Employment Promoting Growth in Bangladesh: Monetary and Financial Sector Issues

December 2008

Policy Analysis Unit
Bangladesh Bank
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This paper has been prepared by Mustafa K. Mujeri of the Policy Analysis Unit, Bangladesh Bank. The views expressed in this paper are those of the author and do not necessarily reflect the views and policies of the Bangladesh Bank.

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1. Introduction

Reducing poverty remains a formidable challenge for Bangladesh. Although economic growth has improved in recent years, the better economic performance has not translated into satisfactory poverty reduction. Recognizing this disjuncture between the country’s record on economic growth and progress in poverty reduction, current policies emphasize that strong economic growth alone is not adequate for sustained poverty reduction in Bangladesh. For successful poverty reduction, the strategies must also ensure that the poor can get increasingly higher share of the benefits of growth.

In Bangladesh, almost all households depend on employment as their primary source of income. This is especially true for the poor households since the only abundant productive resource that the poor have is their own labor. Increasing employment opportunities and raising the returns to labor is therefore the most viable option to reduce poverty and meet the country’s human development goals. In this context, one important issue is to recognize that simply having access to employment is not enough to lift the poor households out of poverty. For reducing poverty, both quantity and quality of employment need emphasis for which economic growth alone is not adequate. This requires an employment-centered strategy to growth in which employment opportunities would expand for the poor along with returns adequate enough to raise the households out of poverty.

Rapid and sustained poverty reduction in Bangladesh thus calls for integrating three elements within the growth policy framework: first, sustained economic growth at reasonably high rates; second, expansion of productive and remunerative employment opportunities; and third, expanding the access to jobs for the poor. The government’s development strategy recognizes the need to orient growth policies toward creating decent employment opportunities for which several options are emphasized, such as adopting policies for making growth more employment-friendly, increasing overseas migration of workers, and undertaking special employment creation programs through micro credit and employment based safety nets and public works programs.\(^1\)

\(^1\) The country’s labor force is likely to grow to 58.3 million in FY11 from around 52.8 million in FY08 indicating the need to create additional jobs for 7.3 million people between FY09 and FY11 including a backlog of 1.8 million unemployed labor. This requires an employment growth rate of 4.7 percent per year relative to a slow employment growth of 1.6 percent since the 1990s. Moreover, with existing trend, total number of underemployed persons will reach 26.6 million in FY11 for whom creation of decent employment opportunities is essential for poverty reduction. See Moving Ahead: National Strategy for Accelerated Poverty Reduction 2009-2011, Draft, Planning Commission, Government of the People’s Republic of Bangladesh, May 2008.
Obviously, in a ‘labor-surplus’ economy such as Bangladesh, the developments in the labor market are crucial to bringing about desirable changes in growth possibilities and meeting poverty reduction and other social goals. In particular, the expansion of decent employment opportunities through both wage and self-employment to absorb the growing labor force is a key challenge to ensure both rapid growth of productivity-enhancing employment and fulfill the poverty-reducing labor rights, such as the rights to work, employment, social protection, and social dialogue in an integrated manner.

This paper examines several elements in the country's monetary policy and the overall financial sector which would support employment-centered and thereby poverty reducing growth in the economy especially through distributing the benefits of growth broadly.

2. Labor Market and Employment Structure

The estimated population of Bangladesh is 142.4 million in 2008, which is growing at a rate of 1.4 percent per annum in recent years. Of the total population, more than 70 percent live in the rural areas. The share of the labor force in total population has remained relatively stable at around 35 percent in the recent decade. The Labor Force Survey 2005-06 gives a labor force participation rate of 58.5 percent for the entire country. The rates are higher in rural (59.4 percent) than in urban areas (55.7 percent) and for illiterate people. The participation rate for women is significantly lower (29.2 percent) than that of men’s (86.8 percent).

The labor force in Bangladesh has expanded rapidly over the last two decades. The total labor force was 47.4 million in 2006 compared with 36.1 million in 1996.2 This shows that every year more than one million people enter the labor force and, given the present demographic trend, the growth of the labor force is unlikely to taper off during the coming decade.

The rural-urban variation in the labor force growth is also significant. Between 2000 and 2006, the rural labor force grew by 19 percent to 36.1 million; while the growth in urban labor force was from 8.7 million to 11.3 million, an increase by 30 percent. Among others, this reflects the impact of significant urbanization that has taken place in the country. In urban areas, females accounted for 24 percent of the labor force in 2006 compared with 19 percent in 1996. The size of the female labor force in the rural areas increased from 3.8 million to 8.6 million over the same period. While the total labor force

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2 The numbers refer to economically active population aged 15 years and above which is the definition of the labor force adopted by the Bangladesh Bureau of Statistics (BBS).
participation rate increased from 52 percent to nearly 59 percent between 1996 and 2006, the male participation rate remained unchanged at around 87 percent but the female participation rate increased sharply from 16 percent to 29 percent.

