Creating an investment-friendly policy ecosystem in Bangladesh

Thursday, Feb 18, 2016

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Bangladesh is among selected least developed countries (LDCs) where the pace of gross domestic product (GDP) growth accelerated, poverty dropped sharply and inequality fell since 2000. Prudent macroeconomic management, characterized by low fiscal deficit, contained inflation, balance of payments (BoP) surpluses, and a very comfortable reserve position served as the solid foundation for the continued strong growth.

Average growth of 6.0% since 2005 has been sustained, notwithstanding global recession, political disturbances, commodity price shocks and natural disasters. Manufacturing sector has been the largest single contributor to growth. Its share in GDP has risen from 10% in 1980 to 18% in 2015.

Growth has been broad-based with demographic dividend resulting in population growth reduction and human development improvement. Net new jobs of 13.8 million has been added during the period, 2003 – 2013, with women’s employment up by 7.0 million (to 16.8 million in 2013).

Per capita income rose to $1314 in 2015 from $818 in 2010, crossing the threshold to make Bangladesh a lower-middle-income country.

BANGLADESH AT A CROSSROADS: Bangladesh aims to become higher-middle-income ($4126

– $12735 in constant 2015 prices) and high income (over $12735 in 2015 prices) by 2041. To reach the 2041 targeted income level, Bangladesh's per capita income needs to grow by at least 13% per annum in dollar terms, compared with the targeted Seventh Five Year Plan growth rate of 8.0% in dollar terms.

The task will be extremely challenging in view of the fact that, over the last three decades, the average annual per capita GDP of China, world's best performing economy, grew by 11.5%. Realization of 7th Plan objectives will be the first critical step in that direction.

Realization of the 7th Five Year Plan Targets: The major objective is to spur growth to 8.0% and reach investment level of 34% by fiscal year (FY)20. Private investment is expected to reach 26.6% of GDP from the current level of 22% of GDP. Foreign direct investment (FDI) is expected to reach 3.0% of GDP ($9.9 billion) from 1% ($1.7 billion) in FY15.

Export target is expected to rise from $31 billion to $54 billion in FY20, which is in line with the targeted doubling of exports by 2021. Share of manufacturing in GDP is expected to grow further to 25%.

STATE OF INVESTMENT IS A MATTER OF CONCERN: Despite the government's planned objective to move to a higher growth trajectory (up to 8.0%) under the Sixth Five Year Plan (FY11-15), Bangladesh's growth performance remained range bound at more than 6.0% level, primarily because it experienced only a modest increase in gross domestic investment. Between FY06 and FY14, gross investment has only risen from 26% to 28.7% of GDP, mostly from public investment (from 4.5% to 6.9% of GDP).

Private investment, accounting for 77% of total investment, will be vital to growth but remained stagnant in relation to GDP at 20%-22% of GDP.

Bangladesh is low in "Doing Business" index (173 out of 189). Its score is lower than its South Asian neighbours, India and Pakistan. Bangladesh ranks 110 out of 148 countries in "Global

Competitiveness” report and ranks 131 out of 178 countries in “Index for Economic Freedom” for being “mostly unfree”.

Bangladesh Enterprise Survey 2013 reveals that political instability is the top-most concern of businesses. Other concerns are: electricity, access to finance, high interest rate, governance, unskilled labour and access to land. It takes 1442 days to enforce a contract, and financial cost of enforcement is 67% of the claim, whereas it takes 400 days in Vietnam, and 453 days in China. Financial costs in these two countries are 29% and 16% of claims, respectively.

HIGH COST OF TRADE: It takes 28 days to export (costing $1281) and 33 days to import (costing $1515), in contrast to six and four days respectively, for the best performers.

The key drivers of investment are:

* Energy

* Connectivity and logistics

* Regional and global integration

* An efficient and financially strong financial system

* Access to serviced land for setting up industries

THE ENERGY SITUATION OF BANGLADESH: Access to electricity in Bangladesh is still low. Despite significant gains under the 6th Plan, 73% households have access to electricity, which is much lower than India and Pakistan. Availability and reliability of power is a key concern of businesses with 28% of businesses considering electricity as their top obstacle, according to a World Bank survey.

