associated violence. Since 2002, the International Maritime Bureau (IMB) in its annual reports has been routinely branding Chittagong as unsafe sea port. Some of the fatal pirate attacks against fishermen have taken place off Bangladesh coast in the recent years. In some cases, fishermen were killed, thrown overboard, taken hostage or robbed. Sharing common riverine border with the neighbours has further complicated the situation making transborder piracy difficult to control. Local media often publishes such reports of armed attacks and missing of fishermen in Bangladesh waters. Moreover, pirates often operate in disguise as fishermen making it further difficult for the law enforcing agencies to identify and apprehend them. Recent media reports vividly reveal that the Hilsa fishing areas of the Bay of Bengal are now under the control of pirates (Islam, Ahmed and Bhuyan 2009). Lack of adequate information and data related to deep sea piracy appear to be a serious limitation to offer a full picture about the deep sea piracy in Bangladesh. Pirates are powerful organised gangs. They have modern arms and fast moving vessels in their possession, which they use against unarmed fishermen. They have been identified as the greatest threat for fishermen, especially in the coastal areas. Thus, abducting of fishermen, looting their fishes, fish nets and other valuables, taking fishermen, as hostages, demanding ransom from their families, using of excessive violence, killing and/or injuring fishermen, etc. constitute serious security threats for coastal area people (Islam, Ahmed and Bhuyan 2009).

5.2.3.3 National Interests

To understand why and how nations act in their relations with each other, one must know in respect of each nation what it wants to achieve i.e. its national interests and national aims/ objectives and what it is capable of doing or its power potential. The answer to these two questions will become the basic determinants, which shape the policies and actions of nations within the state and with respect to each other. National interests are in effect the interpretation of the national purpose by those at the helm of affairs in the context of prevailing conditions and then assessment of future prospects. Interests are central to any discussion of international relations and national strategy because a state uses the term interest to signal its desires and intentions to other states. They may be defined "as the general and continuing end for which a state acts (NDC 2008)." There are different types of national interests: political, economic, ideological, security, environmental, etc. National aim refers to a condition in the future, desired and aspired by a nation (i.e. common consent) promoted by the government and achieved by harnessing the efforts of the population (NDC 2008). In a democratic state, these aims are based on national interests and have the approval of a majority of the population. The fundamental aim of Bangladesh, as enshrined in the constitution, is to realise through democratic process a society which is free from exploitation, where all citizens enjoy equality, freedom of human rights, the rule of law, and justice irrespective of cast, creed, and religion. National policy is designed to achieve these aims. However, it is somewhat interesting to note that at present Bangladesh does not have any articulated or published national security objectives and national security policy. In order to formulate the national strategy, besides identifying the threat to national security, the national security objectives are also required to be identified.

As Bangladesh ushered into an independent nation, it displayed high degree of internal solidarity stemmed mainly from the people's experience of the war of Independence, the relative ethnic homogeneity of the population, the common linguistic and cultural affinity of the people. However, the inability of the nation to develop a consensus on core national issues undermines the social, political and economic cohesion of the country. It is most unfortunate that our core values are yet to be identified and national consensus yet to develop on such issues. It is of prime importance that a basic security perspective is evolved without any further delay. To determine the core values of the nation a public debate involving representatives of different sections of conscious citizens may be a useful process. A renowned security analyst Brigadier General (Rtd) Abdul Hafiz suggests the following as Core Values of the nation[5]: (i) political independence and territorial integrity irrespective of whether security environment is nuclear or not; (ii) ensure internal conditions conducive to uninterrupted socio-economic development for the population; (iii)

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[5] Quoted in Army Headquarters Project Study, *National Security Vis-à-vis Financial Constraints- Bangladesh Perspective*, By 66 Infantry Division, 1999, pp. 9-10.

ensure the organic (physical and collective) survival of population; and (iv) preserve the nation's intrinsic value system.

5.2.3.4 Economy

Economic issues play vital role in ensuring a country's stability and security. Economic issues are very important on national security because of their spill-over effects on other national values. Persistent underdevelopment and deprivation of economic well-being can degrade national morale and precipitate social unrest, adversely affecting the socio-political system of a country (Khan 1996). Economic development of a country is also a pre-condition for its armed forces to be well founded and sustained with the desired credence.

Major handicaps to Bangladesh's economic development can be attributed to many reasons. The main reasons are unchecked population growth, political unrest, religious fundamentalism, lack of agricultural modernisation including old method of cultivation, illiteracy, lack of technical expertise, poor resource base and untapped resources, trade imbalance and unbridled smuggling, labour unrest and finally financial management and corruption. Bangladesh is one of the poorest countries of the world with a per capita gross national product (GNP) of only US$ 690. The economy is basically agrarian and agriculture still absorbs 48.4 per cent of the total labour forces of the country but contributes 20.60 per cent of the total gross domestic product (GDP). The industrial sector shares only 29.73 per cent of the GDP of the country which is one of the lowest in South Asia. The country's economy is so dependant on the agricultural sector that any fluctuations in agricultural output easily tend to destabilise the total economy. During 2008-09, the per capita GNP increased at a rate of only 5.88 per cent. This annual growth rate is very much insignificant to cope with the increasing demands on food, shelter and social services. Bangladesh has been facing severe balance of payment difficulties as it always has an imbalance of payment. The underlying reason is that the country is dependent on foreign import, not only for its development activities but also for meeting its demand for food and other commodities. Smuggling has further intensified the imbalance in trade. Smuggling is the main source of black money, the existence of which in the economy of Bangladesh prevents the growth of industrialisation and export promotion, which are necessary for economic development of a country. Among other problems, lack of basic infrastructural facilities including the shortage of gas and electricity is the major concern which is a hindrance to an investment friendly environment. Corruption is rampant in every spheres of life. It is said that lack of democratic institutions in the past gave way to mismanagement, corruption and malpractice, which had put great strains on the economy. But with the restarted journey of democracy since the early 1990s, there has been hardly any significant change observed. A major weakness of national economy is it's over dependence on aid and assistance from external sources. Vulnerability to aid dependence of the various sectors of the economy and the people is a critical phenomenon which often minimises the sovereign decision making power in Bangladesh. Nuruzzaman opines, "If security in the external sense means the preservation of independent decision making authority on issues of national interest, then Bangladesh has been forced to compromise it much earlier."

It is increasingly realised that it is the lack of economic development, not the lack of military hardware that is responsible for insecurity all over the developing countries of the world. Security indeed derives strength from the economic development of the country. So, these days while defining the objective of national security the stress is more on fighting the poverty and underdevelopment in all spheres of national life.

From the preceding discussions, the following major conclusions can be drawn:

a. As a South Asian developing state, the geographical setting and geopolitical environment of Bangladesh is significant and can be both an advantage and disadvantage. It may either help enhance national capabilities or add to the vulnerabilities. Therefore, it is important that the potentialities are exploited and integrated in order to enhance the national capabilities through the exercise of appropriate national power.

b. Security threats of Bangladesh are multidimensional, and these threats stem both from external and internal sources. But unlike external threats, the internal threats are most serious and most fundamental in nature. Although Bangladesh does not face an imminent danger of external hostility, there are emerging regional and internal security threats that need to be addressed. It is, therefore, urgently needed to take appropriate measures in order to put an effective check on Bangladesh's multiple sources of security threats. These threats are to be faced with a comprehensive policy at the national level, and, at the same time, security forces including military must be able to provide the necessary security.

c. NTS threats include political threats such as political instability, terrorism; economic threats such as poverty and piracy; environmental or man-made threats such as environmental degradation; and social threats such as overpopulation, proliferation of small arms, etc. appear to pose most serious and significant threats to national security of Bangladesh. So, the issue of security should be approached in a comprehensive manner by also taking non-military factors into account. The national security strategy should focus on developing its economy to sustain a viable social and political system and allocating resources for the defence of its people, society and their political boundary.

d. In Bangladesh, there must develop a consensus on core national issues that undermines the social, political and economic cohesion of the country. As a sovereign state, its national interests are to be established through popular consensus and articulated appropriately.

e. Maintenance of security in view of the changes in the political, socio-economic and strategic fields at national, regional and global levels remains an arduous task. Even states with economic capability, well conceived and well formulated doctrine and well defined foes will often find it quite difficult to respond to new changes. As a developing state, Bangladesh's national capabilities including its economic potency fall far short of meeting the external and internal challenges emanating from the evolving regional and global scenario.

5.3 NATIONAL SECURITY OF BANGLADESH: REVIEW OF EXISTING SYSTEM

5.3.1 Existing Components of NSS of Bangladesh

NSS in Bangladesh mainly consists of security management and oversight bodies[6] and core security actors meaning army, navy, air force and other statutory security forces to include border/ coast guards, police, Ansar and Village Defence Party (VDP), etc. Existing national security system is mainly structured based on the traditional concept of national security. The security sector mapping of Bangladesh will reveal that, under article 61 of the constitution, the President has the ultimate authority and responsibility for the national defence (security). The President acts on the advice and recommendations of the Prime Minister (PM) in all matters relating to the Ministry of Defence (MoD) as there is a parliamentary system of government in Bangladesh. Being the executive head, the PM has statutory authority, direction and control over the military services and this control is exercised through the Armed Forces Division (AFD), and the administrative details are channelled through the MoD.

[6]The executive and civil management body, the legislative body and civil society organisations.

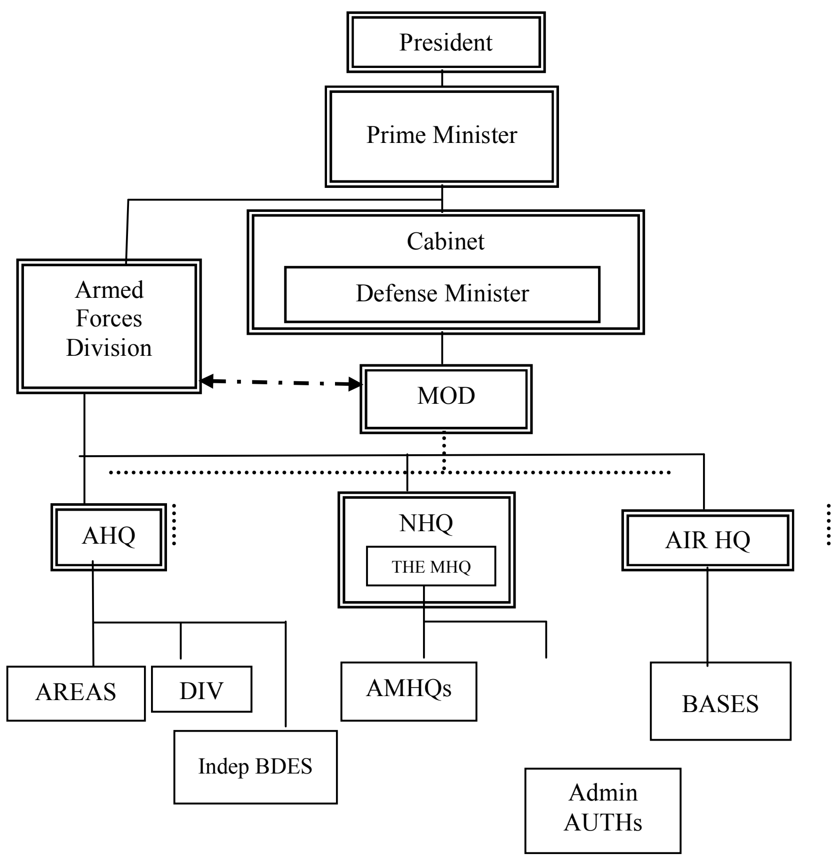
5.3.1.1 Higher Defence Organisation (HDO)

In order to address the complex issue of national security and coordinate the inter-Services functions in conformity with the national policy, AFD is presently performing the role of HDO. The existing organisational structure of HDO is given in Chart 5.1. The present responsibilities of AFD mainly encompass peacetime functions. As proposed in Draft Joint Warfare Doctrine, in case of any war or outbreak of hostilities, Joint Command Centre (JCC) will be activated within AFD to assume the operational command responsibilities of three services.[7] It will provide strategic guidance including aim, resources and limiting factors. At the operational level, it will issue campaign plan to the Services Headquarters. Activities of AFD during wartime are presented in Chart 5.2.

Considering this connotation, the war-time major anticipated functions of AFD are to: (i) formulate national military strategy and determine the theatre based on the PM's strategic guidance; (ii) coordinate, prepare and promulgate Campaign Plan; and (iii) represent the Armed Forces in a coordinated manner to higher national security body/forum through the Services Chiefs and Principal Staff Officer (PSO) AFD.

[7]As proposed in Draft Joint Warfare Doctrine, the PM will act as the Chairperson in JCC. Defence Minister and three Services Chiefs will be the members and PSO. The AFD will act as the coordinating member. The JCC, with the advice of three Service Chiefs, will formulate Campaign Plan in order to attain strategic objectives. Three Service Chiefs in their own capacity will also provide individual or corporate advice to the Government, when necessary. During peacetime till the JCC is activated, the AFD will coordinate all activities of JCC for the purpose of preparation and immediate transition to JCC. It will be staffed by the AFD. To assist JCC in day-to-day activities and co-ordination between the services, Joint Command Centre and Co-ordination Cell (JC^4) has also been proposed. The JC^4 will be chaired by the PSO and its members will be the Chief of General Staff, Assistant Chief of Naval Staff (Operations) and Assistant Chief of Air Staff (Operations). This cell will be staffed by the three services and would function round the clock.

Chart 5.1: Existing Organisational Structure of HDO



Legend:

Operational Chain of Command:

Administrative Chain of Command:

Coordination:

* MHQ stands for Martime Headquarters.

Source: Joint Warfare Doctrine, Annex B to Section 5, page 5B-1.

Chart 5.2: Flow Chart showing Wartime Activities of AFD

STRATEGIC AND OPERATIONAL LEVELS

Source: Joint Warfare Doctrine, Annex B to Section 5, page 5B-1.

The National Committee for Security Affairs (NCSA) is the highest policy making body on national security affairs, which was first formed in 1992 and reconstituted in 1997. NCSA is responsible for evaluating all matters related to national security and defence, assess and evaluate internal security situation, instructing measures related to national security, making necessary recommendations to the Cabinet and dealing with other related issues.[8] Defence Committee of the Cabinet (DCC) is the highest-level committee on defence matters comprising number of designated members of the cabinet. According to the War Book, this committee is responsible for conducting the general affairs of war. The

[8] In NCSA the PM is the Convener and its members include: a number of Ministers; the three Service Chiefs; a number of Secretaries; PSO, AFD; Director General's (DG) of Directorate General of Forces Intelligence (DGFI), Bangladesh Rifles (BDR), National Security Intelligence (NSI); and Inspector General of Police (IGP).

legislative bodies include the National Parliament and the Parliamentary Standing Committee on Defence. MOD is responsible for the overall defence of Bangladesh. However, it does not involve itself in the operational activities of the armed forces. It deals with works of three services, military land and cantonments, cipher documents, budget, legal and statutory matters of the Armed Forces, gallantry awards and decorations and pardons, reprieves and respites, etc of the Armed Forces. The AFD is a principal government organ under the PM's Office to coordinate all operational and training matters relating to the Armed Forces.[9]

5.3.1.2 The Armed Forces

The military or armed forces have existed throughout history and are widely viewed as the shield and sword of a state. They are the core security actors and the Bangladesh Armed Forces (military) are no exception. They came into being in the thick of Bangladesh's Liberation War in 1971. During the last 38 years, they have been expanded gradually and organised into the present day shape of professional Armed Forces. Like most of the militaries around the world, they perform the following functions: (i) protection of the country's independence, sovereignty and territorial integrity; (ii) internal security tasks (assistance to civilian law enforcement authorities to maintain order in exceptional cases, disaster relief operations, participation in nation-building activities, etc); and (iii) international peacekeeping missions. Notwithstanding new security developments and threats, like most militaries of the world, the traditional most important task for Bangladesh Armed Forces is still to defend the country against foreign military attacks. Bangladesh Armed Forces include Bangladesh Army, Bangladesh Navy (BN) and Bangladesh Air Force (BAF). These three Services Headquarters are responsible for organising, training and equipping their forces for the conduct of prompt and sustained combat operations on land, sea and air in order to defeat enemy forces. They prepare their own plan for conducting and supporting campaigns/major operations basing on the overall campaign plan prepared by the AFD. For all operational matters, they receive directives from the AFD. But they chiefly rely on the MoD for administrative and financial matters.

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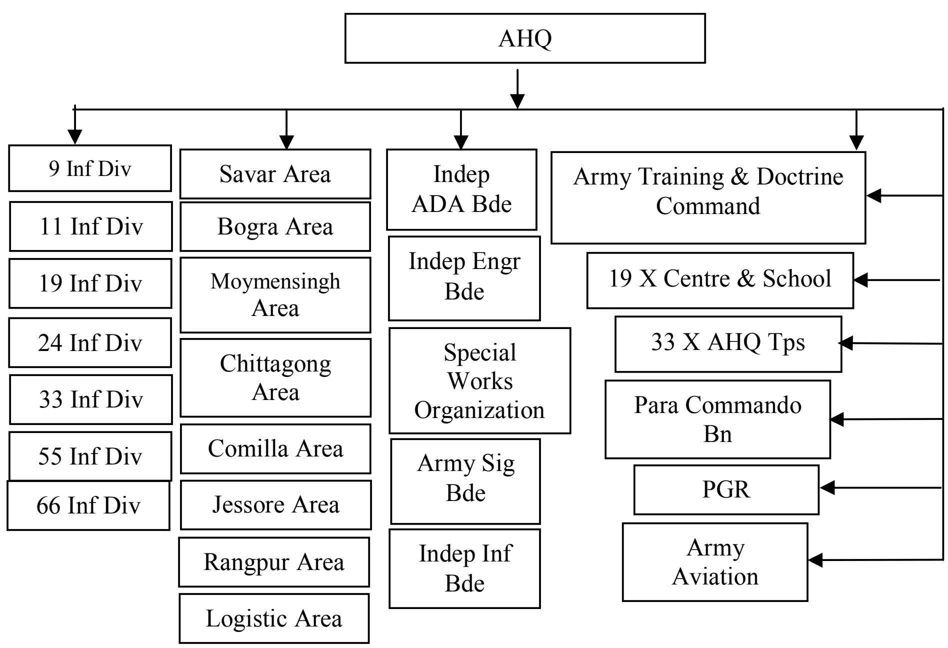
[9]AFD has the authority, direction and control over the Services on operational and administrative matters under the direct supervision and guidance of the PM. The PSO, a Major General, heads the AFD and is entrusted to perform the duties of a full-fledged Secretary with total administrative and financial authority as that of a Secretary in any other Division or Ministry.

Bangladesh Army

Bangladesh Army started its journey from the nucleus formed with the members of erstwhile Pakistan Army who revolted against the authority during the Liberation War in 1971 to protect the interest of the people of Bangladesh. The revolted personnel were initially organised in an unconventional manner which in the later stage of liberation war gradually turned into fighting formations. After the independence, the army has been structured into a professional army with all its supporting units and establishment. The roles of Bangladesh Army in general are to: (i) defend sovereignty and territorial integrity of the country; (ii) aid the civil administration in the maintenance of law and order when requested with the support of normal law enforcing agencies; (iii) assist civil administration when requested in the event of any disaster or calamity; (iv) develop and plan the mobilisation of civil resources in support of ground operations; and lastly, (v) support peacekeeping operations world-wide.

The Army consists of a number of Divisions which are responsible for the defence of an assigned geographical area. Present outline structure of Bangladesh Army is shown in Chart 5.3.

Chart 5.3: Present Outline Structure of Bangladesh Army



Source: Authors' Compilation.

It consists of seven Infantry Divisions, an Independent Infantry Brigade, an Independent Air Defence Artillery Brigade, two Independent Engineer Brigades, a Signal Brigade and a Composite Brigade, In addition, a Para Commando Battalion, Army Aviation, Army Supply and Transport Battalion, Army Military Police Unit, Army Security Unit are also under the Army Headquarters. Army Postal unit which is a war increment, a number of Logistic Area and Area Headquarters, and various training centres and schools are there to provide the necessary logistic and training support. A standard Infantry Division has three Infantry Brigades, an Artillery Brigade, an Armoured Regiment, an Engineer Battalion, a Signal Battalion and a Divisional Support Battalion. Besides, each Division has a Supply and Transport Battalion, three Field Ambulances, three Field Workshop Companies, an Ordinance Company, an Independent Ammunition Platoon, a Military Police unit and a Field Intelligence unit. Most of the Division/ Brigade/ Logistic Area of Bangladesh Army do not have the full complement as per authorisation. Though the overall shortage of manpower is around 3.44 per cent, the shortage of officer is 25.78 per cent which is very disproportionate. At present Bangladesh Army is operating with a significant number of weapons and equipment deficiencies. These deficient weapon and equipment list includes tank, Armoured Personal Carrier (APC), anti-tank weapon, vehicle, engineer plant and equipment, and signal equipment. Weapon and equipment wise the percentage of deficiency ranges from 28 to 47.

The major weapons and the equipment in the inventory of Bangladesh Army are shown in Table 5.1. Most of Bangladesh Army weapons are from the 1960s and 1970s, which belittles its overall military prowess. According to a report,[10] which was placed by Bangladesh Army before the Parliamentary Standing Committee on Defence Ministry on 28 May 2009 for discussion, 90.3 per cent small arms and 89 per cent field artillery guns used by the army were bought during the 1960-1980 period while all the tanks in the inventory are also from that period. The report focuses on the shortage of manpower in the force and says talented youths are discouraged to join the army as facilities in the civil and corporate professions are better than those in the military service. It suggests making the military service attractive by increasing salaries and other benefits.

It also points out that the number of engineer battalions is very inadequate for implementing development activities in different parts of the country. There is also shortage of equipment to deal with natural disasters like flood, cyclone and earthquakes. The acute shortage of fund stands in the way to starting replacement of outdated weaponry and modernisation of the force.

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[10] *The Daily Star*, Dhaka, 14 June 2009.

TABLE 5.1

MAJOR WEAPONS AND EQUIPMENT OF BANGLADESH ARMY

Main Battle Tanks	Active AIFV/ Light Tanks	APCs	Towed Artillery	Mortars	Light SAM Launchers	AA Guns
210	10	180+	190+	361	20	146

Source: Based on *The Military Balance 2009*, IISS, London, Routledge and Taylor & Francis, January 2009.

Bangladesh Navy (BN)

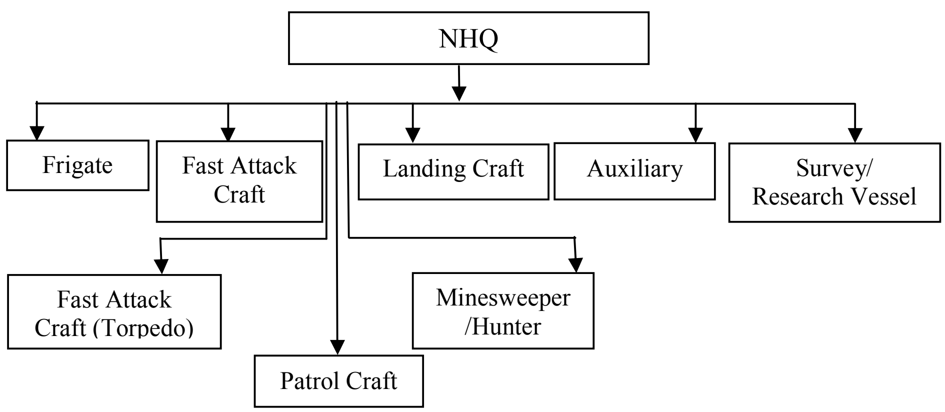
BN came into being during the Liberation War in 1971 and started its brave stride with only two gunboats named PADMA and PALASH and a small number of Naval Commandoes. After the independence, it started expanding and gradually achieved "Limited Blue Water Navy" capability. It has undergone many changes over the last couple of decades not only in size and shape but also in its role, mission and vision and grown into its present form as the vanguard of maritime defence of the country.

BN's mission is to "Safeguard the sovereignty over the internal waters and territorial sea, and sovereign rights over the Contiguous Zone, Exclusive Economic Zone (EEZ) and Continental Shelf of Bangladesh while supporting riverine and maritime economic activities including free flow of riverine and sea borne trade." The roles of BN are to: (i) safeguard/defend the territorial waters of Bangladesh; (ii) keep the Sea Lines of Communications (SLOC) open during a war; (iii) keep the sea ports of Bangladesh open for shipping during a war; (iv) protection of the Bangladesh fishing fleet; (v) Coast Guard duties; (vi) patrolling in riverine waters of Bangladesh; (vii) search and rescue (SAR) at sea; (viii) cyclone warning for Naval ships and craft; (ix) protection of Bangladesh merchant ships in the high seas; (x) assist the civil administration in maintaining internal security and peace whenever called for such duties; (xi) assist the civil administration in the event of natural calamities like flood, cyclone, tidal waves, earthquake, etc. whenever called for such duties; (xii) Naval control of shipping (internal and external, inland or foreign) Organization; (xiii) oceanographic survey; and (ivx) any other task for which the government may deem it necessary to deploy the Navy.

Present outline structure of BN is shown in Chart 5.4. Since the inception, BN has in its inventory mainly the over aged ships/crafts fitted with technologically inferior weapon and sensor and the force structure of BN is the result of a series of compromises and makes shift solutions. The existing approved manpower of the navy is 19,676 and at present it has seven per cent deficiency.

BN is a surface Navy having over 75 ships of different categories (Table 5.2), the majority of which have been acquired as 'off the shelf' basis. Most of the ships are older than 25 years. Only 15 ships/crafts are aged less than 25 years[11]. Combat capability of the old ships has decreased and their maintenance and operation cost is high as well as risky. These ships lack multidimensional warfare capabilities. With the passage of time these old ships have become a retarding factor against the developments of BN. Weapon/sensor up-gradation (missile, gun, torpedo, radar and sonar and Early Warning (EW) systems, etc.) and life extension (replacing engine, generator and hull/structure) of existing ships are major concerns which require immediate consideration. In addition, the fleet needs specialist vehicle like hydrographic ship for survey in sea area, landing ship for disaster relief operations, salvage ship for rescue of vessels at sea and high speed boats to augment law enforcing duties at sea and coastal area.

Chart 5.4: Present Outline Structure of Bangladesh Navy



Source: Authors' Compilation.

TABLE 5.2
SHIPS AND CRAFTS OF BN

Frigates	Corvettes	Missile Craft	Torpedo & Coastal Craft	Inshore & Riverine Craft	Mine Vessels	Amphibious Ships	Landing Craft	Support ships
4	3	9	18	11	5	11	5	10

Source: Based on *The Military Balance 2009*, IISS, London, Routledge and Taylor & Francis, February 2009.

[11] *The Daily Star*, 24 June 2009.

Bangladesh Air Force (BAF)

The nucleus of BAF was formed during the War of Liberation in 1971 at a place called Dimapur in North-East India. BAF started functioning with a handful of officers and airmen of the then Pakistan Air Force. After the independence of the country, BAF started functioning with only one Dakota (DC-3) aircraft, two Otters and two Allouette-3 helicopters with its Headquarters established at Dhaka. Soon after, BAF gradually began to take shape with the induction of Mig-21 fighter-interceptors, along with the AN-26 transport aircraft, the MI-8 helicopters, and a few Air Defence Radars. The mission of BAF is: "To prepare, operate and maintain an air force capable of projecting air power in order to uphold and promote our national interest," as drafted in light of the responsibilities and duties assigned by the government. The BAF roles are to: (i) safeguard/defend the Bangladesh airspace; (ii) attack on enemy's offensive power and on centers of his power of resistance in time of war; (iii) provide intelligent information by means of photographic, radar, electronic and visual reconnaissance; (iv) create favourable air situation for assisting Bangladesh Army and BN at times of war; (v) provide long range transportation for strategic movement of land and other forces; (vi) provide SAR and casualty evacuation; and (vii) assist the civil administration in maintaining internal security and peace whenever called for.

