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IS BANGLADESH POISED TO BE LAUNCHED ON AN EAST-ASIAN DEVELOPMENT PATH?

Some Thoughts on Performance, Prospects and Puzzles

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INTRODUCTION

In recent years Bangladesh's growth performance has been widely recognized to have gone through major transformation. Not only has the rate of growth steadily increased, agencies like the World Bank have given it high marks for poverty reduction. Rates of savings and investment have increased rapidly and the country has achieved substantial export growth. Optimistic observers have wondered if the country is poised to be launched into an East-Asian kind of growth path, widely recognized in the development literature as the best-practice development path in the post World War II period.

This paper looks at some of the major indicators of economic performance in Bangladesh since 1990 to evaluate the optimistic prognosis described above. The objective is to juxtapose the performance against the East Asian experience to get some idea about the magnitude of actual achievement and future prospects. I am keenly aware of the limitation that this evaluation suffers from the lack of day-to-day observation from close proximity. And yet innocent ignorance may serve the admittedly limited purpose of identifying issues and puzzles that participants' well-informed eyes might miss.

By now the principal features of the development experience of the East Asian pioneers[1] are well known: (a) extremely high rates of growth, 6 percent per capita per year or higher sustained over more than three decades which enabled the countries to

[1] In this category I include the Republic of Korea, Taiwan, Hong Kong, Singapore and – in a little earlier period – Japan.

make a transition from low-income category to high-income category; (b) the high rate of growth accompanied by an absence of increased inequality of the distribution of income so that growth led to an extraordinarily rapid reduction in poverty; (c) initial dependence on external assistance quickly replaced by very high rates of savings financing very high rates of investment; (d) export-led growth that was initially characterized by concentration on labor-intensive manufacturing exports of substantial diversity followed by regular periodic transformation in the composition of exports, quickly climbing the hierarchy of more technologically-sophisticated goods with high income-elasticity of demand; and (e) a quick and early demographic transition. It is worth noting that later entrants, notably China, have exceeded the growth rate achieved by the pioneers; but have failed to avoid increased inequality. While the sheer force of their stratospheric growth rates has succeeded in reducing poverty, often remarkably by the test of the absolute numbers pulled out of poverty as in the case of China, the rate of poverty reduction that they experienced was far less than the potential rate (the potential rate being defined as one that would obtain if the distribution of income had remained unchanged for the given growth rate). Is Bangladesh showing signs of making transition to a pattern of growth that characterized the East Asian pioneers? How do its development policies compare with what the East Asian pioneers did?[2]

GROWTH AND STRUCTURAL CHANGE

Table 1 shows annual average growth of GDP, agriculture and manufacturing industries. The first row shows the growth rates for the decade of the 1980s as benchmark. During this decade Bangladesh achieved an annual GDP growth rate of 3.7 per cent which, at the time, came as a reassuring rejection of the early fears that the new nation was destined to be an economic cripple. This rate of growth, high in the context of the dismal prognosis by much of the international community at the birth of the nation,

[2] These are not the only aspects of development that matter. One that is conspicuously absent is the environmental challenge. This is not discussed in the paper because I do not know enough about the performance of the East Asian pioneers on environment. Nor do I have the competence to make a comparison between them and Bangladesh in this regard. It however appears to me that the East Asian pioneers' record on environment has been better than that of the later imitators. It also appears that the environmental challenge faced by Bangladesh is substantially greater than what the East Asian pioneers faced.

was driven by relatively balanced growth of the broad sectors: agriculture, manufacturing and the rest ("broad" services including transport, trade, construction and bits of residual categories such as fishery and minerals). Sectoral growth elasticities with respect to GDP was 0.7 for agriculture, 1.35 for manufacturing and about 1.1 for the rest of the sectors taken together. These elasticities were not widely off the expected limits.

The next three rows of the table show the annual average growth rates for the three successive half decades (the last of these periods actually stretching over six years). During the first half of the 1990s the rate of growth of the Bangladesh economy increased despite a sharp fall in the rate of agricultural growth. The growth of the economy during this period was driven primarily by the high growth of the non-agricultural sectors. The rate of growth of manufacturing industries sharply accelerated as did the growth of the rest of the sectors taken together.

The second half of the 1990s witnessed another significant upward jump in the rate of GDP growth, crossing the 5 percent annual bar and sustained on the average for the entire half decade. This was largely driven by a remarkable upward shift in the rate of agricultural growth. The growth of the manufacturing industries actually significantly declined while the average growth of the remaining sectors was again somewhat higher than the growth rate of GDP.

During the most recent sub-period, 2000-2006, the growth rate of GDP accelerated again, though more modestly than it did between the preceding sub-periods. This was substantially due to the recovery of manufacturing growth. Agricultural growth slipped a little while the remaining sectors of the economy grew a shade faster than GDP.

One might conclude that the most recent sub-period - the first six years of the new century - represents a better sectoral balance in growth than in the two preceding sub-periods. The first half decade of the 1990s was a period of stagnation of agriculture, which had negative growth in two of the five years. The second half of the 1990s was a period of lagging manufacturing industries which had elasticity with respect to GDP of just over one, not high enough for the stage of development of Bangladesh. Furthermore, during this period the growth of large-and-medium-scale manufacturing – the organized modern manufacturing - fell below the growth of the small-scale-and-cottage manufacturing. In the most recent sub-period GDP elasticities of agriculture and

manufacturing were respectively 0.6 and 1.3, indicating a much better relative balance in their growth rates. The GDP elasticity of the remaining sectors taken as a whole – sectors that might broadly be described as services – was just over one, lower than one would expect. However, the alternating stagnation of either agriculture or manufacturing that characterized the preceding two decades appears to have ended.

Table 1

Average Annual Rates of Growth (Percent)

Period	GDP	Agriculture	Manufacturing	Manufacturing	
				Large Scale	Small Scale
1980-1990	3.7	2.6	5.0	-	-
1990-95	4.4	0.3	8.2	8.4	7.7
1995-2000	5.2	3.9	5.6	5.5	5.9
2000-2006	5.6	3.3	7.5	7.4	7.8

Note: The time periods need explanation. For 1980-1990 the average of annual growth rates of ten fiscal years are shown. The first of these ten annual growth rates is the rate of growth between fiscal 1979/80 and 1980/81 and the last of them is the annual growth rate in 1989/90 over 1988/89. Similarly the period 1990-95 shows the average of the five annual growth rates of which the first is between fiscal 1989/90 and 1990/91 and the last is the growth rate between 1993/94 and 1994/95. Similarly for the other time periods, the last one showing the average of six annual growth rates terminating in fiscal 2005/06. The data are from, Bangladesh Bureau of Statistics (BBS), 2001 and the BBS data shown in Government of Bangladesh, Ministry of Finance (GOB MOF), 2000, 2003 and 2007. The latter publications are cited in the paper as *BES* followed by the year of publication. All the estimates are based on the revised GDP series at constant 1995/96 prices described in BBS, 2001.

Between the 1980s and the most recent six-year period ("early 2000s" henceforth) the GDP growth rate accelerated by close to two percentage points per year. Over the same period the rate of population growth fell by another four-fifths of a percent.[3] Combining these one finds that the growth rate in per capita GDP jumped nearly three fold between the 1980s and the early 2000s, from 1.5 percent per year to 4.2

[3] According to data shown in BBS, 2001, population growth rate, worked out from the actual data used to convert GDP into per capita figures, was 2.17 percent per year during the 1980s. According to the similar data shown in *BES, 2007*, population growth rate during the early 2000s was 1.35 percent. One should note that the World Bank, generally using the official GDP estimates, does not seem to believe in the official population growth estimates. World Bank's *World Development Indicator 2007* (cited hereafter as *WDI 2007*) uses a current growth rate of 1.8 percent. For the period 1990-2005, similarly, World Bank's estimate of population growth, 2.1 percent, is much higher than the official growth rate of 1.55 percent implicit in the BBS data cited above. This paper will return to this issue later.

percent per year. This represents a remarkable transformation which should have vastly improved the prospects of poverty reduction, even if one allows for minor errors in measurement.

Table 2 shows the structural change in the composition of GDP in the last decade and a half. Agriculture's share in GDP fell rather sharply in the first half of the 1990s; but, as indicated above, it is more a reflection of the severe stagnation of agriculture in that period than real structural change away from the sector. During the next decade agriculture's share of GDP at constant prices fell rather slowly, by only 3 percentage points. Also note that the fall in agriculture's share of GDP was significantly faster at current prices than at constant prices, which indicates that during this period agriculture's terms of trade fell. This is true for both the period of slow agricultural growth prior to 1995/96 and the period of faster agricultural growth after 1995/96.