In 2013, manufacturing firms lost on average 840 hours of production due to lack of power. Despite improvement in electricity generation capacity, the gap between demand and supply of power is growing. Increase in capacity is due to short term contracts and investment in smaller quick rental power plants.

Investment in large power plants and private investment in this sector will be important to government’s efforts to increase power generation. By 2030, investment in the power sector to increase capacity to more than 30,000 MW while also replacing many old plants, together with distribution network, will require new investment of about $60 billion. Investment in renewable energy is also an imperative.

CONNECTIVITY AND LOGISTICS: For economic growth, Bangladesh needs to improve connectivity in rural areas. Rural urban connectivity hinders business climate and poverty reduction. Only 37% of the rural households live within 2.0 km of all-weather road, compared to 61% in India and Pakistan. Improving logistics is the key to enhancing Bangladesh’s competitive edge in the international market. High logistics cost is an implicit tax. Readymade garment (RMG) and many other potential export sectors are faced with increasing competition and the continuous challenge of delivering exports on time. Doubling of RMG exports to $50 billion by 2021, and sustaining high import growth associated with domestic demand will be a huge logistical challenge for Bangladesh.

The country needs to improve East-West connectivity, to improve market access across major rivers. Completion of the Padma Bridge project would be a major step in that direction. Air transport is suffering from congestion and lack of capacity. Inadequate cargo storage and handling capacity hides export of perishable products (fruits, vegetables, fish, etc.). Handling capacity expansion of the ports needs to be expanded with construction of new deep sea ports and modernization of handling capacity of existing ports by increasing the role of private sector and introducing competition. Massive investment in transport and logistics infrastructure will be the key to achieving growth and export objectives.

REGIONAL AND GLOBAL INTEGRATION: Dynamic manufacturing sector benefits from outward orientation, based on other successful Asian exporters (China, Korea, Thailand and Vietnam). Regional and global integration is vital in this regard. Acceleration of export growth will demand a significant increase in overall investment from domestic and foreign sources (FDI). It will require concerted policy effort. Example of Vietnam shows that accelerated, export-oriented development is possible, even in today’s global environment.

Promoting integration with Asia (the fastest growing region) is vital, especially for export diversification. Much of East Asian countries’ foreign trade is intra-Asian. But Bangladesh unfortunately is not part of the Asian value chain. Bangladesh's development of export-oriented intermediate goods industry will depend on its success in this front. Bangladesh's cost advantage from low labour cost may not allow it to reap the full benefit without regional integration and the advantage may even be wiped out by disadvantages on trade facilitation side.

Foreign direct investment (FDI) has represented a small fraction of gross domestic product (GDP) and private investment in Bangladesh. FDI inflow in 2015 reached to $1.7 billion (0.9 per cent of GDP). In 2012, FDI stocks remained below 7.0 per cent of GDP. The average cumulative FDI as percentage of GDP in the least developed countries (LDCs) is 25 per cent, in Vietnam it is 51 per cent, and in South Asia, it is 12 per cent. FDI in Bangladesh has mostly been in the telecom sector (mostly service sector). FDI helps in augmenting the quality of investment.

Foreign firms are a source of innovation spillovers. FDI can play an important role in export diversification and technology transfer. This is also well documented in Bangladesh. Korean investment in garments industry has led to the emergence of the readymade garment (RMG) sector in Bangladesh. Malaysia has invested in bicycle exports. FDI in shipbuilding can improve capacity and reputation of the sector. In FDI, Bangladesh has very limited success so far, but the potential is immense. Export-oriented FDI sources from India, China, Japan and Korea can enhance market access and competitiveness. There needs to be well-serviced, well-located industrial lands, increased transparency and enforced standards to attract foreign firms.

SLUGGISH INVESTMENT IN INFRASTRUCTURE: For a long time, Bangladesh had neglected investment in infrastructure, making it the most binding constraint on investment. Public investment in infrastructure is 2.0 per cent of GDP, and it lags behind its regional competitors in quality. Infrastructure investment in China and Vietnam exceeds 7.0 per cent of GDP. Most emerging economies have successfully tapped private sector funding for infrastructure investment. Bangladesh needs to do much more in this sector.