To perform the assigned roles, BAF is organised with a number of air bases and units. BAF has five operational air bases one each at Tejgaon, Kurmitola, Chittagong, Jessore and Tangail with well coordinated staff and command structure. Outline structure of BAF is shown in Chart 5.5. Like Bangladesh Army and BN, most of the units of BAF do not yet have the full complements as per authorisation and the manpower shortage is around 4.5 per cent of the total strength. The major equipment is the fighter aircraft, the transport aircraft, the trainer aircraft, the helicopters and the Air Defence Radars. The force has over 160 planes-fighter, transport and training aircraft and helicopters, of which 70 per cent are aged over 20 years and 18 per cent inducted in the last 10 years.[12]

5.3.1.3 Other Components

Other statutory security forces include the para-military forces like BDR, Bangladesh Coast Guards, auxiliary forces like Bangladesh Ansar and VDP and the prime law enforcement agency Bangladesh Police. Besides performing their peace time responsibilities, the para-military and auxiliary forces come under the operational control of Armed Forces during emergency/war. BDR and Battalion

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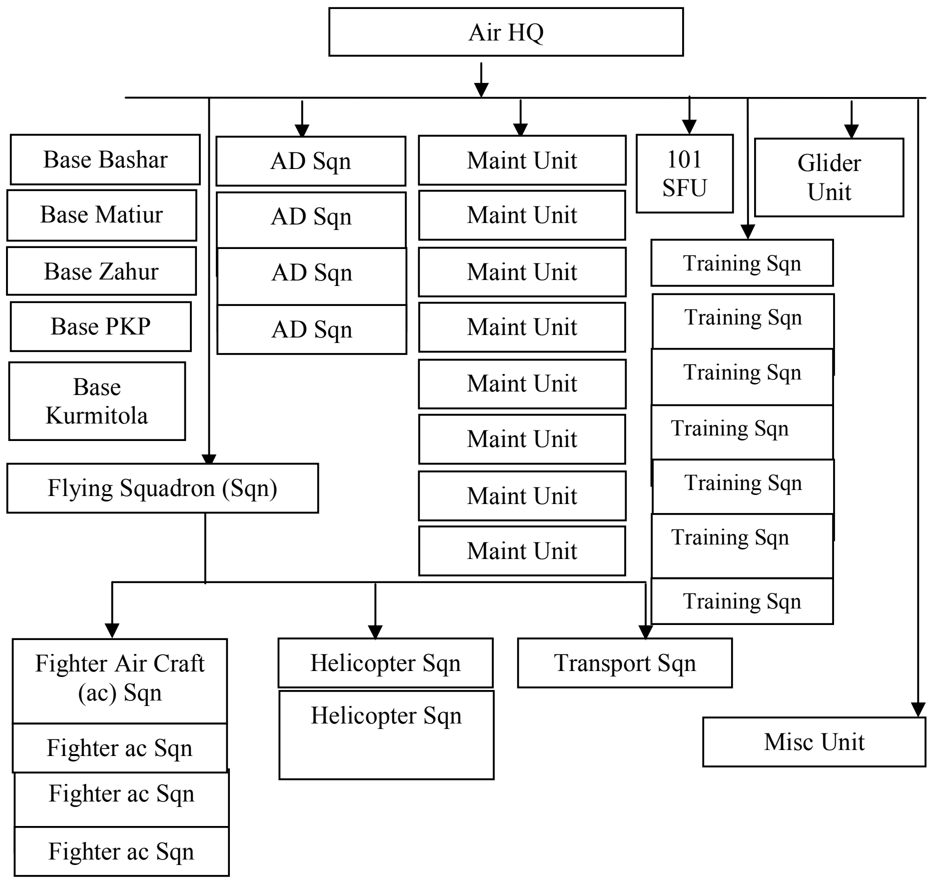
[12] *The Daily Star*, Dhaka, 09 August 2009.

Ansars are integrated in the operational plan of the Army Divisions of the respective deployment area and Bangladesh Coast Guard forms part of the naval operational components.

Chart 5.5: Present Outline Structure of BAF



Source: Authors' compilation from various sources.

Bangladesh Rifles (BDR)

BDR has been organised keeping in view its roles in peace and war. This organisation comes under the Ministry of Home Affairs and officered from army. The mission assigned to BDR is to protect the border of Bangladesh and prevent smuggling and to come under operational control of army during emergency/war.

BDR forces total about 44,000, organised in 13 sectors, 46 battalions that staff more than 550 BOPs. It is mandatory for every BOP to carry out patrolling by day and night along the border belt as well as within five miles from zero line within Bangladesh territory. It is worth mentioning that approximately 1/5th of the total force remain on patrol in the border areas at any time of the day or night. Communication and distance between BOPs are important factors that affect operational capability. On the average, the distance between one BOP and the other varies from 10 to 20 kilometre. In most cases road conditions are deplorable and in some cases, even road does not exist.

In addition to maintaining the security of the border, BDR is responsible for checking smuggling across the border. Although the BDR is legally empowered, it lacks human and material resources to keep a sharp watch over more then 4000 km long frontiers. In the rugged mountainous jungles of the CHTs, the thinly guarded frontier is a threat to the security and sovereignty of the country. As such, there is a requirement to deploy additional forces in the mountainous jungles of the CHTs. Although the BDR is fully committed to the protection of border and prevention of smuggling, they are often called out to restore law and order, ensure peaceful elections, and provide post-disaster relief and perform many other tasks which definitely are hindrance to their main task of protecting the border of Bangladesh and prevent smuggling.

Bangladesh Coast Guard

Bangladesh Coast Guard was established in 1994 under the Ministry of Home Affairs and it formally started functioning from December 1995. Over a decade, Bangladesh Coast Guard has raised a small fleet of about 12 ships/ crafts along with a modest infrastructure of 3 Bases, 8 Stations and 6 outposts along the coastal areas. Presently they are operating with only 1000 personnel against an approved authorisation of 2,000 personnel including civilians. Uniformed personnel are taken from the BN on deputation. The vision of Bangladesh Coast Guard as set by Bangladesh Government is "Ensure security and maintain national interest in maritime area." To protect the national maritime interest and address anticipated threats, the role of Bangladesh Coast Guard has been outlined in the Bangladesh Coast Guard Act 1994. These are: (i) protection of the national interests in Bangladesh waters; (ii) prevention of illegal fishing in the maritime zones of Bangladesh; (iii) prevention of the illegal entry into or departure from Bangladesh through Bangladesh waters; (iv) enforcement of any order or warrant issued by the court or any other authority in respect of any ship entered the territorial waters of Bangladesh or any person on board such ship; (v) search and prevention of environmental pollution in Bangladesh waters; (vi) ensure security of persons working in Bangladesh waters; (vii) prevention of drug smuggling in and out of the country; (viii) participation in SAR and salvage operations for distressed vessels, personnel and goods during natural calamities; (ix) arrange broadcast of warning signals and other information through radio or other media during natural calamities; (x) rendering assistance to the navy in times of war; (xi) patrolling in Bangladesh waters; (xii) rendering assistance to concerned authorities for ensuring security of the sea ports; (xiii) suppression of destructive and terrorist activities in Bangladesh waters and assist other authorities in this regard; and (xiv) accomplish other responsibilities ordered by the government. Like any other forces the efficiency of Bangladesh Coast Guard in carrying out its role depends on the efficiency of its personnel and effectiveness of the logistic support provided. However, with the existing state it is handicapped to shoulder the optimum responsibility due to constraints of resources and other limitations like lack of adequate and appropriate platforms, lack of strength, age old vessels, vast operating area, etc.

Bangladesh Ansar and VDP

Bangladesh Ansar and VDP comes under the Ministry of Home Affairs and consists of three basic components: Ansar Bahini (commonly known as Sadharon Ansar), Battalion Ansar and VDP. Raised in 1948 Ansar Bahini was re-organised after independence in 1972. This force is having its organisation up to union level. Every union is having a platoon of 32 persons and every upazilla is having a company of 100 men and a platoon of 32 women. The total strength is about 3,27,000 including 27,000 Female Ansars. At present about 30,000 Ansars are employed all over Bangladesh. The main responsibilities of Ansar Bahini are: (i) to assist the government or any organisation under the government in matters/works related to public security; (ii) to participate in any work related to public security; (iii) to participate in any work related to public welfare for socio-economic development of the country; and (iv) to assist Bangladesh Army, BN, BAF, BDR, Police and Battalion Ansar as and when directed by the government.[13]

Battalion Ansar was raised in 1976 to augment the strength of the security forces. The main job of Battalion Ansar is to assist the Armed Forces and other law enforcing agencies in their assigned tasks. At present there are 35 male and 1 female Battalion Ansar deployed all over the country, of which 15 Battalions are in CHTs. Their responsibilities are: (i) to assist the government or any organisation under the government in matters/works related to public security; (ii) to participate in any work related to public welfare for socio-economic development of the country; (iii)

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[13] Ansar Bahini Act 1995 (Act No. 3 of 1995).

to participate in disaster management; (iv) to participate in any other work as directed by the government; and (v) to assist Bangladesh Army, BN, BAF, BDR and Police as and when directed by the government.[14] Battalion Ansars are equipped with small arms and light weapons including Machine Guns and Mortars of small calibre.

VDP was raised in 1976 to improve the law and order situation in the rural areas and the socio-economic condition of the rural masses. VDP consists of one platoon of male members and one platoon of female members in each village. There are about 4.6 million VDP members, of which 50 per cent are female. The urban version of VDP is called Town Defence Party (TDP). The VDP and TDP members are employed in socio-economic development activities like poverty alleviation, literacy movement, hygiene and sanitation, environment protection, family planning, income generating activities for self employment and in various awareness programmes. They are also employed in election duties and guarding of village markets and important installations of rural areas.

Bangladesh Police

Bangladesh Police has an ancient history and heritage. The resistance by the Bengali members of police at Rajarbag against the crackdown of the Pakistan Army was basically the first chapter of armed struggles during our Liberation War in 1971. The present structure of policing in Bangladesh bears much of the British heritage, as it has a long history of British period, then Pakistan and finally to the present time, having a lot of changes and developments. After the independence of Bangladesh in 1971, the Police force of this country was named as Bangladesh Police and started functioning with the infrastructure left by the Pakistanis. Presently, Bangladesh Police is operating with a strength of 116,376 personnel in 571 Thanas under seven Ranges and six Metropolitan Police.[15] Besides these, there are Armed Police Battalion and Rapid Action Battalion (RAB) operating under the Bangladesh Police Headquarters.

Armed Police Battalion was raised in October 1975 for special duties like collection of arms and ammunitions and controlling the underground parties. To assign them with the counter insurgency operation responsibilities, the force was organised in the line of infantry battalion as second line force. Today it has ten battalions assisting district police in controlling law and order situation and special duties like VVIP protection, election duties, etc. Armed Police Battalion roles are: (i) performing internal security duties; (ii) executing recovery of illegal arms and

[14] Ansar Bahini Act 1995 (Act No. 4 of 1995).
[15] http://www.police.gov.bd/images/img/organogram.pdf accessed on 31 December 2009.

ammunition; (iii) operating against outlaws of the society; (iv) apprehending armed miscreants; (v) assisting other law enforcing agencies in maintaining law and order; (vi) participating in war as second line force; and (vii) guarding KPIs/VPIs during war.

RAB started its journey on 26 March 2004. The RAB emerged out of a tremendous necessity to fight the prevalent criminal activities which had almost jeopardised the normal course of public life. RAB was formed by amending The Armed Police Battalion Ordinance 1979 under the Ministry of Home Affairs with the selected members from Bangladesh Army, BN, BAF, BDR, Bangladesh Coast Guard, Bangladesh Police, Bangladesh Ansar and VDP and other non-military cadres of the government. Its responsibilities are to: (i) provide internal security; (ii) collect information on crime and crime related activities; (iii) recover unauthorised weapons, ammunitions, explosives and similar items as directed by government; (iv) conduct investigation of any crime as directed by government; (v) arrest armed organised criminals; (vi) assist police and other law enforcement agencies in maintaining the law and order situation; and (vii) perform any other work as directed by the government. At present there are 12 Battalions deployed all over the country with the Forces Headquarters located at Dhaka. They have total manpower strength of 8,289 against an authorisation of 9,727.[16]

5.3.1.4 Intelligence Organisations

National Security Intelligence (NSI) is the national intelligence organisation of Bangladesh. Directorate General of Forces Intelligence (DGFI), the Armed Forces intelligence organisation and Special Branch (SB) of Police are also operating at the national level. Besides these, all the three services of Armed Forces, BDR and RAB are having their own intelligence setup. Lack of policy guidelines to meet the present and future security challenges of Bangladesh in a consistent approach is a major weakness of the intelligence organisations. The structural conditions of all these organisations are not very improved. They lack appropriate equipment, technological advancement and most importantly trained manpower to operate as an effective organisation. Most of these organisations in recent years have been used by the regimes in power for their political gains instead of national interest. As such, questions were frequently raised about their role and efficiency. Bangladesh had experienced intelligence lapses in a number of occasions in the past, which had disastrous consequences on the national security. The latest example in this regard was the rebellion and killing incident that took place at the BDR headquarters at Pilkhana by its members on 25-26 February 2009 that killed 74 people including 57

[16] RAB Journal 2009, p. 3.

Army officers. It is also interesting to note that there had been no central intelligence coordination committee at the highest level to coordinate the efforts of all these organisations. However, following the BDR incident in 2009, a "National Committee for Intelligence Coordination (NCIC)," headed by the Prime Minister, was formed to coordinate the activities of different intelligence agencies.

5.3.2 Existing NSS of Bangladesh: Strengths and Weaknesses

A nation's security depends "primarily on its comprehensive national strength, which includes its economic and technological prowess (Sisodia 2009)." Clearly, this reveals a major weakness of Bangladesh existing NSS due to prevailing socio-economic condition. As stated earlier, Bangladesh's core values are yet to be identified and national consensus is yet to develop on such issues. There have been also no formal documents articulating national security objectives, national security strategy and national defence policy. The developments of Armed Forces are to be based on a formally published or written defence policy, which provides policy guidance, legislative support, resources and long term capability enhancement programmes for dealing with threats to national security. It also implies certain actions to ensure that the forces and the weapons necessary for the mission are in existence. These actions in turn may imply decisions on budgeting, on personnel, on materials, and possibly on organisation (Ahmed 2001). Absence of such documents evidently indicates that Bangladesh's existing NSS has not been based on an agreed and spelt out National Security Strategy which is so vital for the national sovereignty and preservation of the political, economic and social values of a nation.

The formal policy formulation has to be directed by a HDO, like National Security Council, or Cabinet Committee on Defence and Parliamentary Committee on Defence (Osmany 2008). Since its formation NCSA was never made constructive and its functional level was not clearly delineated. Although NCSA was formed under the dispensation of the democratic government, differences of opinion prevail regarding its composition. There are widely-held opinions that it should include opposition leader of the parliament, professional experts from within the government as well as from outside the government like think tank (s) on security, economy, international relations, professional bodies, academia, etc. (Islam, Ahmed and Bhuyan 2009). In a democratic country, the Parliamentary Committee on Defence has to oversee issues such as budget, procurement, arms control, the readiness/preparedness of the military and so on. According to Article 76 of Bangladesh Constitution, parliament should appoint amongst its members as the rules of procedure a Standing Committee for Defence. It is encouraging to note that in Bangladesh, the Parliamentary Standing Committee on Defence started functioning since the democratic journey began.

Till the early 1990s, Bangladesh has been ruled either by civil or military or civil-military governments. Within the framework of traditional security system the existing Bangladesh defence organisations have come to the present shape after going through many changes by the said governments and in devoid of any formal defence policy. These changes were made as and when the necessity was felt and either because of political need or as a result of the persuasion of military leaders of particular time. According to John (1994), guiding principles for force structuring are: (i) national military strategy, whether it is deterrence, defence or offensive; (ii) defence of specific interest, is there requirement of forward deployment; (iii) alliance requirement, commitment of forces that needs at least earmark force; (iv) General Purpose Force, if preferred that requires organic mobility and capacity to deter opponent; (v) technology has limits as a combat multiplier; (vi) heavy forces are not ideal for all circumstance but light forces are less capable and more vulnerable—a mix of force is necessary; and (vii) active force should be maintained to counter most likely threats. Reserve forces should provide depth of organisation and equipment necessary to mobilise the nation when confronted with the gravest of perils. Though it can be argued that, all these are not necessarily applicable in the perspective of Bangladesh, the present state clearly reflects that even a minimum of them have not been fulfilled in structuring the Bangladesh Armed Forces.

Besides the shortages of manpower, the major weaknesses of the Bangladesh Armed Forces are their weapons and equipment. All the three services of Bangladesh Armed Forces are having deficiency of weapons and equipment against their authorisation. The deficiency state of Bangladesh Army alone in terms of weapons and equipment reveals a deplorable state of the forces. They also possess weapons and equipment which are outdated and have decreased combat capability. The platforms and air crafts possessed by BN and BAF are almost obsolete having no access to the latest technological advancement and thus their operational capability is no match to modern day warfare. The maintenance and operating cost of these aged weapons and equipment are a continuous burden on their yearly budget. The fund is a major constraint in the way of their modernisation. However, small or large, whatever the size may be, it is imperative that the Armed Forces are allocated the appropriate resources to help plug the organisational shortcomings and increase operational capacity in accordance with the country's economic reality. Once the requirement and size of the Armed Forces are agreed upon, the government needs to continuously support them in order to allow their growth in keeping with the modern day security requirement in a sustained manner.

Although born out of war, the Armed Forces have never experienced the same after being structured. Since independence, there has been hardly any comprehensive assessment conducted regarding the country's security environment at the highest level. Such assessment should identify both traditional and non-traditional security threats. The missions and tasks of the Armed Forces and other security organisations need to be re-defined in the assessed security environment of the country. What should be the shape of the forces that will execute these missions and tasks; and what changes are therefore, required in the existing force structures are to be identified. It needs to be examined, in particular, as to whether Armed Forces existing structures created over the last four decades would continue to be useful in the future or not.

The concept of jointness of the services itself is a force multiplier which must be exploited to the full. The jointness can be achieved by meshing the war fighting capabilities of the three services and providing them with common focus for conducting military operations. In essence, military forces need to be directed centrally at the strategic level and applied jointly at operations level. To get dividend from the foreseeable security environment, Armed Forces has to consider its structuring keeping in mind the joint environment. At strategic level, the priority task is to harness the nation's economic and industrial resources and translate them into military utility. In Bangladesh, such resources which can generate military useful output within operational timeframe are scanty and therefore, remain a major weakness. It follows that there is a minimum need for industry engaged in defence planning process to play role in the reconstitution, regeneration and subsequent recuperation of forces. The aim is to provide the operational commander with sufficient logistic and sustainability resources to enable him to deploy and employ his combat power flexibly and to maintain the tempo of the operation[17]. Hence, there is a serious requirement of analytical approach to organise, restructure and equip the Armed Forces keeping in mind the budgetary constraints to withstand any hostility under joint environment.

As part of military components, Bangladesh Army is most likely to play the dominant role as a means of national power. When question of protecting the sovereignty will come, in comparison to BN and BAF, the Army will have to bear maximum responsibilities due to the realities on the ground. As part of the anticipated National Security Strategy, the Army is expected to conduct sustained land operations even in the absence of other services. The role will demand a significant presence that will deter external threat from any aggression. To be responsive to the security needs of the country, the Army must grow the capability

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[17] *British Defence Doctrine,* Joint Warfare Publication 0-01.

to withstand overwhelming odds and yet survive to fight back. It should be capable of conducting continuous combat under adverse air situation and ignoring the limitations imposed by the day night cycle.

Although the economy restricts the size of the standing army, it must develop the capability to expand rapidly in time of crisis. This can be done by maintaining a large reserve which can be mobilised during war to sustain conflict. The sections of population who can be easily turned into soldiers should be exploited to the maximum and on-the-shelf plans must be kept ready to mobilise all able bodied men to pursue national interests. Army must be prepared to blend conventional and unconventional warfare (UW) in the implementation of National Strategy.[18] As the country is in defensive posture the definition of victory for her would be to 'defeat enemy's aggression." What realistically Bangladesh should aim at is to force the aggressor to pull back his forces from own territory within the shortest possible time. So, the defensive posture must be integrated with limited offensive plan and hence the need arises for weapons of deterrence capability.

Armed Forces have always extended support to the Government in mitigating the sufferings of the people during and after all the national calamities that have happened since independence. They have also fought a protracted insurgency in the CHTs under the direction of Government for long 23 years and finally prepared the ground for the Government to sign Peace Accord. Even today, there are about 9,000 Bangladesh Army personnel deployed in the CHTs. Armed Forces of the country played crucial role in dismantling dictatorship and restoration of democracy in the country in 1991. Since then, they have also played very crucial role in maintaining law and order during all national elections and thereby help institutionalising the democratic process. Armed Forces have contributed to the infrastructure development of the country by undertaking various development works which includes land development in Dhaka city area, construction and repair of flood protection embankment at different places of the country, road construction project in Dhaka, CHTs, Cox's Bazar and other inaccessible areas; and countrywide low cost houses for the homeless people. Their role in the disaster management since independence, including the floods in 2008, *SIDR*, *Aila,* etc., has been instrumental. Thus, there is a growing interest in using the Armed Forces for more domestic tasks like internal security, disaster management, development work and maintenance of law and order situation which turns out to be a great strength for the nation.

It is more than a decade now that the personnel of Bangladesh Armed Forces are being employed in the UN Peace Support Operation in large scale in consonance

[18] Bangladesh Land Force Doctrine, *Draft Operations of War*, Vol. 1, P. 2-5.

to our national policy of supporting peace and harmony in the world. Bangladesh is one of the highest troop contributing countries since the mid 1990s and presently the second highest contributor with 10,282 peacekeepers, including 8,773 military and 1,509 police personnel, in 11 missions in 10 countries.[19] Since the country began participating in peacekeeping missions in 1988, it has contributed over 73,176 soldiers in 41 UN missions in 30 countries. The troops earned Taka 7,445 crore over the last seven fiscal years only.[20] Bangladeshi troops engaged in the UN peacekeeping missions face a dearth of equipment, though their work abroad earns the country around Tk 1,200 crore a year. The crisis is acute in 19 contingents across Liberia, Sudan, Ivory Coast and Congo. The peacekeepers from Bangladesh do not have enough APCs, water treatment plants, bulldozers, generators, rollers and freezers–all necessary to carry out their duties properly. Around six per cent of the funds allocated for the army in fiscal years 2004-08 were spent on defence purchase, of which the purchase meant for use in UN peacekeeping missions cost around 8.46 per cent of the said funds. It is, therefore, necessary that arms, heavy vehicles and other military gears required by the peacekeepers are purchased so the troops in the UN missions are considered well-equipped and dynamic. These extra employments of peacekeeping have a connotation in designing the Armed Forces. For any peace keeping mission if a given number is deployed in the mission area, a similar number undergoes pre-deployment training in the country to replace those and an equal number having completed the mission undergoes induction training to take over their unique responsibilities in the military units/ establishments.[21] It also takes time and effort to form a contingent prior to the deployment and disband the same on return from the mission. Thus, at a time the troop's engagement for any UN peacekeeping mission is practically three times of the peacekeepers actually deployed in the mission.

As a legacy of pre-independence era, there has been a lack of closer civil-military relations in Bangladesh, particularly between security institutions and media. This relation had serious impact on the security forces actions and image portrayed in various times, especially during the crisis period of the nation. Though, in most occasions, it did not tally with common people's perception, it did surface as a weakness of the security institutions. The reason could be the lack of awareness of some media regarding the sensitivities of the armed forces and security

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[19] http://www.un.org/en/peacekeeping/contributors/2009/oct09_3.pdf accessed on 01 December 2009.

[20] *The Daily Star*, Dhaka, 10 June 2009.

[21] KII, 18 December 2009.

institutions so far as these relate to national security concerns. It is also to be understood that in the modern era of free media, a newspaper is a daily product and so is a TV Channel broadcast and, hence, they are in constant need of timely, authentic and factual information. It is quite encouraging to note that in the last few years there has been a surge in efforts to build closer civil-military relations through increasing contact with media and the public. So, there is a need to construct a series of next steps, and ways forward, that will allow for new ideas on civil-military relations to be carried forward and put into practice. In order to further this effort, it is imperative to strengthen the Inter Services Public Relations (ISPR) Directorate to make it a truly professional and functional agency of the Armed Forces.

Until recently Bangladesh lacked permanent central intelligence coordination committee at the highest level. In absence of such a committee the country had to face a lot of intelligence lapses in the past, which had disastrous consequences on the national security. Bangladesh's experience also reveals that intelligence services are faced with the twin challenges of being both effective and accountable. In times of intelligence failure, people decry the lack of transparency, capacity and foresight of intelligence services. They also find themselves taking issue with the human rights records of such services, and their periodic disregard of individual rights such as the right to life, the prohibition of torture as well as the right to privacy, albeit these are enshrined in national constitutions, or otherwise upheld by law.

5.3.3 Options Available to Bangladesh

From the present day regional and international security environment, it is understandable that physical invasion in this century has become an out-of-date and counter productive phenomenon. But this should not make a country like Bangladesh feel complacent about its defence needs. Rather, keeping in view the threat posed to its security, it will be quite pertinent to examine the options available to Bangladesh for developing a credible deterrence with minimum expenditure.

Option 1: Large Standing Armed Forces with Small Reserve

A large standing armed force with a small reserve is obviously the best option for any country to counter external military threat. As a general rule, countries with hostile neighbours must have a sufficiently strong standing armed force ready to take the fields at a moments notice to meet the exigencies of war. Such an option usually can be exercised by the nations having adequate resources and manpower. Raising and maintaining large armed forces often tends to outrun national economic capacities. Even many of the rich and advanced nations have not adopted this option being uneconomical. For Bangladesh, despite having a large population, this option can be clearly ruled out on the economic ground alone.

Option 2: Small Standing Armed Forces with Large Reserve

A small standing armed force with large, trained or semi-trained reserve is one of the options for countries like Bangladesh having a large population but lacking in resources. The rich and developed countries usually have a small but modern armed force. They rely on manpower to be mobilised in emergency. This option calls for having a large pool of trained manpower with short-term engagement and periodical refresher training. Some inherent weaknesses in this option are: (i) the reserve components of the armed force is not likely to have the same standard of training and efficiency as that of the regular units; (ii) a force composed of the both regular and reserve elements usually faces command, control and administrative problems; and (iii) timely mobilisation of the force is challenging.

Option 3: Medium Standing Armed Forces with Large Reserve

Bangladesh does not have the required resources to maintain a large armed force; it should rather opt for a medium but highly skilled armed force. In other words, there would be no quantitive expansion but qualitative development of the armed forces should continue. Arguably, a medium size armed force may also seem meagre compared to its adversary, but the main objective of such an armed force in any eventuality would be to consume enough time in deterring the aggressor, as would be enough to mobilise international opinion with diplomatic moves on the one hand and mobilise its operational reserve on the other to sustain conflict. It should develop the capability to expand rapidly in time of crisis. The sections of population who can easily be turned into soldiers should be exploited to the maximum with the blending of conventional and UW.

Option 4: Small Standing Armed Forces with People's War Concept

People of all groups like students, workers and peasants participate in people's war. The small standing armed force forms the nucleus, while the bulk of the able-bodied trained or semi-trained population carry out the fight. They resist the enemy with all their resources and fight in a protracted struggle until the victory is achieved. The Liberation War of Bangladesh in 1971 is an example of successful people's war. Guerrilla tactics is generally used in people's war, though the ultimate victory comes through conventional means. The weaknesses of this option are: (i) the country as a whole, or in parts, may be easily occupied by the adversary without much of fighting which may not be acceptable; (ii) mass mobilisation needs lot of motivation, strong political leadership and may also take a long time; (iii) organisation and training of the men will be highly complicated affairs; (iv) due to protracted warfare, the economy of the country may be crippled; (v) adversary may divide the nation politically with the help of puppet government and fifth columnists; and (vi) assistance of a third nation is essential which in the case of Bangladesh would be almost difficult due to geographical reality.

A comparative study of all the options discussed so far is given in Table 5.3

TABLE 5.3

COMPARATIVE STUDY OF THE OPTIONS AVAILABLE FOR BANGLADESH FOR DEVELOPING A CREDIBLE DETERRENCE WITH MINIMUM EXPENDITURE

Items	Large Standing Armed Forces (Option-1)	Small Standing Armed Forces with Large Reserve (Option-2)	Medium Standing Armed Forces with Large Reserve (Option-3)	Small Standing Armed Forces with People's War Concept (Option-4)
Cost	Uneconomical	Less costly	Less economical	Economical
Type of warfare	Conventional	Conventional/ unconventional	Conventional/ unconventional	Conventional/ unconventional
Duration	Short	Short	Short /Protracted	Protracted
Intensity of conflict	High	Medium	Medium to high	Low to medium
Method of intake	Voluntary	Voluntary	Voluntary/ conscription	Voluntary/ conscription
Participation of population	Limited	Less	More	Maximum
Command and control	Easy	Easy/difficult	Easy/difficult	Difficult
Suitability of terrain	Operate easily	Operate easily	Operate easily	Difficult
Standard of training	Best	Good	Good	Minimum
Outside assistance	Not Must	Helps	Helps	Essential
National consensus	Difficult	Possible with motivation	Possible with motivation	Possible with emergency/difficulty
Mobilisation	Easy	Slow	Slow	Slow and difficult
Initial loss of territory	Minimum	Not much	Minimum	Maximum
Training difficulty	Easy	Difficult	Not so difficult	Difficult
Logistics	Easy	Difficult	Easy	Easy
Motivation needed	Minimum	Little	Moderate	Maximum
Subject to enemy subversion	Minimum	Less	Less	Maximum

This comparative study suggests that Bangladesh should go for either Option 2 or Option 3, which would suit our socio-economic condition. The requirement of having operational reserve to support the standing armed forces, small or large, is also another important consideration in deciding the options available. A viable option to maintain effective operational capability of the armed forces could be reduction of the service for Non-Commissioned Officers (NCO) and lower ranks, with no pension benefits[22] and to have them in the reservist list for a relatively longer period. However, all these call for a meticulous review at the highest political level which should then be followed by a security doctrine and a defence policy.

