

Impact of Government Policies on Economic Development in Bangladesh

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Abstract

An analysis of the impact of government policies on economic development is very important for further policy decision. This paper attempts to analyse such impact in the context of Bangladesh for the period of 1972-2015. It is observed that the government policies in Bangladesh drastically shifted from socialist to market-oriented economic system in the mid-1970s that emphasised on private sector-led export-oriented industrialisation strategy, instead of public sector-led import substitution industrialisation strategy. Governments provided lots of facilities to the industrial sector including duty free import of industrial raw materials and machinery. As a result, the share of industrial sector in GDP increased largely from 10 percent in 1973 to 32 percent in 2015. The GDP growth increased gradually from around 3 percent in 1973 to above 6 percent in 2015. The inflation rate significantly reduced from around 54 percent in 1973 to around 6 percent in 2015.

Keywords: Government Policies, Import Substitution Industrialisation, Export-oriented Industrialisation, Privatisation, Trade Liberalisation, Economic Development.

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Views expressed in this paper are author's own and not necessarily reflect the views of Bangladesh Bank.

1. Introduction

The economy of Bangladesh was largely dependent on agriculture, immediate after the Independence of the country in 1971 and the share of agricultural sector in Gross Domestic Product (GDP) was 55 percent in 1973. But the agricultural sector of Bangladesh was highly dependent on natural processes and affected by the natural disasters like floods, cyclonic storms, tornados, river erosions, landslides etc. As a result, GDP growth was very low (3.3 percent in 1973) and the inflation rate was very high (54.2 percent in 1973) in the initial years after Independence. During that period, the country was highly dependent on imported goods mostly financed by foreign aid, as the export base was narrow and workers' remittances were insignificant.

The economy has significantly improved over the years in terms of GDP growth, inflation and external balance. Since the mid-2000s, GDP growth has generally been above 6 percent and above 7 percent from 2016, while average annual inflation has been below 6 percent from 2016. Import coverage of exports has been increased and the dependence on foreign aid has been reduced over the years. Thus, exports' share in total trade increased from 34.5 percent in 1973 to 41.8 percent in 2015. Trade openness, which is usually measured by trade-GDP ratio, increased from 13.2 percent in 1973 to 41.3 percent in 2015. Foreign aid (loans plus grants) as percent of GDP reduced from 6.9 percent in 1973 to 1.8 percent in 2015. Bangladesh graduated from lower income group to lower-middle income group in 2015 and will overcome Least Developed Country (LDC) status by 2024 if the current status of Gross National Income (GNI) per capita, Human Assets Index (HAI) and the Economic Vulnerability Index (EVI) prevail for the next six years.

The economic condition of Bangladesh has improved over the years due to the expansion of both industry and service sectors for which the role of government policies were very significant. Therefore, it is very important to analyse the government policies and their impact on Bangladesh economy which would be helpful for further policy decision. But there are relatively few studies that have rigorously analysed this issue. This paper aims to fill this gap by analysing the economic policies and their impact on different sectors of Bangladesh economy during different political regimes in between 1972 and 2015.

2. Government Policies during Different Political Regimes

Policies of successive governments in Bangladesh have reflected the ideological orientation and political interests of the ruling party as well as demands of the prevailing environment. Thus, the Awami League under the leadership of Sheikh Mujibur Rahman (1972-1975) shaped its policies to conform to the principles of nationalism, democracy, secularism and socialism, while the two military turned pseudo-political regimes headed by Major General Ziaur Rahman (1976-1981) and Lieutenant General Hussain Muhammad Ershad (1982-1990) freely tampered with these principles and made significant constitutional changes to suit their own political designs. The latest democratically-elected governments (1991 to date) have been following a hybrid approach in their policy strategy.

2.1 Policy Measures of the Mujib Government (1972-1975)

The Awami League (AL) formed the first government in independent Bangladesh in 1972 under the leadership of Sheikh Mujibur Rahman. The government of that period faced serious challenges, which included the rehabilitation of millions of people displaced during the liberation war, organising the supply of food, health care and other necessities. According to World Bank's estimation published in Time (1972), about 6 million homes were destroyed and nearly 1.4 million farm families were left without tools or animals to work their lands during the liberation war. Due to that war, the peaceful pursuit of agriculture was seriously disturbed, workshop and factories were made unserviceable, trade links both internal and external were disconnected, the public treasury was almost empty, transportation and communications systems were totally disrupted, roads and bridges were damaged and inland waterways were blocked. As a result, the country's GDP was very low and the prices of daily necessary goods were very high, which in turn boosted corruption and smuggling (Chakravarty, 1995). The situation with regard to the external sector was particularly difficult. Bangladesh had to deal with a shallow export base but high import demand, insignificant amounts of foreign remittances and low foreign investment. Thus, the foreign exchange reserve was very low and the balance of payments was extremely adverse.

To improve that situation, the Mujib government proclaimed socialism as fundamental state policy and nationalised almost all large enterprises including banks, life and general insurance companies, major industries like jute, textile and sugar, shipping and a major portion of international trade under the country's first Industrial Policy 1973. As a

consequence, the share of the state-owned industrial sector increased from 34 percent in 1970 to 92 percent in 1972 (Rahman, 2006). The government distributed surplus agricultural lands (above land ceiling limits) among landless farmers and abolished land taxes on holdings of up to 8.3 acres (Hossain & Chowdhury, 1994). The government adopted a public sector-led import substituting industrialisation strategy. It undertook some protective measures in the form of quantitative restrictions, restricted import licensing, differentiated and high rates of nominal tariffs, and subsidised loans to traded goods. These protectionist measures were not dictated only for the purposes of the industrialisation strategy but to rein in the worsening balance-of-payments situation. However, they were associated with overvaluation of the domestic currency.

In 1972, Bangladesh joined various international organisations, including the IMF and the World Bank. Sheikh Mujib travelled to the United States, the United Kingdom and other European nations to obtain humanitarian and developmental assistance for Bangladesh. He signed a treaty of friendship with India, which pledged extensive economic and humanitarian assistance. Bangladesh received the first Imports Programme Credit (IPC)-I from the World Bank in 1973. Based on such support, Sheikh Mujib outlined some state programmes to expand primary education, sanitation, water and electricity supply across the country. A five-year plan released in 1973 focused state investment on agriculture, rural infrastructure and cottage industries.

In spite of several initiatives, the situation did not improve in terms of the growth of GDP, the stability of the price level and the external sector balance. During the Mujib regime, the country faced a great famine in 1974 in which 70,000 people reportedly died (Rahman, 2012). However, the government realised the seriousness of the problems of inflation, current account deficits, corruption and black markets. In response, Mujib increased his power by forming Bangladesh Krishak Sramik Awami League, the only legally reorganised party of Bangladesh on June 7, 1975, and banned all opposition parties. He brought in several economic measures that were successful in mopping up excess liquidity and reducing the pressure on inflation. He adopted the New Industrial Investment Policy 1974 that encouraged the private sector activities in manufacturing and tried to reduce the dominancy of public sector through disinvestment. But, paradoxically, in spite of better economic prospects, the stage was set for political change with the assassination of Mujib on August 15, 1975 (Hossain & Chowdhury, 1994).

