

# The Bangladesh Journal of Political Economy

SPECIAL ISSUE ON  
INTERNATIONAL  
TRADE AND DEVELOPMENT

Editors:  
Dr. Abdul Ghafur  
Dr. Sadrel Reza



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ECONOMIC ASSOCIATION

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Economy

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TRADE AND DEVELOPMENT*

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THE BANGLADESH JOURNAL OF  
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*Special Issue on International Trade and Development*

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# Economic Policy of the Government of Bangladesh\*

by

A. M. A. MUHITH\*\*

In the two days of intensive discussions that will follow you will deliberate over the issues of international trade and economic development. I thought I should leave that subject to the experts and instead make use of this opportunity to speak about the economic policy that we have adopted to promote economic development in Bangladesh. This may provide some background to the significance of international trade and capital flows on weak economies.

2. Economic development, *inter alia*, aims at providing more of goods and services at the disposal of the members of a nation. Increase in the wealth of a nation classically occurs with increasing specialisation or division of labour. This means employment of labour more extensively as well as intensively; this means acquisition of greater skills and application of new technology; this also means increased capital formation. Increasing division of labour is possible only under increasing exchange of goods and services between people specialising in various production processes. International trade by promoting exchange of goods and services between nations axiomatically contributes to economic transformation and social welfare. The history of almost three decades after the Second World War bears testimony to the contribution of international trade to economic growth. It is generally observed that the unprecedented growth that the world economy witnessed after the War was fuelled by three elements, *viz.*, trade, cheap energy and phenomenal advance in science and technology.

3. This seminar is being held at a time when all the traditional engines of growth seem to have lost their dynamism. The era of cheap energy came to an end in 1973 and in 1979 it was made known more brutally. The rapidity with which scientific and technological progress contributed to productivity has not been there for a

\*Inaugural address by Mr. A.M.A. Muhith, Minister for Finance and Planning, Government of the People's Republic of Bangladesh at the Bangladesh Economic Association seminar on International Trade and Economic Development on 5-6 November, 1982.

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while. Also perhaps limited availability of raw materials and basic minerals has somewhat blunted the manoeuvrability of technological fixes. But recently the stagnation in world trade has spelt disaster for economic development. In 1980 world trade grew by only 1% and in 1981 it has not registered any growth at all. And what are the consequences? For the first time there is a decline in per capita income in the developing countries. For three consecutive years developed countries experienced negative growth. The developing countries are suffering acutely from both savings gap and trade gap. Resource transfer from the developed to the developing countries has fallen. Export earnings of developing countries have drastically declined, primary commodity prices having suffered the severest decline in fifty years. Very high and volatile interest rates have increased the debt burden, reduced the real value of net resource transfer and exacerbated the liquidity problem of the developing countries. Investment all around has been declining and unemployment reached a record level. Depressed effective demand in turn is adversely affecting production and investment.

4. With this scenario at the background you have to appraise the economic policy that we have enunciated. Bangladesh is in such an economic situation that without growth we simply cannot survive or maintain the fabric of the society. The demographic investment required in Bangladesh is about 8% of GDP whereas saving ratio is only about 4% or 5% of GDP. The structural problems affecting our development prospects are simply formidable and economic self-reliance realistically is a distant horizon. Already absolute poverty rules supreme in the country. But expectations are high, the demonstration effect is all there. There is a real threat of social upheaval through the dual explosion of population and expectations. Rapid economic development, therefore, is an unavoidable economic policy objective in Bangladesh. How to achieve this objective in conditions of population pressure that is threatening the carrying capacity of the country, severe lack of capital assets, acute shortage of healthy and skilled manpower, limited ability to export goods and a difficult aid environment is indeed a nightmare for policy makers and planners. Yet we have to move forward because there is nowhere else to go. The audacity to move forward demands two perceptions; first, you have to take a long-term view and second, you have to be an optimist.