Considering the total size of the population, the number of unemployed population is low. As per the ILO definition, the unemployment rate was 4.2 percent in 2006. This is not surprising in a country like Bangladesh since the participants in the labor force are compelled to engage in some work—even for few hours and at low wages in the informal sector—in order to subsist with his/her family. Thus the standard unemployment rate does not give a real picture of the supply-demand balance as well as the degree of inefficiency that prevails in the labor market. The un- and under-employment rates are generally higher among the youth and educated labor force especially among those with secondary or post-secondary and higher education.

Another important aspect of the labor market in Bangladesh is the formal-informal divide in employment which has significant consequences for return to labor and security of employment. The concept captures forms of employment that lack regulatory, legal, and/or social protections. Informal employment is defined in terms of the nature of enterprise in which the work takes place (e.g. the informal sector) and the relationships in employment. In this context, it is important to note that underemployment, indicating inadequate level of labor demand, can manifest itself in forms other than work time as measured in Bangladesh. For example, in the case of a self-employed person (e.g. a street vendor), demand for labor depends on the amount he/she can sell in any period of time. The amount also determines his/her earnings. If earnings are low due to inadequate demand, he/she will have to work longer hours to generate required income for survival. In such cases, low demand in the economy leads to longer working hours but, in reality, the self employed person should be considered underemployed due to low productivity and inadequate demand for his/her labor.

In the specific situation of Bangladesh, the concept of unemployment based on standard definitions needs to be supplemented by the concepts of visible and invisible underemployment. Underemployment exists when a person's employment is inadequate, in relation to specified norms or alternative employment, account being taken of his/her occupational skill (training and work experience). Some estimates suggest that the underemployment rate (defining as those who worked less than 35 hours during the reference week of the survey) is as high as 24.5 percent (10.9 percent for males and 68.3 percent for females) in 2006. The underemployment rate is higher in rural areas than in urban areas. See, Key Findings of Labor Force Survey 2005-2006, Bangladesh Bureau of Statistics, Ministry of Planning, Government of the People’s Republic of Bangladesh, 2008.

Among others, one factor that may have contributed to high unemployment rate of the educated youth is that the educated youth is less likely to move into the ‘discouraged workers’ category and withdraw from the labor force. They are more likely to seek employment and not discouraged just because their unemployment rate is high relative to other working age populations since the group belongs to the earlier stages of their life cycle.

In practice, enterprises are considered informal in Bangladesh if they are not registered with the relevant authority. Thus employment in the informal sector comprises all employment that takes place in informal enterprises including self employed/own account workers, unpaid family helpers, day laborers, paid employees in informal enterprises, informal employers, and similar other categories. Outside the unregistered and/or small enterprises sector,
In 2006, the vast majority (79 percent) of the total employed labor was engaged in informal activities. The gender difference in this respect is wide: of the total female employed labor, 86 percent were employed in the informal sector while similar share was 76 percent for male labor.

In terms of status of employment, self-employed/own account workers category forms the largest group accounting for 42 percent of total working labor in 2006 followed by unpaid family helpers (22 percent). The movement across different categories over time indicates increasing commercialization of the economy and higher mobility of the labor force across various activities. There exists, however, significant gender difference in terms of status of employment. More than 60 percent of the female labor (compared with less than 10 percent of male labor) worked as unpaid family workers in 2006. The majority of the poor women work as unpaid family workers or for daily wages in agriculture or in non-farm and family enterprises.

A noteworthy development in the case of female employment is the boom in the ready-made garments (RMGs) sector in which nearly 90 percent of the employees are women. In 2006, about 32 percent of the employed women worked in non-agricultural sectors of which more than a third was engaged in the RMG sector. Garment industry jobs that tend to be concentrated in big metropolitan cities (Dhaka and Chittagong), have attracted many young women migrant workers from the rural areas, often from the poorer households. For these young women, factory work means not only higher earnings, but more status and responsibility relative to other work available in the rural areas including a sense of pride and empowerment at being able to support their families.