2.2 Policy Measures of the Zia Government (1976-1981)

After a sudden and shocking end of the Mujib regime, the Zia government inherited a collapsing economy (Maniruzzaman, 1980). To bring economic stability, the Zia government distanced itself from the earlier socialist approach and started a policy of economic reform and liberalisation by privatising a number of public sector enterprises. Zia announced a '19-point programme' of economic emancipation which emphasised self-reliance, rural development, decentralisation, free markets and population control.

The Zia government revised the industrial policy of Mujib government in 1975 and emphasised the role of private sector in all spheres of economic activities, including industry and trade (Alam, 1994). In 1976, the government allowed public-private partnership in public sector enterprises and decided to encourage foreign direct investment in most of the erstwhile reserved sectors (Rahman et al., 2012). In 1977, the government revised the industrial policy again to reduce the role of public sector and allowed the private sector to operate in most industries, except large scale industries like jute, textile and sugar industries reserved for the public sector (Alam, 1994).

In order to encourage private investment, the government adopted some important policy measures, including: (i) raising the private investment ceiling from BDT30 million to BDT100 million in 1975 and completely withdrawing the investment ceiling in 1978, (ii) initiating the development of a capital market by reactivating the Dhaka Stock Exchange Ltd., (iii) allowing the use of unutilised private funds for new industries or for the purchase of public enterprises without any questioning by the government, and (iv) extending the tax holiday period for new investment from 5 years to 7 years in the developed areas, and 7 years to 9 years in the less developed areas. Consequently, the private investment climate improved considerably and a large number of small and medium scale industrial units were set up with the help of credit from industrial and agricultural banks.

The Zia government boosted private foreign trade through a number of policy measures. Some of them were: (i) reducing import duty on capital machinery from 20.0 percent to 2.5 percent in respect of less developed areas, (ii) widening the range of imports under the Wage Earner Schemes and Export Performance Licenses (XPL), (iii) introducing the Ordinary General License for the import of industrial raw materials, (iv) establishment of Export Promotion Bureau in 1977, (v) introducing the Export Credit Guarantee Scheme, and (vi) introducing the Duty Drawback and the Special Bonded Warehouse

schemes. In addition, a number of fiscal incentives such as rebates on income taxes and concessionary duties on imported capital machinery were provided by the Zia government for export development (Rahman, Shadat & Raihan, 2010).

The Zia government emphasised rural development. A massive programme of manual digging and excavation of canals was launched, a large rural credit programme was adopted, and the 'Swanirbhar (self-help) movement' was boosted during that period. As with Mujib, the Zia government continued large scale agricultural subsidies and ensured high product prices especially for food items, in order to boost agricultural production. Despite the focus of development strategy on agriculture, the Zia government avoided any move toward effective land reforms, as adopted by Mujib government, so as to solidify rural elite support for the government. The Zia government adopted the second five-year plan (after a two-year hiatus, over July 1980-June 1985) that emphasised higher productivity in agriculture and manufacturing.

In order to achieve economic development, Zia developed close relations with the United States, Western Europe, Africa and the Middle East, moved to harmonise ties with Saudi Arabia, China and North Korea, and to normalise relations with Pakistan. In 1980, he proposed an organisation for the seven nations of South Asia (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka) to bolster economic and political co-operation at a regional level which succeeded in 1983 through establishing the South Asian Association for Regional Co-operation (SAARC). In 1980, the government signed an agreement with the International Monetary Fund (IMF) for support from the Extended Fund Facility (EFF).

The economic policies of Ziaur Rahman were successful particularly for low inflation. However, he was seriously criticised for his ruthless treatment to the army opposition and the rehabilitation of some controversial persons like Ghulam Azam, a Bangladeshi politician convicted of war crimes. Thus, Zia was assassinated by the group of army officers on May 30, 1981.

2.3 Policy Measures of the Ershad Government (1982-1990)

After the assassination of Zia, the then vice president Justice Abdus Sattar came to the power as President through a general election. But he was overthrown within a short period by the army chief Lieutenant General Hossain Muhammad Ershad. Thus Ershad came to the power on March 24, 1982 as Chief Martial Law Administrator, though he

became President of the country later. After taking power, Ershad faced many challenges particularly the economic development of the country. The economic policies of the Ershad government were almost similar to those of the Zia government, but eventually they were heavily influenced by the Structural Adjustment Programmes (SAPs).

Bangladesh was one of the very first countries to receive structural adjustment assistance under the Extended Fund Facility of the IMF in December 1980, the last fiscal year of Zia regime. But the loan contract was revoked after six months due to failure of maintaining the domestic credit ceiling (Matin, 1986). It was reinstated after the Ershad government assumed power. The Ershad government received IPC-XI of the World Bank in 1982, and the Structural Adjustment Facility (SAF) and the Extended Structural Adjustment Facility (ESAF) of the IMF in 1986 and in 1990 respectively on condition of policy reform in the trade and industrial sectors. The government also received the World Bank's long term Structural Adjustment Loans and Sectoral Adjustment Loans in 1987 for the development of industry, energy, export and financial sector of the country (Bhattacharya & Titumir, 2001).

Bangladesh carried out a number of important policy reforms under SAPs. Privatisation of the state-owned enterprises, including financial institutions, was the prime focus. The new industrial policy of 1982, adopted by the Ershad government, enabled the privatisation of large state-owned enterprises, encouraged private investment in heavy industries, and sought to attract foreign companies to invest in the industrial sector. To encourage private investment, the government established the Board of Investment (BOI) in 1989, which provided incentives to private entrepreneurs in the form of credit facility with easy terms and low interest rates. Thus a new class of entrepreneurs was created and they bought substantial chunks of state-owned enterprises.

To boost exports, the Ershad government continued various fiscal incentives of Zia government like rebates on income taxes, and concessionary duties on imported raw materials and capital machinery (Rahman, Shadat & Raihan, 2010). To boost the export of non-traditional items, the Ershad government introduced Interest Subsidy Scheme (ISS) in 1983 under which the exporters enjoyed concessional interest on loans from the commercial banks, which were refinanced by the Bangladesh Bank. The ISS existed up to 1989, before the creation of the Export Development Fund (EDF). The Ershad government implemented the BEPZA Act 1980 by establishing the first Export

Processing Zone (EPZ) in Chittagong in 1983, which became very important for the export sector's development. In 1987, a back-to-back LC system was introduced to enable the exporters to import raw materials on a deferred payment basis.