5. I have already furnished too long an introduction and let me now turn to the economic policy of the government. A view shared by many is that our economic policies have not been consistent and we did not afford enough scope for the citizens to participate in the overall development activities. Immediately after liberation, we resorted to large scale nationalisation of the non-agricultural sector and set up a number of public sector agencies. We were partially forced by circumstances to do so as many industrial and commercial units were abandoned by their erstwhile owners and managers. This drastically reduced the scope of operation of the private sector in industry and finance. It was expected that owner-

ship of industrial assets will generate surplus for investment and growth in the public sector. Contrary to expectations the actual result of nationalisation of organised industry and finance has not been propitious. The nationalised units in the industrial sector incurred huge losses which amounted to about a billion taka in ten years. Most of these losses were met by money creation which imposed a disguised tax on the fixed income groups, the unemployed and the rural poor. The growth of entrepreneurial capabilities and labour productivity got stunted as there was little scope for creative work. The basic fault in our planning in the past has been lack of consistency and realism in the pursuit of economic policies. We extolled the virtue of rural development and self-sufficiency in food production but we failed to undertake investments that would contribute to rural or agricultural growth. We spoke about higher levels of production but did not focus our attention on productive investment. We spoke of import substitution but our actions supported import dependence. We spoke of hard decisions but planned in a grandiose manner much beyond our means. As a result in spite of substantial development outlay, we are barely maintaining availability of goods and services at a constant level for our growing population. Of course, in the bargain the poor are becoming poorer while a few others are getting richer.

6. I would like to stress that we have not been guided by any doctrinaire approach. The compulsion of our circumstances is rapid amelioration of poverty. The productive potentials of the country must be realised so that a availability of goods and services expands and simultaneously employment opportunities and income earning capacity of the masses increase. We have to strive for simultaneous growth in production and equitable distribution of increased wealth. Increase in production demands the efficient use of capital assets, investment of surpluses, improvement in technological base of the economy, skills formation and innovative management and organisation. Social justice, on the otherhand, depends on prevention of exploitation, provision of job opportunities, control of wealth concentration, provision of command over assets to the rural poor and improving their access to social services. As the society is organised today and as its power structure is, the public sector should focus on rural development, population planning and building of social and physical infrastructure. Directly productive activities like agriculture and industry require government support rather than control, direction rather than ownership, innovation of free enterprise rather than conformity of bureaucracy. Of course, it will be unrealistic to assume that private sector can work miracles. The performance so far is a mixed one—we have successes and failures in both the public and private sectors. Mismanagement is not the monopoly of the public sector and misuse of funds has not remained confined to the private sector only. With renewed dedication the economy has to be moved forward, productive efficiency improved, skills and technology upgraded and investment accelerated.

7. The socio-economic framework to which we are committed is, therefore, essentially pragmatic—based on lessons we have learned the hard way. We have clearly stated that ours is a mixed economy as it has actually been since the emergence of the country as an independent nation. Agriculture that contributes 55% of the GDP is in the private sector. Large and medium industry that contributes only 6% of the GDP has been largely in the public sector. We are now attempting to provide better opportunities to the private sector and confine the public sector capability to chosen areas—areas of high technology and large investments. In the power and energy sectors as also in some areas of transport and communication sectors (*i.e.*, railways, highways and tele-communications etc.), the public sector will continue to play the dominant role. In the area of social infrastructure public sector in such a poor country as ours has necessarily to play the crucial role. Merit wants like education, health or welfare services will be provided by the public sector. Old age security, housing and many amenities of social life are generally provided by the private sector with public sector playing only a supportive role. Trade essentially has been in the private sector with a few public sector agencies playing a limited role. This is the pattern of our economy and we are committed to moving it forward within this framework of public private sharing of responsibilities. Government regulations and laws which are unduly restrictive are being adjusted in order to release the creative energies of the nation.