Performance of Indian private sector is particularly noteworthy in its infrastructure financing strategy.

EXPORT OVERVIEW: Despite the fact that Bangladesh is an export-led economy and its share is growing over time, the role of trade in Bangladesh economy is still low. In fiscal year (FY14), imports accounted for 21 per cent of GDP and exports accounted for 17.5 per cent of GDP, which are lower than Indonesia, Thailand and Vietnam (where total foreign trade accounts for 90 per cent of GDP). Vietnam’s annual export is $150 billion, five times more than Bangladesh. Electronics ($45 billion) account for 30 per cent of Vietnam’s total exports. Vietnam can be an example for Bangladesh to create a growth-conducive environment, attract investment and project openness by joining trade groups (like Asian Pacific Economic Cooperation or APEC, Trans-Pacific Partnership or TPP and Association of South East Asian Nations or ASEAN).

Growth acceleration will require Bangladesh to be more export-oriented. Its export is currently based on low-skill, low-wage competitiveness in the RMG sector. Bangladesh has potential to increase its trade competitiveness and investment attractiveness.

By 2021 Bangladesh targets to double its total exports to more than $60 billion led by RMG exports to $50 billion, which will require major initiatives. These initiatives can be broken down into five pillars. These are: (1) breaking into new markets; (2) breaking into new products; improving transport logistics; (3) improving workers’ skill and welfare; (4) meeting the challenge of serviceable land; and (5) an efficient financial sector.

PILLAR 1: BREAKING INTO NEW MARKETS: High trade transaction costs are the most important obstacles faced by developing countries in exploiting the opportunities offered by the world trading system. Four issues are critical to Bangladesh’s logistics efficiency: (1) handling of containers in Dhaka-Chittagong corridor (low containerisation, 15 per cent), (2) customs and border management modernization, (3) air transport capacity, (4) regional transit and connectivity.

Bangladesh has not penetrated into growing markets, such as China, India and the broader Asia. Its export is mostly garments to the European Union (EU) and USA. Bangladesh’s merchandise export will be 52 per cent higher and it can gain $1.8 billion from integration with South Asia and East Asia. Greater penetration in the growing markets will increase cross-border investment in support of trade.

Due to proximity, a comprehensive free trade agreement (FTA) with India could raise exports to it by 297 per cent. Under India-Sri Lanka FTA, bi-lateral trade increased five times since its effectiveness in 2001. India-Bangladesh needs to address trade issues such as frequent trade disputes, long hours of gridlocks at custom transit points and non-tariff barriers (NTBs) faced by major companies. Pre-arrival clearance of goods and increased capacity (better machineries usage) of handling trans-loaded goods can improve the situation. A functional regional transit system (Bangladesh, Nepal, Bhutan, India and Myanmar) will unlock real benefits. Building of Bangladeshi brand would also be vital to long-term export and investment objectives.

PILLAR 2: BREAKING INTO NEW PRODUCTS: Openness to trade acts as a disciplining force on domestic market leading to lower costs, higher quality inputs and intermediate goods of producers. Bangladesh needs policy reforms to reduce anti-export bias. It needs a trade-neutral tariff and supplementary duty structure. Removing tariff exemptions will increase revenue by 7.0-9.0 per cent. Trade policy regime needs to encourage diversification. An incubating environment for finding newer export product clusters, other than RMG, is vital.

Bangladesh’s intermediate good export is minimal. Support to intermediate products, such as electronic and automobile components, must be extended. Example of Vietnam in electronics and Thailand in automobiles is particularly noteworthy. Bangladesh needs to streamline quality standards in order to export new products. An aggressive policy to attract FDI is vital to export diversification, transfer of technology and improving Bangladesh brand by upgrading the product quality. Bangladesh has a large labour pool, low labour cost and an understanding of English language for global communication and a perfect geographic location. Bangladesh needs to adopt more transparent and streamlined FDI laws.