In spite of rigorous policy measures under the structural adjustment programme, the economic performance of the Ershad government was not satisfactory in terms of growth, inflation and external sector balance. As a result, the political situation which was quite unstable became more vulnerable in 1990 and Ershad offered his resignation on December 6, 1990.

2.3 Policy Measures of the Democratic Governments (1991-2015)

After the resignation of President Ershad, the elected civilian government came to the power in Bangladesh in 1991 and the system have been continued till today. Therefore, the governments of Bangladesh during 1991 to 2015 may call democratic, though there were political conflicts between the ruling and opposition parties. But, there were no major conflicts with the armed forces, except the military coup on January 11, 2007. Therefore, economic development was the main challenge for the governments during 1991-2015. The democratic governments significantly extended the reform process that was started in the mid-1970s and followed by the Zia and Ershad governments (Rahman, 2006). The areas of major policy reforms during that period were: financial sector reform, fiscal sector reform, industrial sector reform, service sector reform and external sector reform.

Financial Sector Reform

The financial sector of Bangladesh, which was dominated by the banking industries, provided credit to the state-owned enterprises and the priority private sectors like agriculture, export, and small-cottage industries as per the directives of Bangladesh Bank until the end of the 1980s. During that period, Bangladesh Bank controlled bank credit and administered the interest rate directly. The government adopted a Financial Sector Reform Programme (FSRP) under the Financial Sector Adjustment Credit of IDA for the period of FY1990-FY1996, with the aim of making the banking system market-oriented and competitive (Bangladesh Bank, 1991). Under FSRP, Bangladesh Bank withdrew the control on bank credit and deregulated the interest rate structure gradually (Moral, 2012). Bangladesh Bank started to use indirect monetary policy instruments instead of direct credit control since 1993. In this regard, Bangladesh Bank introduced repo, reverse repo, BB Bill and foreign exchange sale/purchase as an instrument of monetary policy. It also started to use cash reserve requirement, statutory

liquidity ratio, bank rate, demand loans and refinance facility as an instruments of monetary policy. On the interest rate front, the policy was liberalised and the banks were free to fix their own deposit and lending rates on the basis of market forces, except for export credit. Now, Bangladesh Bank controls the interest rate indirectly by changing the Repo and reverse repo rates, which are also called the policy rates.

Fiscal Sector Reform

The fiscal balance in Bangladesh was negative and thus the government was heavily dependent on foreign sources for deficit financing during the 1970s and 1980s. Therefore, the fiscal reform emphasised the revenue collection and borrowing from the domestic sources. In this regard, the government introduced the system of Value Added Tax (VAT) and Supplementary Duty (SD) on July 1, 1991. The VAT and SD were imposed on almost all taxable goods and services (domestic plus imports) as substitutes for sales tax (100 percent) and excise duty (90 percent). In context of domestic borrowing, particularly from non-banking system, the government introduced several savings instruments including Family Savings Certificate, Savings Certificate with 3-Monthly Interest and Pensioners Saving Certificate. The government emphasised on non-bank borrowing due to create earning opportunities for a particular group of people like women and retired persons. But, interest rates on government savings certificates were higher than bank credit.

Industrial Sector Reform

Successive governments of Bangladesh formulated 10 industrial policies up to 2015, of which the 6th-10th industrial policies were formulated during the democratic regime. While these were broadly similar to previous industrial policies adopted by the Zia and Ershad governments, some important features were: (i) continuation of the privatisation of public enterprises, (ii) infrastructure development through public private partnerships, (iii) expansion of EPZs, (iv) fiscal and other incentives to priority sectors like agro-based food processing and labour-intensive industries, and (v) initiatives to develop the jute industry by producing diversified jute goods.

Service Sector Reform

To develop transport services, the governments emphasised the construction of road, rail, and water ways, bridges and flyovers, and airports. Government allowed and encourage private transports in the railway and airway. The government also extended

the bus and rail services across the border.

The government brought a dramatic change in the field of communications by allowing private radio and television channels from the early 1990s. The government also liberalised its telecommunication system by issuing licenses to the private operators in 1989, for providing mobile phone services. 3G mobile services were introduced by the state-owned Teletalk in October 2012, and have also been extended to all 64 districts by the three giant private mobile operators, namely Grameenphone, Banglalink and Robi.

The government encouraged private investment in the housing sector and provided easy loan with low interest rate. Bangladesh House Building Finance Corporation, a specialised public financial institution, finances for the construction and renovation of houses and purchasing residential apartments in all over Bangladesh. Commercial banks also provided housing loans sometimes as per government direction. As a consequence, the real estate business increased tremendously over the years.

External Sector Reform

The liberalised trade policy, which had been pursued since the mid-1970s, gathered momentum during the democratic regime. The government reduced both tariff and non-tariff barriers significantly and rationalised the tariff slabs in line with the reduction of tariff rates. According to World Bank (1999), Bangladesh is the fastest liberalised country in the developing world after Cambodia, even though the status of least developed country allows for some relaxation of the rules of General Agreement on Tariffs and Trade or World Trade Organisation. Usually, the liberalised import policies are followed for three reasons: the interests of domestic consumers, interests of domestic exporters who need to import industrial raw materials and capital machinery, and the norms of regional trade agreements like South Asian Free Trade Area. Among them, the interest of domestic exporters is dominant for Bangladesh. In order to develop the export sector, the democratic government adopted some policy measures including: (i) extend the Export Development Fund, (ii) provide bank loans to the exporter at lower interest rate, (iii) ensure uninterrupted supply of electricity, gas and water for all export-oriented industries, (iv) develop the infrastructure for backward and forward linkage industries of export goods, (v) support for improving product quality by using modern and environment-friendly technology, (vi) support for sending marketing missions abroad to participate in the international trade fairs, (vii) support for foreign training on product development and marketing, (viii) assist to set up sales and display centres as well as

warehouses in abroad, (ix) initiate to achieve duty-free market access to the developed and developing countries, and (x) initiate to diversify the export market, particularly to the Asian countries.

In order to develop the foreign exchange market, the government unified the exchange rate system by abolishing the secondary exchange market on January 1, 1992. On July 26, 1993, Bangladesh Bank imposed restrictions on domestic authorised dealer banks to use only US dollar and the currencies of the members of Asian Clearing Union (ACU) in dealing with Bangladesh Bank. Authorised dealer banks were free to set their own buying and selling rates for the US dollar and the rates for other currencies were determined on the basis of cross rates. In April 1994, the government accepted the Article VIII obligations of the IMF that constituted a commitment to current account convertibility in Bangladesh. The development of an inter-bank foreign exchange market was another commitment of that obligation. From January 1, 1996, Bangladesh Bank ceased to deal with the currencies of other ACU members and allowed the authorised dealer banks to deal only in US dollars, and for other currencies on the basis of cross rates. This process was continued up to May 30, 2003. On May 31, 2003, Bangladesh Bank introduced the floating exchange rate system, under which the exchange rate is determined on the basis of demand and supply of the respective currencies. Under this system, authorised dealer banks are free to set their own rates for interbank and customer transactions. However, in order to achieve monetary policy goals and to avoid undue volatility in the foreign exchange market, Bangladesh Bank remains vigilant in its role in the foreign exchange market by closely monitoring the exchange rate movement, and the buying and selling of foreign currencies for stabilising the market (Government of Bangladesh, 2014).