5.3.4 Identifying Areas of Change for a Cost Effective NSS of Bangladesh

By now, it is quite perceptible that approach to security in a comprehensive manner presupposes addressing both military and non-military aspects. Considering our national interest, geo-strategic environment, threat perception and our socio-economic condition, enforcement of a major change in our existing HDO structure and the three Services will not be cost-effective as well as operationally effective. The areas of changes identified are, therefore, basing on the assumption that Bangladesh would adopt either option 2 or 3 (either small or medium standing Armed Forces with large reserve) for developing its Armed Forces to a credible deterrence; these changes are basically needed to enhance the forces operational effectiveness. In doing so, the foremost requirement is to downsize the deficiency in terms of manpower, especially of the officers' as well as weapon and equipment. Though the modernisation of Armed Forces is a continuous process, it may not be achievable in the short and medium term because of the high cost as well as the fund needed for it. So, there should be a policy of selective and progressive modernisation based on a perspective plan within an achievable time frame. The possible changes or modernisation plan of the forces should include and aim at:

a. Bangladesh Army

(1) Enhancing infantry battalion's anti-tank, surveillance and intelligence capabilities;

(2) Extending artificial strategic depth through high-tech surveillance means;

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[22] It may be considered to introduce soldiers on 5 to 8 years contract as practiced in many countries. These soldiers will be provided with military training possessing civil organisation/utility. On completion of their contract period, only a few of them may be retained permanently purely on merit and performance. Others on retirement will be placed on reserve with one time payment; 40-50 per cent personnel in the rank of NCOs and below may be of this category.

(3) Achieving night fighting capability for infantry, armour and division support elements;

(4) Acquiring battlefield air defence capability;

(5) Broad based automation of field formations and units with a view to subsequently establishing data link at army level;

(6) Mechanisation of at least one brigade element with amphibious capability to enhance striking capability of strategic reserves;

(7) Rapid response capability against heliborne threats;

(8) Improved firepower (tank, field gun and anti-tank guided missiles);

(9) Bridging and gap crossing equipment, fast moving crafts and landing craft tanks (LCT); and

(10) Limited Electronic Warfare capability.

b. BN

(1) Replacing aged ssurface platforms with the modern combat capability.

(2) Enhancing present surface navy capability to three dimension with the inclusion of naval air arm (helicopter and Maritime Petrol Air Craft) and submarine;

(3) Induction of few platforms with air defence capability;

(4) Enhancing specialist ships capability like Mine Swiper, Hydrographic, Landing and Salvage Ships;

(5) High speed boats;

(6) Weapon/Sensor up-gradation (missile, Gun, Torpedo, Radar, sonar and EW systems).

(7) Life extension (replacing Engine, Generator and Hull/Structure) of existing ships.

c. BAF

(1) Replacing aged air crafts with the modern combat capability and avionics;

(2) Acquire EW capability (induction of aircraft for airborne early warning and enhancing air defence radar capability);

(3) Iinduction of surface-to-air missile systems;

(5) Enhancing maritime air operation capability;

(6) Enhancing overhauling and maintenance capability;

(7) Enhancing operational capability of the air bases.

While implementing the acquisition/modernisation plan BN may look for additional budget from the following agencies/sources: (i) ministry of fisheries for fishery protection duties; (ii) ministry of home till the time Coast Guard is in a position to undertake current peacetime constabulary duties of BN; (iii) department of survey; (iv) ministry of environment; and (v) ministry of energy for protection of offshore resources.

5.4 ADDRESSING INTER-AND INTRA-SECURITY ISSUES OF BANGLADESH

In this section a major focus, among other issues related to inter-security, has been given on border security probing into pertinent issues related to it. It then discusses measures to tackle border security at two levels: a. intra-country level and b. inter-country level. Institutional measures to address border security problem have been given special merit. However, based on the extent and magnitude, further focus has been given on three other inter-state security issues that are causes of state and human insecurity, and concern the state security agencies of Bangladesh (i) Human Trafficking; (ii) Small Arms Trafficking; and (iii) Illicit Drug Trade. In this study, intra-security issues will refer to those threats that are internal in nature and considered generally home grown. However, cross-border implications cannot be ruled out. In recent years, the number of intra-security issues has increased both in terms of typology and magnitude. Three such issues namely terrorism, piracy and crime have been examined and measures to address these intra-state security issues have been discussed.

5.4.1 Border Security

Discussions on border security will concentrate on India and Myanmar—Bangladesh's two contiguous neighbours with whom bilateral relations have remained problematic owing to divergent perceptions, misperceptions, lack of mutual trust, etc. These have, in turn, impacted upon addressing border security. Lake (2007), telling us the US perspective of border security, identifies it as a key element of the overall homeland security endevour, and considers it as a "pivotal function in protecting the American people from terrorists and their instruments of destruction." Bangladesh should view border security from the overall homeland security perspective. For sure, the goals of national security of Bangladesh cannot be achieved without protecting the well-being of its people.

5.4.1.1 Key Problems about Bangladesh-India Border

India shares over 4,000 kilometre of porous land boundary with Bangladesh—the longest among all its neighbours. Three key problems about India-Bangladesh border can be identified. These three unresolved key problems have made the subject of border security a growing concern of national security for Bangladesh. These are:

1. Incomplete demarcation
2. Enclaves
3. Adverse possession

1. Incomplete demarcation: Incomplete demarcation relates to 6.5 kilometre of land between India and Bangladesh.[23]

2. Enclaves: There are 111 Indian enclaves (measuring 17,158.1 acres) that lie within the territory of Bangladesh and 51 enclaves of Bangladesh (measuring 7,110 acres) that lie within the territory of India.

3. Adverse possession: When it comes to the point of adverse possession one discovers that there are about 52 pieces of land which actually belong to Bangladesh but are in the adverse possession of Indian. By contrast, about 49 pieces of land that are India's are actually in the adverse possession of Bangladesh (Krishan 2000). To date, the key Agreement between Bangladesh and India relating to their land border is the Indira-Mujib Agreement of 1974. Article 2 of the Agreement envisions that all the areas in adverse possession of each country would be measured and demarcated at the earliest. Once these are completed, then the areas in adverse possession would be exchanged within six months. First, while the Bangladesh government has ratified the Agreement in 1975, the Indian government has not done so as yet. Second, the Indian government, through two supplementary agreements signed in 1982 and then in 1992, instead of agreeing to lease it in perpetuity to Bangladesh as it was envisaged in the 1974 Agreement, has agreed to the provision for the common use of the *Tin Bigha Corridor* by both countries. [24]

5.4.1.2 Bangladesh-India Border Issues

Issues, that entail India and Bangladesh border reflect at least three reciprocated sets of claims, denials and counterclaims by both countries. These are:

[23] Two joint boundary working groups have been set up to complete the boundary demarcation. Plainly they could not finalise the matter.
[24] *Khabarer Kagaz* (Dhaka), 7 July 1992.

1) India's claims that cross border movement of illegal immigrants is causing economic, social and political problems, especially in Assam and the north-eastern hill states, but in many other parts of India—a claim which successive governments of Bangladesh have fully denied;
2) India's further claim that Bangladesh is acting as a host to terrorist separatist groups which use Bangladesh as a base to carry out attacks in India's North East—also disputed by Bangladesh, but with the counter claim that militant opposition outfits intent on overthrowing the government in Bangladesh use Indian territory;
3) Bangladesh's claim that India is building an illegal fence without mutual agreement and for a military rather than simply civilian purpose—a claim denied by India (Bradnock 2006).

It needs mentioning that according to the 1974 Agreement both India and Bangladesh agreed that no defensive structure would be erected within 150 yards of the border. After 1982, India kept continuing so in the form of barbed wire fencing. Bangladesh viewed this as defensive structure. On the other hand, India contended that the expression "defensive structure" meant walls or bunkers which would impede the movement of military vehicles. Barbed wire, India maintained, was not a military barrier as a tank could easily pass through it. India's other contention was that the 1974 Agreement also provided for a stop to unauthorised immigration and smuggling and that the fence would help do both.

5.4.1.3 Bangladesh-Myanmar Border Issues

Bangladesh and Myanmar share a common border of 283 km. In 1979, Bangladesh and Myanmar (then Burma) signed the Land Boundary Agreement. Despite the existence of the Land Boundary Agreement, the following border issues have given rise to border security problems between the two countries.

1. Illegal crossing of Bangladesh's border by Myanmar citizens;
2. Smuggling of arms and drugs;
3. NASAKA (the Myanmar's border security force) activities along Bangladesh-Myanmar border;
4. Erecting barbed wire fencing along the Bangladesh-Myanmar borders.

In addition to the entry of Myanmar citizens, Bangladesh claims that tension runs high along Myanmar-Bangladesh 283 kilometre long border as Myanmar unilaterally erects barber wire in Bangladesh's territory. Bangladesh has no objection if Myanmar erects such wire within its own territory. Since this is not the case, NASAKA indulges in such a practice that gives rise to border security problem. Characteristically, Myanmar denies what Bangladesh claims.

5.4.1.4 Mechanisms to Tackle Border Security

Mechanisms to tackle border security should be applied at two levels: (1) Intra-country level, and (2) Inter-country level.

Intra-country level

At the intra-country level, a concerted well-functioned communication and coordination system is a prerequisite for the security personnel to address border security. In Bangladesh, where, according to a top BDR source, "a serious lack of coordination among the government agencies working on the border" exists, aiding "the criminal gangs, smuggling groups and their networks to achieve their own purpose,"[25] the need for such aforesaid system can hardly be over emphasised. What augurs ill for Bangladesh is that "this lack of coordination remains not only at central level but also at the bordering level where officials of different agencies work together."[26] Ironically, these officials "who work at the same points of the border consider themselves as competitors of each other. This attitude encourages smugglers and criminals and facilitates crimes."[27] Clearly, these impediments make border management too difficult and cumbersome for Bangladesh. Hence, at the intra-country level, establishing an integrated border management wing (IBMW) by the Bangladesh government under the Ministry of Home Affairs is long overdue.[28] This IBMW must have its Department of Border Management (DBM) with Border Area Development Programme (BADP) to promote security and development among the bordering people. BADP should become a part of the Five-Year Plan, making BADP truly and meaningfully operationalised. Significantly, the Grameen Bank can facilitate development programmes for the bordering people by providing special border micro-credit (SBMC). In addition, the government should open a series of dialogues with major developmental donor partners to make them interested in undertaking border developmental projects, providing grant, etc. These can help to tackle border management problems, facilitating security and development of the bordering people.

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[25]Quoted in *The Daily Star* (Dhaka), 8 December 2009, p. 1.
[26]*Ibid*. p. 1, p.15.
[27]*Ibid*., p. 15.
[28]Recently, from the BDR, an integrated border function, under the Home Ministry headed by an additional secretary, has been sought. See, *ibid*., p. 1.

While these should be nationally and centrally managed, at the local level, the formation of a cluster of Border Village Community (BVC) under the supervision of local community leaders is also long overdue.[29] The central function of such BVC will be to promote security and development programme in the bordering region in league with the border security personnel by helping them to combat illegal activities and other crimes along border. Leaders of BVC and government can undertake joint border development programme (JBDP) to deal with the immediate pressing security and developmental needs of bordering people. Such JBDP will be helpful to generate intra-country level confidence building measures (CBMs). The recent BDR's suggestion that a prohibition on movement of the locals within the 150 yards of no man's land from evening to morning—a move when comes into effect would help in "curbing smuggling and saving lives of Bangladeshi nationals"[30] should be cherished as a coveted goal. But a lot of homework needs doing to make it feasible as restricting people's movement from dawn-to-dusk is not an easy job.

Executive Director of United Nations Counter-Terrorism Committee Directorate (UNCTED), Mike Smith, contends: "Stronger border control means better trained border force, improved aviation security, more secure travel documents, machine readable data, and strengthened capacity to see what money is coming to the country . . . ."[31] Thus, border security is a multilayered issue, and border management entails both internal and external security dimensions. At the intra-country level, the Bangladesh government must direct all-rounded efforts to ensure effective intra-coordination among various agencies responsible for border security. For Bangladesh, border security will remain quite problematic unless intra-coordination problems are addressed holistically at national and local levels. Therefore, an IBMW premised on a flawless integrated communication and coordination system must be ensured at the intra-country level to address border security.

Inter-country level

For Bangladesh, at the inter-country level, a direct application of military means should not be the preferred mechanism to address border and other inter-security issues. Instead, politico-institutional mechanisms should be the preferred instruments. Seen thus, CBMs can greatly help in border management. To promote

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[29] Recently, BDR has also proposed such a local mechanism which should have been introduced long before. For BDR's suggestion on this point see, *ibid.*

[30] *Ibid.*

[31] *The Daily Star* (Dhaka), 11 November 2009, p. 2.

CBMs, first of all, political and diplomatic negotiations are necessary. To carry out these negotiations, all Tracks—Track I, Track II and Track III—should be applied. The CBMs are assorted arrangements involving hotlines, people-to-people exchange, coordination conference, prior notification of military exercises, joint statements, joint communiqué, etc. All these measures are used to lessen tensions. Communication, constraints, transparency and verification measures are regarded as key CBMs tools. But a communication system that permits swift identification of the threat and coordination of the appropriate joint response should be an integral part of CBMs tools. A joint response presupposes a cooperative system. Thus, at the inter-country level, a cooperative border monitoring system is an effective means to address border security. A successful implementation of a cooperative border monitoring system hinges on the establishment of effective CBMs. And, CBMs are contingent upon political and diplomatic negotiations. Therefore, a holistic approach should be adopted to promote CBMs which have significant role to control and manage border security problems between Bangladesh and India, and between Bangladesh and Myanmar.[32]

For example, during the 28th India-Bangladesh Border Coordination Conference at the Director-General (DG) level talks in Dhaka in 2008, a path-breaking development occurred as both countries agreed to start joint patrolling of their border against infiltration and smugglers. Describing the Dhaka Conference "ice-breaking," BSF DG, A. K. Mitra, who held talks with Major-General Shakil Ahmed, DG, BDR, said, "The patrolling would be done in the most vulnerable border stretches." According to the plan, the BSF and BDR would exchange lists of infiltration-prone stretches along the 4,000 kilometre by the end of September. The partrolling mechanism would be established after that. Apparently in a serious mood to address their differences, the two sides also agreed to forge a joint-strategy against cattle smugglers, which have been identified as the key causes of firing by the border forces of the two countries at each other.[33] According to a reliable source,

[32] Recently, reportedly, the BDR Chief stated that they hold talks and share information regularly with the BSF but no DG-level meeting between the border forces of Bangladesh and Myanmar was held in the last three years. *The Daily Star*, 3 December 2009, p. 15.

[33] Aasha Khosa, "BSF, BDR agree to start joint patrolling of border," *Business Standard* (New Delhi), 28 August 2008. Reportedly, cattle smuggling across the border is a multi-million dollar industry. Infertile cattle from North India are taken to Bangladesh through a highly organised network of smugglers. Reportedly, Mitra divulged out that the BSF impounds 8,500 cattle a month. According to him, the year 2007's haul was 131,000. The report quoted him saying that India has "realised 90 per border firing between the two forces happens because of the smugglers." Quoted in *ibid*.

to address the cattle smuggling, the cattle corridors, through which Indian cattle enters Bangladesh, would be closed. Instead, a "border hat" (market/bazaar) should be organised to legalise the matter.[34] This could be a one way to tackle this particular border problem. Added to the 28th conference, the 30th BSF and BDR DG level Border Coordination Conference was held in Dhaka from 11 to 14 July 2009. During the conference both sides discussed issues related to border management, prevention of smuggling and trans-border crimes and maintenance of border pillars. They agreed to increase frequency of meetings between Company Commanders and stepping up confidence-building measures.[35] These meetings show the importance of negotiation to strengthen CBMs.

Institutionally, establishing a "Joint Border Research Centre" will be helpful to address border security problems. Under the "Joint Border Research Centre," the following research topics could be studied (aiming at increased cooperation and development to bring about the well-being of the people living in the border regions):

1. Cooperation in combating terrorism, human trafficking;
2. Cooperation in combating smuggling, especially narcotics;
3. Development of joint economic, agricultural and tourism projects;
4. Development of a joint infrastructural plan (roads, communication, electricity, etc);
5. Development of advanced communication centres;
6. Development of social, health, welfare, and education facilities for the people living in the border regions.

Given the current border security context, regional cooperation, as discussed, and joint studies on the preceding topics under a "Joint Border Research Centre" may help in better and effective management of the border, enhancing security and development of bordering people. Thus, at the inter-country level too, the step of "integrated border management (IBM)" is necessary to tackle border security. The IBM concept encompasses both border surveillance and border checks. Unlike the European border model, the governments of Bangladesh and India may undertake an integrated border security management in the long-term. By contrast, as a long term measure, it is necessary to enhance and increase diplomatic activities with

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[34] KII with a BDR personnel, 28 November 2009.

[35] *Bharat Bichitra*, (a High Commission of India Publication), Vol. 5, Issue 3, 15 July 2009, p. 1.

Myanmar and develop an agreement with that country replicating that of the Joint Directives for the India-Bangladesh Border Authority 1975. This will establish a legal framework to deal with the border problems with Myanmar.

In sum, the challenge is to find ways to enhance border management and security to a level that is commensurate with the threats of illegal cross-border activities while facilitating legitimate cross-border travel, trade and commerce and protecting human rights.

5.4.2 Other Inter-State Security Issues

Bangladesh, like many other of its neighbouring countries, has dedicated a significant amount of effort to deal with inter-security issues in terms of resources, time, strategies/policies and manpower. Undoubtedly, such effort and dedication could have been used in more productive activities otherwise. At the same time, security experts recognise that if cross border security threats are left unchecked, they will grow in magnitude and intensity. Hence, the potential national loss due to the above mentioned security threats is far greater than it is visible or measurable. It only suffices to say that, with a vast population and acute poverty, the number of incidences, actors and victims will inevitably increase if effective measures are not taken. The task of building a productive manpower with limited resources will be one of the greatest challenges that Bangladesh is likely to face in future. Considering the threats of inter-intra state insecurities on national security, Bangladesh has taken legal and practical measures to eliminate sources of insecurities to the state and individual by engaging its security agencies, namely, Bangladesh Army, BDR, BN, Bangladesh Coast Guard, Bangladesh Ansar and VDP, RAB and Bangladesh Police**.** The measures to address three major inter-state sources of insecurity are discussed below.

5.4.2.1 Human Trafficking

The definition of human trafficking that is now widely used is the one given by the UN in 2000 in the *Protocol to Prevent, Suppress and Punish Trafficking in Persons, Especially Women and Children Supplementing the UN Convention Against Transnational Organized Crime*. The Protocol states:

"Trafficking in persons" shall mean the recruitment, transportation, transfer, harbouring or receipt of persons, by means of the threat or use of force or other forms of coercion, of abduction, of fraud, of deception, of the abuse of power or of a position of vulnerability or of the giving or receiving of payments or benefits to achieve the consent of a person having control over another person, for the purpose of exploitation. Exploitation shall include, at a minimum, the exploitation of the prostitution of others or other forms of sexual exploitation, forced labour or services, slavery or practices similar to slavery, servitude or the removal of organs.[36]

As the above definition of trafficking suggests, perpetrators take a good care to hide their activities from any form of monitoring or assessment. This makes the task of getting reliable data from both international and national sources difficult. "Consequently figures are estimated and tend to be quoted and cross-quoted in all literature" (ADB 2002). Hence, it is of no wonder that statistics on human trafficking vary widely. Same is the case with Bangladesh. There is no reliable data concerning human trafficking. Available statistics show wide discrepancies which range from 4000 to 48,000 per year (Khan et al.). On the other hand, the figure provided by the government is far low. According to "Bangladesh Country Report on Combating Trafficking of Women and Children," in 2007, 117 trafficked persons have been rescued and 936 cases have been prevented at the airport and land port. Furthermore, all the rescued persons have been rehabilitated to their parents. However, the same report says, "It is difficult to give an accurate figure on trafficked persons particularly women and children, but there are enough indications of significant number of trafficking cases as well as rescue and recoveries" (GoB 2008).

Effects of trafficking are severe at both the national and international levels. The trafficked survivors are often treated as criminals in the receiving countries. They may be apprehended with or without charges, arrested, taken into custody or incarcerated in jails, languished in police lock-ups or shelter homes for indefinite periods or may face deportation. They usually do not have access to legal and medical assistance (GoB 2007). Trafficking also harms the physical and psychological well-being of the victims in both short and long term. Trafficked persons have often faced extreme psychological stress that in turn leads to trauma, depression and in some cases suicide. These impacts reach beyond the individual coping capacity, requiring resources to be used from already overstretched health services (GoB 2007). Trafficked women and children are often not accepted in the society which makes the rehabilitation programme difficult. Reintegration of women who were involved in the sex trade is even more difficult due to the stigma attached to prostitution (GoB 2008).

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[36]See http://www.uncjin.org/Documents/Conventions/dcatoc/finaldocuments2/ convention_%20traff_eng.pdf accessed on 07 April, 2009.

Measures Taken by the State

Bangladesh Government has acceded to and ratified a number of regional and international conventions on women and children that contain provisions for prevention and combating trafficking of women and children. The government has taken various measures to combat trafficking in women and children. These are categorised in the following way.

Prevention

Bangladesh's endeavours to prevent human trafficking have two aspects. One aspect is the formation of different committees and enforcement of laws. Formation of National Anti-Trafficking Committee, which is basically an Inter-Ministerial/Inter-Organisational committee, formation of GO-NGO National Coordination Committee, establishment of a police monitoring cell at the Police Headquarter, apprehension of traffickers by the law enforcing agencies, screening at the Air/Land ports, capacity building of the members of law enforcing agencies and public prosecutors on human trafficking and strengthening partnerships between the Ministry of Home Affairs and the representatives of the development partners, especially the USA—all these fall in this category. The second aspect is motivational programme to create awareness. This involves the implementation of the national motivational policy that works from district to union level.

Protection

The protective measures undertaken in Bangladesh are rescue and recovery of trafficked persons by law enforcing agencies i.e. Police, BDR, RAB and Coast Guard, rehabilitation/reintegration of recovered persons which also involves the NGOs, repatriation of trafficked persons through foreign missions of Bangladesh or other organisations including NGOs and follow up recovered and rehabilitated trafficked persons through different committees at various administrative units.

Prosecution

The Bangladesh government has made several changes in its legal provisions to address the issue of trafficking, exploitation and violence against women and children. It has also established special tribunals in 33 districts for prosecuting the cases relating to violence against women and children, including trafficking. To make this special tribunal a success, government has also established an Inter-Ministerial/Inter-Organisational Case Monitoring Committee. There is also a similar committee at the district level.

Challenges

- Reviewing the government's attempts, it appears that elaborate, rather profuse organisational set ups are in place to combat trafficking (Khan…..).
- In terms of empowerment and capacity building, adequate emphasis should be placed on the local level agencies, but prevailing efforts continue to remain top-down (Khan 2008).
- Bangladesh has several laws governing children's and women's rights but they are not consolidated in one structure. Instead, they are scattered in various laws and statutes (GoB 2008).
- Trafficking of male has been comparatively neglected in government's policies and actions. However, this remains to be a global practice.
- Labour trafficking, which is being typified as an issue of concern at both national and international levels, is still not sufficiently addressed.
- Mere awareness is not enough in preventing trafficking when the victims are lured by job offers and better future. Hence, more tangible poverty alleviation measures should be in place to prevent trafficking.

5.4.2.2 Small Arms Trafficking

Far from popular belief that Bangladesh will remain unaffected from small arms and light weapons (SALW) since Bangladesh is not fighting a "classical" war nor faced with any insurgency movement like its neighbours, the nature, trend and magnitude have proven otherwise. The rise of more than 100 criminal syndicates and a number of fanatic groups over the past decade has created a huge demand for arms and explosives within Bangladesh. Evidence is the mere fact that the number of illegal and legal firearms has increased from a handful of old and rusted 303 in the immediate post 1971 Liberation War to several hundred thousand Improvised Explosive Devises (IED) of new shiny automatic revolvers, grenades and IED today.

Unfortunately, the recent flow of small arms and explosives (except for the period of the Caretaker Government) has not slowed down in spite of several measures to seize illegal arms and ammunition that are trafficked into Bangladesh. Whether Bangladesh is a transit country or an end use country has been debated in great length but without any definite answer. Yet, the concern at this point is whether such ambiguity impacts counter arms trafficking measures? Although the security agencies have at times made commendable achievement in recovering illegal weapons and controlling arms trafficking, it needs to be analysed as well whether the existing mechanism is adequate in controlling the flow. As pointed out by (Khan 2001), "Political instability, nexus of politics and violence, proliferation of small arms, etc. are all recipes for disaster and, unless addressed, will impact on our national security adversely."

Existing mechanisms for controlling small arms proliferation and its effectiveness

The law is very strict on the illegal possession and use of firearms. It also states punitive action against the criminal. The original law, the Arms Act XI of 1878, is rather old, formulated during the British colonial period. New acts have been added to deal with the rising crime. The legal framework dictates the terms of licensing, issuing and carriage of arms and explosives in Bangladesh. Violation of any articles of the Act can leads to a minimum of six months sentence.

On the ground, the law enforcing agencies, security forces, and intelligence agencies are responsible for maintaining law and order in the country. Their functions may overlap. In general, however, they operate within their respective mandate and maintain close communication with each other. Law enforcing agencies, however, have not been as effective as one would like to see. There are many reasons for their inability to address crime and terror, ranging from financial constraints to political interference. However, it is for a certain fact that recent increase in incidences of terrorist attacks and crime in Bangladesh has been possible due to the easy availability of illegal weapons and explosives. A serial of bomb attacks, terrorist acts, violence against the state and people, and several seizures of large consignments of arms and ammunitions within the span of only ten years have raised concern for the security experts, policymakers, investors and the civil society about the potential threat of small arms on national security.

In the case of arms recovery, the police and paramilitary forces are generally responsible for illegal arms recovery drive. However, on the initiative by the government, arms collection drives are undertaken in various parts of the country from time to time to curb the diffusion of illegal weapons. Such drives may involve the military and can be undertaken on a nation wide in a very limited time as was done in 1972, 1973 and 1974 (Khan 2000). For example, such drives were taken before national elections as well as in south western part of Bangladesh.

In order to curb arms trafficking, security agencies that operate along the sea and land borders also play an active role. BDR, for example, checks routinely for illicit movement of arms and explosives across the land border, while Bangladesh Coast Guard and BN are responsible for checking illegal entry of any contraband items through the waterway. The seizure of ten trucks of arms haul in Chittagong jetty in 2005 has been one of the most successful operations of arms recovery that involved all the concerned security agencies.

At the international level, Bangladesh has been engaged multilateral talks on the issue of small arms and light weapons. The Government of Bangladesh had taken steps in implementation of the United Nations Programme of Action (UNPoA) on the *Illicit Trade in SALW in All its Aspects*, and accordingly was following precautionary measures. Some of the recent measures were: (i) Adoption of destruction as a major means of disposal of confiscated illegal SALW; (ii) Observance of 9 July every year as “Small Arms Destruction Day”; (iii) Issuing license for small arms after strict verification; (iv) Monitoring licensed arms traders to control illegal arms uses; (v) Increasing patrolling through its borderlines and checking all entry points; (vi) Deploying strict border security forces at border outposts; (vii) Monitoring and vigilance of welding machines factory; and (viii) Monitoring and remaining alert about activities of courier service providers and transport agencies. The government of Bangladesh has also decided that of the illegally confiscated SALW, only those which are re-useable according to expert opinion would be allocated for uses and the rest of such weapons would be disposed through destruction (Hossain 2009).