8. It is the policy of this Government that public sector should not take up activities which can be better done in the private sector. Public sector should concentrate in areas where private capital is shy. Public sector should yield place to private enterprise whenever the latter becomes willing to come forward in any area. Public sector should be made to compete with the private sector on equal footing for scarce resources like credit, foreign exchange and market. We have already spelt out the limits to public sector operation and expressed our firm determination to provide safeguards and necessary support to private enterprise. It is in this spirit the Government announced the new industrial policy providing for increased participation of the private sector.

9. Major emphasis will continue to be on the development of the agricultural sector. The issues of low productivity and food security have to be resolved through a frontal attack on the technological fixes on the one hand and organisational structure on the other. Technological fixes can be highly productive but only for a while. For longer term solution the structure of agriculture and rural setting have to be changed. To cope with the problem of mounting rural unemployment in the medium term, improvement in agricultural practices and investment in rural infrastructure are the major instruments. Simultaneously, however, income earning avenues must be provided to nearly half of the rural population in on and off farm employment. This class of deprived and poor people have to gain control over productive assets. Production, services and trade—all three activities

together can make a dent in the rural scene. A streamlined credit system for both agriculture and other rural activities, organisation of the farmers and non-farming people and upgradation of technology hold the key to the success of this development policy. I am deliberately refraining from talking about technical inputs for food production which will continue to receive attention. But in the rural sector the problem of the landless has assumed a great urgency and ways have to be found to organise them and provide in their hands some control over productive assets.

10. Family planning will continue to receive high priority in our programme. It is expected that with the restructuring of the administrative system, and the development of local councils the effectiveness of family planning programmes will be increased in terms of project implementation. If you want to experience the explosion of the population bomb, this is the place for such an experience. This explosion does not take place with a bang but it slowly unfolds itself. It cuts down per capita availability of goods and services, brings about distortion in distribution of those goods and services, sharpens deprivation of more people, contributes to pauperisation and limits and scope for better utilisation of available resources like land and water. This is the greatest threat to the stability of Bangladesh society and it does not admit of instantaneous solution. Demographic transition to lower fertility is a painstaking multi-faceted process.

11. The country is in dire straits, it has to find a solution to the food-energy-population equation. The carrying capacity of the land is being taxed by increase in population. Sustenance of this population demands higher levels of food production and larger supply of energy. We need to harness our known energy resources more extensively and with greater care. We also have to take advantage of our soil and climate to generate forest resources. We have further to make better use of nature's gifts like sun and wind. Energy resource development and harnessing of more energy enjoy high priority in our development strategy.

12. Compulsory primary education will continue to be a goal of economic policy of this government. However, since our resources are limited, it is necessary to set up priorities in education planning. Funds deployed for higher education should be commensurate with the expected benefits. There is a redirection of resources to primary and vocational education. We want to educate the school age boys and girls and ensure that they do not drop out of primary schools. We are determined to improve the technological base of the economy by imparting technical training to our unemployed youth and school-going children. We believe that this will generate employment, contribute to production though specialisation of labour and at the same time keep us well provided for export of manpower.

13. The yawning trade gap is a matter for great concern. The inequity of the global trading system has been exceptionally hard on us. In the last two years we lost through deterioration in the terms of trade approximately a billion dollars. The enormity of this loss in purchasing power can be better appreciated by reference to two other statistics. Our trade gap is about one and a half billion dollars a year and our receipt of aid has been around \$ 1.2 billion per annum during the last three years. We attach high priority to export expansion and diversification which is, however, predicated upon production of more exportable surplus. The industrial policy assigns high priority to export-oriented industries. Banking system has been geared to supporting the export sector in a big way. Incentives for export is being provided in every possible manner—tax and duty relief on capital goods as well as exportable production, assistance in marketing and finance for fixed and working capital on favourable terms. We have difficulties with shipping facilities but we are making efforts to improve conditions. I would like to caution that competition for market is very severe and a advantageous position for ourselves can only be carved out if we move fast and move with quality production.