Table 2

Sectoral Composition of GDP (Current and Constant 1995/96 Prices): Percent

Sector	1990/91		1995/96	2005/06	
	Current	Constant		Current	Constant
Agriculture	25.9	24.0	19.5	15.0	16.4
(Crops)	(20.2)	(18.4)	(14.4)	(11.1)	(11.8)
Fishery	3.6	4.4	5.1	3.9	4.7
Manufacturing	13.0	12.5	14.8	16.6	16.4
(Large Scale)	9.1	8.9	(10.6)	(11.8)	(11.7)
(Small Scale)	3.9	3.6	(4.2)	(4.8)	(4.8)
Construction	5.8	5.7	6.6	7.9	8.8
Trade	12.1	12.0	12.4	13.7	13.6
Transport etc.	9.4	8.9	8.7	10.4	9.7
Other (Mainly Services)	30.2	32.5	32.8	32.5	30.5

Note: Data are from the BBS shown in the issues of *BES*, for 2000, 2003 and 2007. Transport includes communication and storage. Other includes all non-trade and non-transport services and mining (contributing just over one percent of GDP). The fall in the share of the residual category between 1990/91 and 2005/06 at constant prices is due to the fall in the shares of (informal) community, social and personal services and "real estate, rent and other business".

The share of manufacturing industries in GDP increased: more rapidly in the period before 1995/96 than in the period thereafter. Indeed in the decade after 1995/96 the increase in the share of manufacturing in GDP has been very modest.

The "tertiarization" of the economy took place at a rather modest rate which was even slower in the second period than in the first. At constant prices the share in GDP of all sectors other than agriculture and manufacturing increased from 64 percent in 1990/91 to 66 percent in 1995/96 while by the year 2005/06 it went further up to just 67 percent.

Thus the last decade of accelerating growth has witnessed at best limited structural change in the composition of output, with a modest reduction in agriculture's share of GDP, a modest increase in the share of manufacturing industries and an even more modest increase in the share of the remaining "tertiary" sectors in GDP. A good part of the increase in the share of manufacturing was due to an increase in the share of small-scale industries.[4]

Change in the sectoral composition of output does not adequately account for structural change; one also needs to consider the change in the composition of employment. Employment data are available from Labor Force Surveys (LFS) for a limited number of years within the time period under consideration (Table 3). Furthermore they suffer from numerous difficulties the most important of which is that employment in the LFS is determined by the principal occupational category, rather than the actual labor use by sectors. This perhaps presents little problem for sectors like manufacturing and formal activities in which the labor force by and large has a single occupation. This however is not true of agriculture and informal activities. A worker may be employed in agriculture for a part of the year while working in informal construction, transport or trade for the rest of the time. For a group of such workers a given change in the sectoral composition of employment category in the LFS can be out of line with the actual change in the sectoral composition of labor use. There is also the question if the sectoral categories in the LFS closely conform to the sectoral categories of GDP. The conclusions that follow ignore these problems of measurement; but they nevertheless

[4] Without necessarily questioning the validity of the estimated acceleration in the growth rate in small-scale industries, it is worth noting that the revision of GDP accounts for the period starting 1990 (1989/90 fiscal year) instituted a quantum index for small-scale industries, based on a bundle of goods, which yields a higher rate of growth of this sector's contribution to GDP than was the case for the old method.

appear robust enough to survive possible correction for above problems were such corrections possible.[5]

Table 3

Sectoral Distribution of Employed Labor Force (Percent of Total)

Sector	1983/84	1990/91	1999/2000	2002/03
Agriculture	58.8	51.7	50.5	51.7
Manufacturing	8.9	17.0	9.5	9.8
Construction	1.7	1.5	2.8	3.5
Trade	11.6	12.3	15.8	15.1
Transport	3.9	4.6	6.8	6.8
Other (Mainly Services)	15.1	12.9	14.6	13.1

Note: Labor force 10 years and over is included in the LFS for all the years except 2002/03 for which the LFS provides data only for those 15 years and above. Throughout the so-called "usual definition" of employment has been used. For 1990/91 and 1999/2000 the LFS also had estimates based on an "extended definition" which included many categories usually treated as household work. This table is based on the LFS data reported in Islam, 2007.

The most important question is whether the decline in agriculture's share in output in the period under review has been accompanied by a corresponding decline in agriculture's share of employment. The answer is an unambiguous no. Between 1990/91 and 2002/03 agriculture's *share* of employment remained unchanged while over that period agriculture's *share* in output fell by more than 37 percent.[6] Comparisons over other time periods yield just as gloomy or gloomier conclusions: in the two decades leading to the early years of the new century agriculture's share of employment fell by a meager 12 percent while its output share fell by almost a half; and around the turn of the

[5] The years for which sectoral output shares are shown in Table 2 and sectoral employment shares are shown in Table 3 do not coincide. This however is not an obstacle: output shares for other years are available, though not reported in Table 2.

[6] Output shares are at current prices because that is a better indicator of change in relative income endowments of and returns to factors. Agricultural value added at current prices was 16.2 percent of GDP in 2002/03.

century agriculture's share of employment increased when its share of output fell. Thus productivity and earnings of those employed in agriculture has been falling *relative* to the productivity and earnings of the rest of the labor force. Already in 1990/91 agriculture's share of employment was two and a quarter times its share of GDP, meaning that the population with agriculture as the principal source of livelihood had far lower productivity and earning than the rest of the population, resulting in a greater concentration of poverty among those earning livelihood from agricultural activities. Over time the productivity and earning differential between agricultural population and the rest has increased with a consequent increase in the difficulty of poverty reduction.

On historical evidence, manufacturing industries should account for a higher share of GDP than of employment. This is indeed the case for all years except 1990/91 for which the LFS shows an extremely high share of employment, completely out of line with other years. This must be treated as a quirk, perhaps because of the lack of comparability of manufacturing categories between 1990/91 and other years. But there is little support, on the evidence of the sector's employment share for other years, of a significant increase in the sector's share of total employment over a period of significant, though by no means remarkable, increase in the sector's share of GDP.

Construction, trade and transport, on the other hand, have increased their share of employment far more rapidly than their share of output. For this to be credible and consistent with efficient growth, the composition of employment in these sectors must have shifted in favor of more labor-intensive and less formal kinds of activities.

To summarize, the change in the composition of employment has not been remotely consistent with the pattern that either development theory or the history of successful development leads one to expect: there has not been a shift in the composition of employment away from agriculture and low-productivity activities in favor of manufacturing industries and modern services.[7]

[7] To be fair, above evidence does not necessarily rule out the possibility that modern components within construction, trade, transport and other services have had healthy growth in employment, i.e., a rate of employment growth that is higher than the overall rate of employment growth but lower than the rate of output growth in these sectors. But, for that to be the case, there must have been an unhealthy accumulation of labor in low-productivity and traditional components of these sectors. All these of course are subject to the qualification that the LFS sectoral classification into these sectors is broadly consistent with the GDP classification of these sectors.

SAVINGS AND INVESTMENT

Table 4 shows the rates of savings and investment. There has been a rapid increase in the domestic savings rate over the last decade and a half. "National" savings rate - defined as the ratio of the sum of domestic savings, workers' remittances, net factor income from abroad (almost always a negative item), and other net unilateral transfer from abroad (presumably official and unofficial gifts to the government, NGOs and private individuals) to GDP - has increased equally fast and by this measure Bangladesh now saves at roughly the same rate as does South Asia and the low-income countries as a group.[8] Investment as proportion of GDP has also increased about as rapidly as savings. This rapid increase in the rates of savings and investment appears to indicate Bangladesh's success in macroeconomic performance and, prima facie, the increase in the investment rate would appear to be the main factor behind the acceleration in the growth rate. Indeed between 1990-95 and 2000-05 the rates of increase in the investment rate and GDP growth rate appear to be the same. This would suggest that the increase in the rate of investment has not been accompanied by diminishing returns to investment.

There are however several serious questions and puzzles about these findings. The present official series on GDP and its expenditure accounts was introduced around the turn of the century. For about two decades until the turn of the century estimates are available according to both the new and the old methods. There was a qualitative upward shift in the entire time series of savings and investment rates in the revised GDP series (the new series) as compared to the old series. Even for as recent a year as 1999/2000 the domestic savings rate is 18.8 percent of GDP according to the new series, more than twice the rate according to the old series (8.7 percent), and the investment rate is 23.0 percent according to the new series, nearly a quarter higher than the rate according to the old series (18.5 percent). The very first issue is the lack of a convincing demonstration that the upward adjustment in the savings and investment rates in the revised GDP series truly represents a proportionately improved performance in savings and investment. That

[8] This conclusion is based on the comparative data shown in *WDI 2007* which uses the *national* savings rate for Bangladesh but does not make clear if the savings rates for the comparator groups are also similarly measured. If for the comparator categories the rate refers to domestic savings or if the difference between national and domestic savings in the comparator groups is smaller than in Bangladesh – a virtual certainty – then the domestic savings effort in Bangladesh is smaller than in the comparator groups.

such a huge change in the outcome should not discuss the reasons behind it, is profoundly puzzling.[9] Secondly, the crude incremental capital output ratio (ICOR) for Bangladesh is about 4.2 in the early 2000s whereas it is 3.6 or a shade lower for South Asia and the low-income countries as a group.[10] Thirdly, the notion that increased growth has been due to increased investment raises questions about the sharp periodic change in sectoral growth rates. Agricultural growth can be affected by weather which is subject to fluctuations; but it is doubtful if sustained periodic fluctuations of the proportions that actually took place can be explained by fluctuations in weather alone. It is even more difficult to explain the fluctuation in industrial growth. Either sectoral investment shares have fluctuated rather wildly – a factor that itself begs explanation in a period of steady increase in the investment rate – or there have been other powerful effects on growth rates.