3. Impact of Government Policies

The impact of government policies on economic development seems to be positive during the last four decades of independent Bangladesh. This section analyses such impact on major macroeconomic variables separately to explore the real scenario.

3.1 Movement of Economic Variables in the Real Sector

In Bangladesh, GDP growth was highly volatile during the 1970s and followed an increasing trend thereafter (Figure 1). It was volatile due to large share of agriculture (Figure 2), highly influenced by the natural processes. The GDP growth in FY1975 was

negative due to a big decline in agricultural output (18.7 percent) resulting from the catastrophic flood in 1974.

Figure 1: GDP Growth in Bangladesh (%)

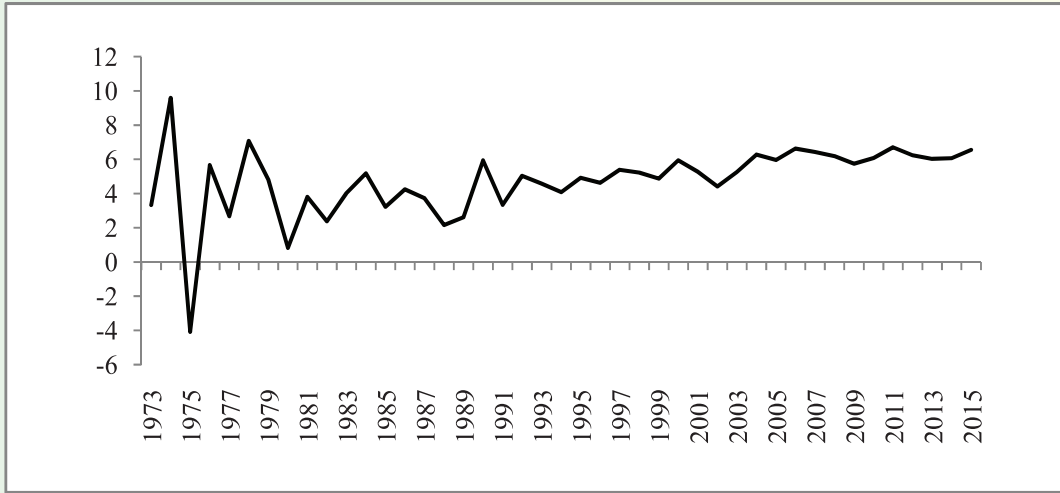
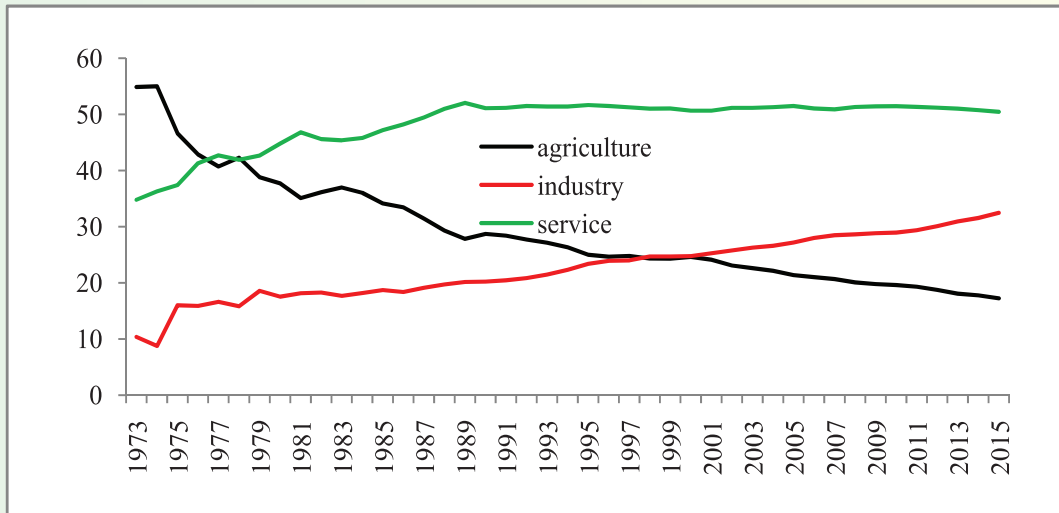


Figure 2: Sectoral Share in GDP (%)



From 1990, GDP growth increased due to better performance of industrial and service

sectors. As Figure 2 shows, the share of industry and service sectors increased and that of agricultural sector decreased over the years. Among the industrial and service sectors, the performance of the former was better than that of the later.

Several economic and non-economic factors expedited GDP growth. Among them, the most important factor was the rate of investment, which increased gradually over the years and reached a significant level in 2015 (Figure 3). This was largely due to the government's policy of encouraging and supporting private investment in the export-oriented manufacturing industries from the mid-1970s, as well as the increase of both domestic and national savings rates (Figure 3).

Figure 3: Savings and Investments (% of GDP)