5.4.2.3 Illicit Drug Trade

Bangladesh finds itself at the crossroads of two of the world’s largest drug triangles: the *Golden Triangle* in the east, and the *Golden Crescent* in the west. Studies and intelligence reports suggest that the two triangular trades are not only inter-linked, but an important route and access to the international drug market. Bangladesh’s ports provide transit facilities to the international drug traders. According to Interpol, five per cent of the total world trade was routed through Cox’s Bazar. However, a more serious concern that has emerged, directly or indirectly from drug trafficking, is that Bangladesh society is today vulnerable to drug abuse. According to an official of the Department of Narcotics Control (DNC), “Bangladesh is not a drug producing country, but due to its geographical location it is vulnerable to drug abuse and drug trafficking (Rahman 2009).” Although drug trafficking and drug abuse are still not alarming compared to neighbouring South Asian countries, and appears to be more of a threat to human security than state security, the mere nexus between drug traffickers and underworld criminal syndicates and insurgent groups is a concern for the state.[37]

Drug addiction has emerged widespread as a nationwide concern. In the urban areas, drug in abuse is estimated to be more widespread than in the rural area of Bangladesh, with over 400,000 addicts including Dhaka, Chittagong, Rajshahi, and Khulna (Rahman 2009). The traditional use of opium and cannabis is shifting to the

[37] Interview with an official from DNC.

more dangerous heroin and injecting drug use, with the associated spread of Human Immunodeficiency Virus (HIV) infection. The risk of a rapid escalation of drug abuse, trafficking and production is high. According to an estimate, five million people are core drug addicts in Bangladesh and married male and female addicts have increased in number from three per cent a few years ago to 33 per cent in 2008 (Saber 2008).[38] Another concern is that, HIV/Acquired Immune Deficiency Syndrome (AIDS) among Injection Drug Users (IDU) has shown increasing trends. According to one survey report, HIV prevalence dramatically increased from 1.7 per cent in 2001 to seven per cent in 2006 among IDU. All indications show that "all the risk factors which give birth to explosive HIV epidemics are present in Bangladesh today."[39]

Measures Taken to Address Drug Trafficking

Bangladesh has enacted the Narcotics Control Act of 1990 and amended it in 2002. The Act covers the control of narcotic drugs and psychotropic substances, including provisions for the treatment and rehabilitation of drug dependent people. The DNC, a very technical and multidimensional department administered by the Home Affairs, is responsible for implementing drug law enforcement and drug abuse control programmes. It has three core functions: (1) Demand reduction, (2) supply reduction, and (3) harm reduction. The first two are dedicated to control drug trafficking. DNC has an intelligence gathering and operational role and it oversees the implementation of demand reduction initiatives. It is also charged with coordinating the efforts of other enforcement agencies of Bangladesh (Police, Customs, BDR, and Bangladesh Coast Guard). DNC does not collate national arrest and seizure statistics, in part, because the other agencies are reluctant to disclose the necessary material.[40] It must be noted that drug use is not considered a criminal offence in Bangladesh, rather seen as a medical condition.

BDR and Bangladesh Coast Guard are mainly responsible for checking cross border drug trafficking. The role of the Armed Forces in anti drugs drives should also be noted. Although it is difficult to quantify the volume of the drug trade taking place everyday, it can be safely said that drug trafficking is increasing. The number of cases filed every year and number of drug addicts indicate that the trend of drug

[38] Cited in Saber (2008), "National Security of Bangladesh: Challenges and Options", *NDC Journal* ,Vol. 7, No. 1, June 2008.
[39] Quoted from Misti McDowell's Message in, "International Day Against Drug Abuse and Illicit Trafficking", *Department of Narcotics Control,* 26 June 2009, p.16.
[40] Drugs and Laws in Bangladesh, at http://addictionsupport.aarogya.com accessed on 20.12.2009

abuse and drug trafficking is growing. Special operations are carried out from time to time to seize illegal drugs. Such operations are also carried out in the bordering areas where trafficking of phensydyl and heroine/ ganja are illegally transhipped through train (Kabir 2009). During the CHT insurgency, the army played an important role in destroying poppy fields.

The DNC provides training to its officers on drug control, specialisation on intelligence gathering, crime control, investigation related training, etc.. DNC had developed a team of experts on laws related to drugs. DNC files around 650 cases in a month, but loses most of them on legal ground.[41] Law enforcing agencies such as RAB have a database for illicit drugs. The DNC also has a separate computer cell to keep record of the seized drugs, details of the drug, cases file, cases under investigation and so forth.

In terms of legal framework, Bangladesh has international and regional cooperation to control drug abuse and drug trafficking. Bangladesh has signed the following convention:

- Single Convention on Narcotic Drugs, 1961;
- Convention on Psychotropic Substance, 1971;
- UN convention against Illicit Trafficking in Narcotic Drugs and Psychotropic Substance, 1988;
- SAARC Convention on Narcotic Drugs and Psychotropic Substance, 1990.

Through the following bilateral treaties and understanding, contracting countries have shared information on drug trafficking from time to time:

- 1994 between Bangladesh and Myanmar;
- 1995 Between Bangladesh and Iran; and
- 2006 between Bangladesh and India.

The following are the current projects in cooperation with the United Nations Office of Drug Control (UNODC):

- Prevention of Transmission of HIV among Drug Users in SAARC Countries.
- Prevention of Spread of HIV among Vulnerable Groups in South Asia.
- Regional Precursor Control Project for South and South West Asia.
- Strengthening Drug Law Enforcement Capacities in South and South West Asia.

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[41] KII, DNC dated 17 December 2009.

Challenges and Measures

According to the Director General (DG) of DNC, drug trafficking is an *all-embracing* threat to Bangladesh's security. It affects the state, society and the individual. In contrast, existing means and resources to control the threat are to the bare minimum. Although DNC is the nodal agency to combat drug trafficking of the country, the department lacks infrastructure, resources and manpower. Its role as a law enforcement agent becomes difficult due to the lack of basic amenities such as vehicles, walkie-talkies arms, and even uniform. The criminals, in contrast, are armed and have more mobility in terms of transport and communication than the law enforcement agents. This slows down anti-drug operations. The other major hurdle for effective drug control is the lack of coordination between the various law enforcement agencies: RAB, police, BDR and DNC.

The Narcotics Control Board (NCB) should be strengthened so that administrative resources to curb trafficking and abuse could be increased. For effective drug control, the lack of coordination between the various law enforcement agencies may be reduced by having a better understanding between the agencies and effective communication means. "Uniform, article 54 of the Arms Act, and proper modes of communication will significantly improve the Department's capacity to act as an enforcement agency."[42] The government can play a proactive role by providing support to the treatment centres, generating employment through technical education, and raising awareness of the effects of drugs through incorporating the subject into the education curriculum. Rehabilitation centres with the help of government and private sector can be instrumental in providing employment for those who have recovered from drug addiction to prevent relapse. DNC may be allocated enhanced budget for capacity building without which the agency will remain ineffective.

5.4.3 Intra-Security Issues

5.4.3.1 Terrorism and Religious Extremism

Terrorism is both an intra and inter security threat for Bangladesh national security. Bangladesh, in recent years, faces the threats of terrorism from a number of directions, as discussed in section 1. In the light of the emerging threats from terrorism, what are the challenges for the counter-terrorism experts? How are they addressing these threats that are quite different from their previous experiences of dealing with terrorism? Is there a counter-terrorism strategy that guides policy makers and security agencies? The following discussion will address these queries

[42] KII, DNC.

in order to have an understanding of the existing counter terrorism mechanisms in Bangladesh in light of the changing dynamics of terrorism.

In addressing terrorism, Bangladesh is currently confronted with dual challenges: One, on the global front, it faces the threat of transnational terrorism; and second, on the home front, it faces threats from home-grown terrorism. The threats from transnational terrorism, especially after the 9/11 terror attack followed by the US Global War on Terror, raises a pertinent question for the counter terrorism strategists: Are the existing security measures capable of addressing transnational terrorism from tactical and structural perspectives? At the national level, as discussed, the security agencies are faced with home-grown terrorist outfits, including the leftist political parties, the Islamic extremist militant groups, and ethnic terrorism insurgent groups of CHTs who allegedly maintain a close nexus with transnational criminal organisations. With these challenges in the forefront, what kind of counter-terrorism strategy does Bangladesh pursue?

Although Bangladesh does not have a formal Counter-terrorism Strategy like many countries, its operations are based on four basic principles:[43] (1) to *prevent* acts of terror, (2) to *pursue* terrorists and sponsors of terrorism; (3) to *protect* the public, national infrastructure and national interest, and (4) to *prepare* for the impact of terrorism. Based on these four broad principles, the following measures are undertaken by the government to contain terrorism in Bangladesh.

Measures to Address Terrorism

The recent terrorist attacks, both globally and nationally, have brought the attention of security experts in identifying the terrorist groups and their activities in Bangladesh, and countering these threats through global, regional and national efforts. Bangladesh Prime Minister Sheikh Hasina, a victim of terrorist attack herself, has floated an idea of forming a regional taskforce with a view to combating terrorism more concertedly and effectively. The concept of taskforce as a counter terrorism strategy has found its expression in the Awami League election manifesto of 2008. True to her commitment, her government is now about to give shape to her concept of regional taskforce on terrorism.

At the national level, security agencies have taken measures to address *all* categories of terrorism in Bangladesh. Following are the modalities for counter-terrorism.

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[43] There is yet no specific strategy to combat terrorism in Bangladesh. However, a draft Counter-Terrorism Strategy paper was prepared under the initiative of Bangladesh Enterprise Institute (BEI)in 2006-2007. See for details, Sobhan et al (2008).

Preventive Measures

Bangladesh has been taking anti-terrorism measures since its inception. Operation Treasure Hunt, Clean Heart, and Special Power Act of 1974, Anti Terrorism Act 1993, Public Safety Act 2000, Speedy Trial Act 2002 were some of the laws that were enacted to curb terrorism. The Money Laundering Prevention Act 2009 and the Anti Terrorism Act 2009 were new laws enacted to curb terror financing and acts of terror. These laws facilitated international cooperation in recovering money illegally transferred to foreign countries and mutual legal assistance in criminal investigation, trial proceedings, and extradition matters. The new ordinances were part of the effort to enable Bangladesh to enter the Egmont Group, the international body of Financial Intelligence Units (FIU) that plays a critical role in fighting terrorist financing (US Dept. of States 2009). Parallel to traditional measures, steps have been taken to address the root causes of terrorism as a means to *prevent* vulnerable people from turning into terroists or sympathising with terrorists.

Terrorism measures include response to terrorist-event

Terrorist groups such as the JMB, HuJI-B, JMJB have been banned from all activities. Top leaders were arrested and sentenced to death and incentives were declared for providing information about terrorists. RAB with the assistance of other law enforcing agencies is actively engaged in rooting out terrorists, extremists, and militants. Measures have been taken to pursue and investigate terrorist to impede planning, travel and communication. According to a noted social scientist of Bangladesh, "Cooperation in enhancing capacity of the administration, including security forces, is certainly of importance in helping Bangladesh fight terror" (Shelley 2009). In this connection, the need for capacity building of law enforcement and intelligence agencies including regional and global cooperation has become the government's top priority.

Terrorism-counteraction measures cover all dimension of action against terrororism, including the need to *protect* citizens and infrastructure through strengthening law enforcement. Formed in July 2009, the NCIC, headed by the Prime Minister, meets every month to coordinate the activities of different intelligence agencies. The cabinet secretary, principal secretary to the Prime Minister's Office, DGs of NSI, DGFI and SSF and IGP are members of the committee.[44]

The government announced "zero tolerance" to militancy and terrorism and formed a 17- member "Committee for Resistance and Prevention of Militancy"

[44] *The Daily Star*, January 10, 2010.

headed by State Minister of Home Affairs. The objective of the committee comprising representatives from various ministries and agencies, is to take various innovative steps to make people aware about extremism.

In the wake of continual bomb scares by the militant groups, security measures were strengthened in the major cities and important installations of Bangladesh. Scanning machines, bomb detectors, etc. have been introduced at various public places, including schools, shopping malls and conference centres. To check cross border terrorism, the government has decided to set up security devices including "fingerprint scanner" and also sensitive software at all immigration check posts. Machine readable passports (MRP) and visas have been made mandatory by International Civil Aviation Organisations (ICAOs) to help identify the movements of international terrorists and Bangladesh is in the process of implementing all these initiatives.

5.4.3.2 Piracy

Piracy has emerged as a major security issue for the fishermen living in the coastal areas of Bangladesh. In 2007, a total of 263 incidents were reported to IMB. However, research shows that the actual figure is much more than in many cases (perhaps as many as 50%). Ship owners are unwilling to report attack against their vessels as they think doing so will increase maritime insurance premiums, resulting in "lengthy and costly post-incident investigations (Islam, Ahmed and Bhuyan 2009)." In the case of Bangladesh, 15 piracy incidents took place in 2007, which had put Bangladesh in the 4^{th} top position (ICC-IMB…)[45] Although, according to IMB, the number of piracy incidents has been declining in Bangladesh since 2007 due to various efforts taken by the government, the problem is still not under control yet. As the IMB Quarterly Report 2008 puts: "Although the number of attacks has fallen, the area is still listed as very high risk. Pirates are targeting ships preparing to anchor. Most attacks reported take place at Chittagong anchorages and approaches (Islam, Ahmed and Bhuian 2009)."

The area surrounding the port of Chittagong is inhabited by people who mostly derive their livelihood from the sea. Barter trading with seafarers and ship-breaking are major forms of local economic activity. Small boats which barter fresh provisions such as fish and vegetables in exchange for various items, including ship scrap, are a common feature at the port of Chittagong. Robbers have been known to exploit this situation by using the pretext of barter to board ships, and items stolen

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[45] ICC-IMB, Piracy and Armed Robbery Against Ships Annual Report 2007, available at http://www.intertanko.com/upload/WeeklyNews/IMBPiracy.pdf, accessed on 07 December 2009

from ships are sold at the recycling market. The presence of many small unregulated boats also serves as cover for the robbers. These challenges are compounded by the fact that the security of the port is handled by several different agencies with limited resources.[46] Besides attacking ships, pirates also attack coastal fishermen. Several pirate gangs are reportedly active there in abducting fishermen (Islam, Ahmed and Bhuian 2009). High rate of incidence of piracy and armed attack on ships severely damages the image of Bangladesh internationally. This acts as a potential threat to its international trade and to its economy not to mention the direct threat piracy bears on physical safety.

Measures Taken by the Government

Over the past few years, the Bangladesh authorities have undertaken several initiatives to enhance security of the port of Chittagong and its surrounding waters, and reduce the incidence of actual and attempted armed robbery against ships.

At the national level, the Government of Bangladesh has established a committee to coordinate measures to enhance both land and maritime security. This committee is headed by the DG of the Department of Shipping, and consists of members from eleven different government organisations, involved in security and port operations. This includes the Chittagong Port Facility Security Office. At the local level, the Chittagong Port Authority (CPA) has established a port security committee which monitors the security situation at all twelve port facilities. The port security committee holds regular coordination meetings with ship owners, agents and other stakeholders to improve the safety of the seafarers.

In an effort to reduce the number of small boats operating near larger merchant ships, fishing has been prohibited at the port's anchorages. Measures to regulate the movement of small craft have also been introduced. These involved restricting the number of small craft allowed to operate in the anchorage areas, and allocating identification numbers and coloured markings to those small craft authorised to operate in these areas.

The law enforcement and security agencies have also stepped up their presence around the port. The Bangladesh Coast Guard has established a forward operating base at the mouth of the Karnaphuli river to provide quick response to ships in need of assistance. River patrols conducted by the Chittagong Port Authority and the Bangladesh Coast Guard provide waterfront security along the river, and the

[46] ReCAAP Adding Value Charting Trends, *Annual Research Report 2007*, available at http://www.southchina sea.org/docs/Recaap_Trends.pdf, accessed on 14 December 2009.

Chittagong Port Authority has made additional patrol boats available to the Bangladesh Coast Guard, in order to maintain regular patrols in the area.[47]

In the case of protecting fishermen from pirates, the job is done mainly by the Bangladesh Coast Guard. It runs its routine patrol and undertakes operations occasionally. In the Sundarbans area, it takes the help of the police. Recently the Coast Guard undertook joint operation with the police.[48] For example, a joint operation of police and Coast Guard, named "NIRAPOD JIBON," was launched from 21 September to 26 October 2005 to protect the coastal fishermen from the pirates. As an outcome of this operation, Bangladesh Coast Guard captured two single barrelled guns, one pipe gun, four ram da (machete) and apprehended 57 pirates/smugglers.[49] Since 2001, Bangladesh Coast Guard has apprehended a total of 2,019 pirates. In 2001, only 13 were apprehended which gradually increased to 597 in 2006.[50]

Challenges and Measures

Fishermen do not want to report or file cases of piracy. Those who do, are vulnerable to further attacks by the pirates. As a result, the task of the law enforcing agencies becomes more difficult as they cannot take any legal measure. The Bangladesh Coast Guard does not have the necessary vehicles, modern equipment and manpower to act effectively against the pirates. In the coastal areas, the police face similar problems of lack of manpower and resources. Pirates, on the other hand, are equipped with modern vessels, arms and equipment. Level of cooperation between the police and the naval force is low in curbing piracy. Combating piracy has become more complex with the security of the port being handled by several different agencies with limited resources.

To address piracy, concerted efforts should be made to enable the affected people to file their complaints at the police station. Coast guard and police capability in terms of vehicles, modern equipment and manpower should be enhanced. The effort of different agencies of the port should be coordinated and there should be better cooperation among the law enforcing agencies. Separate training for the police posted in the coastal areas may also be imparted.

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[47] See ReCAAP, *op. cit*.
[48] KII, Bangladesh Coast Guard.
[49] See http://www.coastguard.gov.bd/news.html accessed on 15 December 2009.
[50] See http://www.coastguard.gov.bd/achivements.html accessed on 15 December 2009.

5.4.3.3 Crime

Crime is considered in the Bangladesh context a major source of human insecurity. Two types of crimes have been discussed here—unorganised and organised. Drug abuse and crimes committed by drug addicts, land violence, theft, and robbery have been categorised as unorganised crimes as these are sporadic in nature. On the other hand, extortion, bribery, unlawful acts by law enforcing agents, smuggling, small arms, drugs, human trafficking, and piracy have been identified as organised crime as these crimes are hierarchically structured and have extensive supportive networks. A household survey carried out in 2007 by Bangladesh Institute of International and Strategic Studies (BIISS) suggested that the people suffered from both organised and unorganised crimes where the tools of violence were mostly indigenous and foreign made weapons, explosives, sticks, knives and other sharp objects. Crime related to drug abuse was the key cause of insecurity for the people in that particular survey. The survey identified drug abuse as the major cause of organised crime in 2007, followed by torture and terrorism to be the cause of insecurity (BHSA 2007).

Interestingly, a comparison of crime and insecurity between 2006 and 2007 revealed that in 2007 most of the organised crimes had reduced while unorganised crimes had increased. Unorganised crimes such as incidences of theft, hijacking, social violence, sexual harassment and land violence had gone up in 2007 compared to 2006 (BHSA 2007). Effective law enforcement measures during the Caretaker Government were identified as the major cause for the lower incidence of organised crime.

5.4.4 Limits to Bangladesh's National Capacity in Meeting Inter and Intra-Security Threats

Since the end of the Cold War, the number and intensity of the security issues have increased both in terms of nature and extent. This has not been easy for the state security agencies to cope with. As Korba (2009) writes, "The issue of how necessary it is to make the institutions of the state security system adapted to the changed conditions after the end of the Cold War became a preferred research problem." At the risk of stating the obvious, it is nonetheless appropriate in the present context to repeat that Bangladesh is an impoverished, disaster-prone, over-populated with serious obstacles for good governance. Bangladesh is a country that is not endowed with nature's liberal bounty. Whatever natural endowment it has in the form of fertile land and water resources, over-population and management problems eat into the development and vitality of the nation. The country's economic indicators are dismal, social indicators poor, infrastructure abysmal, employment situation frustrating, trade balance unfavourable, aid dependence embarrassing and, above all, governance indicators and political culture uninspiring. All in all, the attributes or potentials of Bangladesh clearly suggest that the ability of the state to respond to internal NTS in addition to non-traditional security concerns and needs is weak indeed (Kabir et al. (2007). The lim its to Bangladesh's national capacity to respond to security situations and people's needs also result from factors beyond its borders—regional setting and global order.

As discussed in section 5.2, India surrounds Bangladesh on three sides–west, north and east, the length of the border between the two countries is more than 4,000 kilometre. The insurgency-infected seven states of India (so-called seven sisters) lie to the northeast of Bangladesh, with concerns of security fallout on either side of the border. And, the Indian Navy dominates the Bay of Bengal that washes the shores of Bangladesh in the south. Bangladesh shares a tiny border of 283 kilometre with the military-ruled, unstable Myanmar. Due to religious and ethnic repression unleashed by the military junta in Yangon, there had been two huge streams of Rohingya refugees (in 1978-79 and 1991) having crossed into Bangladesh. About the remaining 30,000 of the 250,000 from the second influx are now camped in several places of Cox's Bazar, causing a great deal of non-traditional insecurities to the host population (Kabir *et al.* 2007). A major consequence of all this is the ever increasing allocation of resources for traditional security in Bangladesh, sometimes at the expense of that for NTS. For example**,** measures to controlling trafficking of arms and drugs in national waters are weak.

The Bangladesh Coast Guard was formed to carry out peacetime policing combating against smuggling activities, piracy, drug trafficking, gun running, etc. But due to shortage of necessary manpower and logistics, its functions are limited to patrolling the ports' harbours and the forest areas of the Sundarbans only (Ali 2008). The effectiveness of the intelligence agencies to track the perpetrators of terrorism, explosive manufacturers, etc. and even prevent terrorist acts has not always been satisfactory. Intelligence organisations are reactive rather than proactive. There are numerous intelligence organisations at various tiers, but their efforts are not coordinated. Lack of training and resources to deal with contemporary terrorists may be some of the hurdles (Arif 2008). Similarly, the police are not well trained to recover arms and explosives nor are they as resourceful as some of the armed groups, whether these are criminal syndicates or terrorists. In the context of the above stated limits of the state, the following are some of the steps to have a security mechanism in Bangladesh in terms of resources, capability and effectiveness:

(a) Controlling small arms and explosives requires trained and resourceful law enforcement agencies. In most cases, national agencies such as the intelligence, police, paramilitary forces, etc. need to be trained to deal with the matter more effectively. Secondly, building up database, coordination within the agencies and information sharing among the ministries and agencies are necessary for investigation purposes and tracking the criminal. Thirdly, proper storage facilities of recovered weapons, including marking each one, are absolutely essential to prevent them to be out in the black market once again. Fourthly, role of the police and other law enforcing agencies must be streamlined and standardised.

(b) An effective maritime strategy will provide the basis for Bangladesh not only to protect Bangladesh's waterways and its mineral resources but also help in combating/suppressing piracy, robbery, drug trafficking, operations of terrorist and other transnational networks.

(c) Effective intelligence to trace underworld criminal syndicates, drug and arms traffickers, etc. as well as prevent terrorist attacks, counter-trafficking training, etc. is strongly desirable. Increasing the existing manpower and empowering them with modern technology through training and cooperation with international organisations such as the Interpol should be more frequent and vigorous.

(d) Common criminal database that is accessible to all security agencies may be maintained and shared by relevant ministries and agencies. Bangladesh Police in coordination with the intelligence agencies and other security agencies such as RAB, BDR and Bangladesh Coast Guard can share information on terrorist and criminals, source of funding, training etc. Apparently the investigation system and police procedure in Bangladesh is still primitive and requires that, the use of information technology needs to be exploited (Arif 2006). For that, appropriate technology should be modernised and developed immediately as the need for modern technology to identify and track terrorist is an universal prerequisite to counter any security threat–globally or locally.

5.4.5 Existing Human and Other Resources: Utilisation and Effectiveness

Human resources are deployed in various intra-security issues, such as maintaining security along the border, supporting law enforcement agencies, curbing internal security threats like terrorism, organised crime, drugs and narcotics trafficking and piracy in the Bay of Bengal. Over the years, the number of human resources has not been increased substantially, although the security threats have considerably increased in terms of extent, magnitude and depth. For example, the total paramilitary and auxiliary forces has increased by around 7 per cent from 1991-92 to 2009. These forces operate with distinct objectives and the forces include: BDR, Bangladesh Coast Guard, Armed Police Battalion, RAB and Battalion Ansar. As stated earlier, these forces are administratively controlled by the Ministry of Home Affairs. Existing human and other resources utilisation and effectiveness of these forces are discussed in the succeeding paragraphs.

TABLE 5.4

MANPOWER IN PARAMILITARY FORCES

Year	Battalion Ansar	Armed Police/RAB	BDR	Bangladesh Coast Guard	Total
1991-92	20,000	5,000	30,000	..	55,000
1994-95	20,000	5,000	30,000	..	55,000
1999-00	20,000+	5,000	30,000	200	55,200+
2004-05	20,000+	5,000	38,000	200	63,200+
2009	20,000+	13,289	44,000	1,000	78,289

Source: IISS (various years) and authors compilation.

5.4.5.1 BDR

According to the mission assigned, BDR is to protect the border of Bangladesh and prevent smuggling. Border security is important for a number of reasons for Bangladesh. Specifically, the country is alleged to be a "transit" of movement of arms, drugs and narcotics. Several insurgent groups are active in North-Eastern states of India, which are operational adjacent to Bangladesh-India border. Their activities deepen Bangladesh's security threats due to incomplete and disputed demarcation of border, ineffective border management, illicit activities around the border, lack of mutual trust, etc. (Islam, Ahmed and Bhuiyan 2009). The deployment of human resource in the border has not increased during the 1990s; the number was stagnant at 30,000 throughout the decade. During the present decade, the number of the BDR has increased to 44,000. This indicates that the government has to allocate extra resources for its additional manpower to secure the border, which, in essence, would need further resources in terms of weapons, equipment and logistics. As mentioned earlier, various cross-border threats have emerged in the last few years, which are mostly non-traditional in nature. Although border forces have successfully tackled some of the threats, still there are ample scopes to enhance their capacity with advanced technology and transform the force from manpower-intensive to technology-oriented. In particular, the orientation of information technology, strong database and use of Global Positioning System (GPS) are likely to enhance their efficiency and facilitate them to operate with fewer manpower along the border. Alongside, the close cooperation with the border security force of the neighbours, especially regarding acts of various separatist groups, trans-national terrorists, illicit traders, etc., can help reduce costs related to border security and management.

5.4.5.2 RAB

As mentioned earlier, RAB is an anti-crime and anti-terrorism elite force of the country. Despite being criticised on the grounds of illegal arrests, torture and unlawful murder in the name of "crossfire," RAB has seized a total of 3,149 illegal arms and more than 36,000 rounds of ammunition since its inception. It has also been successful in curbing so-called Islamic militants and arresting top terrorists, including the "Bangla Bhai" and "Sheikh Abdur Rahman." Currently, 12 RAB Battalions are working throughout the country.[51] RAB has an upper hand due to a combination of more efficient members from armed and paramilitary forces as well as a political support in its operation. As such, the utilisation of the human and other resources of this force is most effectively done, though the shortage of manpower is acute in RAB which creates hindrance towards effective drive against crime and extremism.

5.4.5.3 Ansar Battalion

They augment the strength of the security forces in the country. The objective of this force is to ensure safety and security of rural Bangladesh, mobilise for socio-economic development and to come under operational control of the Armed Forces during any emergency or war.[52] Presently out of 36 Battalions, 15 of them are deployed in CHT in insurgency operations. The rest of the battalions are deployed in other districts of the country and assisting the law enforcing agencies. They also take part in national events such as elections and natural calamities. Although they have proven record in performing anti-crime and anti-extremism drives, this auxiliary force is inadequately equipped with poor infrastructure, logistics; it has meagre remuneration for its members. However, this force performs a significant role in maintaining law and order all over the country.

[51]See www.rab.gov.bd. accessed on 17 December 2009.
[52] See http://www.ansarvdp.gov.bd. accessed on 17 December 2009.

5.4.5.4 Bangladesh Coast Guard

Bangladesh Coast Guard is deployed to curb piracy and maintain security in the coastal area. Its uniformed members are from BN on secondment. Its operational activities commenced in December 1995 with two patrol craft received from Bangladesh Navy on loan. Since then it has been active in several high-profile anti-piracy operations in close conjunction with the Navy, Army, Border Guard, and various security and police forces.[53] Its primary assignment is to protect the country's offshore resources, merchant vessels and counter piracy in coordination with the Navy. It also supports the Customs, Department of anti-Narcotics, Ministry of Energy, Shipping, Fisheries, Forestry, and Relief and Rehabilitation. Its present strength of 1,000 personnel and the number of crafts/vessels it possesses are too meagre to operate effectively in coast guard duties. It suffers from lack of adequate resources and appropriate platforms/vessels; lack of manpower strength to meet its assigned mission; difficult terrain with inadequate helicopters: lack of suitable fast moving boats and special equipment like night vision goggles; lack of coverage capability due to the absence of required platforms and bases/stations; and ageing of few vessels it has.

Although the paramilitary forces have manifold responsibilities in tackling non-traditional threats as well as support Armed Forces and civilian administration when required, they are insufficiently equipped and paid to perform in difficult circumstances. For example, the budget and deficiency of physical facilities of Bangladesh Coast Guard given in the Table 5.5 and Table 5.6 depict a clear picture of the state of effectiveness that can be expected from the force.