But a far more serious puzzle concerns the consistency of the data on savings and investment with the widely-held notion that Bangladesh has been heavily dependent in the past and continues to be significantly dependent today on foreign aid and net capital inflow. According to the old series Bangladesh consistently had "net capital inflow" – defined here as an excess of investment over *national* savings - throughout its history although it fell sharply as proportion of GDP since the early 1990s. According to the new series – as can be read from Table 4 – national savings exceeded investment in each period indicating that Bangladesh did not have capital inflow in the entire period under review.[11] If true this would be a startling finding for an economy which is well known, and officially recognized, to be substantially dependent on external resource inflow.

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[9] BBS, 2001, which introduced the new series, along with its detailed comparison with the old series, sheds no light on the causes behind the increase. Effects of a different set of relative prices for the constant price alternatives of the two series can not explain this as the above estimates are at current prices. It is possible that during a decade of rapid trade liberalization relative prices shifted in favor of investment goods (dominated by imported components) and against consumption (dominated by non-traded goods) which can possibly explain some *increase* in the above rates over time. But the sharply *higher* rates according to new series as compared to the old series must be due to methodological differences between the new series and the old series.

[10] The ICOR estimates for South Asia and low-income country group are based on investment rates and growth rates shown in *WDI 2007* for the year 2005. For Bangladesh it is derived as the ratio of investment rate to GDP growth rate for 2000-05 data on which the estimates in Tables 1 and 3 are based. Using *WDI 2007* data for 2005 the ICOR for Bangladesh still turns out to be above 4.

[11] During the period under review, only in one year, 2000/01, investment exceeded national savings by 0.7 percent of GDP, but in every other year national savings equaled or exceeded investment, often by a significant margin. Overall, national savings far exceeded investment. By 2005/06 national savings

Table 4

Investment and Components of Savings
(Percent of GDP)

Year	I	NS	DS	REM	NFI	OUT

1990/91	16.9	19.6	14.5	2.5	2.6	
1991/92	17.3	19.3	13.9	2.7	2.8	
1992/93	18.0	18.2	12.5	3.0	2.7	
1993/94	18.4	18.8	13.1	3.2	2.5	
1994/95	19.1	19.3	13.3	3.2	2.8	
1995/96	20.0	20.2	14.9	3.0	2.3	
1996/97	20.7	20.7	15.9	3.5	-0.3	1.6
1997/98	21.6	21.8	17.4	3.5	-0.2	1.1
1998/99	22.2	22.3	17.7	3.7	-0.3	1.2
1999/2000	23.0	23.1	17.9	4.1	-0.6	1.7
2000/01	23.1	22.4	18.0	4.4	-0.8	1.2
2001/02	23.1	23.4	18.2	5.3	-1.0	1.0
2002/03	23.4	24.9	18.6	5.9	-0.7	1.0
2003/04	24.0	25.4	19.5	6.0	-0.7	0.7
2004/05	24.5	25.8	20.0	6.4	-1.1	0.6
2005/06	24.7	27.7	20.3	7.7	-1.3	0.9

Note: I = Gross investment; NS = Gross national savings; DS = Gross domestic savings; REM = Remittances made by Bangladeshis working abroad; NFI = Net factor income; and OUT = Other net unilateral transfers from abroad. NS = DS + REM + NFI + OUT. For years before 1996/97 NFI could not be separated from OUT due to the lack of my access to the relevant publications so the sum of the two are shown together. Data are from BBS, 2001 and *BES,* 2007. For some years, data from the two sources overlap. For these cases data from the second source have been used on the assumption that the latter source uses the most recent BBS estimates. NFI is shown in US$ and has been converted into Taka by using the prevalent exchange rate.

The GDP accounting identity tells us that domestic investment is the sum of domestic savings and import surplus in trade in goods and services. During the period under review, the gap between investment and domestic savings, as a proportion of GDP, has remained roughly unchanged: 4.5 percent of GDP during the first five years of the

exceeded investment by 3 percent of GDP and by 2006/07 the difference grew to 5 percent of GDP (figures for this year are not shown in the table because the estimates available at the time of writing remain provisional).

1990s and 4.7 percent of GDP in the first six years of the new century.[12] By introducing some further details into the BBS accounting system one can highlight certain features of the sources of financing the import surplus, the gap between investment and domestic savings:

(a) Remittances made by Bangladeshis abroad, a positive element, has grown rapidly;
(b) Net factor income, mostly investment income, received from abroad, a *negative* element, has grown as a proportion of GDP (i.e., has become a larger negative proportion of GDP) ; and
(c) Other net unilateral transfers, NGO transfers and government grants, a positive component, has fallen as a proportion of GDP;

The BBS accounting defines "national savings" as the sum of domestic savings and the above three components of the current account of balance of payments. Note however that, in addition to the above three, there is also to consider the net balance in the capital account as a source of bridging the import surplus.

The point of Table 4 is to show that there has been a radical restructuring of the sources of financing the gap between investment and domestic savings while the gap itself has remained unchanged as a proportion of GDP over the period under review. Net factor income has become an increasingly larger (negative) proportion of GDP and other net unilateral transfers, grants from foreign sources, have steadily declined as a proportion of GDP. The declining contribution of these two sources to the financing of the import surplus has been more than offset by remittances which, as a proportion of GDP, has more than tripled over the period under review.

Another remarkable fact is that for the last five years under review remittances have financed more than the entire gap between investment and domestic savings. This means that net inflow from all other sources – net capital account balance plus other net unilateral transfers less net factor income paid abroad – has not made any contribution to financing the gap between investment and domestic savings.[13]

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[12] These are the averages of the differences between investment rates and domestic savings rates from BBS' expenditure accounts of GDP, not from the trade accounts. There is significant difference between the estimates due to "errors and omissions" characteristic of trade accounts.

[13] Furthermore, for the last of the three years under review rising net factor income paid abroad has outstripped grants from foreign sources.

How can one then explain the continued dependence of Bangladesh on foreign capital inflow the evidence of which is all too clear: government budget is substantially dependent on *net* foreign financing, to the extent of 2 per cent of GDP or about a third of public investment, [14] in addition to the amount needed to repay outstanding external debt; and the large NGO sector would collapse without external assistance. And yet paradoxically this aid dependence coexists with a situation in which the entire domestic investment is more than fully financed by domestic savings and remittances. How can this be explained?

Net aid inflow leads to one or more of the following possible outcomes: (a) a larger import surplus, the classic method of foreign aid absorption, either by increasing imports or reducing exports; (b) an increase in foreign exchange reserves; and (c) private capital outflows. As explained above, aid inflow has not financed any part of import surplus. There has indeed been an increase in foreign reserves. In the most recent five years under review the aggregate increase in foreign reserves amounted to no more than 0.8 percent of GDP.[15] Since this is far less than the net foreign aid inflow, one is forced to consider the remaining alternative: private capital outflows.[16]

Private capital outflow strongly suggested by the official accounts is just one of several kinds of capital flight that may have been taking place. Recent investigations into corruption has amply shown that a major source of this has been the payments extracted

[14] This is the figure for 2005/06, the lowest of all years.

[15] As best one can estimate from the data shown in *BES 2007*, annual *increases* in reserves in the fiscal years 2001/02 to 2005/06, converted into Taka by using the average exchange rates of respective years amounts to 132 billion, which is 0.78 percent of the aggregate GDP at current prices over those five years. If one takes a longer time period into consideration, by 2005/06 foreign reserves in US$ had more than doubled over 1991/92; but this increase lagged far behind the increase in the value of imports. If one views foreign exchange reserves in Bangladesh as largely the working capital needed to facilitate trade, then the reserve position in 2005/06 was worse than in the early 1990s. In the three years starting 1991/92 reserves were equivalent to an average of more than six months' imports. In 2005/06 it was less than three months' import equivalent.

[16] Admitting that I have no expertise in the intricacies of the balance of payments capital accounts and my access is limited to the summary accounts published in the *BES* which does not help unearth necessary details, I see the following patterns and trends: in recent years foreign direct investment has grown to reach about one percent of GDP. Gross long-and-medium term multilateral debt flow has been about 1.5 percent of GDP although less than half of it has been used to repay outstanding debt in this category. Outflow due to net repayment of short-term debt has however grown and by 2005/06 the large net outflow due to the repayment of commercial loans rendered the entire investment account negative. Disturbingly, a very large negative flow has consistently appeared as "errors and omissions". Despite my inexperience in the field, I tend to believe that this kind of accounting can hide a lot of private capital outflow.

from import procurements (mostly of capital goods) and investment contracts and much of these payments have flown out without leaving a trace on official accounts. The fact that the crude ICOR in Bangladesh has been so significantly higher than the average in South Asia and the low-income countries as a group may partly be due to the higher rent on investment and procurement contracts in Bangladesh than in the comparator groups, themselves subject to such practices, though perhaps to a lesser extent.