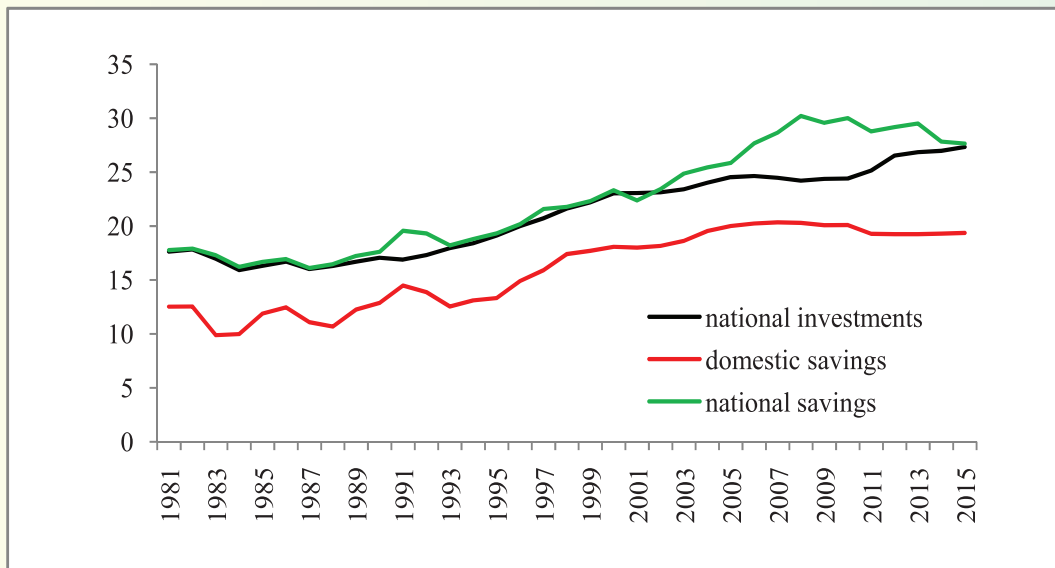
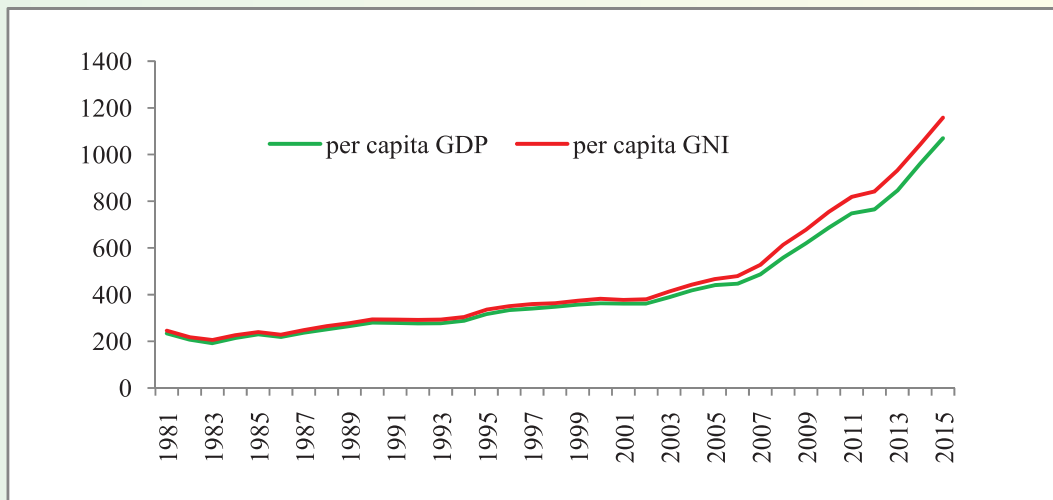


Figure 4 shows that per capita GNI was always higher than per capita GDP and the gap between them increased, mainly due to the inflows of workers' remittances. Consequently, the national savings rate was always higher than the domestic savings rate, and the gap between them was very high during the last 15 years.

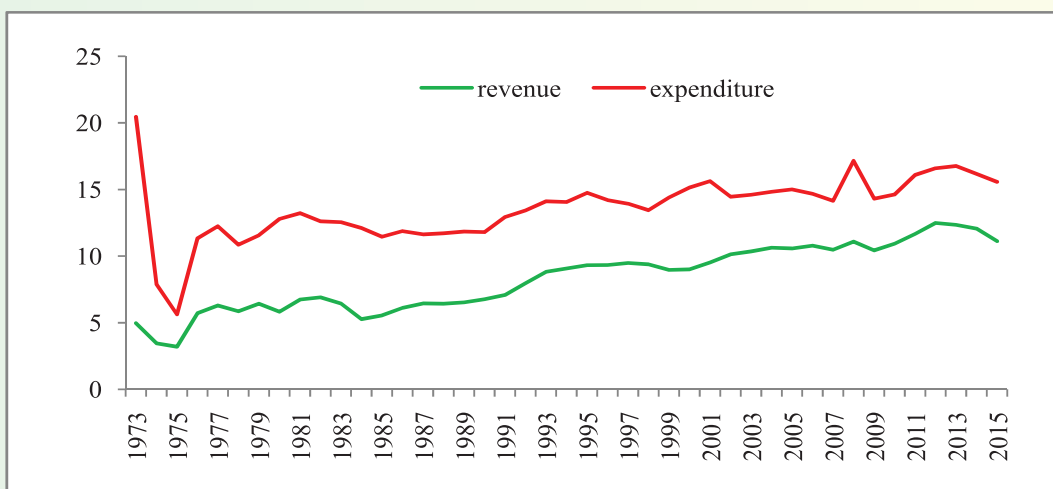
Figure 4: Per Capita Income in Bangladesh (USD)



Export demand and workers' remittances also added to the rising trend of GDP growth in Bangladesh. Export demand, particularly for readymade garments, raised the contribution of the industrial sector to GDP significantly. Inflows of workers' remittances influenced consumption and investment demand in the economy.

3.2 Movement of Economic Variables in the Fiscal Sector

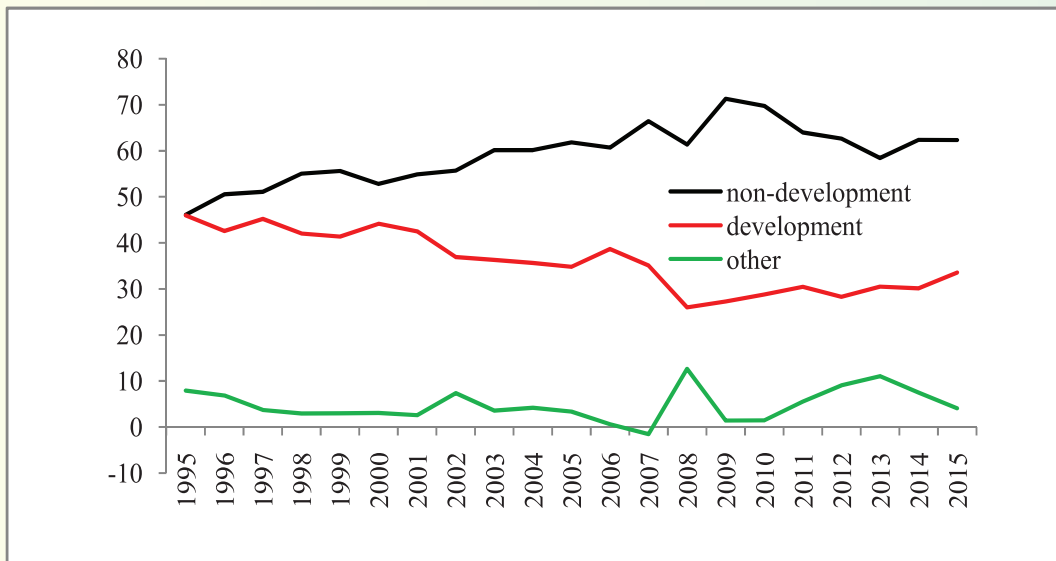
Figure 5: Government Revenue and Expenditure (% of GDP)



The fiscal deficit was very high in 1973, immediately after Independence (Figure 5), as

government spending was required to reactivate a war-damaged derailed economy. But the famine of 1974 was associated with a squeeze on government expenditure. However, government expenditure and revenues (% of GDP) increased from 1976. The government expenditure was always higher than the revenue collection and thus the fiscal balance was negative until 2015.