14. I should perhaps say a word about foreign investment. Because investible resources are so limited, because expertise and technology are not domestically available, we welcome foreign capital. We believe such investments will generate wealth, provide employment, bring improved technology and management style and contribute to export promotion. In industries which are capital intensive, involve sophisticated technology and are geared to export market we specially welcome foreign investment. Guarantees and facilities for foreign investment have been amply provided. One of the areas in which we invite foreign investment with open arms is oil and gas exploration where investment, technology and research and development are so very crucial.

15. I have reiterated that equitable distribution of income, resources and opportunities for a better life of the poorer section of the society will continue to be a major goal of our economic policy. Our project planning should be such that further deterioration of the unemployment situation is halted. We shall, therefore, continue to emphasize labour intensive activities while deciding investments in areas where a choice of technology is available. We would be guided by a planning framework which will ensure both production and consumption of daily necessities such as food, clothing, health care, drinking water and basic education. To reach the fruits of development to the vast multitudes we are determined to direct investment to the rural areas. A greater share of development expenditure must be in the rural sector. And effectiveness of rural programming must be improved through planning and execution of projects and programmes at district and thana levels. Our programme of devolution of government functions and responsibilities to district and thana levels is designed to provide the rural push in investment and improve efficiency of programmes that

encompass vast masses of people such as family planning, primary education, rural works, rural forestry or agricultural production. This, we are confident, will enable the vast masses to participate effectively in the development process. I visualise a day in not too distant a future when the central government will concern itself with a limited number of national and interregional projects and programmes while thanas will be planning and executing a large part of the national development plan.

16. Very often the question of aid dependence is raised. A country with limited capital assets and limited number of people who can be effectively taxed, and at the same time suffering from the inequities of the global economic order has, of necessity, to rely to some extent on transfer of resources from abroad in its struggle for economic emancipation. We recognise, however, that inflow of resources will only be beneficial if it helps acceleration in national efforts. In order to be prepared also for a catastrophe scenario we are emphasising domestic resource mobilisation, rationalisation of transfer payments, improvement in the performance of public sector enterprises and a priority of growth oriented investment programme. We welcome aid that respects our priorities and choice of technology and contributes to higher production and better institutional development. We recognise the crucial role of technical assistance and the beneficial impact of small voluntary efforts. But we would like to see the optimal use of our own expertise and appropriate technology. We want voluntary operations to be in conformity with our priorities and with our vision of the society.

17. It is unfortunate that the Second Plan that we launched two years ago in 1980 could not be finalised so as to provide the necessary guidance to steer the ship of our economy. High expectations of aid and ambitious targets have eroded the productive outcome of our investment programme. We have been living beyond our means and we have been subsidising the life-style of the privileged few. We drew up large investment programmes but then cut them midway thus upsetting production objectives. We estimated unrealistic resource availability and then made up the gap by deficit financing causing inflation and depreciation of currency value. In formulating the economic programme of this year we have been guided by a concern for fiscal realism, austerity, productive investment, capacity utilisation and rural thrust in development. The Planning Commission will soon finalise the Second Plan to provide the framework for the next two years in the light of work done for the preparation of this year's Annual Development Programme and the new focus in priorities and policies. We hope to present along with the final version of the SFYP, the outlines of a physical programme for the next two years.

18. This in short is the economic policy that we have developed over the last six months or so. You will notice how the policy decisions have been influenced by the external economic realities. Aid flow to Bangladesh has not really

suffered so much if we consider the decline in aid availability globally. But the depressed condition in world trade has made a lot of difference to the investment policy and balance of payment picture of Bangladesh. Unfortunately we are not in a position to offset the adverse effects by borrowing from the commercial market. So we have to fall back upon catastrophe planning. We are often asked to adjust but adjustment by cutting down growth rate or in a situation where manoeuvrability is almost non-existent is easy to be admonished but difficult to implement. Yet we have taken courage in both hands to adjust. The success of our policy, however, will depend on the dedication of our people on the one hand and the understanding of our development partners on the other.

19. Ladies and gentlemen, I take great pleasure now in declaring the seminar open and wish you all success in your deliberations. I shall earnestly look forward to the conclusions and recommendations of the seminar.