PILLAR 3: IMPROVING WORKERS’ SKILL AND WELFARE: Improving skills and literacy is vital for growth and would allow current products, such as garments, to be more competitive. Around 50 per cent of the labour force has secondary education. Less than 1.0 per cent of labour force has professional degrees such as engineering and medicine. Bangladesh has a skilled-labour crisis. Minimising tragedies by work safety guidelines in export sector has become a precondition for sustained export growth. RMG sector has become much stronger post-Rana Plaza through its proactive engagement with Accord and Alliance.

Taking advantage of the working-age youth population will be vital. Bangladesh is passing through the demographic dividend phase. It is going to last for another 30 years. We must develop our work force to reap the demographic dividend as done by Korea, China and Vietnam. Training and retraining will ensure resilience to trade shocks, enhance mobility across sectors, and increase their income and welfare.

PILLAR 4: MEETING THE CHALLENGE OF SERVICEABLE LAND: Lack of serviceable land for investment and industrialization is widely recognised. Industrial enclaves are a solution to the land-problem. Providing publicly acquired land for essential industrial usage will create clusters of growth. Bangladesh Economic Zones (EZs) Act of 2010 aims to resolve the land constraint. Although no new EZs are fully operational until now, with the Prime Minister’s announcement for establishing 100 Economic Zones (EZs) across Bangladesh, the initiative has regained momentum. The EZ initiative aims to welcome investment from destinations such as China, India and Japan. In this regard, the government has already announced to establish EZs exclusively for the Japanese, Chinese and Indian investors. EZs will also be established by the private sector. Seven private EZs are already under construction. Fast-track development of the EZs and their effective marketing and smooth operation may really help change the FDI and domestic investment scenario over the medium term.

PILLAR 5: REMOVING THE INEFFICIENCIES IN THE FINANCIAL SECTOR WILL BOOST INVESTMENT AND GROWTH: It is widely understood that the high cost of fund in Bangladesh is primarily attributable to the inefficiencies and inadequate risk management of our financial institutions:

n The interest rate spread of private commercial banks is more than 6.0 per cent, compared with about 3.0 per cent in most emerging economies. This is largely because of the large non-performing assets and the associated loan loss provisioning.

n The inefficiencies of the public sector banks is being covered by recapitalisation of banks with public money.

n Underdeveloped insurance, pension fund, and bond market have limited scope for infrastructure financing from domestic sources, which is a major constraint in infrastructure development

n Without a properly functioning bond market and a market-based yield curve, scope for developing mortgage financing is very limited, hindering the development of the housing sector.

Bangladesh entrepreneurs can certainly enjoy single digit borrowing rates if these inefficiencies in the financial system are addressed systematically.

CONCLUDING OBSERVATIONS: Building a supportive institutional arrangement will be key to the establishment of a dynamic and private sector-oriented policy ecosystem in Bangladesh. Bangladesh has the potential to mobilise huge amounts of resources from private and official sources of domestic and foreign origins in carrying out a massive infrastructure investment plan. What it critically needs is the institutional capacity to undertake and implement such a massive investment programme.

In other contexts in recent months we have strongly argued that the government may wish to establish a dedicated Infrastructure Fund by expanding the budget deficit by 2.0 per cent of GDP for five years. Such a time-bound fiscal expansion would allow for creation of a $25-billion fund for infrastructure investment. Bangladesh Bank may also contribute another $10 billion by transferring some of its reserves (in excess of six months reserve coverage) to a dedicated Sovereign Wealth Fund (SWF). The resulting $35 billion of fund can also be leveraged with private sector funds under various public-private partnership PPP arrangements. The consequent total investment could be in the range of $50-70 billion.

Managing the implementation of such a large infrastructure programme would require strong central coordination and a fully dedicated competent team, perhaps located at the PM’s office, with strong political support from the highest level of the government. In order to address the private sector supportive policies, Bangladesh also needs to put in place a system for ensuring transparent public-private consultation process.

The Business Initiative Leading Development (BUILD) should help address the effective contribution of private sector in policy formation. It is a joint initiative of the Dhaka Chamber of Commerce and Industries, Metropolitan Chamber of Commerce and Industries, Small & Medium Enterprise (SME) Foundation, International Finance Corporate (IFC) and the European Union (EU). Strong analytical and policy research, some at the government levels and others through independent policy think-tanks, should also underpin policy formulation.