A third category of capital flight may consist of under-invoicing of exports for which there was plenty of incentive, despite a move away from the past regime of overvalued exchange rate, in the form of tax evasion and insurance against uncertainty. Finally, from time to time there has almost certainly been "capital flight" by way of diverting potential remittances from Bangladeshis working abroad.

Together aggregate capital flight must have been very substantial although no serious attempt at estimating this admittedly difficult measurement has been made. There are however several important implications of this phenomenon for development policy. First, aggregate investment in the country is not limited by the supply of investible resources but by the incentive to invest. I have often argued that the process of reform of the past ISI regime has neglected the task of replacing the distorted incentives to invest in the past by an alternative, rational system of incentives in most countries that followed the reform package of the international development agencies. Had there been stronger incentives to invest, much of the capital that I suspect to have flown out might instead have boosted the domestic investment rate.

Secondly, this substantially weakens the argument that public investment crowds out private investment, a doctrine that hinges on the assumption of fixed and limited supply of investible resources. To the extent that better infrastructure and externality in the Allyn Young sense are important determinants of incentive to invest in a country like Bangladesh, and lack of incentives is an impediment to converting potential savings into actual savings, public investment of the right kind is likely to have a distinct crowding-in effect on private investment. Needless to mention that this would not be the case if higher public investment were to be a source of greater rent seeking and corruption due to the absence of a minimum effectiveness of governance.

EXPORT-LED DEVELOPMENT?

As Table 5 shows, there has been a substantial increase in the ratio of exports to GDP, especially over the last decade when it went up by two-thirds. There also appears to have been a radical change in the composition of exports with a sharp fall in the proportion of primary exports and a corresponding increase in the proportion of manufactured exports. If one considers total foreign exchange earnings by including remittances then the picture looks even better: over the decade ending in 2005/06 remittances as proportion of GDP increased from 3 percent to 7.75 percent. No doubt these represent important improvements over the past and these are often claimed to indicate the positive outcome of the reform of the trade regime, by moving away from the ISI strategy, an overvalued exchange rate and strong discrimination against exports.

These outcomes are however glaringly distant from those of the East Asian kind of export-led growth. First, the export/GDP ratio today is substantially lower than what it is for the low-income countries as a whole (25 percent in 2004/05 when the ratio for Bangladesh was 17 percent) and significantly lower than what it is for the South Asian region (20 percent in 2004/05).[17] Furthermore, I believe there is an upward bias in the growth of the export/GDP ratio because the exchange rate has depreciated much faster than the rate of increase in the GDP deflator. Had foreign exchange earnings been converted into domestic currency by assuming an unchanged real exchange rate, the export/GDP ratio would have increased more modestly: from 10.8 percent in 1995/96 to 16.8 percent in 2005/06. There is a second upward bias in the export value/GDP ratio that I am unable to quantify for want of information: the import intensity of exports – defined as imported input required per dollar value of export – must be far greater today than during the 1980s. Thus over the long period "net export earnings" as a proportion of GDP must have increased by less than is shown by the figures in the table.

Second, it is not convincing to argue that the change in the composition of exports represents a diversification of exports or even a significant structural change. Thirty years ago, nearly three-quarters of exports were accounted for by jute in raw and manufactured form. Today an even higher proportion of exports are accounted for by a single category

[17] These comparative figures are from *WDI 2007*.

of goods, ready-made garments (including knitwear). By most indices, exports today are less diversified than they were three decades before. Jute goods and tea have virtually been eliminated as exports and, with minor exceptions in terms of export share e.g. pharmaceuticals, there has been no development of alternative exports of robust magnitude.

Table 5

Growth and Composition of Exports

A. Export/GDP Ratio (Current Prices)

	Merchandise	Total
1980/81	6.2	…
1995/96	9.5	10.8
2005/06	16.8	18.9

B. Composition of Merchandise Exports

Category	1975/80	2005/06
Raw Jute	23.9	1.4
Jute Manufactures	48.9	3.4
Leather Products	9.8	3.3
Frozen Food	4.7	4.4
Tea	6.6	0.1
Garments & Knitwear	-	75.1
Other	6.1	12.3

Note: Data are from BBS, 2001; *BES 2007* and Khan and Hossain, 1989. Leather products in 2005/06 include only shoes. Any other leather product exports are in the residual "other" category. The difference between merchandise and total exports is accounted for by non-factor services, for which the figure used for 1995/96 is actually for the year 1996/97.

Third, it is hardly justified to argue that the phenomenal growth in garments exports has been the outcome of an export-led development strategy. These exports owe their growth to the protection that they received in the form of export quota in advanced industrial economies under multi-fiber arrangements (MFA). Many analysts in Bangladesh and abroad, including me, were skeptical about the ability of these exports to continue to grow, or retain their world-market share, in the post-MFA world. This fear

appeared to be unfounded by the good performance of these exports in 2005 and 2006. Of late press reports in Bangladesh indicate that these exports are facing difficulty.[18] It is to be seen if the continued good performance of these exports in the immediate post-MFA period indicates that what were an "infant" export in the earlier years, protected by quotas in importing countries, have been transformed into an adult or whether this was aided by the restrictions on China's garment exports to the industrial countries which are due to expire soon.

A far more fundamental issue is the lack of growth of broad-based, diversified exports. The reasons behind this must be sought in the general explanation for the rather anemic rate of industrial growth, a topic to which this paper will return. But I would like to argue that the easy access to foreign exchange resources from exports to protected markets and from remittances of workers abroad, exacerbated by large foreign aid flows, closely resembles the phenomenon of "resource curse" or "Dutch disease". These flows kept the rate of exchange well above the critical level at which a broad range of exports would have become competitive and some of the traditional exports that have been wiped out would have remained competitive. This resource curse needed to be dealt with by compensatory action to offset the generalized infancy that industries suffer from and to promote the range of exports that would have become or remained competitive in the absence of the foreign exchange surge.

INEQUALITY AND POVERTY

The period under review is covered by four household surveys by the BBS, respectively for 1990/91, 1995/96, 2000 and 2005.[19] Table 6 shows the Gini ratios for the distribution of income made by me (in collaboration with Binayak Sen) and by the World Bank. Our estimates of Gini ratios are consistently lower than the ones made by the World Bank, but they indicate a higher rate of increase in inequality for the common period that both sets of estimates cover.

[18] *The Daily Star* of 19 October 2007 reported that in July 2007 readymade garment exports fell 24 percent from the earnings in previous July. This included an almost equivalent percent decline in exports of knitwear.

[19] This suggests that the reference period for the first two surveys is the fiscal year and for the last two surveys the calendar year.

Table 6

Gini Ratios Based on the HIES Data

	1991/92	1995/96	2000	2005
Khan-Sen Estimates of Gini Ratios for Income Distribution				
Bangladesh	0.303	0.359	0.405	
Rural	0.276	0.310	0.356	
Urban	0.327	0.389	0.437	
World Bank Estimates of Gini Ratios of Income Distribution				
Bangladesh	0.39	0.43	0.45	0.47
World Bank Estimates of Gini Ratios of Real Consumption Distribution				
Bangladesh			0.31	0.31
Rural			0.27	0.28
Urban			0.37	0.35

Note: Income Gini ratios are all for nominal income. The real consumption Gini ratios, presumably Gini ratios at constant 2000 prices, are a bit lower for Bangladesh as a whole than nominal consumption Gini ratios (0.33), but neither shows any change between the two years. One wonders how accurately one could calculate the real Gini ratios which, to be estimated properly, would require price deflators for consumption at different levels, if not for every single individual. The estimates are from Khan and Sen, 2006 and World Bank, August 2006.

We do not know the cause of this difference though we can guess at least one possible reason. We worked out income for each household by redefining it to exclude from the BBS definition certain capital receipts which should not be included in income, components that are highly unequally distributed.[20] This would explain why our inequality estimates should be lower than the ones based on the BBS definition of income. The difference in the rate of increase could similarly be explained by the declining share in income over time of the components excluded by us. If the World Bank estimates are based on the BBS definition of income, the difference between levels

[20] See Khan and Sen, 2001 for the details of the difference in income definitions.

of inequality and possibly the difference between their rates of change over time would also be explained by this.

Our estimates do not extend to 2005; but the World Bank estimate of income inequality for that year would put Bangladesh in the category of Asian countries with high inequality and way out of line with the inequality that the East Asian pioneers had. If the above explanation of the difference between our estimates and the World Bank estimates is right, then the *rate of increase* in income inequality has been closer to our estimates, quite rapid, even though current inequality would possibly be a bit lower than is estimated by the World Bank.