TABLE 5.5

BUDGETARY ALLOCATION FOR BANGLADESH COAST GUARD ('000' TAKA)

Head	2005-06	2006-07	2007-08
Officers' Pay	110.00 (3.45)	120.64 (2.15)	132.00 (1.88)
Others' Pay	351.00 (10.99)	541.50 (9.64)	751.00 (10.70)
Allowances	490.38 (15.36)	934.56 (16.64)	1,167.52 (16.64)
Supply & Services (Including Training)	875.02 (27.41)	1,085.06 (19.32)	1,198.15 (17.08)
Maintenance & Preservation	246.00 (7.71)	459.00 (8.17)	675.15 (9.62)
Resource Mobilisation & Procurement	320.30 (10.03)	1,178.24 (20.98)	1,355.97 (19.33)
Land Acquisition	0 (0.00)	65.00 (1.16)	267.44 (3.81)
Construction & Works	800.00 (25.06)	1,231.29 (21.93)	1,468.71 (20.93)
Total	**3,192.70**	**5,615.26**	**7,015.94**
Growth Rate (%)		75.88	24.94

Note: Figures in the parentheses Indicate percentage of total**.**

Source: Authors' compilation from various sources.

[53] http://en.wikipedia.org/wiki/Bangladesh_Coast_Guard. accessed on 17 December 2009.

Although the size of the Coast Guard is small, its budget is relatively high due to its initial organisational situation with relatively heavy infrastructure of the headquarters and command element. In FY2007-08, the per capita budget was Taka 779,549. Majority of the resources are spent on pay and allowances and supply and services. A notable amount is also spent on resource mobilisation and procurement. However, as the coastal area and the maritime zone are critical for maritime resources and on security and strategic grounds, the Coast Guard deserves priority in terms of resource allocation for increasing human resource, procuring physical equipment and installing modern technology, especially IT.

TABLE 5.6

DEFICIT OF VESSELS FOR THE COAST GUARD

Category	Deficit (%)
Fast Petrol Craft	0.00
Harbour Petrol Boat	83.33
High Speed Boat (Big)	80.00
High Speed Boat (Small)	50.00
Pontoon (Big)	76.47
Pontoon (Small)	73.33
Inflatable Rubber Boat	100.00
Defender Class Boat	100.00

Source: Authors' compilation from various sources.

5.5 PROMOTING COOPERATION ABOUT SECURITY ISSUES

5.5.1 Regional and International Cooperation and Partnership

The globalisation and liberalisation of world economy have given rise to a new set of problems. Flynn (2000) has tersely reflected these: "The global economy's movement toward more open societies and liberalised economies does not just facilitate the movement of products and workers—it also expedites passage for terrorists, small arms, drugs, illegal immigrants, and disease." To these, can be added illicit human trafficking, organised crimes, etc. Bangladesh has been plagued by each of these problems that have national security implications for Bangladesh. No single country can solely effectively address these problems which are transnational in nature. These security challenges can be better addressed through regional and international cooperation and partnership. Furthermore, in a globalised world, pressures from transactional corporations and international financial institutions call for regional and international cooperation and partnership, especially for a country like Bangladesh which does not possess abundant varied natural resources. Any strategy of Bangladesh's CNS should take into consideration the aforesaid ground realities that Bangladesh faces.

5.5.1.1 SAARC-SAARC Cooperation and Partnership

SAARC-SAARC cooperation and partnership have become more relevant now adays, given the aforesaid set of transnational security threats that the region confronts. These set of transnational security threats provide SAARC member states compelling grounds to forge an effective SAARC-SAARC partnership, exploring areas of cooperation. It needs mentioning that all SAARC member states have already signed and *ratified* two important Conventions that can address (if proper implementation is done) some transnational threats mentioned earlier. In addition, SAARC can play a role in institutionalising CBMs in South Asia to promote SAARC-SAARC cooperation and partnership. The necessity of such an institutionalisation of CBMs has become urgent in view of the growing transnational security threats that the SAARC region faces. Following a brief discussion, first, we highlight the two important Conventions and subsequent measures that various SAARC summits have adopted to address some growing transnational security threats in an attempt to foster regional cooperation and partnership. Next, it touches on institutionalisation of CBMs through SAARC mechanism.

1. SAARC Regional Convention on Suppression of Terrorism

The SAARC Regional Convention on Suppression of Terrorism, which was signed in Kathmandu in November 1987 during the third SAARC summit, came into force on 22 August 1988 following ratification by all member states. The SAARC Terrorist Offences Monitoring Desk (STOMD) has been established in Colombo to collate, analyse and disseminate information about the terrorist incidence, tactics, strategies and methods. As part of effective regional mechanism to monitor terrorism, Bangladesh has already established its national focal point for exchange of information on terrorist activities among the SAARC countries. Bangladesh continues to support the Monitoring Desk in Sri Lanka to coordinate action among arms and other contrabands within and outside of SAARC countries to combat terrorism in the region.

2. SAARC Convention on Narcotic Drugs and Psychotropic Substances

SAARC Convention on Narcotic Drugs and Psychotropic Substances, which was signed in Male during the fifth SAARC summit in November 1993, came into force on 15 September 1993 following ratification by all member states. Incorporating the generally accepted principle of extradition or prosecution consistent with the respective national legislative regimes, the Convention envisages the widest measures for mutual legal assistance among member states in investigation, prosecution and judicial proceedings in respect of drug offences. The implementation of the Convention is monitored by the Technical Committee on Prevention of Drug Trafficking and Drug Abuse during its annual meetings.

During the thirteenth SAARC summit held in Dhaka in 2006, the heads of states or governments expressed their satisfaction at the ratification of the Additional Protocol to the SAARC Convention on Suppression of Terrorism by all member states and called for putting in place effective mechanisms for its implementation. They also underlined the imperative for an early conclusion of a Comprehensive Convention on International Terrorism and agreed SAARC member states would strengthen their cooperation in such important areas as exchange of information, coordination and cooperation among their relevant agencies. They also directed that concrete measures be taken to enforce the provisions of the Regional Convention on Narcotic Drugs and Psychotropic Substances through an appropriate regional mechanism.

Emphasis on the importance of people-to-people contact (Track-III) by heads of state or government during the fourteenth SAARC summit, held in India in 2007, shows flexibility of the SAARC members. This, in turn, is going to open a window of opportunity to promote regional cooperation at Track-III level under SAARC mechanism. Eventually, this may create ground for establishing the process of cooperation at official level (Track-I).

Recognising the "serious threat" posed by terrorism to the peace and stability of South Asia, the fifteenth SAARC summit, held in 2008, in a declaration supported "strongest possible cooperation" against terrorism and signed a key agreement about it. The summit saw firming up the SAARC Convention[54] on Mutual Legal Assistance in Criminal Matters after hard negotiation in the wake of resistance by Pakistan to the extradition clause. It needs mentioning that the Convention will provide a legal framework for greater cooperation amongst security forces of member countries to track, assist and handover of criminals and terrorists on request from any member country. Appreciating the Convention, the SAARC heads of state and government noted that the mechanism would provide for the "widest measures of mutual assistance in criminal matters to ensure greater sense of security within the region." They emphasised the need for strongest possible cooperation in the fight against terrorism and transnational organised crime amongst the relevant agencies of the member states, especially in the area of information exchange. The

[54] The summit emphasised the need for early ratification and implementation of the Convention by the member countries.

summit recognised the growing linkages between the phenomenon of terrorism, illegal trafficking in narcotic and psychotropic substances, illegal trafficking of persons and firearms and underscored the need for addressing the problem comprehensively. The leaders emphasised the need for criminalising any act of provision, collection and acquisition of funds for the purpose of committing terrorist acts in line with the UN Security Council Resolution 1373 adopted in 2001. A need for completing all legislative and other relevant measures to implement within member states, the provision of the Regional Convention on Narcotic Drugs and Psychotropic Substances was also underscored.

3. Institutionalisation of CBMs through SAARC Mechanism

Institutionalising CBMs within the framework of SAARC could be a strategy to promote regional cooperation and partnership. Official channel or Track-I initiative, where states act as actors to foster cooperation at the bilateral, regional and international levels, has proved to be insufficient. Hence, non-official channel or Track-II initiative and Track-III initiative, meaning people-to-people dialogue, have become necessary. Retired military officials, former diplomats, academics, journalists, lawyers, human rights activists are chiefly act as actors to undertake Track-II initiative. By contrast, the civil society organisations (CSOs) mainly undertake Track-III initiative.[55] Hence, as strategies to promote CNS in Bangladesh, Track-I, Track-II and Track-III initiatives can be undertaken either separately or simultaneously as the situation dictates.

A three-day "Regional Workshop for Senior Police Officers and Prosecutors in South Asia for Effectively Countering Terrorism" was held in Dhaka during 8-10 November 2009. The Workshop was jointly hosted by the Bangladesh government and the UNCTED and orgranised by Bangladesh Enterprise Institute (BEI), Dhaka, with the support of the governments of Australia and Denmark.[56] The Workshop, in which a total of 18 participants from eight member states of SAARC participated, can be regarded as unprecedented in that it was the most tangible manifestation of *interface* of Track-I, Track-II and Track-III initiatives to counter terrorism regionally in which the UN has become an active partner. The Workshop is likely to contribute positively to CBMs in the SAARC region if the member states work concertedly, showing their political willingness. In this respect, Track-II and Track-

[55] The work by Behera, Evans and Rizvi has given a list of such CSOs, identifying forty dialogue channels (although some of them have become dysfunctional later) in South Asia and about 12 additional channels active beyond the region, thereby promoting regional cooperation at Track-III.

[56] *The Daily Star* (Dhaka), 11 November 2009, p. 2.

III initiatives can play further active role. However, these CBMs could be at the three levels:

1. Military CBMs
2. Political CBMs
3. Cultural and Socio-Economic CBMs.

1. Military CBMs may include the following:

a) maintaining and enhancing a good level of transparency through inflow of accurate and adequate information on defence spending among SAARC countries;
b) increasing the number of observers including international observers for joint military, naval and air exercises within the SAARC countries and beyond;
c) permitting active and rewarding participation from across the border in National Defence College (NDC) courses among SAARC countries;
d) exchanging military instructors at various levels among SAARC countries;
e) undertaking joint security studies by establishing a SAARC Centre for Defence Studies and Cooperation.

2. Political CBMs may include the following:

a. exchanging meeting between political parties and parliamentarians through communication network among SAARC member states;
b. curbing propaganda in the media: both print and visual, confining the "blame game" and "bashing game" to the minimum among SAARC member states;
c. creating institutional link such as Parliamentary Committee, Judiciary, etc.

3. Cultural and Socio-Economic CBMs may include the following:

a. reinvigorating SAARC by reforming its Charter;
b. establishing SAARC Chairs exclusively related to cultural and socio-economic well-being of the SAARC region;
c. undertaking joint socio-cultural projects among SAARC members;
d. encouraging more and more Chambers of Trade and Commerce exchange visits to promote developmental activity of SAARC;
e. establishing a SAARC social safety network.

4. Reflecting on the Existing Capacity of the SAARC: Towards Evolving a Roadmap for an Effective SAARC

In the preceding paragraphs, discussions have highlighted how to expand political, military, economic and socio-cultural CBMs among SAARC member states within the SAARC framework. These have demonstrated the level of SAARC's existing capacity to manage things. Plainly enough, the SAARC mechanism suffers from institutional weaknesses. Conversely, the very institutional pillars of SAARC are not strong. Taking the cue from here and keeping in mind the preceding discussions, it can be asserted that the existing SAARC's functional capacity is *not optimum.* Hence, an attempt towards evolving a roadmap for a functionally effective SAARC presupposes enhancing the existing SAARC's capacity. This, in turn, calls for developing an *overriding general consensus among SAARC leaders to adopt a common concerted approach to implement important SAARC conventions via a workable institutional framework. Such a consensus-based workable framework is a first step towards mapping out a roadmap for a functional SAARC*.

Hence, how to make SAARC more functional in an era of increasing globalisation, privatisation and sub-regional cooperation remains a moot concern. This concern gives rise to a set of fundamental questions such as: Does a more useful and effective SAARC presuppose reforms within the SAARC Charter? Does it mean that an *eclectic* security structure needs cultivating as the region suffers from "strategic harmony" (asymmetric power structure in which India remains at the apex of the pyramid of regional power structure as the predominate power, generating a fear psychosis, especially among its smaller neighbouring countries)? Do the ground realities of the region hold any promise to erect that edifice (eclectic security structure)? Does an expanded SAARC hold a key to a more robust SAARC? Are there common areas and agenda where SAARC's states can cooperate to make it more effective and functional? What, where is the SAARC viable mechanism that can address these concerns? Depending on a viable and feasible SAARC mechanism, answers to these questions could be made in the positive (except the "eclectic" security structure, for India would not be a party to that) in that there is scope to address these questions, provided there exists, as flagged earlier, an overriding general consensus-based mindset among all leaders of SAARC members to lift SAARC's functional capacity to a new height.

It can be decisively argued that an *overriding general consensus-based SAARC mechanism, which is capable of injecting necessary reforms within the SAARC Charter in tandem with the existing internal and external political, economic, environmental and socio-cultural situation of the region, constitutes the first* *element of the bedrock of the proposed roadmap that would take SAARC towards a truly useful, functional and effective regional umbrella of cooperation.*

To materialise this, reforms, necessary to make a viable and functional office of the SAARC-Secretariat, should not only be considered imperative, but ought to be urgently identified as the need of the hour. A viable SAARC-Secretariat presupposes enhancing administrative and decision-making capacity of the Secretary-General of SAARC. Ironically, SAARC history tells us that the SAARC Charter does not support the Secretary-General of SAARC-Secretariat. This has to do with lack of implementing mechanism. The Group of Eminent Persons (GEP) recommendations, given during the 10th SAARC Summit, can become instrumental toward implementing the mechanism that has limited SAARC's existing capacity to minimum.

A viable and feasible office of SAARC-Secretariat in which it becomes a fitting organ constitutes an inescapable part and parcel of the very proposed roadmap that is being suggested in this study. To be more exact and specific, *an all-rounded reformed SAARC-Secretariat, in which SAARC Secretary-General emerges as an effective decision-making body and SAARC member states accept the ruling of SAARC Secretary-General, remains an integral part of the suggested roadmap which will make the SAARC institutional mechanism robust and timely, thereby lifting SAARC's existing capacity to a novel acme*.

This, in turn, will make SAARC capable of addressing a set of fundamental issues (trans-boundary and non-trans boundary) relatively effectively. Once again, the rule of the games has to be, as emphasised earlier, an overriding general consensus-based mindset among the leaders of SAARC member states.

While such structural reforms constitute a part of the suggested roadmap for an effective and functional SAARC, a set of programmatic and institutional steps need operationalising and implementing, for which structural reforms are preconditions. Put differently, implementation and operationalisation of programmatic and institutional aspects of SAARC sit on structural reforms that have been discussed and recommended so far as an integral part of the suggested roadmap.

A set of burning key issues such as climate change, environmental and human security, countering terrorism, expanding intra-SAARC trade within the mechanism of South Asia Free Trade Agreement (SAFTA)—all can be effectively addressed once the institutional capacity of SAARC is reinvented, reinvigorated and revitalised through desirable and feasible structural reforms discussed thus far—reforms that constitute the fundamental element of the recommended roadmap towards a functionally effective SAARC.

A SAARC roadmap, which is tailored towards a truly functionally effective SAARC, should adopt an integrated approach to counter terrorism within the

SAARC framework. This, in turn, must be in line with the UN framework for countering terrorism. This point has already been discussed in the text. To evolve a common roadmap via a regionally integrated approach calls for an overriding general consensus-based mindset and approach as well. One can refer to 22-points recommendations on countering terrorism offered by the Consortium of South Asian Think Tanks (COSATT) that was established in January 2008 in collaboration with the Konrad Adenauer Stifung (KAS).[57] As underlined in this study, interfacing of Track-I, Track-II and Track-III is needed, and such an interfacing strategy should be an element of the recommended roadmap that this study proposes. It is essentially so because a regionally integrated and holistic approach to counter terrorism also presupposes interfacing of three Tracks. Because an interfacing approach helps countering terrorism more effectively, and therefore, it becomes an element of the recommended roadmap of our study.

A suggested roadmap aiming at functional SAARC should take into consideration the point of enhancing intra-SAARC trade. Such a roadmap should have the provision to streamline maximum level of differences regarding tariff structure so that the pace of intra-SAARC trade gets a new boost. Specifically, the roadmap should have a special provision to implement the Article 8 of SAFTA that would facilitate to expand trade relations among SAARC states, which included harmonisation of standards, customs cooperation, simplification of bank procedures, transit facility for intra-SAARC trade, removal of barriers in intra-SAARC investments, connectivity, etc. The Concert of Europe was possible because of the concerted efforts of the statesmen of the day. The Concert of SAARC is not highly unlikely because parties concerned have the motivation of embracing cooperative mechanism where transaction will be on a win-win basis. Through such a non-zero-sum framework of cooperation and SAARC leaders' consensus-based mindsets, a workable Concert of SAARC is possible. After all, there is a limit to be carried away with the baggage of the past.

Thus, the bottom line is that these programmatic and issue-based aspects of SAARC can be materialised once structural reforms are made viable and feasible–an aspect which is an essential part of the recommended roadmap that this study has proposed.

We are aware that politically the region is beset with chronic instability. This is something the EU did not have to face. Although ASEAN confronted political problems, it could make some impressive progress that SAARC could not. Clearly, a set of structural problems that SAARC faced, and has been facing, was faced by

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[57] See, "Countering Terrorism: Building a Common Approach in SAARC", COSATT, 2009, www.ipics.org

ASEAN to a lesser degree. This is not to down play the problems that ASEAN encountered. At SAARC level, problems kept bedevilling the region because it became a hostage to two rival powers of the region. Given all these barriers, the suggested roadmap, outlined in the preceding discussions, is likely to raise SAARC's existing capacity to a new elevation in an era of globalisation, competition, privatisation and sub-regional cooperation. It is suggested here that dysfunctional aspect of SAARC should not be overplayed and overstated. The steady progress that SAARC has so far made itself explains its capacity to move forward. It is quite easy to put limitations of SAARC on the front burner. Instead of doing so, collective and concerted efforts should be directed to materialise the contour of the recommended consensus-based roadmap that holds a lot of promises for the well-being of the region.

5.5.1.2 ASEAN-SAARC Dialogue Parternership and Cooperation

Terrorism, drug and narcotics have become growing security concerns for ASEAN. ASEAN have taken some good measures[58] regarding the matter. It is here ASEAN-SAARC can share each other's experience to complement and supplement their efforts in an attempt to explore partnership and cooperation. India is a full Dialogue Partner of ASEAN. This has led India to be integrated into the multidimensional dialogue processes that have been taking off in Asia-Pacific. Furthermore, Pakistan is also ASEAN's Sectoral Dialogue Partner. Hence, two key members of SAARC are already engaged actively in promoting close link with ASEAN. Bangladesh, which became the twenty-six partner of ARF on 28 July 2006, has embarked on acquiring a Sectoral Dialogue Partnership with ASEAN. These developments can make Bangladesh an ASEAN bordering state or what some would like to say a "land-bridge" between ASEAN and SAARC. In addition, Bangladesh has shown its recent renewed interest in the proposed Trans-Asian Railway (TAR), a project of the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP). Once materialised, it will link Bangladesh, among others, with six East Asian countries such as Myanmar, Thailand, Laos, Cambodia, Malaysia and Singapore as well as European countries through Turkey. It needs mentioning that as part of TAR agreement that Bangladesh signed on 10 November 2007, a 130-km-railway-track will be laid from Dohazari of Bangladesh to Gundum in the Arakan state of Myanmar via Ramu in Cox's Bazaar. The TAR

[58] For details, the 2001 ASEAN Declaration on Joint Action to Counter Terrorism, Bandar Seri Begawan, 5 November 2001; ASEAN-US Joint Declaration on Counter-Terrorism, at www.aseansec.org/7424.htm, and on ACCORD and its plan of action, http://www.undo.un.or.th/accord/default.htm

and the East-West Economic Corridor (EWEC) will promote Bangladesh's economic interests to ASEAN and beyond. The EWEC is considered as the sole land link which will connect the Indian Ocean with the Pacific. In essence, all these will give Bangladesh greater connectivity with ASEAN, and not to mention, with Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMSTEC) countries.

5.5.1.3 The EU-SAARC Cooperation and Partnership

Following the signing a first Memorandum of Understanding (MoU) in 1996, the EU and SAARC agreed in 1999 to cooperation on four priority actions: (1) improve market access for SAARC products to the EU, (2) work towards a cumulation of rules of origin of SAARC products for exports to the EU, (3) technical support for the establishment of South Asian Free Trade Area, and (4) support for harmonisation of SAARC standards. The cumulation of rules of origin was granted and facilitation of market access was addressed by activities like information seminars. But the financial support part of the MoU was never implemented.[59] Only an identification mission was undertaken. There are no programmes to draw experience from for the programming of future financial cooperation with SAARC. Despite the limitations mentioned earlier, two key lessons for future programming need reflecting:

1. The four areas of cooperation agreed in 1999 are regarded still useful as a broad framework of reference for cooperation between the EU and SAARC.
2. Political developments in the region have a direct impact on the possibility implementing SAARC related projects. Programming needs to take account of this by providing maximum flexibility to increase and decrease funds for SAARC projects in line with political developments.[60]

In accordance with Article 177 of the Treaty Establishing the European Community, the Community's development cooperation policy shall foster the sustainable economic and social development of the developing countries. On the basis of Article 179 of the same Treaty, a new Development Cooperation Instrument (DCI) was adopted in December 2006. Bangladesh is eligible to participate in cooperation programmes financed under the DCI [European Parliament and Council Regulation (EC) No. 1905 of 18 December 2006 establishing a financial instrument for development cooperation. The framework

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[59] Commission of the European Communities External Relations Directorate General, Directorate Asia (except Japan and Korea), Policy, Planning and Coordination, "Strategy Paper and Indicative Programme For Multi-Country Programmes in Asia 2005-2006", p. 16.

[60] *Ibid*., p. 17.

programmes for research and technological development (Part three, title XVIII art. 164b) constitute important impetus to build and consolidate partnership between the EC and Bangladesh through the increase of the transfer of technology, the exchange of scientists and researchers and the encouragement of partnerships between research centres in Bangladesh and the EU member states.

5.5.1.4 OSCE -SAARC Cooperation and Partnership

The urgency to promote cooperation and forge partnership between OSCE and SAARC has already been underscored in that both OSCE and SAARC share common features and common principles (Wagner 2000). Consequently, a meaningful partnership between OSCE and SAARC needs underlining in that the OSCE hare relevance for fostering regional cooperation in the SAARC region. Although a series of factors have limited this relevance, areas, in which the both have scope to develop partnership and generate cooperation, are: democracy, human rights and peacekeeping. The relevance of OSCE in promoting democracy in Bangladesh has had its reflection in the following quote: “To introduce common value like the commitment to democratic principles, as the OSCE did, would mean, on the other side, to introduce some kind of sanctions if democratically elected governments are toppled by the military (Wagner 2000).” Regarding human rights, the introduction of a High Commissioner on National Minorities following the OSCE’s example is regarded as a good start. The High Commission identifies ethnic-minority tensions which may give rise to domestic or regional conflicts, threatening security and peace. SAARC, of which Bangladesh is a member, may be able to contain such tensions should it follow the OSCE’s example. On the peacekeeping, it may be said that many South Asian countries have a good record of peacekeeping missions in the framework of the UN. Bangladesh has been one of the leading countries in this field. The experience of OSCE’s in preventing conflicts through peacekeeping will complement and supplement the experience and capacity building of Bangladesh’s peacekeepers under the UN framework. Viewed holistically, the aforesaid three issues are linked to national security and development of Bangladesh. It should be within the strategy of the CNS of Bangladesh to include the aforesaid areas of cooperation adopting the OSCE framework so that it can replicate OSCE as a model of partnership. A working partnership between the two can benefit each other enhancing the developmental process of Bangladesh and SAARC as well.

Another important area of OSCE-SAARC partnership and cooperation could be border security. OSCE has already adopted a comprehensive approach to address the issues such as border management, border security and border policing to assist participating member states. Following the Budapest Ministerial Declarations in 2001, it was agreed that OSCE would expand its cooperative mechanism with other international, regional and sub-regional organisations and institutions—all on the basis of the Platform for Cooperative Security. Responses to border issues within the OSCE include activities undertaken by various OSCE bodies, institutions and field operations, and focus on a variety of aspects of border security, including police, customs and immigration. Since Bangladesh has serious border management problems with India and Myanmar, and since some common trans-border issues (terrorism, illicit drug and women trafficking, etc) have affected SAARC countries, SAARC as a whole and Bangladesh in particular can approach OSCE to share its experience of cooperative mechanism, seeking OSCE's assistance in capacity building to address border security of Bangladesh. The concept of an IBM, which has been modelled after the European experience, has its relevance to address the border security between Bangladesh and India. IBM, in the context of managing border security of Bangladesh and India, has already been proposed. But it is still in its infancy. Both Bangladesh and India and SAARC as a whole will be able to get better insight and assistance in the field of raising an IBM infrastructure if SAARC collectively and Bangladesh individually share and utilise OSCE's experience about the matter. This will further forge OSCE-SAARC partnership and cooperation.

5.5.1.5 The UN-Bangladesh Cooperation and Partnership

To date, the UN continues to remain as a major pillar of Bangladesh's foreign policy following Bangladesh's membership to the UN in 1974. The UN's central objective is to maintain global peace and security—an objective which is also a cornerstone of Bangladesh's foreign policy in that it supports the maintenance of peace and security within the international community to promote international cooperation and partnership. Although Bangladesh became a full-member of the UN in September 1974, Bangladesh-UN cooperation started on humanitarian grounds, just following the attainment of its statehood. Bangladesh has ratified most of the UN instruments such as conventions and treaties and actively participated in almost all major UN conferences. Bangladesh's performances in major UN forums such as the General Assembly and the Security Council have heightened its credibility and image in the UN sphere. Consequently, it was given several UN important positions such as the president of the General Assembly, chairman of various Commissions and committees and executive member of a number of UN bodies and specialised agencies. These have greatly contributed to cultivate the UN-Bangladesh cooperation and partnership. UN support to Bangladesh in socio-economic development is of crucial significance. Bangladesh's success in its struggle for higher standard of living depends much upon its partnership with the UN.

The most vivid demonstration of the UN-Bangladesh partnership and cooperation is tangible in the field of peacekeeping. Bangladesh is currently the second largest contributor of UN peacekeeping troops, out of 116 countries, with 9,849 military and police deployed overseas.[61] In *Agenda for Peace*, Boutros Boutros-Ghail, the former UN Secretary-General, mentioned four major methods of maintaining peace in the world—Preventive Diplomacy, Peace Making, Peacekeeping and Post-conflict Reconstruction. Over the years, the Bangladesh peacekeeping mission under the UN frame has played an important role in all the above-mentioned four key methods of maintaining peace in the world, thereby promoting international cooperation and partnership with various countries in which it committed its peacekeeping forces. Bangladesh's contribution to the UN peacekeeping prompted the former UN Secretary-General, Kofi Annan, to describe it as "a model member of the UN, providing leadership amongst the least developed countries . . . and contributing substantially to peacekeeping and humanitarian operations."[62]

Another area of the UN-Bangladesh partnership and cooperation is counter terrorism. Bangladesh has already strongly supported the UN Security Council Resolution 1373 on terrorism and has remained committed to abiding by its obligations. It has already become signatories to 12 of the 13 UN Conventions on terrorism and is in the process of acceding to the UN Convention on Suppression of Nuclear Terrorism (Karim, undated). The UN Global Counterterrorism Strategy (UNGCTS) was adopted by the General Assembly on 8 September 2006 (General Assembly Resolution 60/288). This event marked the first time member states agreed to a comprehensive, global, strategic framework on counterterrorism to bring all the counterterrorism activities of the UN system into a common framework, putting special emphasis on the Security Council's Counter-Terrorism Executive Directorate (CTED) and the Secretariat's Counter-Terrorism Implementation Task Force (CTTTF). The legitimacy conferred by the adoption of UNGCTS by all 192 of its member states, combined with the reach and resources of UN agencies, places

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[61] "UN Peacekeeping Chief Arrives Wednesday", 7 October 2009, available in http://www.bdnews24.com/details.php?id=144322&cid=2&aoth=1 accessed on 15 November 2009.

[62] "The Bangladesh Army in UN Peacekeeping", ONUCI (the United Nations Operation in Cote d'Ivoire) Feature, No. 011, 2005, p. 1. For background study on the Bangladesh UN Peacekeeping Operations, see T. A. Zearat Ali, "Bangladesh in United Nations Peacekeeping Operations", *BIISS Papers*, No. 16, July 1998.

the UN in the best position to assist the global community in coordinating counterterrorism efforts.[63] A key aim of UNGCTS is building state capacities to counter terrorism in which the UN has been playing the role of coordination and coherence. Executive Director of United Nations Counter-Terrorism Committee Executive Directorate (UNCTED), Mike Smith, has observed that strengthening the government's capacity, having border control and aviation security as well as stronger financial intelligence can help Bangladesh address terrorism.[64] Bangladesh's strategy should be to seek the UN support and cooperation in these fields in an attempt to strengthen the UN-Bangladesh partnership.