Figure 6: Share of the Components in Government Expenditure (%)



The share of government expenditure on development activities was larger than that of non-development activities in the earlier period. But the scenario changed from 1995 (Figure 6), mainly because of rising interest payments and transfer payments. Interest payments increased as the government borrowing shifted from foreign to domestic sources, particularly towards the non-banking sources. The interest rate on domestic borrowing was always higher than that on foreign borrowing; and the interest rate on non-bank borrowing was higher than that on bank borrowing. Transfer payments increased due to government programmes such as old age allowance, freedom fighters' allowance, employment generation programmes, programmes to cope with natural disasters and other shocks, incentives provided to parents for their children's education and incentives provided to families to improve their health status. Subsidies and incentives schemes for the export sector's development were also important in this regard.

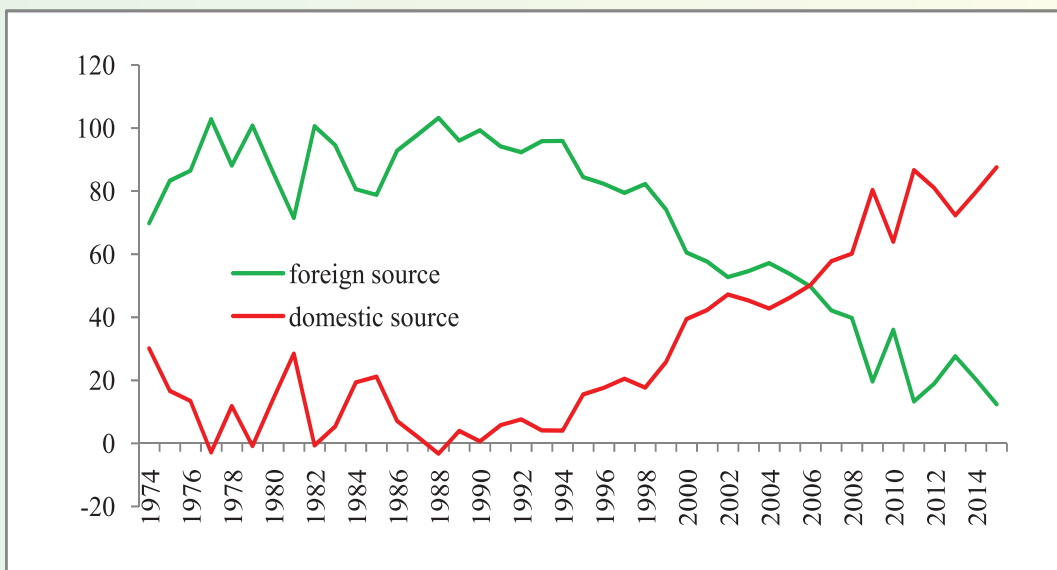
Table 1: Sources of Government Revenue (%)

Components	1973	1992	2015
Income tax	4.9	13.6	32.5
Custom duty	33.1	28.9	10.5
Excise duty	28.0	14.7	0.7
Sales tax	9.9	Nil	Nil
VAT and SD	Nil	18.8	48.6
Other*	24.1	24.0	7.6

Note: VAT = Value Added Tax, SD = Supplementary Duty. *Includes other tax and all non-tax revenues.

Sources: Bangladesh Bank and Bangladesh Economic Review.

With regard to revenue collection, income tax and value added tax (including supplementary duty) were the main components for the increasing trend of total revenue as percent of GDP (Table 1). Customs duty, which was the largest component of total government revenue, declined drastically due to the liberalised import policy. Sales taxes were completely and excise duties were partially integrated with value added tax and supplementary duty.

Figure 7: Sources of Deficit Financing (%)

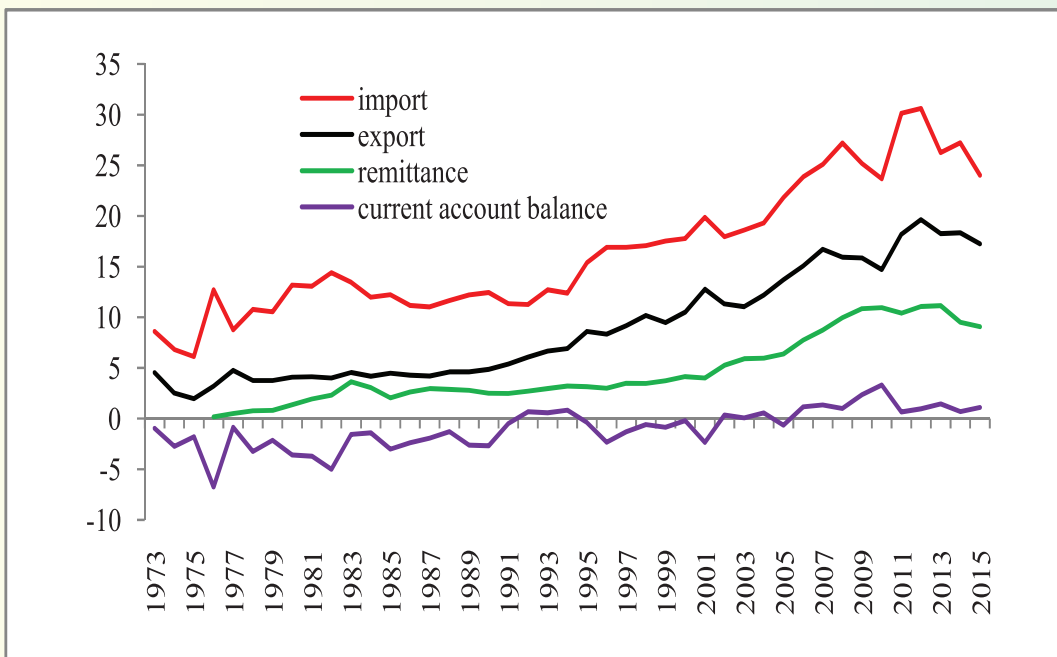
Source: Bangladesh Bank.

With regard to deficit financing, the share of foreign financing was very large compared to domestic financing during the 1970s and 1980s (Figure 7). The share of domestic sources started to increase and that of foreign sources started to decrease from the early 1990s, as the government became largely dependent on both bank and non-bank sources for deficit financing, specifically after 2006.

3.3 Movement of Economic Variables in the External Sector

The Current Account Balance (CAB) consists of net trade in goods (exports minus imports), net trade in services, net income from abroad and net current transfers. Among them, net trade in goods, net trade in services and net income were always negative and current transfers, which constituted mostly by workers' remittances, were always positive. Figure 8 shows the movement of CAB and its major components (% of GDP) for the period 1973-2015.