There is a good deal of controversy in Bangladesh about the change in the direction and magnitude of poverty. The World Bank has recently come up with estimates, defined in terms of a per capita *consumption* threshold, that claim that the headcount *rate* of poverty has declined by approximately a quarter between 2000 and 2005 and some Bangladeshi researchers have raised strenuous objections to that claim.[21] This paper has no intention of getting involved in this debate. Instead it wants to highlight the simple point that Bangladesh's disequalizing growth has wiped out a good part, perhaps by far the larger part, of the potential poverty reduction that its growth would have permitted.

[21] The World Bank also claims that poverty over the period since 1990 has been very substantial (see for example Mahajan, 2007). In my view it is quite likely that absolute poverty, measured by the usual indices, has fallen over the period under review, but it is impossible to make a convincing quantitative estimate of the actual decline due to the uncertainty about the data. I do not have access to the details of World Bank estimates for earlier periods. For the period 2000 to 2005 The World Bank (World Bank, 2006) has argued that the *proportion* of people in poverty, measured with reference to a per capita *consumption* poverty threshold, fell by about a quarter. On-going work on the 2005 HIES at the BIDS suggests, somewhat startlingly, that during this period of rapid overall growth, the rate of poverty, measured with reference to per capita personal *income*, actually increased. See, for example, Rahman, 2007 which estimates, on the basis of an income definition which is somewhat different from that of the BBS, that per capita nominal income of the lowest 55 to 60 percent of the population, and indeed for the entire population on the average, increased by less than the increase in the cost of living. The justification that consumption is a better basis for poverty measurement than income is questionable: while its defenders argue that it is a better indicator of "permanent" income than actual income, it has been argued by others that in a poor country actual consumption of the poor can be a misleading indicator of sustainable consumption because poverty often forces the poor to finance current consumption by borrowing or liquidating assets. Available reports on the results of the 2005 HIES are full of question marks and inconsistencies: for example, The World Bank estimates based on it show a sharp decline in urban-rural inequality, more for income than for consumption, and an absolute fall in per capita urban personal income! Preliminary results coming out of the work of the BIDS, as noted above, suggests a decline in per capita real personal income if one accepts their implicit consumer price index which is higher than the one underlying the World Bank's estimates of consumption poverty. None of these outcomes is individually impossible, but none seems particularly plausible.

Table 7 illustrates the adverse effect that rising inequality had on poverty reduction over the period 1991/92 to 2000. First consider the *actual* reduction in poverty (see the note to Table 7 for the source of the poverty threshold). In rural areas, despite a 15 percent increase in real per capita personal income, the headcount rate of poverty declined only a little and the absolute number of persons in poverty increased from 43 million in 1991/92 to 48.5 million in 2000. Worse still, the average poverty gap *of the poor* increased and the distribution of income among the poor became worse.[22]

Table 7

Poverty in Bangladesh: Facts and a Counterfactual

	Rural			Urban		
	1991/92	1995/96	2000	1991/92	1995/96	2000
			Actual			
Headcount	46.95	52.77	45.19	30.22	31.05	25.27
Per Capita Poverty Gap (PPG)	13.10	16.45	14.32	7.77	8.51	7.09
Weighted Poverty Gap (WPG)	5.06	6.96	6.39	2.88	3.09	2.76
			Assuming 1991/92 Lorenz Distribution for All the Years			
Headcount	46.95	49.14	35.95	30.22	21.55	10.88
Per Capita Poverty Gap (PPG)	13.10	14.03	8.92	7.77	4.95	2.14
Weighted Poverty Gap (WPG)	5.06	5.50	3.17	2.88	1.71	0.69

Note: The Table is from Khan and Sen, 2006 which explains the details more fully. The estimates were made by combining the decile distribution data for income with the poverty lines used in the IPRSP (GOB MOF, 2003). Computations were made by using a program developed at the World Bank which fits a parametric Lorenz distribution to the decile distribution data and finds the values of the three measures of poverty by juxtaposing the poverty line and average income against that distribution.

Urban population had a 45 percent increase in real per capita personal income. There was a 16 percent reduction in the headcount *rate* of poverty even though the

[22] The average poverty gap of the poor is per capita poverty gap (PPG) divided by the headcount (HC) rate. Since the PPG increased and HC fell, albeit by a little, the average poverty gap must have increased. Similarly, a faster rise (slower fall) in the weighted poverty gap – which magnifies the weight of the more extreme poor since it is the average of the *squared* poverty gaps of individuals, the average calculated over the entire population and the gap defined to be zero for all the non-poor – than in the PPG indicates an increase in inequality among the poor. See Fields, 2001 for an explanation of the different measures of poverty. Absolute numbers of urban and rural poor have been obtained by applying the headcount rates to the official urban and rural population estimates.

number of urban population in poverty increased from 6.5 million in 1991/92 to 7.1 million in 2000. Another interesting point to note is that all three indices of urban poverty worsened between 1991/92 and 1995/96 despite a decent 16 per cent (3.7 per cent per year) increase in per capita real personal income.

The last three rows of the table show the counterfactual: the poverty outcome in the hypothetical case of the growth in per capita personal income being exactly what it was but the *inequality in the distribution of income remaining the same as in 1991/92*. All three indices of poverty would have been dramatically more favorable. By 2000 the proportion of population in poverty would have declined to 36 per cent in rural areas (as compared to the actual of 45 per cent) and a mere 11 per cent in urban areas (as compared to the actual of more than 25 per cent). Furthermore, average income gap of both the rural and urban poor would have declined. While actual indices of urban poverty went up between 1991/92 and 1995/96, they would have fallen significantly in the counterfactual case. Rural poverty over that period would have increased – an outcome of the estimated fall in rural per capita income over the period about which I remain somewhat skeptical – but this increase would be far smaller (2 percentage points) than what the estimate of actual increase (of 6 percentage points) in the headcount index shows.

For Bangladesh as a whole 49.5 million people - 43.8 per cent - were income poor in 1991/92. Estimates of *actual* poverty show that in 2000 there were 52.6 million poor – a 6.4 per cent *increase* in absolute number – or 40.8 per cent of the population – a 3 percentage point decline in the headcount rate. Had the distribution of income remained unchanged over the period, the outcome would have been dramatically different: the absolute number of people in poverty would have fallen to 39.3 million – a 20.6 per cent *decline* in the absolute number – or 30.5 per cent of the population – a 13.3 percentage point decline. At this rate of annual average decline in the headcount rate (1.56 percentage points per year), the total decline in the headcount rate over 15 years would have been more than 23 percentage points, which would be better than the equivalent of the Millennium Development Goal (MDG) of halving the rate of poverty over 15 years!

The conclusion that stands out is that the rapid increase in inequality has robbed Bangladesh of more than three-quarters of the potential decline in the headcount index of poverty over the period of a decade for which we can make our estimates (an actual

decline of 3 percentage points as compared to a potential decline of 13.3 percentage points). The pursuit of the MDG of poverty reduction must put as much emphasis on containing the rise in inequality as on promoting growth.

The extension of the exercise to 2005 has not been possible due to the lack of information. But if one accepts that the inequality in the distribution of income increased - as is suggested by both the World Bank estimate and the ongoing work at the BIDS – then the above conclusion that the actual poverty reduction was smaller than the *potential* poverty reduction would also hold for this period.[23] If one combines the preliminary estimate of the BIDS that real income growth has been negative with the finding that inequality in income distribution increased then the outcome would look much gloomier: an increase in the actual incidence of *income* poverty between 2000 and 2005.[24]

It is thus of critical importance that growth in the future be less disequalizing (more equalizing) than it has been during the period under review. There are two broad paths of making growth more equalizing: the first is to increase the shares of the equalizing components in incremental income and the second is to make individual components of income less disequalizing (more equalizing). The problem is that most of the income-elastic components – those that increase faster than aggregate income as economic growth occurs – are disequalizing. In this category are income remittances from abroad (domestic remittances from urban to rural households are an exception); property income; non-farm entrepreneurial income; and "salary" income. Non-agricultural wage is the only major income-elastic component which is equalizing.

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[23] The increase in income inequality was small according to the World Bank estimate. The BIDS income estimates for twenty groups shown in Rahman, 2007 suggest a sharper increase in income inequality.

[24] Would one get a different outcome by comparing the actual with the counterfactual if one worked with a *consumption* poverty threshold as the World Bank does? The outcome would depend on the change in consumption inequality: the result would be similar, if more or less extreme, if the inequality in the distribution of consumption has increased. My own work shows that consumption inequality increased at about the same rate as income inequality for the period for which I made the estimates from the HIES data (Khan and Sen, 2001). I do not have the World Bank estimates of consumption inequality for the period before 2000 in sufficient detail to be able to make the kind of comparison that is made in Table 7. As noted above, the World Bank estimates that consumption inequality for Bangladesh as a whole remained unchanged between 2000 and 2005. This is based on the finding that urban consumption inequality actually *fell* during this period and urban/rural inequality in per capita consumption also *fell* very substantially. I find both these to be highly implausible for reasons that would require much more space to elaborate than I can squeeze out in this paper. Before leaving this subject, I would reiterate that controversies about the actual magnitude of change in inequality and poverty can not be resolved with the present state of information and I myself would like to reserve judgment on the change between 2000 and 2005 until I have the opportunity to analyze the unit record data for 2005 HIES.