Table 1: Trend in Employment Pattern

<table>
<thead>
<tr>
<th>A. Sector of employment</th>
<th>% of employed persons</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2000</td>
</tr>
<tr>
<td>Formal</td>
<td>24.7</td>
</tr>
<tr>
<td>Informal</td>
<td>75.3</td>
</tr>
<tr>
<td>B. Employment status</td>
<td></td>
</tr>
<tr>
<td>Self-employed/own account workers</td>
<td>46.6</td>
</tr>
<tr>
<td>Employer</td>
<td>16.7</td>
</tr>
<tr>
<td>Employee</td>
<td>12.1</td>
</tr>
<tr>
<td>Unpaid family helpers</td>
<td>24.3</td>
</tr>
<tr>
<td>Day laborers</td>
<td>...</td>
</tr>
<tr>
<td>Others</td>
<td></td>
</tr>
<tr>
<td>Total (employed in million)</td>
<td>39.0</td>
</tr>
</tbody>
</table>

Note: ... signifies relatively small number.
Source: BBS

employment may be considered as informal if it lacks core legal or social protections (e.g. domestic workers). Moreover, de facto informal employment may also exist within the formal sector such as for different categories of casual workers.
The above highlights two important characteristics of the country’s employment situation. First, the problem of unemployment mostly affects the youth labor in Bangladesh. This suggests that the economy needs to generate employment opportunities for the youth at a much faster rate compared with the past. Second, the large majority of the unemployed youth are educated who are deprived of employment opportunities largely due to mismatch between supply and demand in the labor market, inappropriate and inadequate skills to effectively perform in the labor market, and slow pace of job creation particularly in the formal sector. The policy implications are clear: in order to meet the challenges in the labor market, Bangladesh needs to create jobs for the educated youth at a rapid rate, which will come mostly through rapid expansion of productive and skill intensive formal and informal sector activities.

**Wage Levels and Labor Market Regulations**

High wage rates are often blamed for slow growth of productive employment in the formal sector in less developed countries. Wage rates are considered high when total labor cost exceeds the productive contribution of the employed labor. Standard explanation of such labor market developments runs in terms of high wages and rigid labor market regulations (e.g. trade unionism and minimum wage laws). In Bangladesh, the total number of employed labor is estimated at 49.7 million in FY08. With current employment characteristics, about 10.4 million of the total employed labor are likely to be engaged in formal sector while the rest are involved in informal activities.

For illustrating the high wage issue, we take a hypothetical policy goal of raising formal sector jobs by 25 percent (from 10.4 million to 13.0 million). For the purpose, we simulate how much the average wage of a formal sector worker needs to fall in order to achieve the above goal. For the simulation, we assume a wage elasticity of employment of -0.6 which is a typical value for countries like Bangladesh. With the above numbers, the average formal sector wage would have to fall by nearly 42 percent to generate 2.6 million new formal sector jobs. The resulting average wage of a formal sector worker would be Tk. 3,060 per month in 2008, which is 32 percent lower than the estimated household poverty line for the year. As a result, nearly 51 million people (10.4 million formal sector workers plus their dependents) would suffer. On the other hand, 12.7 million people would benefit, that is, the 2.6 million workers getting new formal sector jobs and their 10.1 million dependents. If we assume that these workers with new jobs would come from informal sector activities, their earnings would rise by around 10 percent. However, these people would still be living below the poverty line and the total size of the formal sector would remain small at around 26 percent of the total workforce.

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employed labor. So, although the depth of poverty for a small segment of the labor force might be reduced with such policies, the net effect would be a marked increase of the incidence of poverty as a result of wage cut in the formal sector.

Although labor unions are often considered as a major source of labor market rigidities, unions represent a small and diminishing share of the country's labor force. Trade unions now represent only about 4 percent of the country's total labor force. Moreover, few union workers seem to enjoy wage premiums since the 'elite and senior workers' who enjoy high premiums based on education and skill usually remain outside the labor unions. In general, the labor unions represent production workers belonging to semi-skilled and unskilled categories. Thus labor unions are not an important source of labor market rigidities in Bangladesh. Similarly, minimum wages exert little influence on wage setting. So appropriate strategies for employment promotion in Bangladesh require measures to expand decent employment through comprehensive employment targeted economic programs, including measures to raise labor productivity, broaden credit availability especially to employment intensive sectors, and enhance access to economic and social infrastructure.

### 3. Monetary Policy and the Financial Sector

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 program adopts reserve money (RM) as the operating target while broad money (M2) is used as the intermediate target. 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. However, if the close link between RM

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8 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.

9 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
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.

Inflation and M2 Growth

The relationship between the growth rate of M2 and inflation is relatively weak in Bangladesh (Figure 1). 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. 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 side triggered inflation dynamics is the rise in real interest rate thereby reducing investment and consumer spending.

Interest Rate Issues

Figure 2 shows the average real (inflation-adjusted) deposit and lending rates of the banks. The real lending rate has remained relatively high in


10 Over the last 12 years, the correlation coefficient between M2 growth and inflation has been negative while the value is 0.33 between FY00 and FY08.

11 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, M.K., M.G. Mortaza, and M. Shahiduzzaman, Trend and Characteristics of Recent Inflation in Bangladesh, Policy Paper No: 0901, Policy Analysis Unit, Bangladesh Bank, September 2008.
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, small and medium enterprises (SMEs), and rural nonfarm activities. High interest rates make credit expensive to support the expansion and development of many of these labor intensive activities. This brings out the need to target short term interest rates at levels consistent with long run labor 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 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 mobilization and efficient credit allocations in the economy. In recent years, although IRS showed a marginally declining trend, it still remains high (Table 2).