Figure 8: CAB and its Major Components (% of GDP)



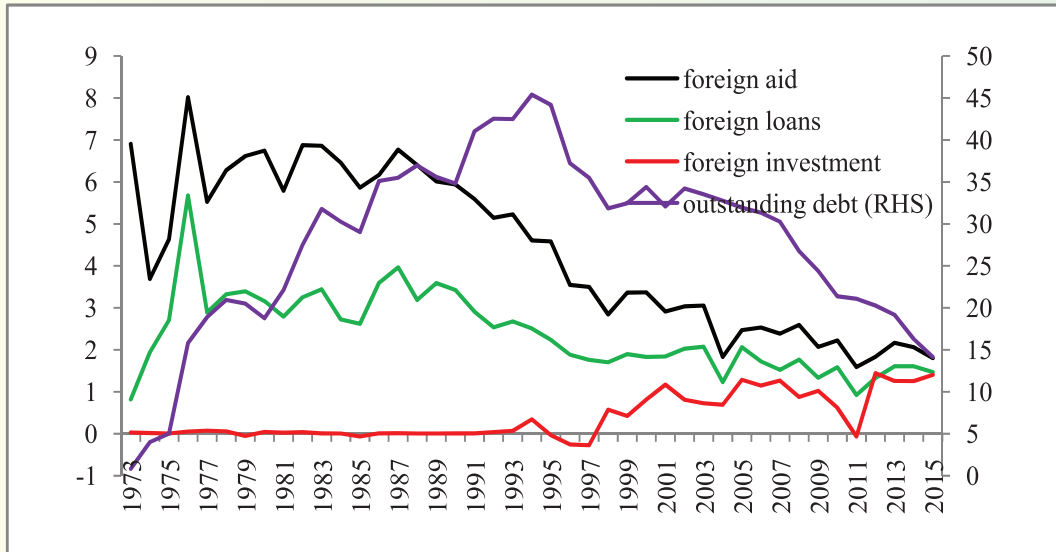
Source: Bangladesh Bank.

The current account balance turned positive in 1992 for the first time and continued up to 1995. It was positive again in 2002 and continued up to 2015, except 2005. The contribution of exports and remittances was very significant to make current account balance positive. The expansion of exports was mainly due to government policy that emphasised private sector led export-oriented industrialisation and therefore liberalised imports particularly for imports of industrial raw materials and capital machinery.

People from what is now Bangladesh had been migrating to the UK and the USA from the colonial period, mostly with the motive of settling themselves permanently or semi-permanently in those countries. After Independence, Bangladeshi nationals migrated to the Middle Eastern countries after the first oil price hike in 1973, mostly so as to save money to send home remittances. However, such remittances increased over the years due to migration of more nationals not only to the Middle East but also to other Asian countries like Malaysia, Singapore, Japan and South Korea. Migration to the USA, the UK, Italy and Germany was also significant.

The capital account balance remains importance, as Bangladesh still depends on foreign aid and also expects more foreign investment. As Figure 9 shows, the foreign aid (loans plus grants) as percent of GDP was very high during the 1970s and 1980s, but it showed a steep declining trend after 1987. On the other hand, the foreign investment (direct plus portfolio) as percent of GDP was very low up to 1993, but it increased thereafter.

Foreign aid was very essential for Bangladesh during the first two decades of independent Bangladesh to overcome two critical economic gaps-the domestic savings-investment gap and the export-import gap (Dornbusch & Edwards, 1990). The situation improved over the years due to the increase of export earnings and workers' remittances. Besides, the domestic savings rate also increased due to the improvement of per capita income. As a result, foreign aid as percent of GDP decreased sharply over the years. Among the components of foreign aid, the grants-GDP ratio decreased more compared to the loans-GDP ratio (Figure 9).

Figure 9: Foreign Aid, Foreign Investment and Outstanding Debt (% of GDP)

Note: The difference between black line and the green line measures grants (% of GDP).

Sources: BB, WDI, BER and ERD.

Although the foreign aid as percent of GDP and even outstanding debt as percent of GDP decreased over the years (Figure 9), the trend of their absolute value was increasing until 2015. Besides, the government of Bangladesh still pursues foreign aid particularly for the development of infrastructure like roads and highways, railways, bridges, flyovers and electric power. Currently, foreign aid in the form of project aid is very high compared to food aid and commodity aid. The most foreign aid has been from international agencies.

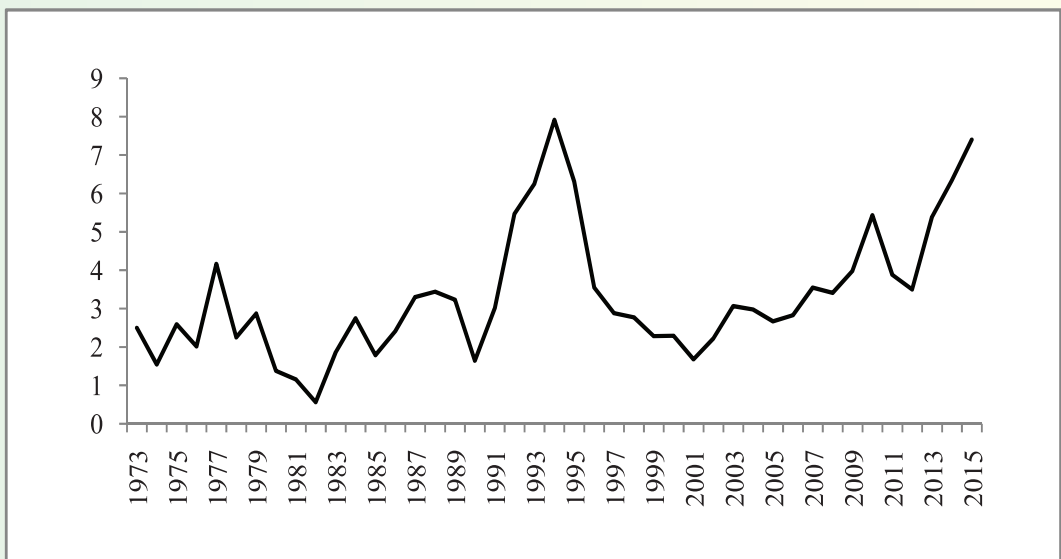
Foreign investment registered an increasing trend from the early 1990s due to government's initiatives, particularly the expansion of EPZs. The government opened almost all manufacturing and service sectors for foreign investors either independently or through joint ventures with local public and private enterprises. Non-discriminatory treatment between foreign and local investors was insured with respect to loan facilities, tax exemption and technical assistances; non-expropriation of foreign investment by the state; repatriation of proceeds from sale of shares and profit; and the opportunity of unlimited equity participation. Considering the favourable environment, many foreign investors from different countries invested in different projects. Asian countries were the largest investors out of the 53 countries that invested in Bangladesh during 2006-2015.

They invested mostly in telecommunications, followed by health services.