Agricultural wages, growing about as fast as overall household income, is strongly equalizing. Income from farming is strongly equalizing for overall income distribution in Bangladesh. For rural Bangladesh it was disequalizing in the past but turned out to be mildly equalizing by 2000.[25] This paper will return to the implications of these factors for making future growth less disequalizing.

DEMOGRAPHIC TRANSITION

Official BBS data indicate that the total fertility rate fell by a half between 1981 and 2004, a period over which annual population growth rate declined from 2.3 percent to 1.5 percent (Table 8). This constitutes a significant achievement towards demographic transition. This would appear to be almost an unexpected achievement as the transition started at a time when the indices representing its standard preconditions – improvement in living standard and educational attainment especially of the women – had not shown adequate progress. While the achievements indicated by the official BBS data are indeed substantial, there are several important questions to consider.

The most important question relates to the confidence that one can place in the official estimates. As the table shows, the World Bank remains unconvinced about these claims. If one accepts the Bank estimates, then the magnitude of the transition looks rather modest: a decline in the rate of population growth from 2.3 percent to 1.8 percent over a period of nearly a quarter century. (Presumably comparable) World Bank data for other countries show that the current demographic growth rates in Bangladesh are higher than the South Asian neighbors' like India and Sri Lanka and just the thickness-of-the-pencil away from Pakistan's (annual growth of 1.9 percent). It is also way behind Vietnam in this regard.

[25] Even in the absence of a land distribution and with the inequality in the distribution of landownership being high and unchanged, increasing incidence of tenancy has made the access to land more equal over time. This has complex effect on the distribution of income: direct income from farming has tended to be more equal; but at the same time there has been a sharp increase in rental income as share of total income accruing to landowners. Rent is a highly disequalizing component of income.

Table 8

Basic Demographic Indicators

Year	Bangladesh Bureau of Statistics				World Bank			
	CBR	CDR	Growth Rate	TFR	CBR	CDR	Growth Rate	TFR
1981	34.6	11.5	2.31	5.04				
2004	20.8	5.8	1.50	2.52				
2005					26	8	1.8	3.0

Note: The BBS data are from *BES 2007* and the World Bank data are from *WDI 2007*.

I am not aware of the reasons why the World Bank estimates of demographic performance are different from the official ones and am unable to judge which of the two deserves greater confidence. The point of referring to the difference is simply to bring out the possibility of uncertainty about the official claim. Note however that even if the official claims were right, Bangladesh would have fallen far behind the rate of demographic transition in the East Asian pioneers, for example the Republic of Korea where the population growth rate fell from 2.5 percent in 1965 to less than one percent in 1985.[26] With the current rate of population growth Bangladesh would have to persist with a very unfavorable dependency ratio and a need for social infrastructure like primary education and health facilities which, if adequately provided, would eat up a good deal of the country's resources.

AN EXPLANATION OF THE DIFFERENCE IN PERFORMANCE

We have examined above Bangladesh's recent performance on five principal elements of the growth experience of the East-Asian pioneers and found that they all fall fundamentally short. Bangladesh has indeed experienced quite a bit of acceleration in its growth rate; but, apart from the growth rate itself being significantly lower than what it historically was in East Asia, it has failed to achieve the defining characteristics of East Asian growth: rapid structural change in the composition of both output and employment

[26] This information is from the CD ROM version of the *WDI 2005*.

through industrialization and tertiarization; employment-intensive industrialization relieving agriculture of its burden of a high proportion of the workforce; and thereby reducing the gap between labor productivity in agriculture and labor productivity in the rest of the economy. Even neglecting the lack of explanation behind the methodological change in national accounting that led to more than doubling of the domestic savings rate and a sharp upward rise in the investment rate, one can not regard the performance of Bangladesh in this area as similar to the experience of East Asia where the opportunity for profitable investment was the driving force behind rapidly rising investment which pulled domestic savings along. There is at least strong circumstantial evidence that weak incentive for and profitability of investment has resulted in substantial leakage of savings into capital flight. While at comparable chronological stage of development the investment rate in the East Asian pioneers financed not only the growth of the directly productive sectors but also the creation of the large and indivisible infrastructure, in Bangladesh inadequate investment is a major obstacle to the development of both, especially the infrastructure. Export growth in Bangladesh, though substantial in quantitative terms, lacks the diversity and the frequent rapid structural change that characterized East Asian export growth. Indeed there are reasons to believe that the growth of garments exports in the protected market, along with the surge of remittances and foreign aid flow, led to an outcome that in important ways resembles the phenomenon of resource curse that economic policy in the country was completely unable to deal with. In sharp contrast to East Asian pioneers', growth in Bangladesh has been inequality inducing thereby making a given rate of growth far less poverty alleviating than was the case in East Asia. This of course is a characteristic that Bangladesh shares with more recent successful imitators of the East Asian model in other respects, notably China whose growth rate in recent decades has exceeded the growth rate of the East Asian pioneers at comparable stage of development. Finally, though official claims in Bangladesh suggest a commendable reduction in fertility in recent decades, there is lingering uncertainty about the magnitude of this achievement and, even the acceptance of the official claims means that the demographic disadvantages facing Bangladesh are substantially greater than what they were in East Asia at comparable stage of development.

The above suggests that the development path pursued by Bangladesh has been fundamentally different from the one that the East-Asian pioneers pursued. Bangladesh can not be launched on the East-Asian trajectory by mere incrementalism; by doing more and better what it has been doing in recent decades. There are many differences that one can highlight by comparing Bangladesh's development path with East-Asian pioneers'. Development literature in the last quarter century has extensively discussed the characteristic features of East Asian growth. Although interpreters have often differed in their emphases, a kind of consensus seems to have emerged about them. The remainder of the paper will focus on two broad sets of these characteristics that are of critical importance: the first set relating to the system of incentives that was behind their rapid export-led industrialization; and the second set of characteristics that made their growth inequality averse.

In my view a stylized version of the system of promoting East Asia's export-led industrialization should highlight the following four elements:

1. The central role of the market in the allocation of resources was recognized and wild deviations from the market outcome were avoided. Thus factor prices were outcomes of such policies as keeping the real interest rate positive and avoiding arbitrary interventions in the labor market. Interventions in the product market, in the form of price control and rationing, were avoided. Exchange rate was rarely overvalued, the rates of protection were moderate by the standard of the ISI countries and not wildly non-uniform; and the rigidity of quantitative restrictions on imports was minimal. Slavish obeisance to the market was however rejected. Thus, for example in the Republic of Korea, financial repression of moderate degree was widely used to finance export subsidy; protection was pervasive; and systematic deviations from market principles were made to promote policy objectives, which brings us to the next of the elements.

2. Direct incentives were provided to worthwhile infants. The most important example of it is the systematic promotion of exports. The defining characteristic of the East Asian trade regime is not openness to free trade or near-free trade, but non-discrimination against exports. This is best expressed by what Ian Little, a high-priest of neoclassical development policy, said while responding to critics who argued that the success of the Republic of Korea and Taiwan can not be attributed to liberal economic policies:

   > "Let us have no straw men. I know of no economist who has claimed that their success has been due to free trade and laisser-faire. What I and others

> have claimed is that their success (like that of the other members of the Gang of Four) is largely due (among other things, naturally) to the establishment of a trade regime that is virtually unbiased as between the home market and exports…" [27]

Indeed the evidence suggests that, in contrast to the principles of orthodox economic theory, incentives between exports and import substitution were not neutral. They were biased in favor of exports. Available estimates of effective exchange rates for the Republic of Korea and Taiwan at different periods of time show that they were generally higher for exports than for import substitutes. It appears that the trade regime was premised on the argument that exports, competing with those from the established industrial economies, were infants that needed support. It also appears that the categories of exports that received such support, or more of such support relative to other exports, kept changing over time to bring about radical changes in their composition, steadily propelling these countries to climb up the hierarchy of technologically sophisticated exports. The instrument used was countervailing subsidies for exports through a variety of means. As noted above, the most important method, in the case of the Republic of Korea, was subsidized credit for exporters largely financed by the banking system through moderate financial repression.

3. Infrastructure - physical infrastructure such as transport, communications and power supply; and education and skills for the labor force - was provided principally by public investment. This was of critical importance in helping domestic industries overcome their infancy relative to competitors abroad.