5.5.1.6 SAPI-SAARC Cooperation and Partnership

SAPI, with its national SAP members (Bangladesh, Nepal, Pakistan, Sri Lanka, India and Canada), has evolved from a support and capacity building organisation solving local poverty challenges to an international agency advocating for regional good governance, peace and sustainable livelihoods. Good governance is an integral part of internal security of any country. Absence of good governance impedes growth and development. As an international organisation based in South Asia, SAPI and its members have identified its role as one of Regional Advocacy by the civil society for peace and social justice in South Asia. Its agenda such as "Combating Small Arms Proliferation," "Reduction of Disaster in South Asian Nations and Communities," "Trafficking and Human Security," etc. is meant to promote regional and international cooperation. These issues are important security issues for SAARC. Hence, a SAPI-SAARC partnership in addressing these issues can be explored in which member states of both SAPI-SAARC can actively apply Track-II and Track-III mechanisms to promote regional and international cooperation and partnership.

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[63] "Implementing of the UN Global Counterterrorism Strategy", 42nd Conference on the United Nations of the Next Decade, sponsored by the Stanley Foundation, the Inn at Perry Cabin, St. Michaels, Maryland, USA, 8-13 June 2007, p. 39.

[64] Smith gave his opinion during the concluding session of a three-day (8-10 November 2009) regional workshop on "Regional Workshop for Senior Police Officers and Prosecutors in South Asia for Effectively Countering Terrorism" which, as mentioned earlier, was held in Dhaka on 8-10 November 2009. For the story, *The Daily Star* (Dhaka), 11 November 2009, p. 2.

5.5.2 Cooperation in Security Issues: Inter-State and Inter-Military

5.5.2.1 Inter-State Cooperation

Bangladesh-India

As mentioned earlier, Bangladesh and India have been suffering from the organised crime, terrorism, human and arms trafficking, small arms proliferation, maritime piracy, etc. To address these transnational challenges, inter-state cooperation between Bangladesh and India is necessary. Meaningful cooperation between security and intelligence agencies of both countries can play a vital role in this regard. To resolve security and border management issues, the two countries had set up a bilateral institutional mechanism in 1994. As a part of that mechanism, until 2007, eight rounds of India-Bangladesh Home Secretary level talks were held to promote cooperation on issues related to peaceful management of border, security, cross-border movements and enhanced police cooperation.[65] The neighbours also agreed to initiate "swift" action on information received regarding insurgent groups taking shelter in either country. Bangladesh also agreed to expedite inter-ministerial consultations on the drafts of an extradition treaty, mutual legal assistance treaty and a bilateral agreement with India to combat international terrorism. All these developments are part of the bilateral institutional mechanism set up in 1994 to resolve security and border management issues.[66] On 29 September 2009, the Parliamentary Standing Committee on Defence Ministry stated Bangladesh and India had agreed to erect as many as 320 pillars on their border.[67] Such inter-state cooperation will enhance security cooperation between the two countries, especially in managing border security.

Bangladesh-Myanmar

On 29 September 2009, the Parliamentary Standing Committee on Defence Ministry also stated there is no more dispute with Myanmar, another neighbouring country, over the demarcation of land boundary as both the countries had agreed to set up a total of 314 pillars on the border.[68] Such inter-state cooperation has been

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[65] "Indo-Bangla Home Secretary level talks from tomorrow", available at http://www.theinfosage.com/indo-bangla-home-secretary-level-talks-from-tomorrow.html accessed on 9 November 2009.

[66] "India, Bangladesh to set up new mechanisms to combat terrorism", available at http://www.earthtimes.org/articles/show/89872.html accessed on 8 November 2009.

[67] "Dhaka, Delhi agree to erect 320 pillars", *The Daily Star* (Dhaka), 30 September 2009.

[68] *Ibid.*

possible because of the political will and flexibility shown by both countries. Therefore, to enhance inter-state security between the two, more effective negotiating skills have to be developed and applied by both sides so that both can cultivate a win-win situation to increase inter-state security between them. Energy security can be an area of inter-state cooperation between the two. Much effort needs directing by both sides to make it feasible.

Bangladesh-UK

It has been quite some time that Bangladesh-UK has demonstrated keen interests in cooperating on border security policy. For example, the British Ministry of Defence and Bangladesh Ministry of Home Affairs have jointly held the four-day seminar on “Improving Bangladesh’s Border Security and Management,” at Radius Conference Centre in Dhaka in September 2007. The seminar has drawn on the UK’s experience of dealing with border security issues, including through inter-agency cooperation. A British High Commission release put that the seminar was aimed at enhancing awareness of the range and nature of border security issues that concern Bangladesh, encouraging sensitive and coordinated policy responses including countering terrorism, managing border policing and tackling international crime like trafficking in drugs, persons and arms.[69] All these show that Britain can play a significant role in addressing all those security issues that Bangladesh face. Hence, inter-state cooperation between them can continue to develop on the basis of a shared policy of give-and-take in which Britain can share with and provide to Bangladesh its intelligence network and modern technology, giving training to Bangladesh’s elite and police forces to combat the set of security issues mentioned earlier.

A Bangladeshi scholar observes that promoting security cooperation vis-à-vis terrorism—a common problem between Bangladesh and Britain—relates to “extradition treaty, intelligence sharing, reform in Qawmi madrashas and educational grant.” On the issue of terrorism, Bangladesh-Britain cooperation can

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[69] “UK assists Bangladesh on border security policy”, *The Financial Express* (Dhaka), 3 September 2007 available at http://www.thefinancialexpress-bd.com/search_indes. php?page = detail_news&news_id=9 accessed on 25 October 2009.

be quite rewarding on the two "vital specific areas." These are: (1) Influencing Operations, (2) Capacity Building (Shelly 2007).[70]

Bangladesh-USA

The United States (US) government has demonstrated its willingness to continue support to Bangladesh's efforts to counter terrorism, piracy, and maritime and coastal crime. In 2005, between Bangladesh and US, there was good cooperation between law enforcement agencies on several cases relating to domestic terrorism. With US technical assistance, Bangladesh in 2005 drafted a new, comprehensive anti-money laundering law. It has also continued to work with the US to strengthen controls at land, sea and aeronautical ports of entry. This is very significant in that a holistic security arrangement involves constant vigilance at all these three ports of entry. The US role in this respect will be a great security boon for Bangladesh.

Taking part in a hearing before the Senate Foreign Relations Committee at Dirksen Senate Office Building for being confirmed in 2008 as new US Ambassador for Bangladesh, James Moriarty said the US interests in Bangladesh revolve around three inter-twined "d's": democracy, development, and denial of space to terrorism. It appears that inter-state cooperation between Bangladesh and US has been expanding in these areas.

In mid-June 2009, when the US Assistant Secretary of the State for South and Central Affairs, Robert O Blake visited Bangladesh, the Bangladesh government sought border security support and training of more personnel of Bangladesh's police, RAB and Ansars from the USA.[71] In turn, the USA assured Bangladesh of such security support. Therefore, like UK, the USA can play a major role in institutionalising Bangaldesh's elite and police forces. Strengthening inter-state cooperation on such a plane will greatly help in capacity building mechanism for Bangladesh. In November 2009, three high-ranking US military commanders

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[70] Mizanur Rahman Shelley, "Bangladesh Perspectives in the Global War on Terrorism: British Engagement with Bangladesh in Counter Terrorism: Opportunities for Cooperation", in Mufleh R. Osmany and Mohammad Humayun Kabir (eds.) *Global War on Terror: Bangladesh Perspective* ((Dhaka: Academic Press and Publishers Library in association with Bangladesh Institute of International and Strategic Studies, 2007), p. 166.

[71] "Bangladesh seek border security support from USA", The New Age (Dhaka), [Website], 15 June 2009, available at http://www.accessmylibrary.com/coms2/summary_0286-38089936_ITM accessed on 21 October 2009.

visited Bangladesh to further strengthen security and counter terrorism cooperation. The military officials were: Lt General Benjamin R. Mixon, Commanding General of US Army in Pacific, Vice Admiral John M. Bird, Commander of US Navy 7th Fleet and US Marine Corps Major General Randolph D. Alles, Director for Strategic Planning and Policy at the US Pacific Command (USPACOM). These visits underscored the importance of cooperation on security, humanitarian assistance and counter terrorism.[72] It is worth reflecting that earlier the US had proposed joint maritime patrols on the Bay of Bengal to counter piracy—a proposal once comes into effect will act as a cooperative mechanism to counter piracy which Bangladesh needs most.

5.5.2.2 Inter-Military Cooperation

Bangladesh-China

During his visit to Bangladesh in April 2008, the Chinese Foreign Minister, Yang Jiechi, said that military-to-military cooperation is an important part of overall bilateral relations between Bangladesh and China (Sabur, Uddin and Yousuf 2008). A nine-member delegation, headed by Lt. General Jia Ting'an, Chief of the General Political Development of People's Liberation Army (PLA), paid a four-day visit to Bangladesh in April 2009. During the visit Lt. General Ting'an met Prime Minister Sheikh Hasina, and both underlined military cooperation between the two countries.[73] In August 2007, a three-member Chinese military delegation, headed by Chen Bingde, member of the Central Military Commission of the Communist Party of China, paid a three-day goodwill visit to Bangladesh. Added to these, in December 2007, following the Cyclone SIDR, the PLA handed over, via Chinese Ambassador to Bangladesh, Zheng Qingdian, more than 1,600 tons of relief goods to Bangladesh armed forces. However, the Hussein Mohammed Ershad regime of 1982-90 witnessed the highest number of high level two-way military visits between the two countries (Ahmed, Ahmed and Islam 2007). It has been learnt from a reliable source that a defence protocol has been signed between Bangladesh and China in 2004. According to the protocol, China agreed to supply 20 million worth of US$ weapons to Bangladesh. Since then, the Bangladesh Army has received military hardware like *KW-II* (surface-to-air missile), *RAT* (Anti-Tank Missile), and Tank up gradation facilities. Under the protocol China has supplied to the BN surface-to-surface anti-ship missiles (*C802* type), and to BAF, radar.

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[72] *The Daily Sta*r (Dhaka), 3 November 2009.
[73] *The Financial Express* (Dhaka), 8 April 2009.

Bangladesh-India

Inter-military cooperation between Bangladesh and India involves exchanging visits of high and medium level defence personnel, availing of training courses in each others' training institutions and participating in peacekeeping exercises by the military of both countries. Indian defence personnel take courses in the Bangladesh Military Academy (BMA), Defence Services Command and Staff College (DSCSC) and NDC. It needs stating that Bangladesh's Army Chief Lieutenant General Mustafizur Rahman visited India in 2000. The last visit to Bangladesh by Indian Army Chief was also in 2000. India participated in August-September 2002 to the Bangladesh Army and USPACOM hosted multinational peace support operation exercise named *Shanti Doot-1* in Bangladesh under the framework of Global Peace Operations Initiative Programme. Therefore, Bangladesh can explore the possibilities of conducting joint military exercises with India. These joint military exercises may be conducted between Army to Army, Navy to Navy and Air Force to Air Force of Bangladesh and India. Bangladesh Army Chief General Moeen U Ahmed visited India in February 2008 and his visit was reciprocated (at the invitation of Bangladesh Army Chief) by Indian Army Chief General Deepak Kapoor from July 28 to 31 July 2009. Reciprocal visits by the top military officials have been designed to revitalise inter-military cooperation between the two countries.

Bangladesh-USA

Inter-military cooperation between Bangladesh and the US entails joint-military exercises, assisting Bangladesh in managing its natural disaster management and visiting of defence personnel. Since 1988, several joint military exercises and nation building works have been undertaken by the US and Bangladesh Armed forces. The US Department of Defence responded to the 1991 cyclone with over US$28 million worth assistance in kind including medical supplies, other relief commodities and repair of the Chittagong Airport by Corps of Engineer Personnel. In addition, the US President dispatched a joint task force of 4,600 marines and 2,965 sailors, along with seven ships including the helicopter carrier *USS Tarawa*, 28 helicopters and ten landing crafts. The relief mission engaged in air and amphibious transport, communications, medical and engineering assessments and assistance. The relief efforts of US troops are credited with having saved as many as 200,000 lives.

The US troops have visited Bangladesh on several occasions in the past to conduct joint military exercises. There have been three such exercises involving the armies of the two countries in the last ten years. Since 1982, a liaison team comprising the USPACOM and the Bangladesh military has been in operation to coordinate their actions in the Indian Ocean Zone, including in times of disasters, breach of peace and/or hostility in the region. Since 1979, more than 300 military personnel from Bangladesh have received training in the USA.

Bangladesh and the USA have carried out joint exercises as a symbol of their collaboration. “Operation Seabat,” an exercise between US Navy and BN and BAF, was held in August 1995 in the Bay of Bengal. According to Commander Brian Prindle of US Navy, this exercise focused on cooperation between US and Bangladesh naval forces in the fields of surveillance, search and rescue operation during natural calamities, a legacy of the 1991 post cyclonic disaster rescue “Operation Sea Angel.” It was also aimed at forging cooperation between US Navy and BAF in search and rescue technique. The joint exercise is a part of the series underway since 1992. Since 1992 the exercises are held twice annually. Military relations between the two countries further developed by the visit of the Chief of the US Armed Forces General Dennis Joe Reimol, in April 1998, who headed a 97-member goodwill delegation.

In 2007, following the Cyclone Sidr, the US military immediately provided desperately needed airlift to deliver food, water and clothing to remote areas under “Operation Sea Angel II.” On 25 May 2009, the USA assured Bangladesh it would support efforts to develop an elite Bangladeshi naval commando force to counter terrorism, piracy, and maritime and coastal crimes, officials said. “The US government will assist Bangladesh develop this professional, elite force,” US Ambassador James F. Moriarty said while attending a graduation ceremony of a group of naval instructors in southern Chittagong port city. A press statement issued by US embassy in Dhaka stated: “This training demonstrates the US government's commitment to Bangladesh and to regional security by promoting military-to-military relationships throughout Asia and the Pacific.”[74] Added to these, it needs mentioning that a joint exercise “Tiger Shark-I” was held in Chittagong between the BN and the US Special Operations Forces through the month of November 2009 to strengthen inter-military cooperation between the two countries. US Ambassador James F. Moriarty at the closing ceremony of “Tiger Shark-1” said: “This is first Tiger Shark exercise in our ongoing Joint Combined Training Exchange (JCET) programme. The Tiger Shark exercises will increase interoperability both internally within the Bangladesh military and externally with the US to counter terrorism. . . . In addition, there will be three more Tiger Shark training events in the next year. All of these activities will culminate in a combined Bangladesh/US counter terrorism

[74] For details, see *Making Waves* (the monthly e-News Brief of NMF (National Maritime Foundation, New Delhi, India), Vol. 4, No. 5/6 (May-June), 2009, pp. 8-9.

exercise."[75] It needs noting that the Bangladesh Navy Special Warfare and Diving Salvage Unit (SWADS) now has 59 new naval commandos.[76]

Bangladesh-UK

It needs hardly any mention that there has been a strong and spontaneous influence of British legislation and the English language on Bangladesh's civil, judicial, academic and military institutions drawing the two peoples on a common intellectual platform. Since inception, Bangladesh-UK military cooperation may be regarded as cozy and intense. The UK's continual support to provide all out assistance in developing and training Bangladesh Armed Forces is quite noticeable. A good number of Bangladeshi Armed Forces personnel are trained in UK every year at the Sandhurst Royal Military Academy, Royal College of Defence Studies and at the Joint Defence Command Staff Courses. Britain has also provided significant military and advisory assistance in setting up the prestigious DSCSC and the NDC of Bangladesh. British Military Assistance Team had been in Bangladesh as instructors for many years. The two Navies have continued to cooperate closely while most of the ships of BN have been procured from Royal Navy. These have helped BN to achieve a commendable capability. Royal Navy has also provided technical advice in setting up important BN infrastructure such as BN dockyard. The two armed forces have also been working closely in the UN Peacekeeping missions and in the global war on terror. Exchange of high profile military visits has also been a characteristic of inter-military cooperation between the two countries.

In April 2009, a five-day mock naval warfare dubbed "Exercise Shamudro Torongo" (TAURUS 2009) took place in the Bay of Bengal to enhance military cooperation between Bangladesh security forces and the British Navy. Two warships of the British Royal Navy and few ships from BN and Coast Guard took part in the exercise. In addition, few fighter aircraft and helicopters of BAF, a large number of Commando, RAB and police personnel participated in the joint exercise.[77]

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[75] "Remarks by Ambassador James F. Moriarty at the Closing Ceremony of Tiger Shark 1", available at http:// dhaka.usembassay.gov/12_nov_2009_moriarty_remarks_closing_tiger-shark_1.html accessed on 8 December 2009.
[76] *Ibid.*
[77] *The Daily Star* (Dhaka), 30 April 2009.

5.6 RESOURCE ALLOCATION IN NATIONAL SECURITY: PAST TRENDS AND EFFECTIVENESS

5.6.1 Budgetary Allocations for National Security

How much spending is adequate for the national defence of a country? It is a perennial dilemma for the development planners and policymakers. There is no straightforward answer to this question as it entirely depends on a country's goals, resources and the judgment of the political leadership (Sisodia 2009). Resource allocation for defence is a difficult choice for political leadership as well in a democratic country. The money spent on defence cannot be spent on the other priorities like poverty alleviation, health, education, energy and physical infrastructure. Neglecting such priorities means deprivation and hindrance to socio-economic progress, which can ultimately generate non-traditional threats to security.

Some alternative practices were in place to determine defence outlays. During Truman and Eisenhower periods in the US, the approach of calculating defence expenditure was "reminder method". They used to estimate tax revenues, subtract domestic spending, and then gave whatever left over to defence. Conversely, during Kennedy period, budget ceiling was imposed on defence: civilian decision-makers began to reject programmes proposed by the military by arguing that these were unnecessary (Betts 2007). In India, the Parliamentary Standing Committee on Defence in its Sixth Report (1995-96) proposed a long-term commitment of allocation of 4 per cent of its GDP (Sisodia 2009). However, fixing a percentage of GDP may not be strongly meaningful since it does not take into account the size of GDP. For instance, Japan spends about twice of India's defence spending, but it is even less than one per cent of Japan's GDP. Thus, this approach may disregard the net assessment of threats and allocation accordingly. For inter-country comparison, defence spending as percentage of GDP may be useful.

Spending on security sector, military in particular, depends mainly on the economic capability of the country and minimum requirement of the armed forces. A country must have a strong economic base to sustain and support the growth of defence forces in order to rationally utilise its scarce resources. The policy arena of most of the developing and least developed countries (LDCs) has been overridden by economic progress, poverty eradication and social advancement after the demise of the Cold War.

As an LDC,[78] with accelerated poverty reduction and economic and social development remain the priority areas of expenditure in Bangladesh. Over the last three decades, Bangladesh has made notable progress in economic and social arena. From a "test case of development" (Faaland and Parkinson 1976). of the mid-1970s with pervasive poverty and hunger, the country has been able to secure its position in the category of "medium human development" in 2003 (UNDP 2003). It is due, amongst others, to put greater emphasis on the budgetary allocation to social sector, *e.g.*, education, health and social safety net programmes.

5.6.1.1 Trend of Defence Expenditure

The relative importance of Bangladesh's defence expenditure can be analysed in the purview of its share in the GDP. According to the World Development Indicators (WDI), this share ranged between 1.1 and 1.43 per cent during the 1990s and the current decade. However, it has been almost half compared to that of India over the last 20 years or so. Conversely, although this share in Myanmar was even higher than that of India since 1990 up to 1996, it started to fall later on. In 2002, it was equal to that of Bangladesh. Data is unavailable for Myanmar after this year.

Bangladesh' share of defence expenditure in GDP has been even lower than that of Nepal since 2002. This indicates the country's inadequate war preparedness compared to immediate neighbours according to the WDI statistics. In the words of Talukder Maniruzzaman "in determining a state's war making capacity, one has to look at both its potential war power and its immediate war preparedness." (Maniruzzaman 1982). Potential war power or capability of a state can best be assessed by its various economic performance indicators. As to the current war preparedness of a state, the yearly military budget is probably the best indicator (Maniruzzaman 1982).[79]

According to our calculation based on the *Military Balance* data, the defence budget was US$ 912 million in 2008. It was, however, US$ 25.3 billion in India in 2008 and 6.42 billion in Myanmar in 2007 and Bangladesh was significantly behind in terms of its war preparedness. It is worthwhile to mention that India's size of regular defence force has not increased over the last twenty years. Its size of the Army is 1,100,000 since 1991-92; Navy and Air Force have increased slightly. It implies that their defence forces have been equipped with increasing number of weapons and logistics even if adjusted for adjustments for increased recurrent expenditure. Bangladesh's defence forces are lagging behind as well in this respect.

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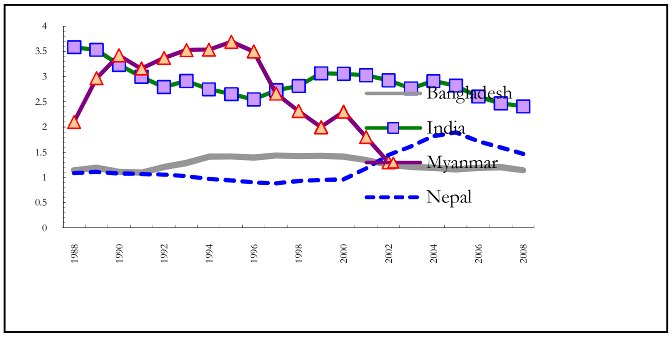
[78] According to the classification of UNCTAD, *The Least Developed Countries Report 2009*, UNCTAD, Geneva, 2009.
[79] *Ibid*, p. 5.

Figure 5.1: Share of Defence Expenditure in GDP



Source: WDI (online).

TABLE 5.7

COMPARATIVE PICTURE OF GDP AND DEFENCE BUDGET OF BANGLADESH, INDIA AND MYANMAR

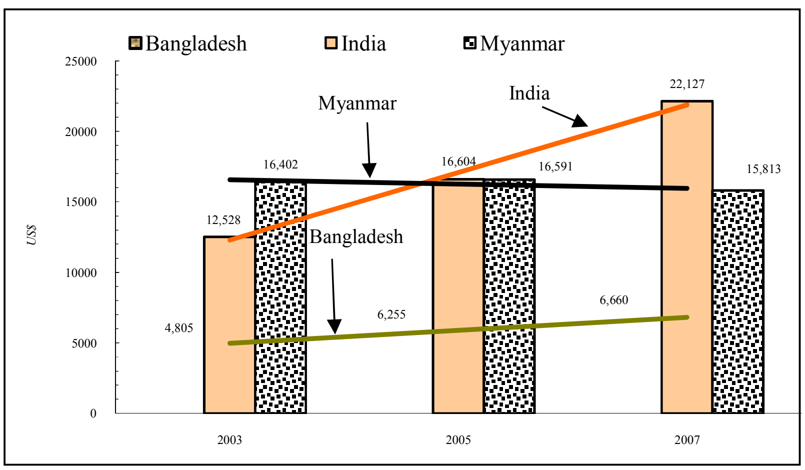
		2001	2002	2003	2004	2005	2006	2007	2008
Bangladesh	GDP (US$ bn)	45.4	47.3	51.7	55.5	36.6	59.4	68	79
	Def Exp (US$ bn)	0.632	0.675	0.645	0.977	..	0.938	0.998	..
	Def Bud (US$ bn)	0.633	0.675	0.603	0.745	0.785	0.852	0.829	0.912
	Def Exp % of GDP	1.39	1.43	1.25	1.76	..	1.58	1.47	
	Def Bud % of GDP	1.39	1.43	1.17	1.34	2.14	1.43	1.22	1.15
India	GDP (US$ bn)	487	505	692.5	686	761	911	1209	1078
	Def Exp (US$ bn)	14.3	13.8	15.5	19.6	22.0	22.4	26.5	..
	Def Bud (US$ bn)	15.5	15.7	16.6	19.4	22.0	22.9	28.5	25.3
	Def Exp % of GDP	2.94	2.73	2.24	2.86	2.89	2.46	2.19	..
	Def Bud % of GDP	3.18	3.11	2.40	2.83	2.89	2.51	2.36	2.35
Myanmar	GDP (US$ bn)[a]	46	60	65	69	..	37	45	21.2
	Def Exp (US$ bn)[b]	2.3	3.0	..	..	..	..	..	..
	Def Bud (US$ bn)[b]	1.5	1.5	6.2	2.26	6.23	6.9	6.42	..
	Def Exp % of GDP	5.00	5.00	..	..	..	..	..	..
	Def Bud % of GDP	3.26	2.50	9.54	3.28	..	18.65	14.27	..

Source: IISS (various years).
Notes: [a] at Purchasing Power Parity (PPP) estimate, [b] estimate at the official exchange rate. Def Exp and Def Bud imply defence expenditure and defence budget respectively.

According to Military Balance 1999-2000 to 2003-2004, Myanmar's defence expenditure was significantly higher than defence budget. There is no published data on defence expenditure after the year 2002, but the increased trend of defence budget indicates that the actual defence expenditure is likely to increase. In 2007, Myanmar's defence budget was US$ 6.42 billion, which was 7.74 times higher than that of Bangladesh. Also, the rate of increase in Bangladesh's defence budget is much lower than that of these two countries. Between 2001 and 2008, defence budget of India and Myanmar increased by 63.23 and 328 per cent respectively, while it increased by 44.08 per cent in Bangladesh. These too suggest that Bangladesh's war preparedness is much lower than that of immediate neighbours.

The quality of Bangladesh's war preparedness can be more precisely assessed by the concentration of weapons and logistics. While the worth of stock of weapon and logistics represent such preparedness, the actual data in this respect is not readily available. However, its proxy would be the defence budget per force as since it embodies the stock of weapon and logistics. Bangladesh's defence budget per force is much lower than that of India and Myanmar. Between 2003 and 2007, Bangladesh's defence budget per force increased by 38.61 per cent. However, the rate of increase was half compared to India, although Myanmar experienced a slightly negative growth in this period (3.59 per cent). In 2007, defence budget per force in India and Myanmar was 3.32 and 2.37 times higher than that of Bangladesh respectively.

Figure 5.2: Trend of Defence Budget per Personnel (in US$)



Source: Calculation based on IISS (2008).

5.6.1.2 Trend of Budget Allocation

Budgetary allocation to defence sector is made in accordance with the country's defence requirements, economic capability and priorities of other competing sectors. The country has to maintain a balance between defence and development. Before the allocation is made, it is important to determine "how much" defence is required, *i.e.*, "how many" force is required in various armed forces (Islam, Ahmed and Bhuyan 2009).[80]

In the recent years, spending on security sector, "defence" plus "public order and safety," has been substantial with an increasing trend in its magnitude. In FY2006-07, security spending was Tk. 9,692 crore, which was 14.5 per cent of the total revised budget of that year. It reduced to 11.76 per cent in the subsequent year but again increased to 13.68 per cent in 2008-09, which again reduced to 11.64 per cent in the proposed budget of 2009-10. However, this sector's budget is the second highest, after education (12.31 per cent of budget in 2009-10).

TABLE 5.8

BUDGETARY ALLOCATION IN IMPORTANT SECTORS (CRORE TK)[*]

	NON-DEVELOPMENT				DEVELOPMENT			
	2006-07	2007-08	2008-09	2009-10	2006-07	2007-08	2008-09	2009-10
Health	2,682 (+273)	2,898 (+34)	3,581 (-72)	3,905	2,275 (-100)	2,363 (-243)	2,615 (-176)	3,075
Education	7,911 (+805)	8,547 (+2)	9,197 (-274)	10,043	2,800 (-986)	2,887 (-709)	3,100 (-258)	3,963
Defence	5,183 (+525)	5,682 (+493)	6,677 (+303)	6,675	116 (-42)	175 (-12)	98 (-65)	261
Public Order and Safety	4,131 (+679)	4,754 (+432)	5,598 (+271)	5,592	262 (+36)	393 (-69)	508 (-68)	722
Local Govt.	1,137 (+278)	1,034 (+43)	1,189 (+86)	1,196	5,465 (+202)	5,037 (-672)	5,220 (+23)	6,736
Social Security & Welfare	2,420 (+81)	3,557 (+472)	5,968 (-92)	7,188	498 (-416)	1,070 (+251)	1,597 (-605)	1,694
Agriculture	3,598 (+404)	6,714 (+2,039)	8,411 (+1,451)	6,576	1,718 (-893)	1,976 (-247)	2004 (-311)	2,374

Source: *Budget in Brief* (various years).