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.

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

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

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. 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 to develop and 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.

**Development of the Financial Sector**

In Bangladesh, the development (and diversification) of the financial sector needs to play a major role in many areas, such as facilitating smooth exchange of goods and services through monetization of the economy and improvements in payments and settlements; and acting as a bridge between the savers and investors and between the present and the future. Moreover, the development of the financial sector raises overall efficiency of the financial institutions by reducing transaction costs, lowering information asymmetries and market frictions, and pooling risks.

13 In an effort to increase formal credit facilities to small and medium enterprises (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 percent of their total loans and advances to the SME sector in FY07. Moreover, while the banks get funds at the Bank Rate (5 percent) from the Bangladesh Bank, their lending rates are high varying within 14 percent to 24 percent for different banks. See Rikta, N.N., Institutional Lending and Financing Policy for SMEs in Bangladesh, Policy Note PN 0804, Policy Analysis Unit, Bangladesh Bank, December 2007. Similarly, the Equity and Entrepreneurship Fund (EEF) was created in FY01 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, M.E., M.M. Rahman and N.N. Rikta, A Note on the Contribution of Small and Medium Enterprises to GDP in Bangladesh, Policy Paper No. 0806, Policy Analysis Unit, Bangladesh Bank, June 2008.

14 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.
The development of the financial system and its role in capital accumulation can be judged by several financial deepening ratios. In this paper, we use four indicators of financial development based on the volume of credit flows between the borrowers and the lenders. These are: total credit-GDP ratio (TCGD) defined as the ratio of total domestic credit to GDP; bank credit-capital formation ratio (BCCF) defined as the ratio between total domestic credit by banks and gross domestic capital formation; non bank credit-capital formation ratio (NCCF) taken as the ratio between domestic credit by non-bank financial institutions and gross domestic capital formation; and domestic credit by non-bank and bank ratio (DCNB) taken as the ratio between domestic credit advanced by non-bank financial institutions (NBFIs) and banks.

Recent data show that the TCGD, which reflects the significance of the financial sector in terms of its relationship with the real sector, increased from 32.5 percent in FY00 to 43.7 percent in FY07. Similarly, BCCF and NCCF which show the relationships between banks and NBFIs respectively to gross domestic capital formation in the economy improved since 2000. While the value of BCCF increased from 102.1 percent in FY00 to 132.6 percent in FY07, the value of NCCF rose from 2.8 percent to 6.7 percent over the same period. The above shows that banks still play a dominant role in capital formation in the economy. Finally, DCNB that captures the dominant role of banks rose from 2.7 percent in 2000 to 5.1 percent in 2007. While the above shows an increasing role of the financial system, the need is to expand its role at a faster pace to meet the emerging challenges of financing the country's priority investment needs.

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.

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 centers 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 nonfarm sector which are important from the point of view of poverty reduction. Two specialized 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.

**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 mobilize 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 programs 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 stabilization 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 mobilizing deposits and other financial resources on the one hand and administering small scale credit programs on the other.

**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.

4. Policy Implications

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 percent 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 labor force and improve the functioning of the labor market so that the laborers can realize higher returns to their labor 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 labor market reforms to mobilize 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 realization 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 labor 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 labor 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 programs 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 programs. 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 organized and administered

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15 The special designations could include several categories, such as promising SMEs program, technically advancing SMEs program and the like. If necessary, SME sanctuaries could be established.
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 program 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 upscale 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 labor 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 labor are better realized and associated costs are minimized. As a labor 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 specialized banks, and creating more effective investment avenues and providing ownership in social development projects for nonresident Bangladeshis. 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 mobilization, it is important for Bangladesh to explore the implications of financial sector reforms on saving mobilization by the liberalized financial system. Although gross domestic savings as a share of GDP increased from 12 percent in the early 1980s to more than 20 percent in recent years, still it is low.\(^\text{16}\) For the majority of the rural households, ensuring two characteristics of the saving

\(^{16}\) India, for example, had a domestic savings-GDP ratio of more than 32 percent 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 program 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.
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 liberalized 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 favorable 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 liberalized 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 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 mobilizing and pooling small savings and other financial resources; and vitalizing public mechanisms (e.g. post offices) to mobilize 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 liberalized financial system through adopting innovative and viable models of mobilizing 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 realization 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 labor 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 program (ADP) within the poverty reduction strategy (PRS) framework to ensure provision of social services that improve the quality and capability of the labor 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 labor market situation. The promotion of effective employment policies requires reliable labor 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.