4. Finally, it was recognized that high profitability of investment needs to be guaranteed by an institutional environment which ensures that the entrepreneurs are able to appropriate the product of their effort; that it does not leak substantially into high transactions costs, payments to corrupt officials and sellers of "protection". The magnitude of "rents" need to be low so that entrepreneurs are not lured by rent seeking away from productive enterprise. In East Asia these were substantially achieved by a broad dependence on market to keep rents low; decentralization of decisions on the basis of clearly defined rules; and the creation of a bureaucracy that was relatively independent of political and economic powers.

Elements of East Asian development path that made growth inequality averse may similarly be highlighted as follows:

1. These countries started with major redistribution of the most important assets of the economy at the time. In Korea and Taiwan, and Japan before them, it

[27] I. M. D. Little, "A Comment on Professor Toye's Paper" in Emmerij, 1987.

was land. In the city states of Hong Kong and Singapore it was publicly-provided housing. This redistribution created the initial basis for egalitarian growth.

2. The most important element of egalitarian growth was employment-intensive industrialization at a rapid rate. Avoidance of artificial overpricing of labor relative to other competing factors helped achieve a high output elasticity of employment. The increase in employment in industries and high-productivity services substantially exceeded the aggregate increase in labor supply.[28] The result was a rapid growth in real wages which increased at roughly the same rate as per capita income. This was a highly effective way of avoiding increased inequality and reducing the incidence of poverty.

3. East Asian development strongly emphasized widespread and egalitarian access to human capital: education, skills and health. The sequence of educational development started with universal primary education, followed by rapid access to secondary education with the closing of gender gap. The result was a broad increase in productivity, that for the poor matching the growth in average productivity.

4. The strategy was driven by a leadership that believed in the sharing of the benefits of rapid growth among the broad mass of population. Economic policy encouraged the working of the market in a way that productivity growth was translated into wage increase of comparable magnitude. The invoking of monopolistic power in the product market and monopsonistic power in the factor market was generally discouraged. Direct interventions in the labor market, e.g. minimum wage legislation, and price and distribution control in the product market were not used as instruments for income redistribution.

A quick comparison of the above with the development policies in Bangladesh shows how they were fundamentally different. At independence Bangladesh inherited an import-substituting industrialization (ISI) regime with all its standard characteristics: an overvalued exchange rate; import quotas; high overall but highly non-uniform rates of protection to promote industries for the domestic market; strong discrimination against exports (which actually got worse as the initial devaluation was quickly eroded by high inflation and the selective promotion of exports in the pre-independence period through

[28] An illustrative example, relating to the Republic of Korea during the 1970s, would look like the following: the output elasticity of employment in industries was of the order of 0.7. An annual growth of industries, and related high-productivity sectors, ranged between 10 and 12 percent. About a half of total employment was located in these sectors. Thus the annual absorption of labor in these sectors amounted to something close to 4 percent of the labor force, way above the annual growth in aggregate labor supply.

the export bonus scheme was scrapped). The economy also had widespread direct controls regulating the product and factor markets: public ownership of industrial and modern service enterprises was extensive; administered prices and public control over distribution were ubiquitous; interest rates and wages in the modern sector were regulated; and the private sector was subject to numerous restrictions.

An extensive program of their reform under the auspices of the international development agencies began as early as the late 1970s, a process that accelerated in the later decades. By the 1990s the trade regime had been reformed by abolishing quotas, drastically reducing tariffs and allowing the exchange rate to be determined by market forces. This represented a decisive abandonment of the ISI system of incentives. Other reforms that took place include: the removal of constraints on the area of operation of the private sector and active encouragement of direct foreign investment; privatization of much of the industries, banks and insurance companies; abolition of rationing, public distribution of food grains and agricultural inputs; increase in the real interest rate making it closer to the market rate; and a drastic reduction of agricultural subsidies.

The reforms in Bangladesh, as in many other developing countries where they were inspired by the international development agencies, set the target of completing the demolition work and did little by way of creating an alternative system of promotion. The orthodoxy that guided reforms actually believed that no such alternative was necessary: "right" prices, interest and wage rates would encourage right kind of savings, inflow of capital from abroad and profitability of investment to ensure growth. There have been piecemeal incentives for one activity or another and selective assistance to certain kinds of exports; but there has been little to compensate for the loss of incentives that the ISI provided in the past and to offset the generalized "infancy" that industries suffer from (see below). It is even doubtful if after all the reform of the trade regime the effective exchange rate for exports was brought up to the level of the effective exchange rate for import replacement.[29]

[29] I have not seen any estimates of these rates for recent years. The statement is based on the observation that even though the tariff rate has been drastically brought down (to a weighted average of 7 percent in 2006/07 from 24 percent in the early 1990s; see *BEA 2003 and 2007*), there is no general system of countervailing export subsidy to offset the tariff that remains.

Both economic theory and the history of economic development belie the pristine orthodoxy that mere reforms towards free market and free trade would ensure efficient growth. Economic theory has long argued that in reality many of the assumptions that underlie the claim that the free market and free trade automatically lead to efficient growth are not fulfilled and that "market failure" is a pervasive phenomenon everywhere, more so in the developing economies. In the entire history of development it is impossible to document a significant case of successful development that was not promoted by wide-ranging incentives to industrialize.[30] The point is that the market reforms implemented in Bangladesh, while desirable in themselves, do not in their totality amount to a coherent system of incentives to promote industrialization and exports. The ISI regime was indeed a powerful system to promote industrialization: while accumulation was enhanced by high profitability of protected industries and the appropriation of rent that thrived under the system, the high rates of profit fostered by protection helped direct accumulated resources to investment. The problem was that it promoted inefficiency and wasteful allocation of resources due to non-uniform protection, discrimination against exports and insulation from international competition. It was therefore right to abolish ISI, but it was necessary to replace it with a system of promotion that was free of the distortions and inefficiencies that the ISI suffered from.

That reforms did not concern themselves with the replacement of ISI with an alternative system of promotion for industrial growth is clear. But did they succeed in promoting the objective that they aimed to achieve namely greater efficiency in the allocation of resources? A condition of successful price reform is that economic institutions and organization are in place to make economic agents obey the prices; i.e., economic decisions are based on them. That a more "rational" set of prices by itself does not promote a more efficient allocation of resources, unless well-functioning institutions make economic agents obey these indicators, was the principal theme of Janos Kornai's critique of the reforms initiated in some socialist economies (Kornai, 1980). He argued that it was useless to reform prices when the prevalence of "soft budget constraint" makes it unnecessary for economic agents to obey them. One could argue that in Bangladesh, as in many reforming developing countries, the preoccupation with the reform of prices and

[30] See Chang, 2002.

indicators of incentives was not complemented by the creation of institutions that are necessary to make economic agents act on the basis of these indicators. An example is the sharp upward adjustment of the nominal rate of interest to ensure a real price of credit that reflected its market price. The objective was to make the allocation of credit more efficient. The outcome was a massive default by the borrowers reflecting a complete disregard on their part of the price of credit. The institutional arrangements concerning borrowing from the banking system had not ensured compliance with loan obligations. For a quarter century such default has gone unpunished despite periodic rhetorical sermons by successive governments against such behavior. The history of recent decades demonstrates that the government simply does not have the institutional capability – or chooses not to develop it in deference to the preference of the groups that have the political power - to enforce the rules of the game implicit in the reform of prices and incentives. Other examples consist of the reform of prices of public services coinciding with a complete breakdown of the system of their delivery.

One of the arguments against the ISI was that the wedge that it drives between domestic prices and world prices needs to be sustained by direct controls that lead to massive rent seeking which is a source of corruption, inefficiency and high transactions cost. The abolition of ISI and the reduction in arbitrary market interventions were expected to eliminate much of the scarcity premium and wasteful rent seeking. In reality only the nature of rent seeking has changed. For example, the appropriation of the scarcity premium on import licenses has been replaced by the appropriation of huge "agency fees", mostly concealed, by the agents of foreign suppliers who compete for public imports under foreign aid, not by bidding lower prices but by the exercise of political power on the part of the local agents. Nontransparent procurement ensures huge scarcity premium on these imports. Remarkable changes have also occurred through the creation of innumerable fiefdoms controlling the delivery of public services and administering ubiquitous regulations, thereby imposing high transaction costs on investors and consumers throughout the economy. An investor is subject to these costs at every conceivable stage of operation: getting a telephone connection, obtaining a construction permit, moving goods through illegal barricades created by political hoodlums who are passively patronized by the government, settling utility bills and

taxes.[31] These transaction costs amount to a substantial proportion of potential profit and create a strong incentive for capital flight.

Although no careful quantification is possible, one gets the impression from evolving dialogue among the civil society that in recent decades there has been an enormous expansion of this kind of transaction costs, usually described as rising corruption and deteriorating governance. The essence of the problem is a political system which permits the exercise of arbitrary power in pursuit of profit. Under ISI it took the form of appropriating the scarcity premium embodied in import licenses and distribution permits. Now that economic reforms have done away with those "conventional" forms of scarcity premium, the same arbitrary exercise of political power has invented new and more numerous forms of appropriating rent. They are far more predatory than the system under ISI. As mentioned above, despite all its inefficiencies, the system of rent appropriation that enriched politically powerful groups under ISI also had as its counterpart a strong incentive for investment in protected domestic industries. Today's ubiquitous system of rent appropriation imposes huge transaction costs on the investors and creates a strong incentive away from domestic investment in favor of capital flight. It is this growth-hostility of corruption, rather than the magnitude of corruption itself, that I want to emphasize.