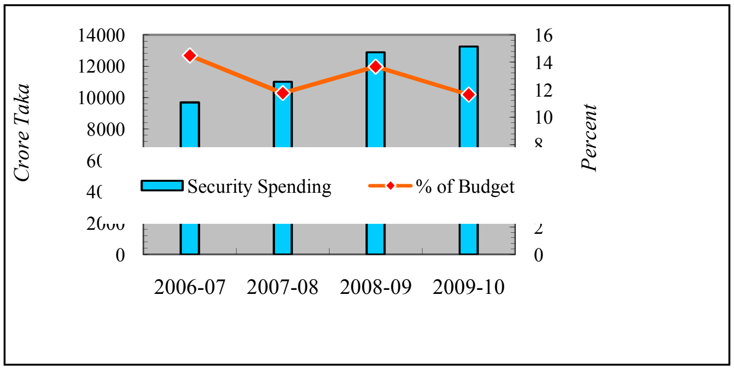
Note: [*] Revised budget other than that of 2009-10. Numbers in the parentheses are the deviations from proposed budget (+ and – indicate estimated additional spending and unused budget respectively).

We, however, retain on the analysis of budget of only defence, *i.e.*, military and paramilitary, for three reasons: (i) defence is critical in maintaining sovereignty, which is fundamental in ensuring security of the state itself; (ii) manpower of

[80] Islam *et al.* (2009), op cit.

defence forces are critical elements of some intra-security agencies; and (iii) defence budget is not available in the published sources. Therefore, budget analysis of this sector is more meaningful.

Figure 5.3: Spending on Security Sector



Source: Budget in Brief[81] (various years).

Defence budget is also one of the largest sectors of expenditure of the government. In the current fiscal year, the total expenditure is proposed to be Tk 113,819 crore. The proposed allocation on defence is Tk 6,936 crore, which is 6.09 per cent of the total budget. The other major sectors of allocation were education (12.31 per cent), agriculture with fishery and forestry (7.86 per cent), social security and welfare (7.8 per cent), local government (6.97 per cent) and health (6.13 per cent).[82]

One of the major weaknesses of the defence budget is that it overspends although most of the government departments could not spend their allocated budgets. Over the last four fiscal years, defence sector received additional allocation in the revised budget. However, it is worth-mentioning that while in all other sectors there are external assistance components, the defence budget is exclusively self-financed. A sizeable proportion of the defence budget is spent on importing armament, spare parts and fuel, which creates pressure on the external balance.

[81] Except 2009-10 all others are revised budget.

[82] Some specialised educational institutions such as cadet colleges, Military Institute of Science and Technology (MIST) and Armed Forces Medical College (AFMC) are parts of military education. However, expenditure of such institution met from Education budget.

Thus, the burden of defence falls equi-proportionately on the national exchequer (Ilahi 2008).

Another important feature of the defence budget is worth-mentioning. While there sufficient balance is maintained between non-development and development budget in important sectors, defence budget is highly skewed towards non-development budget. In FY2006-07, the share of development budget was only 2.19 per cent of the total defence budget, which was further decreased to only 1.45 per cent in 2008-09. In the current fiscal year it is slightly high, 3.76 per cent. However, since a significant proportion of development budget in defence sector remains unspent, it can be inferred that this share would be decreased at the end of the current fiscal year. This ratio is significantly higher in the other important sectors such as local government, health, and social security and welfare. Significant amount of transfer payment is made for poor and marginalised groups in the form of cash and/or kind from non-development budget for their development. In addition, agricultural subsidy comes from non-development budget of this sector. However, defence procurement is made from non-development budget, thus contributing positively to develop war capability.

TABLE 5.9

SHARE OF NON-DEVELOPMENT BUDGET IN SECTORAL ALLOCATION (PER CENT)

	2006-07	2007-08	2008-09	2009-10
Health	54.11	55.08	57.80	55.95
Education	73.86	74.75	74.79	71.70
Defence	97.81	97.01	98.55	96.24
Local Govt.	17.22	17.03	18.55	15.08
Social Security and Welfare	82.93	76.87	78.89	80.93
Agriculture	67.68	77.26	80.76	73.47

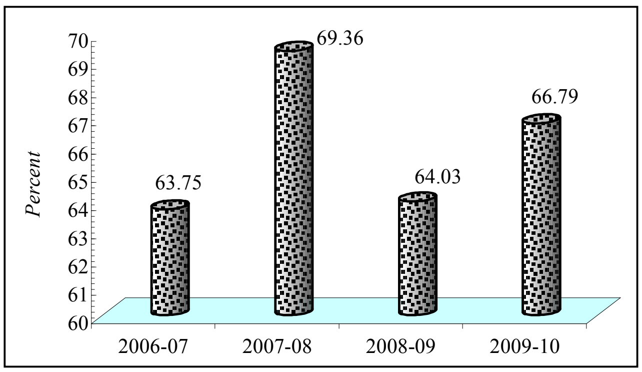
Source: Calculated from Table 5.8.

Budget by Forces

Majority of the budgetary allocation on defence is spent on recurrent expenditure, *i.e.*, salary and allowances, rations, clothing, pension, Military Engineering Services (MES) and training. Only a meagre proportion of budget is spent on strengthening the "biting" capacity. The future war will be high-tech, and short, intense and costly in nature. To fight in such an environment, there is a need for allocating substantial amount of budget in developing fighting capability.

Because of its big size (nearly 80 per cent of the total Armed Forces), the majority of the defence budget is allocated to the Army. Over the recent past, the army budget was around two-thirds of the defence budget. The majority of Army budget spent on salary and allowances (around 60 per cent of the Army budget).

Figure 5.4: Share of Army Budget in Defence Budget



Source: Authors' calculation.

The other major heads of Army budget are supply and services and procurements. The budget on supply and services though increased steadily in magnitude, its share in the Army budget remained almost constant in the recent past (around 15 per cent). On the contrary, the budget on procurement fluctuated significantly; from 10.09 per cent of 2005-06 it increased to 16.02 per cent in 2007-08, then it decreased to 8.22 per cent in the next year. In the current fiscal year it is proposed to 15.41 per cent of the Army budget. It is, however, worthwhile to mention that budget of supply and services increased by around 81 per cent in five years, while budget on procurement increased by 164 per cent in 2009-10 compared to that of 2005-06.

Although the most of the arms, vehicles and logistics are old-fashioned, the expenditure in repair and maintenance is significantly low. It is only 1.14 per cent of the Army budget in the current fiscal year. This indicates efficient use of these resources by the Army. However, the budget on construction and project work has increased steadily, from Tk 2 crore in 2005-06 to Tk 16 crore in 2009-10. This trend indicates that the future expenditure in this head is more likely to increase if the modernisation of the Army takes place during the next Five Year Plan and under the aegis of the proposed Defence Development Plan as new project works would accompany such future development efforts.

TABLE 5.10

BUDGETARY ALLOCATION FOR THE ARMY (IN CRORE TK)

Head	2005-06	2006-07	2007-08	2008-09	2009-10
Pay and Allowances	1672.94 (62.53)	2228.50 (65.97)	2418.05 (59.52)	2693.31 (62.08)	2740.43 (59.15)
Supply and Services (Pension, uniform, food, etc.)	384.03 (14.35)	492.05 (14.57)	584.25 (14.38)	682.88 (15.74)	694.65 (14.99)
Repair and Maintenance	53.29 (1.99)	33.51 (0.99)	45.36 (1.12)	50.00 (1.15)	53.00 (1.14)
Welfare Grants	1.30 (0.05)	1.40 (0.04)	1.50 (0.04)	1.50 (0.03)	1.50 (0.03)
Procurement	269.98 (10.09)	314.83 (9.32)	652.63 (16.07)	356.60 (8.22)	713.85 (15.41)
Construction & Project Works	2.00 (0.07)	8.00 (0.24)	11.00 (0.27)	14.00 (0.32)	15.00 (0.32)
Share and Equity	--	--	--	10.00 (0.23)	--
Refund of Foreign Loan	30.50 (1.14)	15.73 (0.47)	34.96 (0.86)	47.77 (1.10)	92.64 (2.00)
Total	2414.04	3094.01	3747.74	3856.05	4311.06
DW & CE	261.40 (9.77)	284.23 (8.41)	314.52 (7.74)	482.05 (11.11)	321.83 (6.95)
Grand Total	2675.45	3378.24	4062.26	4338.10	4632.89
Growth Rate (%)		26.27	20.25	6.79	6.80

Source: BIISS.

Note: DW&CE means Directorate of Works and Chief Engineer. Numbers in the parentheses represent the share in Army budget (per cent).

In the Navy budget, nearly half of the money is spent on acquisition of assets, and almost 35 per cent of the total allocation is spent on the salary and allowances of officers and combatants. Expenditure on supply and services, which includes training of the naval force, is also a significant amount—almost one-fifth of the current fiscal year's budget has been allocated to this head.

In the Navy, a total of Tk 270.12 crore has been spent to purchase weapons in FY2008-09, which is a big jump from the previous fiscal year. Most of the money was spent to purchase heavy weapons. However, expenditure on maintenance has been significant, which indicates that a notable proportion of resource is lost for maintaining weapons, equipment and ships that are mostly outdated.

In the Air Force budget, most of the money is spent on repair and maintenance. This is mainly because this force is technology and equipment oriented, and majority of which are outdated and need more frequent maintenance. The more recently procured fighter aircrafts are also costly to maintain and requires foreign experts. Extra money is also spent due to absence of overhauling facility. However, the other major areas of expenditure are pay and allowances and supply and services, respectively.

TABLE 5.11

BUDGETARY ALLOCATION FOR THE NAVY (CRORE TK)

Head	2005-06	2006-07	2007-08	2008-09	2009-10
Officers' Pay	19.70 (3.88)	20.50 (3.29)	21.30 3.12)	23.00 (2.33)	25.00 (2.68)
Others' Pay	77.00 (15.15)	86.50 (13.90)	94.00 (13.76)	103.00 (10.42)	115.00 (12.32)
Allowances	80.07 (15.75)	120.40 (19.35)	126.15 (18.47)	161.65 (16.36)	178.45 (19.11)
Supply & Services (Including Training)	91.70 (18.04)	112.79 (18.13)	112.59 (16.49)	171.60 (17.36)	122.74 (13.14)
Maintenance & Preservation	9.80 (1.93)	0.92 (0.15)	9.70 (1.42)	9.60 (0.97)	9.60 (1.03)
Asset Acquisition	230.00 (45.25)	272.86 (43.85)	319.18 (46.74)	519.50 (52.56)	483.00 (51.72)
Total	**508.26**	**622.23**	**682.92**	**988.35**	**933.79**
Growth Rate (%)		22.42	9.75	44.72	-5.52

Source: BIISS.
Note: Figures in the parentheses indicate percentage of total.

Expenditure on Training

Training is an important component and basis of war preparedness defence forces. A considerable amount of money is spent every year for general, technical and foreign training, although expenditure on general training constitutes most of the total. For the army training, it is around 98 per cent of the total training cost, which comes as a grant. Over the last five fiscal years, training cost of the Army has increased substantially. Between fiscal year 2005-06 and 2009-10, total cost increased from Tk. 161.71 crore to Tk. 613.6 crore, *i.e.*, by 279.34 per cent. The cost of technical training doubled, increase in general training cost was nearly threefold over this period (287.88 per cent). Similarly, training cost of the Navy increased nearly threefold between F 2005-06 and 2008-09. However, majority of the Naval training expenditure is made on foreign training. It indicates, on the one hand, certain degree of ineffectiveness of various training institutes for developing skill for the Naval manpower, and a source of draining valuable foreign currency away on the other. This suggests that the Navy has to upgrade and modernise its institutes for developing indigenous capacity.

TABLE 5.12

EXPENDITURE ON WEAPONS/SHIPS AND MAINTENANCE FOR THE NAVY (IN CRORE TK)

	2005-06	2006-07	2007-08	2008-09	2009-10 (Up to Nov)
WEAPON					
Small (Arms and Ammo)	4.07	18.81	1.64	34.13	0.06
Medium (Mil Hardware)	46.88	45.88	54.54	50.65	10.69
Heavy (Capital Purchase)	4.67	17.94	5.83	185.34	0.03
Total	55.63	82.63	62.01	270.12	10.77
MAINTENANCE					
Small (Misc)	0.017	0.008	0.010	0.015	0.005
Medium (Tpt)	2.097	2.099	2.343	3.497	0.006
Heavy (Ship Repair and Maint)	8.958	6.537	4.785	7.390	1.165
Total	11.072	8.644	7.138	10.902	1.176
Maintenance % of Weapon	19.90	10.46	11.51	4.04	10.92

Source: Authors' compilation.

TABLE 5.13

BUDGETARY ALLOCATION FOR THE AIR FORCE (CRORE TK)

Head	2005-06	2006-07	2007-08	2008-09	2009-10
Project Loan	352.1335 (31.61)	377.6915 (33.39)	104.4533 (11.46)	101.1553 (9.49)	90.5110 (8.75)
Pay & Allowances	185.6928 (16.67)	217.2894 (19.21)	225.0273 (24.68)	249.0350 (23.36)	257.9350 (24.92)
Supply & Services	155.8131 (13.99)	184.8305 (16.34)	202.9960 (22.26)	261.1650 (24.50)	229.8150 (22.21)
Repair & Maintenance	218.1600 (19.58)	222.2050 (19.64)	263.9810 (28.95)	269.2750 (25.26)	281.7450 (27.22)
Acquisition of Assets	143.9400 (12.92)	66.1983 (5.85)	40.5500 (4.45)	107.9000 (10.12)	92.7000 (8.96)
Total	1055.7394	1068.2147	837.0076	988.5303	952.7060
Works Budget	58.3056 (5.23)	62.9412 (5.56)	74.7939 (8.20)	77.6272 (7.28)	82.1753 (7.94)
Grand Total	1114.0450	1131.1559	911.8015	1066.1575	1034.8813
Growth Rate (%)	--	1.54	-19.39	16.93	-2.93

Source: Authors' compilation.

Note: Figures in the parentheses indicate percentage of grand total.

TABLE 5.14

EXPENDITURE ON WEAPONS AND MAINTENANCE FOR THE AIR FORCE (CRORE TK)

	2005-06	2006-07	2007-08	2008-09	2009-10 (proposed)
WEAPON					
Small (Rifle, SMG, LMG & MG)	0.38	0.06	1.08	1.48	4.65
Medium (Rocket, Aircraft Gun)	9.32	3.07	3.82	6.05	37.18
Heavy (Missile and Bombs)	2.84	..	6.29	6.91	173.40
Total	12.54	3.13	11.19	14.44	215.23
MAINTENANCE					
Small (Rifle, SMG, LMG & MG)	0.003	0.01	0.1	0.24	0.46
Medium (Rocket, Aircraft Gun)	0.151	..	0.62	0.56	0.20
Heavy (Missile and Bombs)	..	..	..	5.34	0.14
Total	0.154	0.01	0.72	6.14	0.80

Source: Authors' compilation.

TABLE 5.15

TRAINING EXPENDITURE OF THE ARMED FORCES (IN CRORE TK)

	2005-06	2006-07	2007-08	2008-09	2009-10
ARMY					
Training Grant (General)	15.47	20.25	44.19	57.24	59.99
Technical Training	0.65	0.41	1.20	1.10	1.30
Foreign Training	0.06	0.06	0.10	0.08	0.07
Total Army	16.17	20.71	45.48	58.42	61.36
NAVY					
Domestic Training	5.3	6.7	5.3	6.2	
Foreign Training	3.9	4.9	7.2	18.4	
Total Navy	9.2	11.6	12.5	24.6	

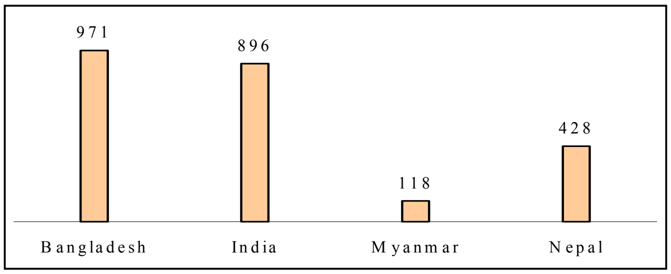
Source: Authors' compilation.

5.6.2 Measures of Adequacy and Effectiveness

According to IISS (2009), a total of 157,053 armed forces constitute defence forces of the country, which includes 126,153 Army, 16,900 Navy and 14,900 Air Force. Population per military is the highest in Bangladesh compared to its close neighbours, which indicates its least preparedness for any future threats like war.

These numbers can be compared with India and Myanmar since the military aggression is most likely to come from the country's immediate neighbours. The gap between Bangladesh's Forces and the neighbours can be a primary indicator of adequacy of human resources.

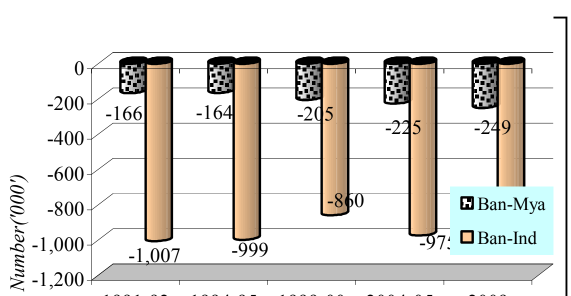
Figure 5.5: Population per Military Force



Source: IISS (2009).

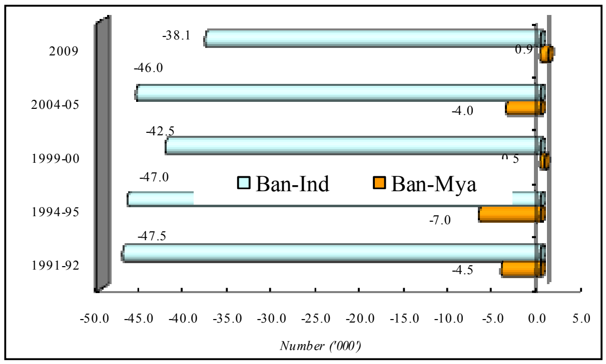
The size of the Bangladesh Army is only one-third of that of Myanmar, and 8.72 per cent of that of India. Thus, a huge gap exists if a one-to-one ratio is considered. In this straightforward calculation, Bangladesh has a little surplus compared to Myanmar in Navy and almost equal in Air Force according to the data of IISS (2009). However, huge gap exists in favour of India in both Navy and Air Force. Population per military is also the highest in this country compared to its neighbours. In particular, this ratio is the lowest for Myanmar, which indicates the best preparedness of this country in terms of human resources employed.

Figure 5.6: Gap in Human Resource between Bangladesh and its Immediate Neighbours (Army)



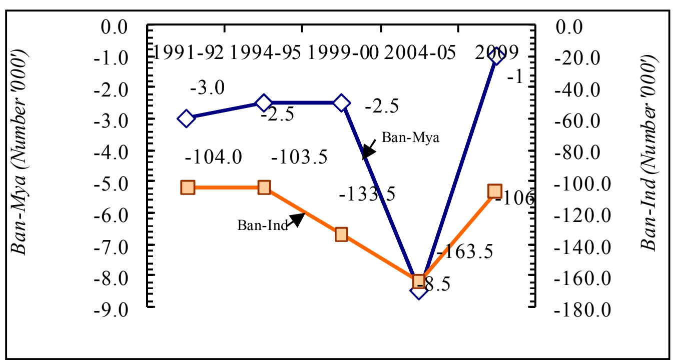
Source: IISS (various years).

Figure 5.7: Gap in Manpower between Bangladesh and its Immediate Neighbours (Navy)



Source: IISS (various years).

Figure 5.8: Gap in Human Resource between Bangladesh and its Immediate Neighbours (Air Force)



Source: IISS (various years).

Minimum Requirements

In a possible future war with Bangladesh, neighbours would not deploy its entire forces against the country. Rather, they would estimate the minimum requirement of forces, weapons and logistics to capture the main establishments in order to paralyse the entire forces of the country. In such a context, it is important to estimate the deterrence capability of the forces to sustain for a period towards drawing international attention and support through diplomatic means.

Table 5.16 presents the deficiency of manpower in the army. It reveals an acute shortage of officers in the Army, which is a quarter of authorised number and two-thirds of civil officers. Shortage is also revealed in combatants, non-combatant and supporting manpower, but here the proportion is small. Talented youths are not encouraged to join the Army as the facilities in civil and corporate professions are better than those of the military services. Furthermore, engineer battalion is extremely inadequate for implementing development activities in various parts of the countries. The Army has a serious shortage of equipment to deal with natural and other disasters, such as flood, cyclone, crash of building, etc.

Like Army, Navy too suffers from a significant shortage of officers, which is around one-fifth of the authorised number. They also lack notable proportion of non-combatant manpower. In the Air Force, the shortages revealed higher in these two categories.

TABLE 5.16

DEFICIENCY OF MANPOWER (ARMY)

Sl.	Head	Deficiency (%)
Army		
1	Officers	25.78
2	Combatant	2.86
3	Non-Combatant	2.73
Civil		
4	Officers	65.52
5	Others	8.80
Total		3.44

Source: Army Headquarters.

TABLE 5.17

DEFICIENCY OF MANPOWER IN THE NAVY AND AIR FORCE (PER CENT)

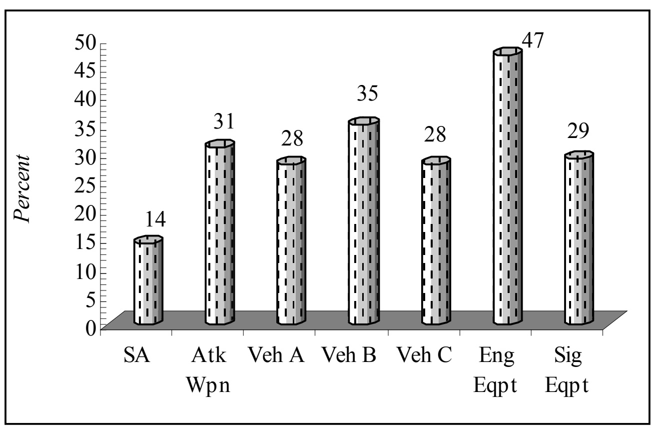
Head	Navy	Air Force*
Officer	21.79	6.46
Combatant	2.79	2.14
MODC (Navy)	0.54	0.94
Non-Combatant	16.31	9.64
Total	7.04	4.54

Source: BN and BAF Headquarters.
Note: MODC indicates Ministry of Defence Constabulary.
* As of 06 October 2009.

The Army also suffers from acute shortage of arms and logistics, which is evident from Figure 5.9. Significant deficiency prevails in all sorts of weapons and logistics, which indicates that the Army would experience serious trouble in deterring any future aggression although it would be able to provide short-term supply of some small arms by utilising capacity of the Bangladesh Ordnance Factories (BOF).

According to a report of Bangladesh Army placed to the Parliamentary Standing Committee on Defence Ministry, the defence purchase for the Army is reported to be around 6 per cent of the Army budget. Most of the weapons of the Army are from the 1960s and 1970s, which indicates an acute paucity of modernisation of the weapons. All the tanks, 90.3 per cent of small arms and 89 per cent of field artillery guns used by the army were bought during the 1960s to 1980s.[83] However, military weapons and technologies are changing very fast in the advanced world and there is no alternative to adopt the technological advancement for increasing the fighting ability of the Army against the potential threat of the huge armed forces of the neighbours as well as tackling non-traditional threats stemmed from the border.

Figure 5.9: Deficiency of Major Weapon and Equipment (Army)



Source: Army Headquarter.

Key: SA = Small Arms; Atk Wpn = Attack Weapon; Veh A= Vehicle A (Tanks and Tracked Armoured Personnel Carrier); Veh B = Vehicle B (All military vehicles); Veh C = Vehicle C (Engineer plants); Eng Eqpt = Engineering Equipment; Sig Eqpt = Signal Equipment.

[83] "More fund sought for modernising army," *The Daily Star*, Dhaka, 14 June 2009.

TABLE 5.18

EXPENDITURE ON WEAPONS FOR THE ARMY (IN CRORE TK)

	2005-06	2006-07	2007-08	2008-09
Budget sought for ammunition only	70.49	61.56	133.21	138.43
Budget allocated for arms & ammunition	1.41	68.48	79.97	43.27

Source: *The Daily Star*, Dhaka, 14 June 2009.

BN has 82 small and large surface ships in its fleet, which are mostly older than 25 years. Only 15 ships or crafts are less than 25 years old.[84] Although the cost of maintenance and preservation has been high in its magnitude, it is proportionately meagre in terms of its share in the navy budget (around 1 per cent). But the main problem is that the maintenance and operation of these ships are risky. Furthermore, BN requires special vehicles like hydrographical ships for survey in the maritime zone, landing ships for operation of disaster relief, salvage ships for rescue of vessels in the sea and a number of high-speed boats to enhance law enforcements in the sea and coastal areas. Upgrading weapons/sensors and extending life of existing ships are also required through renovation and replacement of major parts.

5.6.3 Towards Ensuring Better Cost Effectiveness

In spite of a serious shortage of arms, equipment and logistics, the Armed Forces of Bangladesh are performing very well, which is recognised internationally in the context of their skills, professionalism and overall performance in the UN peace keeping missions. The prominent presence of Bangladesh is acting as a diplomatic deterrence against any aggression. This is one instance of production of highly skilled manpower with inadequate equipment. However, in order to understand the cost-effectiveness of the resource allocation in various physical resources of the forces, it is important to assess their capacity and bottlenecks of realising the optimal output. To partially meet the requirements of weapons, logistics and supplies, Bangladesh Armed Forces possess several physical resources such as BOF, Bangladesh Machine Tools Factory (BMTF), Signal Base Workshop (SBW), Depots, Central Workshop, Khulna Shipyards (KSY), Naval Dockyards, etc.

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[84] "Navy eyes sub, new frigates: Prepares Tk 6,000cr plan to turn it into '3-dimensional' force," *The Daily Star*, Dhaka, 24 June 2009.

Established in 1970, BOF is a large defence industrial complex under the MoD. It has the following main factories: Small Arms Factory, Small Arms Ammunition Factory, Grenade Manufacturing Factory, Artillery Ammunition Factory and Tools Manufacturing Plant. It was set up with technologies, machines, equipment and support facilities initially from China and later on from Germany, Italy, Australia, Belgium and Austria. It is, however, trying to attain self-reliance on manufacturing and supply of arms and ammunitions to Bangladesh Armed Forces and enter the export market.[85] In 1 January 2008, a new Small Arms Factory has inaugurated its production, with a capacity of producing 10,000 rifles a year. Recently, the Parliamentary Standing Committee on Defence expressed satisfaction on the overall performance of BoF.[86]

Managed by Bangladesh Army, BMTF is one of the largest state owned enterprises, which was established in 1969 and commissioned in 1979 due to various difficulties in the management aspects. Under the present capability, it is well-equipped with a variety of high production machineries and equipment for various engineering products. It has basic production facilities like casting, forging, machining, heat and surface treatment, etc. Bangladesh Army can meet many of its requirements from BMTF such as materials and equipment for combat supply, mobilisation and communication stores, engineering equipment, certain general supplies. It has good prospects for products and services for local and foreign markets.[87]

In order to realise the potential of the Factory, the future avenue of development can focus on the following:

- Assemble and manufacture of ICT based products for military and civilian use such as wireless and mobile phone sets; computer hardware, instant power supply (IPS) and uninterrupted power supply (UPS); vehicle and parts; armament and parts; heavy calibre ammunition; anti-tank and anti-aircraft missile; treatment plants and emission control equipment, etc.
- Manufacture various ammunition; measuring tools; target locating devices; shifting equipment for firing range; parts for fire control equipment; armament and motor vehicle parts; generators and pumps; and other defence equipment according to its capacity.

SBW was established in 1976 to carryout base repair of Signal equipment. It, however, has not performed later on as expected due to mainly financial support and

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[85] http://www.bof.gov.bd. accessed on 18 December 2009.

[86] "JS team visits ordnance factory", *The Financial Express*, Dhaka 21 August 2009.

[87] http://www.bmtfbd.com. accessed on 20 December 2009.

equipment. Initiative has to be taken to finance and equip this Workshop to attain desired level of output.

The Army has three central depots: Central Ordnance Depot (COD), Central Ammunition Depot (CAD) and Central Mechanical Transport Depot (CMTD). COD can be engaged to produce various items of general stores and clothing for the Forces. CAD can produce hand grenades, while CMTD can produce batteries.

With technical and financial support from China, 902 Central Workshop of Bangladesh Army commenced its journey in 1992. This Workshop can take on base repair and overhauling of 50 tanks, and overhaul field and air defence guns per year. Furthermore, it can manufacture a wide range of parts for tank haul, tank engine and armament. Although the Workshop has got huge capacity, it lacks innovative ideas and direction to derive optimal level of output. Also, it can be engaged to manufacture and assemble heavy vehicles.

KSY was established in 1954 with the objective of building and repairing various river crafts. Now it is taken over by BN and being involved in building civilian crafts as well (*e.g.*, over bridge in the cities). The capabilities of the Shipyard and Naval dockyards can be utilised in making or assembling gunships and for civilian development purposes.

Defence expenditure of the country continues to be the lowest compared to the immediate neighbours. Despite various constraints in terms of physical resources, the Forces earned impressive recognition of efficiency and professionalism in international arena over the years. As the entire defence expenditure is financed domestically, it must be well spent for ensuring efficiency. Thus, the defence expenditure has to be the "Peace and Security Dividend" towards attaining sustained economic and social progress.