Among the components of foreign investment, only direct investment was visible in Bangladesh. Portfolio investment faced averse sentiment and turned total foreign investment negative during the stock market crashes of 1996 and 2011. However, foreign direct investment as percent of GDP was very low in Bangladesh (1.4) compared to many developing countries including India (2.1), Vietnam (6.1), Myanmar (6.8) and Cambodia (9.4) in 2015.

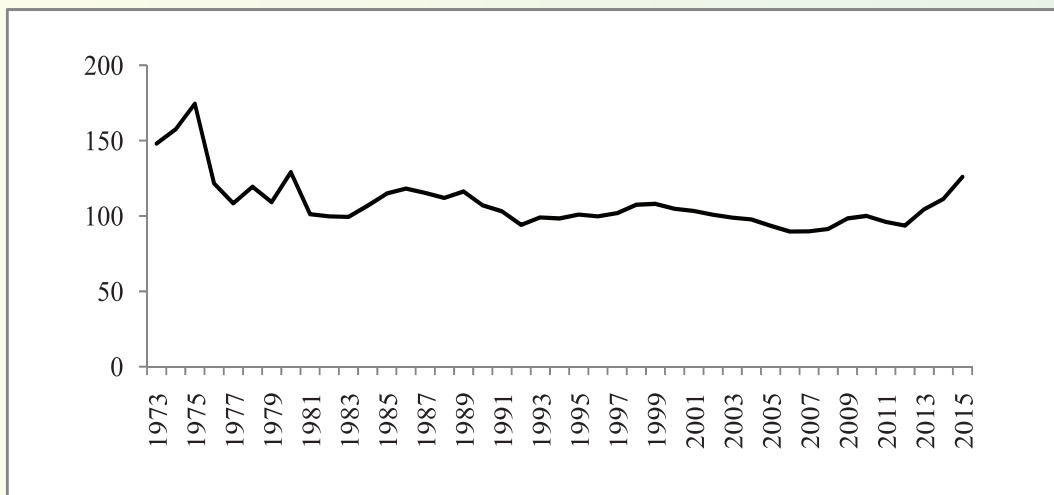
Foreign exchange reserves, which indicate the strength of the external sector, increased significantly over the years, mainly due to the good performance of export earnings and the inflow of workers' remittances. The inflows of other current transfers, foreign aid and foreign investment were also important. Import coverage of forex reserves increased significantly over the years and stood at 7.4 months of import payment in 2015 (Figure 10). Import coverage in the mid-1990s was also very high largely due to low import growth (3.0 percent) compared to export growth (9.8 percent) and remittance growth (15.3 percent). Besides, the large inflow of portfolio investment was important in that period.

Figure 10: Import Coverage of Forex Reserves (Months)



The Real Effective Exchange Rate (REER) was mostly stable with mild fluctuations particularly after 1976, though the nominal exchange rate depreciated remarkably over the year (Figure 11). The nominal exchange rate of BDT stood at USD1 = BDT77.67 in 2015, while it was USD1 = BDT7.88 in 1973. However, there were some real appreciations of BDT against partners' currencies, due to the upward movement of domestic prices. BB's intervention on foreign exchange market was also significant as it controlled the nominal exchange rate directly up to May 30, 2003 and indirectly thereafter. From May 31, 2003, Bangladesh Bank declared floating exchange rate strategy, but intervened sometimes when necessary. In this regard, Bangladesh Bank sells or purchases foreign exchange to the commercial banks in order to control the exchange rate indirectly.

Figure 11: Movement of REER Index (Base: 2010 = 100)



Note: The upward movement of REER index indicates real appreciation and vice versa.

Source: Bangladesh Bank.

4. Concluding Remarks

The fundamental change in the economic policies of Bangladesh occurred after the mid-1970s when the government decided to make the economy more market-oriented and competitive to the international markets. The main objectives of the policy change were higher economic growth, and the reduction of inflation and unemployment. To fulfil these objectives, the governments emphasised private investment particularly in the export-oriented industries and adopted liberalised economic policies especially in the

field of import, bank credit and foreign exchange transactions.

According to the findings of this study, the government policies were associated with higher GDP growth and lower inflation. The dependence of the economy on the agricultural sector reduced and reliance on industrial sector increased over the years. The share of agriculture in GDP reduced from 55 percent in 1973 to 17 percent in 2015, while that of industry increased from 10 percent in 1973 to 32 percent in 2015. Domestic savings as percent of GDP increased from less than 1 percent in 1974 to 19 percent in 2015, while the investment as percent of GDP increased from 6 percent in 1974 to 27 percent in 2015. Though the fiscal deficit as proportion of GDP did not reduce over the years, government revenue and expenditure as proportion of GDP increased significantly. Among the components of revenue, the share of income tax reached 33 percent in 2015, from only 5 percent in 1973. The introduction of VAT and SD was very significant in the field of revenue collection and their contribution to total revenue stood at 49 percent in 2015.

On the expenditure-side, the allocation for the infrastructure development increased over the years. As a result, the transport and communication, local government and rural development, education and information technology, and the energy sector of Bangladesh improved significantly over the years. With regard to deficit financing, the dependence on foreign sources reduced and the reliance on domestic sources increased significantly over the years. The share of foreign sources reduced from 83 percent in 1975 to 12 percent in 2015.

With regard to external sector, both exports and imports as percent of GDP increased substantially over the years and the export growth was slightly better than that of import. But the trade deficit as percent of GDP did not decrease much. The export-GDP ratio increased from 5 percent in 1973 to 17 percent in 2015, and the import-GDP ratio increased from 9 percent in 1973 to 24 percent in 2015. The linear trend growth of export during 1976-2015 was 11 percent, while that of import was 9 percent. Workers' remittances as percent of GDP significantly increased over the years and stood at 9 percent in 2015, from only 0.2 percent in 1976. The current account balance depicted positive values for the last couple of years due to mainly the positive effects of export earnings and workers' remittances.

This enabled a reduction in dependence on foreign aid over the years, which was earlier

needed largely to maintain overall balance of payments (current account plus capital account). The foreign aid-GDP ratio reduced from 7 percent in 1973 to 2 percent in 2015. However, the government pursued some foreign aid till 2015, which was used mainly for the infrastructure development. Foreign direct investment increased over the years due to government initiative, though it was very low compared to other Asian developing countries. Finally, the foreign exchange reserves increased much over the years and its import coverage stood at 7.4 months of import payments in 2015, up from 2.5 percent in 1973.

The contribution of the external sector, particularly the export earnings and the workers' remittances, were very important behind the success story of Bangladesh economy. Despite this success, Bangladesh is still included in the LDC bloc and its per capita GDP is low compared to other countries in the region, including India, Sri Lanka and even Pakistan. However, Bangladesh is going to overcome LDC status by 2024 if the current trend of economic growth continues in the next six years.

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