The lesson is that rent seeking, corruption and such other attributes of an economic regime do not automatically follow from the regime itself; they result from the objectives and institutional capability of the government that operates them. Thus conceivably rent seeking under ISI can be minimized by a government that has the institutional capability of auctioning import licenses and adopt other market-simulating steps. Conversely a liberal trade and economic regime does not necessarily put an end to rent seeking and corruption; it can coexist with them if the government creates opportunity for appropriating scarcity premium and makes it possible to access them by non-market methods. Experience shows that such opportunities are endless. Lest this be interpreted as a veiled defense of ISI, let me reiterate that ISI deserved to be discarded on numerous grounds including inefficiency and inequity. It is however naïve to hope that

[31] World Bank Group's Enterprise Surveys (2002-06) in 97 countries rank Bangladesh way above the average in most indicators of obstacle to enterprise growth, especially policy uncertainty, corruption, lack of confidence in courts' upholding property rights, crime, finance and electricity (*WDI 2007).*

replacing it by a liberal trade and economic regime would automatically promote growth and end rent seeking and corruption.

The above goes a long way to explain the failure of reforms not only to induce faster industrialization and diversified export growth but also some of the causes of increased inequality, notably the rampant rent appropriation. Further explanation of disequalizing growth could be found by comparing the East Asian policies with those in Bangladesh in this regard. Unlike in East Asia Bangladesh did not begin with initial land redistribution. One often encounters justifications for this omission. For example, it is argued that conditions for land reform were far less favorable in Bangladesh than in East Asia. While this argument may have a grain of truth, it is by no means the case that Bangladesh did not miss opportunities for significant land reform.[32] One argument that is often made to justify the absence of land reform in Bangladesh is that it is extremely land scarce, that there is too little redistributable land. Land scarcity in the Republic of Korea, Taiwan and China at the time they embarked on land reform was about as acute as in Bangladesh around that time.[33] Egalitarian distribution of land is of much greater urgency under land scarcity than under land abundance. This is because land-scarcity results in a high factor share of land. Unequal distribution of land in this condition means that a high share of agricultural income is unequally distributed. A second argument that conditions for land reform were more favorable in East Asia than in Bangladesh cites the fact that in the Republic of Korea and Taiwan the government came to own a substantial share of total land and other assets abandoned by the former Japanese owners. Here too Bangladesh was not without an advantage compared to most countries if not compared to Korea and Taiwan. At independence Bangladesh government came to own very substantial assets abandoned by the former Pakistani owners. These assets could finance a significant program of land redistribution if not one of East Asian magnitude. In the event these assets were squandered by plunder and mismanagement that followed nationalization.

Land distribution in Bangladesh continues to be highly unequal. But during the 1990s there has been a redeeming effect due to the greater equality of access to tenanted

[32] See Griffin, Khan and Ickowitz, 2002 and 2004 for a discussion of these issues.
[33] Exactly comparable estimates of land per agricultural worker or land per "agricultural" population are hard to find. However see the figures in Khan, 1988.

land. As a consequence the distribution of direct farm income has improved, though its share of total income has fallen while the share of rental income, a highly disequalizing component of income, has increased sharply.

Another factor contributing to inequality is the failure of employment to grow rapidly in industries and modern tertiary activities. As discussed earlier, wages are among the few components of income that have an equalizing effect on income distribution in Bangladesh. Not only has consistently rapid growth eluded the industrial sector, the growth that has actually taken place has been employment hostile in the aggregate.[34] What explains the employment hostility of industrial growth after reforms that led to freer trade when economic theory argues that such a move should promote greater employment intensity of growth for a labor-abundant economy? It seems that much of the explanation lies in the initial condition of the industrial sector which in the past, during the period of state ownership, had expanded employment far beyond what efficiency would dictate. A comparison of the Labour Force Surveys of 1990/91 and 1999/2000 shows a poor growth in employment which was due entirely to a drastic reduction in employment in manufacturing.[35] This was substantially due to the shedding of surplus labor in the former state-owned enterprises. Carefully-designed compensatory public policy was needed to offset the adverse distributional effects of these reforms. There was little of that.

Be that as it may, the principal problem about low employment growth in industries was due to low industrial growth. The problem of transition by way of absorbing the surplus personnel on the payroll in the state-owned enterprises would have been much easier if industries had grown rapidly.

Another difference between Bangladesh and East Asia in distributional policies is the poor performance of Bangladesh in providing egalitarian access to human capital. This has proved to be an obstacle to the improvement of the productivity of the poor.[36]

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[34] A cursory look at the evidence does not suggest that rapidly-growing exports like garments have been employment hostile. Much of the problem of slow employment growth in industries as a whole is due to the employment growth in these industries being offset by the fall in employment in the industries in decline.

[35] As noted before, the 1990/91 LFS almost certainly overstates manufacturing employment due to other reasons as well.

[36] According to *WDI 2007* Bangladesh has made significant improvement in primary education and in closing the gender gap in primary education. By 2005 primary school completion rate for girls had exceeded that for boys. But about a quarter of boys and girls still fail to complete primary education and it

A CONCLUDING COMMENT

Can Bangladesh reorient its policies to get closer to the development path of the East Asian pioneers? What are the prospects of success for such transition should the policymakers decide to attempt it? It appears that *designing* a system of incentives for export-oriented industrialization is relatively easy. Although a full replication of the East-Asian system may require special dispensation from the World Trade Organization, it should be possible for a least-developed country like Bangladesh to *design* a reasonable system of promotion working around the WTO rules.[37] Ensuring an egalitarian income distribution will prove more difficult as is shown by the experience of the contemporary imitators of the East Asian model.[38] But here too one can *design* policies to limit inequality: by emphasizing employment-intensive industrial growth and by widening the access to human capital.

The real obstacle is in the way of creating institutions for the implementation of these designs. However decentralized and market-based the operations of an economy may be, there are many decisions that individuals need to make and regulations that individuals implement. Well-functioning institutions are needed for these tasks to be carried out. Rather than gradually building such institutions, the country's history since independence is one of a steady erosion of the institutions that existed. Just to illustrate the point, it is hard to see how Bangladesh can create a banking system in the near future which would be able to distribute subsidized credit to the exporters according to clearly-defined rules without allowing the rent to be massively misappropriated.

There is little that I can say about the process of creating appropriate institutions. East Asia successfully created the basic institutions that that was premised on a coalition among major entrepreneurial and social groups in pursuit of national development goals.

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is widely believed that the quality of primary education is low and has perhaps declined over time. The big failure is of course in adult literacy which prevails among less than a third of women and about a half of men according to UNDP's recent *Human Development Reports.*

[37] The maze of WTO regulations and the complex chronology of their coming into force make it hard to know with certainty, but it appears that during the Uruguay Round the developing countries traded away much of the right to do what all the present-day industrial countries did during their industrialization. See Chang, 2002 for a historical perspective.

[38] The experience of China is discussed in Khan and Riskin, 2001.

The state indeed used its power to promote the capitalists as a class, but avoided using power arbitrarily to enrich selected individuals or groups. Successive governments in Bangladesh have failed – never systematically tried – to create a broad coalition among entrepreneurial groups based on a clear definition of the rules of the game and their non-arbitrary enforcement.

There are strong reasons to believe that the erosion of institutions was a necessary part of the "accumulation process" that successive governments in Bangladesh adopted, namely the arbitrary enrichment of individuals and groups belonging to the government in power at any given time in exclusion of the rest of the entrepreneurial and social groups. Capitalist accumulation emphasizing discipline and entrepreneurial reward was inconsistent with accumulation process. One of the first requirements of governance for development is to replace this tribalism by the creation of a consensus among entrepreneurial and social groups about the rules of the game.

Rather than engaging in further discussion on a subject in which my ideas are fuzzy, I would like to conclude by quoting what a former head of the Institute of which the BIDS is a successor said about the replicability of the East Asian experience:[39]

> *If, in all countries, distortions are eliminated – if all prices are right – the government's role is minimal, no inflation exists anywhere, saving and investment are at least 15% of GDP, and world trade is booming, would all grow at the same rate as Korea and Taiwan have in recent decades? The answer surely must be no…*
> *To accept learning and knowledge accumulation both as the bottom line of growth and as having roots deep in the ethos and history of a society requires that explanation and policy prescription probe these precincts that are so alien to mainstream thinking.*

Along with learning and knowledge one might add the creation of necessary institutions – building a consensus among entrepreneurial and social groups about the rules of the game; and an institutional structure to implement them without arbitrariness – to the list.

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[39] Bruton, 1998.

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