As because of confidentiality the finer details of the defence budget remains a matter exclusive to the military, its broad heads can be made public so as to make the ordinary citizens part of this budget through raising constructive voice. In fact, people's participation in defence budgeting would enhance their rights since they pay taxes for defence financing.

5.6.4 Using Technological Advancement for Defence System

In the technological surfance of Bangladesh Army, there are computers at headquarters and division/ formation level. The automation has come in but it is not in operation at battalion or field level. The principal information technology at field or unit level is telephonic instruments. However, global positioning system (GPS) is in use but it is mostly utilised in finding locations and targets in the forces.

Amongst the forces, Navy and Air Force are mainly technology and equipment oriented. For almost one decade, there is no addition of modern aircraft and frigates or vassels. Many aircrafts are now outdated and have become obsolete, but no procurement is taking place to replace those with new generation aircrafts with modern gadgets.

5.6.4.1 Army

A set of practical problems stand against the way to adopt technological advancement of the Army. These include acute shortage of fund for defence purchase, outdated weaponry, shortage of equipment and manpower, inadequate number of engineer plants, and insufficient facilities offered. In addressing the problems, Bangladesh Army planned the "Forces Goal 2020,"[88] a set of goals outlined in 2004 for the modernisation of the Army in accordance with Bangladesh's economic reality. Accomplishing the goals would help plug the Force's organisational shortcomings and increase its operational capability. Bemoaning the fact that, the lack of fund is making the targets harder to attain, the Army maintains that the government should approve the "Forces Goal 2020" in principle. In response to the demand, the government is willing to restructure the country's defence system to ensure security of the country and the people and continue to improve defence capability. The Finance Minister has also announced in the budget speech that enhanced provision in terms of higher training, modern military hardware and other facilities for the Army will be provided, so that it can be fully prepared to face the challenges of the 21st century.[89]

5.6.4.2 Navy

Problems that stand against the way to modernisation of the BN include inadequate fund for replacing old frigates and vessels and missile boats; ever-decreasing combat capability of old ships and ever-increasing maintenance and operation cost of the ships; inadequate manpower; lack of naval bases and training institute. By 2020, BN is planning to implement an ambitious ten-year plan to upgrade it into a three-dimensional force by introducing new frigates, a submarine, maritime patrol aircraft, helicopters and other equipment. By 2010, BN would like to have the second dimension, *i.e.*, Naval Air Arm with the inclusion of 2 Agusta Westland 109E helicopter. The Submarine procurement project will commence in

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[88] All the three services of Armed Forces have planned "Forces Goal 2020" initially at the services level and then coordination amongst the services has been done at the AFD. However, this is yet to be agreed by the Government.

[89] *The Daily Star*, Dhaka, 14 June 2009.

the year 2015, which will be its third dimension. The Navy plans include purchase of three frigates, five large crafts, 12 patrol crafts, two landing craft utility, one hydrographic unit, one salvage vessel, four missile boats and installation of new missiles in some ships to strengthen its surface fleet. As per the plan, three large patrol crafts and 12 patrol crafts will be built at the Navy's own shipyards. The Navy also has a plan for purchasing a submarine by 2019 for the flotilla. Before purchasing the submarine, steps have already been taken to build infrastructure and train up personnel. However, the plan/proposals now await the government's consideration. Based on the possible allocation of fund every year, the Navy expects that the process of purchasing and building surface and aviation platforms to achieve three-dimensional ability will continue.[90]

5.6.4.3 Air Force

Problems that stand against the way to modernisation of the BAF include lack of budgetary allocation. In defence of purchasing new equipment, the BAF is facing tremendous difficulties in playing due role with the aged aircraft. To overcome the drawbacks, BAF is planning to urgently purchase one squadron of fighter trainer aircraft and simulators for fighter planes and helicopters, and set up overhauling plants for the existing F-17 fighter planes and MI series helicopters. It has prepared long-term plans for major defence purchases by 2020 and beyond to modernise the Force. The plans include purchasing of air defence radars and surface-to-air missile systems, replacement of A-5, FT-5 and F-7 fighter planes and induction of aircraft. After 2020, it wants to begin purchasing aircraft in phases to form three air defence squadrons. In defence of the plans, BAF demands a five-layer strong air defence system to protect its airspace from enemy air attacks. Therefore, the planning of BAF is to prepare, operate and maintain an air force capable of projecting air power in order to uphold and promote national interest. Consequently, the Air Force is proceeding with the dream to build a digital air force.[91]

5.6.4.4 Technological Advancement and the Armed Forces in the Future

Scientific and technological breakthroughs have shifted the focus of warfare from territorial conquests or mass destruction to paralyse the enemy's intelligence capabilities and striking its centre of gravity. Surveillance and reconnaissance capabilities, automated command or control or communication systems, long-range strike capabilities against deep targets and mobility superior to those of the adversarial forces are the keys to such new types of warfare. It is, therefore, an

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[90] *The Daily Star*, Dhaka, 9 August 2009.
[91] *The Daily Star*, Dhaka, 24 June 2009.

imperative for Bangladesh to establish military capabilities to deter such threats. At the same time, it needs to gradually develop core military capabilities to tackle unanticipated threats which may have to be faced in the near future.

The new generation technologies should be adopted in the forces to remain updated and relevant. Affordable some of the equipment should be state of the art and manpower should be trained accordingly to operate the modern equipment. The human resource should be developed technologically so that work force is always available to adapt to modern system when opportunity arises to induct those. The armed forces should also be digitised to maintain the defensive capability against information warfare. Modern technologies such as computers, internets, satellites and remotely piloted vehicles have been replacing the conventional weapons. Future wars will most likely be on different planes altogether, involving exploitation of the information spectrum. Developed countries will obviously take advantage of such technological breakthroughs in modifying their operations. Bangladesh should also build information warfare structures as far as consistent with the current capabilities.

Cyber security is very important in information warfare. Psychology based operations affect soldiers. It also proved to be effective in getting cooperation from the common population of the conflict ridden country. The print as well as the electronic media play very important role in this kind of warfare. The modern techniques of cyber security use data mining, artificial intelligence, nanotechnology, stenography, strong encryption methods, and security surveillance, etc. The cyber security can be breached by programmes like virus, logic bomb, worm, chipping hard-kill, soft-kill, etc. These are to be taken care of by the armed forces while such techniques are adopted. In defence digitisation, the objective should be to establish an integrated information system that enables the sharing of information and knowledge both in war and peace as well as real-time distribution or utilisation of such information and knowledge, ensuring interoperability between the battlefield management information system and resource management information system.

5.6.5 Rational and Effective Use of Resources

5.6.5.1 Human Resource

Contemporary military ethics is based on two principal elements: its relationship with the society and relationship with the existing politico-economic institutions. The defence forces in Bangladesh are being deployed in maintaining internal security as well as supporting development activities. Their skill, discipline and quality can be utilised for development and humanitarian activities vis-à-vis performing primary duty: maintain sovereignty and territorial integrity of the country.

In relation to performing primary duty, the armed forces took part in various socio-economic development activities in the past which can be positively taken into account towards making a coercive effort in socio-economic development of the country. For more effective use of defence forces, the following are the avenues of their potential engagement.

They can be employed in socio-economic, infrastructural and environmental development. However, since all the problems cannot be dealt simultaneously, they can be mainly engaged in selected sectors such as social development, infrastructural development and management, and protecting natural environment.

In the area of social development, the Forces can take part in the literacy programme. One of core commitments of the present government is to remove illiteracy from the country by 2014, which is a huge task for the government to make reality. The Forces can be involved in this important task as a facilitator. Family planning, water and sanitation would be the other areas of their active engagement.

The Forces can undertake construction works in transport and communication and their management, especially where they have comparative advantage. They have some examples of profitable entrepreneurship such as Sena Kalyan Sangstha, and Trust Bank, which are contributing significantly to the economy through employment generation. Multipurpose enterprises in the defence sector such as BMTF can be diversified towards producing general consumption items for the forces as well as civilian purposes.

They can be actively engaged in the environmental preservation as the contemporary Bangladesh is heavily emphasising on how to cope with the global climate change. In this context, the forces can be mainly involved in preserving and developing the existing forestry and afforest the coastal areas which are heavily vulnerable to global warming.

Construction and repair of embankment is one of their areas of demonstrated experience. These can serve against flood shelter and salinity in the coastal areas. The experience of river taming in Sirajganj can also be utilised to protect towns and villages, and support irrigation.

The forces have proven track record in lending hands during any disaster within the country. They actively took part during devastating floods and cyclones through humanitarian intervention, and reconstruction and rehabilitation works after such calamities. Also, they were engaged in other disasters like collapse of Spectrum garments building at Savar. Various forecasts reveal that Bangladesh would awfully experience frequent natural disasters in the future due to climate change. As the armed forces are sufficiently capable and experienced in disaster preparedness and management, they can be equipped with further training and logistics in this task. Proper engagement of the forces would substantially reduce adjustment costs of climate change.

5.6.5.2 Physical Resource

BOF is positioning itself to attain self-reliance on manufacturing and supply of arms and ammunitions to Bangladesh Armed Forces and to join the export market. BOF has the ability to conduct following tests:

- mechanical testing (it conducts tensile, compression, impacts bend, cupping and hardness tests for metallic materials from 0.5 ton to 30 ton capacity. All standard loads are available in hardness for vickers, brinell and rockwell);
- physical testing (it determines the density, viscosity, ash content and distillation range for various organic chemicals and substances, which include mineral, and vegetable oils, shellac, soap, paper and card board); and
- metallographic analysis (it facilitates to analyse the micro and macro structure of metallic materials to determine structural details).

On chemical analysis, BOF has the facilities to determine chemical composition of metals/alloys (ferrous and non-ferrous) and other materials through conventional wet analysis as well as instrumental techniques such as colourimetry and spectrometry. It has the facilities to determine full composition of lead, iron, copper and aluminium metals by optical emission spectrometer. It has induction furnace for melting any kinds of metallic material which conducts electricity. It has the ability to manufacture different types of spares of material, such as cast iron, mild steel, high manganese steel, alloy steel and different kinds of stainless steel and non ferrous alloys. BOF offers other services. These services comprise of repair and calibration of thermoelectric pyrometers, calibration of hardness testing machines, production of phosphate solutions, and production of silver vanadate for carbon determination.[92]

BMTF is equipped with variety of high production machineries and equipments for various engineering products. It has basic production facilities like casting, forging, machining, heat and surface treatment, etc. It has thirteen large production shops along with administrative building, training school, residential area, etc. The mechanised foundries of BMTF are the largest in Bangladesh having a combined

[92] See http://www.bof.gov.bd/service.html accessed on 23 December 2009.

output of about 5,000 tons per year.[93] Typical products include electric fan parts, auto and motorcycle spares and bicycle parts, etc. The tool room products are electric line hardware. Forged products are line hardware and open ended spanners, railway components, and perforated steel plank. BMTF has a rich machine shop, equipped with all general and specialised machines.[94] The specialised machines enable BMTF for production of all kinds of gears, drills, taps and turning tools. The total capacity that can be generated is about half million machine hours per year. The surface treatment plant of BMTF is capable of almost all kinds of surface treatment. BMTF produces different products like vehicles (vehicle assembly line, cabin installation of truck, assembled and manufactured truck, assembled jeep, and assembled pick-up); special vehicles (ambulance, prison van, mobile workshop van, fuel tanker, water trailer); tools and cutters; gears; special gear testing machines; machine tools; and others.[95]

KSY is specialised in the field of new building and repair of ships, marine services and manufacturing of various engineering items. It constructs and repairs various types of ships and craft, *e.g.*, tugs workboats and other commercial craft. It is currently committed to the design and new building of a wide range of tugs, workboats and other specialised vessels and cargo vessels with a dead weight of 2,000 tons.[96] Along with ship building and repair, it is providing its technical support to various industries such as jute mill, textile mill, sugar mill, cement factory, power sector, etc. for repair, maintenance and fabrication of their vital machinery. In addition, recently it has manufactured foot over Bridge in Dhaka and a lot of wastage containers for Dhaka City Corporation. It is capable of new building and renovating ships of various types e.g. patrol crafts, cargo and passenger vessels, launches, oil tankers, workboats, tugs, dredgers, explosive barges, self-propelled barges, pontoons, LCT, etc. having maximum light and dead weight of 700 and 2,000 tons respectively. It is equipped with modern machinery that facilitates all sorts of steel and aluminium works of intricate design. It has the capability to install ship's system and top of the range marine equipment for any onboard function. Again, repair and renovation are the most normal activities at KSY, which has so far repaired over 1,800 vessels; out of these, about 50 per cent were man of war. [97]

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[93] See http://www.bmtfbd.com/ accessed on 21 December 2009.

[94] See http://www.bmtfbd.com/products1.html accessed on 21 December 2009.

[95] See http://www.bmtfbd.com/facilities.html accessed on 21 December 2009.

[96] See http://www.ksybn.com/ accessed on 20 December 2009.

[97] http://www.ksybn.com/YardFacilities/DesignAndPlanning.aspx accessed on 20 December 2009.

The other major physical resources are BN Dockyard, SBW, Depots, and Central Workshop. The physical facilities installed in these resources are indeed enormous, and there are scopes to generate significant revenue from domestic and foreign sources by selling their products and services. Currently, the BMTF and KSY mainly supply products to military and para-military forces and state owned enterprises. However, it can undertake joint operation and marketing with the private enterprises and multinational ventures. This will certainly ensure the utilisation of excess capacity, and improve skill of its manpower through knowledge spill over. Furthermore, they can play an important role in mobilising resources for financing expenditure for the armed forces.

5.7 MOVING TOWARDS MORE EFFICIENT CNS IN BANGLADESH

5.7.1 Strategic Measures and Policies

Given that security, as a concept, is an evolving process, Bangladesh's national strategy should be an overarching plan of action. It should include those elements that is influenced and shaped by national interests, national objectives and national policy. These interests and objectives need to be related to the country's national security, foreign policy, social, economic and political milieu. Seen thus, Bangladesh's national strategy cannot and should not be uni-dimensional as the sources of threat affecting Bangladesh are varied and multidimensional. As national strategy presupposes an all encompassing policy, and as goals of strategy are dictated by policy, Bangladesh should have varied strategies such as national military strategy, national foreign policy strategy, national socio-economic strategy and national political strategy. Combination of all these facets of strategies will be the basis of a CNS strategy of which defence is one facet. Hence, an *integrated* approach must be adopted to move towards more efficient CNS strategy in Bangladesh. Given detailed discussions done throughout the report, here an attempt has been taken to tease out a set of strategic measures and policies. These include the following:

a) As a nation-state Bangladesh's core values are to be identified and national consensus are to be developed on such issues. To identify the core values of the nation, a public debate involving representatives of different sections of conscious citizens may be a useful exercise.

b) A comprehensive assessment should be conducted regarding the country's security environment at the highest level. The assessment should identify both traditional and non-traditional security threats. Based on the assessed security environment of the country, national security objectives should be re-defined and an elaborate national security strategy formulated, which will blend all power (political, economic, diplomatic and military) of the nation during peace as well as wartime to attain national interests and objectives.

c) In light of the national security strategy, military strategy to be formulated and an appropriate national defence policy published. The developments of Armed Forces, in order to protect the country's independence, sovereignty and territorial integrity, should be based on this *formally published or written defence policy*.

d) Taking into consideration the overwhelming challenges posed to the state by NTS issues than that of the traditional threats, an elaborate and comprehensive internal security strategy may be immediately formulated and taken to execute the strategy.

e) Keeping in view Bangladesh's continued response to the call of the UN in Peace Support Operation to maintain peace and harmony in the world, Armed Forces involvement in the national development activities including their deployment in the CHT, the option for a smaller size than that of the existing one would be unmanageable and compromise with their operational effectiveness. However, due to the increased demand of other non-military sectors and country's economic condition, there should be no quantitative expansion but qualitative development and modernisation of the existing armed forces should continue.

f) The Armed Forces development and modernisation should continue in a sustained manner matching Bangladesh's ground economic realities. A phased approach in a time frame of 10-15 years should be considered for achieving the Armed Forces modernisation goal with the first priority to fill up the deficiencies of the existing manpower, weapons and equipment. Bangladeshi troops engaged in the UN peacekeeping missions should be provided with necessary arms, heavy vehicles, military gears and other support so that they are considered well-equipped and dynamic. Steps should be taken to encourage talented youths to join the Armed Forces by making the military service attractive by increasing facilities in terms of salaries and other benefits including service security.

g) Arrangement should be made to create an increased number of trained manpower in the Armed Forces for implementing development activities in different parts of the country. Various types of modern equipment to deal with natural disasters like flood, cyclone and earthquakes should be procured on priority basis. These equipment may be procured by the concerned ministries and handed over to Armed Forces for their maintenance and appropriate utilisation in time of need.

h) Besides playing their assigned primary role, the para-military and auxiliary forces of the country must be in a position to augment the effort of the Armed Forces in combating the external threat. Therefore, the para-military and auxiliary forces capabilities are to be strengthened in terms of weapon, equipment and appropriate training. They should also have peacetime affiliation and training together with the Armed Forces.

i) A policy for the creation and maintenance of an operational reserve should be worked out in order to mobilise them rapidly in the event of an external aggression and sustain the conflict. It should develop the capability to expand rapidly in time of crisis. The able bodied population who can be easily turned into soldiers should be exploited up to maximum level by blending UW with conventional one.

j) Development and defence should complement each other. Therefore, security considerations and defence needs should be brought under the development planning to reduce the tangible burden on the country's economy and also make optimum utilisation of the Armed Forces. The range of Armed Forces nation building and development activities can be extended further and their capability should be exploited to the maximum.

k) Effort of all the intelligence organisations of Bangladesh should be coordinated at the highest level by the NCIC. To enhance their efficiency and operate as effective organisations, the intelligence organisations should be provided with appropriate equipment, have access to technological advancement and trained in a sustained manner. Their effort should be focused only on national interest instead of political gains of the party in power.

l) Defence reserve fund has to be created so as to ensure a regular flow of fund for modernisation of Bangladesh Armed Forces. It, however, should not be in the form of block allocation, for which an adequate auditing or oversight is not possible. Rather, it has to be made a part of the budget, either in revenue budget as an endowment fund or in development budget as a development fund, for the defence sector, as national security is considered an integral part of development, and hence be seen as a public good tailored to the well-being of the public.

m) The government should have a sound policy of allocating resources in case of a lack of rigorous, transparent and participatory planning for development of defence sector. Such plans should ideally consider the possibility of alternatives, and the costs and risks attached to them. If that sort of planning exercise takes place, it becomes more rational and easy for the highest political leadership for enhanced and sustained budgetary allocation for this sector with greater support from various sections of the society. Quality of decisions is also enhanced in this process.

n) As indicated earlier, there is a need for synergy with the other relevant sectors for a robust and cost-effective development of the defence sector. For that to happen, a satisfactory mechanism to ensure coordination with the other sectors of national planning of the country is needed. Put specifically, a strong effort is required to coordinate with other related sectors such as inland water transport, ports and shipping, civil aviation, science and ICT, etc. towards optimising the value for money allocated on security sector.

o) The traditional defence planning is strictly confined within the defence forces and tends to be equipment-centric rather than capability-based. In this view, modernisation of defence is perceived to be mostly the acquisition of arms, ammunition, equipment and logistics, but not necessarily the relevant capabilities for a wide range of non-traditional threats. The security system of Bangladesh, particularly the defence sector, needs to adopt the capabilities-based approach (CBA) by looking at complete capabilities rather than discrete equipment and make choices among alternative capabilities to address the same threat or a set of threats. This approach focuses on outputs and outcomes instead of inputs by considering the costs and benefits of each alternative to select the most cost-effective alternative that meets the same objective. The CBA should also take into account the following:

   - total cost of owning and maintaining a capability
   - life-cycle costs of the capability involved
   - abandoning, over time, capabilities no longer required
   - rigorous intra- and inter-service prioritisation

p) In future, however, military forces would be required less for conventional inter-state conflicts but more for unanticipated events and shocks, which implies the need for flexible and broad-based capabilities.

q) The country depends heavily on foreign sources for defence equipment. Self-reliance in defence is a necessary condition for strategic autonomy. Advanced strategic technologies and systems are also not readily available all the times. Even foreign sources cannot be fully relied on for uninterrupted supply of weapons and ammunitions during the period of conflict. As military capability depends on strategic technologies, investment, in defence production as well as research and development, needs to be enhanced.

r) An important aspect of the security sector is to develop human resources for its various forces. In Bangladesh, the defence sector is regarded to be manpower-intensive. Regarding training for non-traditional warfare, the manpower should be trained and equipped for a wide range of tasks to address unanticipated events and threats which are non-traditional in nature.

s) Strategy to attract, train, support and retain the appropriate persons in the defence forces should have the element of assessing the capabilities needed for the missions and tasks and what changes are required, keeping in mind the potential impact of adoption of technological advancement.

5.7.2 Recommendations for the Sixth Five Year Plan (2011-2015)

1. Taking the cue from the preceding set of measures and policies, it can be asserted that to evolve an integrated CNS strategy involves a well-coordinated and well-concerted action plan of various concerned agencies of the government, which will have to act jointly with efficiency and vision to move towards evolving an integrated CNS strategy. Since this will entail much time and a lot of homework and political, military, and diplomatic leaderships, therefore, this paper suggests it as long-term[98] policy recommendation. To move towards that direction, intense diplomatic and political negotiations should be carried out to promote regional and international cooperation and forge regional and international partnerships with the friendly countries willing to transfer technology and software to Bangladesh by shouldering costs of Bangladesh government to help it in evolving such a CNS strategy so that the CNS becomes cost-effective.
2. As a corollary to it, this paper suggests to start off the ground work preparation for the CNS strategy by concerned government agencies as a short to medium term policy recommendation. Funding for starting such ground work preparation may be explored from the willing foreign partners. Such cooperation and support will make it also cost-effective in that it will not have any impact on national exchequer related to defence budget.

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[98] Unless otherwise stated the time frame mentioned in the recommendations for the Sixth Five Year Plan will convey the following meaning: (i) Short term 1-2 years; (ii) Medium term 3-5 years; and (iii) Long term 6-15 years.

3. The paper suggests the Ministry of Defence, which will exclusively remain responsible for defence affairs of Bangladesh and will supervise defence affairs and will work independently under a separate and an independent Defence Minister as practiced in other democratic countries. This is suggested as short to medium term recommendation. This Ministry will remain accountable to the Parliament vis-à-vis its all action plan and procurement policies. This will ensure total transparency and accountability and therefore Parliament will remain as a watchdog against any corruption and misappropriation of fund and inappropriate defence procurement. This will save the national exchequer, thereby making enhancement of national security cost-effective.
4. Short, medium and long term recommendations exclusively related to modernisation of Bangladesh Armed Forces to sustain its qualitative development are given below:
5. For home-grown and cross-border terrorism, this paper recommends short-term, medium-term and long-term strategies. Since the government (s) solely cannot address these two types of terrorism, the short-term recommendation is that the government, in conjunction with the religious leaders, academics, and civil society organisations, will map out a counter terrorism strategy with all possible local intelligence to address home-grown terrorism. The medium-term recommendation in this respect is to go for extensive reforms for *Qwami Madrashas*' curriculum to bring it in line with modern ethos and national mainstream so that nothing is taught in such institutions that inculcate wrong conception about jihad and religious militancy. Forging partnership such-act jointly with the willing foreign friendly countries which have already demonstrated to help Bangladesh in this respect will be fully capitalised. In this regard the long-term recommendation will be to streamline the concept of the regional Task Force on terrorism as proposed by Bangladesh Prime Minister Sheikh Hasina. For this to occur, intense diplomatic and political negotiations should be led by SAARC member states to create a common mindset to operationalise the concept. The Bangladesh government should take the lead to bring other regional countries in a common line so that ground works could be started. It is possible to create a SAARC fund exclusively for this regional Task Force in which the UN should come forward to contribute as it has adopted the UNGCTS in September 2006.
6. Border security has become a growing concern of international security, let alone Bangladesh. The recommendation here will be, as mentioned, to view border security as an *overall homeland security* in that it itself involves

various facets. Here the short to medium-term recommendation at the intra-country level will be to establishing an IBMW by the Bangladesh government under the Ministry of Home Affairs. This IBMW must have its DBM with BADP to promote security and development among the bordering people. BADP should become a part of the Five-Year Plan, making BADP truly and meaningfully operationalised. Furthermore, the paper recommends as a short to medium term recommendation, as mentioned, to set-up a *border hat* (market) by closing the cattle corridors to combat cross-border smuggling and other organised crimes. As long-term recommendation, this paper also suggests, as indicated, to evolve, at the inter-country level, the concept of an IBM which has been modeled after the European experience. As discussed, both Bangladesh and India and SAARC as a whole will be able to get better insight and assistance in the field of raising an IBM infrastructure if SAARC collectively and Bangladesh individually share and utilise OSCE's experience about the matter, forging OSCE-SAARC partnership and cooperation and seeking fund from the willing partners will help to evolve the concept. Institutionally, establishing a "Joint Border Research Centre" undertaking various security and welfare-oriented programme could be suggested as medium to long-term recommendation.

7. The short-term recommendation to address piracy will be to undertake concerted steps by the local government apparatus to create opportunities for aggrieved local people by giving them necessary legal backing to file their complaints in the form of General Diary Report (GDR) at the police stations. The medium to long term recommendation to address piracy will be the setting up of adequate number of coastal police stations and the deployment of adequate number of coastal police equipped with special modern training, weapons and fast moving vessels. Once these are done, it will make the local administrative authority robust and functional, enabling it to face challenges and attacks from pirates who possess modern weapons and fast moving vessels. Simultaneously, exclusive Coastal Rapid Action Battalion (CRAB) stations should be established to support the coastal police forces to curb piracy-related security threats that have endangered the lives of coastal fishers. Once such infrastructure is built and reinforced, it will give a much-needed fillip to address the security problems related to coastal fishers and coastal zones, ensuring their minimum level of developmental well-being. These, in turn, will help to enhance coastal security management, especially related to coastal insecurities originating from the incidences of piracy and organised crimes such as robbery and

theft.[99] Added to these, to undertake intense negotiation as efficiently as possible with the USA (and other like-minded states willing to be a party to such patrolling) which has shown strong willingness to support and cooperate for crafting a *joint maritime patrol strategy* to combat sea piracy and other sea-related crimes in Bangladesh sea areas. To explore this will be a short to medium recommendation–a recommendation which will lessen the burden on our national exchequer related to defence spending, thereby making our national security strategy in this respect cost-effective.

TABLE 5.19

STEPS FOR SUSTAINED DEVELOPMENT/ MODERNISATION OF BANGLADESH ARMED FORCES

Services	Timeframe	Steps for sustained development/ modernization
Bangladesh Army	Short-term	□ Downsize the deficiency in terms of weapon and equipment.
		□ Weapon and equipment for troops deployed in UN Peacekeeping Mission.
	Medium-term	□ Downsize the deficiency in terms of manpower.
		□ Infantry battalion's anti-tank, surveillance and intelligence capabilities.
		□ Night fighting capability for infantry, armour and division support elements.
		□ Automation of field formations and units.
	Long-term	□ Battlefield air defence capability.
		□ Mechanisation of a brigade element with amphibious capability.
		□ Rapid response capability against heliborne threats.
		□ Improved firepower (tank, field gun and anti-tank guided missiles).
		□ Bridging and gap crossing equipment, fast moving crafts and LCT.
		□ Limited Electronic Warfare capability.
BN	Short-term	□ Downsize the deficiency in terms of weapon and equipment.
		□ Weapon and equipment for troops deployed in UN Peacekeeping Mission.
		□ Life extension (replacing Engine, Generator and Hull/Structure) of existing ships.

(Cont. Table 5.19)

[99] BIISS already broached such ideas in its yearly national security report. On this point, Islam, Ahmed and Bhuiyan (2009).

	Medium-term	□ Downsize the deficiency in terms of manpower. □ Weapon/Sensor up-gradation (missile, Gun, Torpedo, Radar, Sonar and EW systems). □ High speed boats.
	Long-term	□ Replacing aged surface platforms with the modern combat capability. □ Three dimension capability with the inclusion of naval air arm (helicopter and Maritime Petrol Air Craft) and submarine. □ Platforms with air defence capability. □ Specialist ships capability like, Mine Swiper, Hydrographic Ships, Landing Ships and Salvage Ships.
BAF	Short-term	□ Downsize the deficiency in terms of weapon and equipment. □ Weapon and equipment for troops deployed in UN Peacekeeping Mission. □ Enhancing operational capability of the air bases.
	Medium-term	□ Downsize the deficiency in terms of manpower. □ Enhancing overhauling and maintenance capability.
	Long-term	□ Replacing aged air crafts with the modern combat capability and avionics. □ Induction of surface-to-air missile systems. □ Enhancing EW capability (induction of aircraft for airborne early warning and enhancing air defence radar capability). □ Enhancing maritime air operation capability.

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