17. It is noteworthy that the Second Plan that we launched two years ago in 1980 could not be finished as it to provide the necessary guidance to steer the ship of our economy. High expectations of aid and ambitious targets have eroded the productive outcome of our investment programme. We have been living beyond our means and we have been subsidising the lifestyle of the privileged few. We drew up large investment programmes but then cut them midway thus upsetting production objectives. We estimated unrealistic resource availability and then made up the gap by deficit financing causing inflation and depreciation of currency value. In formulating the economic programme of this year we have been guided by a concern for fiscal rectitude, stability, productive investment capacity utilisation and rural thrust in development. The Planning Commission will soon submit the Second Plan to provide the framework for the next two years in the light of work done for the presentation of the year's Annual Development Programme and the new letters to partners and donors. We hope to present along with the final version of the STPT, the outline of a physical programme for the next two years.

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# Introduction

by

M. AKHLAQR RAHMAN\*

## I. PRELIMINARY

International trade and investment have played a historical role in the process of economic transition of nations ; and despite highly uneven nature of this process, international economic interdependence has increased progressively over the past centuries. Over the past half a century the state of interdependence has heightened to such an extent that economic development of nations in isolation has become almost inconceivable.

However, the phenomenal growth of international trade and the sweeping changes in its structure over the past decades have left the historical pattern of trade more or less unchanged. In spite of considerable economic development, the low-income countries continue to suffer from destabilitating disequilibrium in balance of payments and chronic deterioration in terms of trade. For example, during the seventies, the volume of external debt of the oil-importing low-income countries rose by about 3 per cent of their GNP, debt services by over 2 per cent of their merchandise export, while the deficit in their current account balance of payments increased at the compound rate of 23 per cent per annum. Consequently, their international reserves decumulated drastically. The prospects for the low-income countries in the eighties would seem to be quite disconcerting, since the world economy has not yet recovered from the economic shocks of the 70s ; lingering recession, mounting unemployment, and high inflation still plague the industrial countries.

The low-and middle-income developing countries are on the horns of a dilemma : if they rely heavily on external borrowing (assuming that it is possible to borrow as much as they would like to) their debt management problems including forced, and sometimes undesirable, adjustment in domestic economies, often due to discriminating conditions imposed by the IMF, gets accentuated ; if they resort to drastic restriction of imports they might end in reducing both economic growth and export.

Since development of economic theories and policies are largely governed by historical conditions, it is only natural that the emerging situation in the world economy should spur the interest of economists, especially of those of the

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low-income developing countries, in the problems of development and trade. The Bangladesh Economic Association recognized its timely importance and organized an International Seminar on International Trade and Economic Development on the 5th and 6th of November 1982. Published in the present volume are the proceedings of that seminar. The four specified themes of the seminar were (i) export-oriented growth ; (ii) export processing zones ; (iii) international monetary problems ; and (iv) imported inflation.

In selecting the specified themes for discussion, particularly the one on 'export-oriented growth', the Association was guided the least by the 'fashionability' of the topic, as Wahiduddin Mahmood would seem to have suspected, but mainly by its genuine desire to initiate renewed research on a problem which has now assumed an overriding importance for the low-income countries like Bangladesh, since the prospect for their becoming self-reliant is critically linked to how rapidly and with what development strategy their saving and trade gaps can be reduced. In the ultimate analysis, the two stylized gaps are inter-dependent, and progressive increase in export appears to be one of the preconditions for narrowing both saving and trade gaps. Whether or not export will play the leading role is a separate question, and will depend on particular conditions of a particular country. There can be no dogmatic generalization in that respect. Yet, investigation of the theoretical and practical conditions for export-oriented growth is of primordial importance to planners and policy-makers in most low-income countries like Bangladesh.

## II. CONFLICT BETWEEN GROWTH AND TRADE THEORIES

Among the economists and policy makers, the relation between international trade and economic development remains one of the most controversial and demanding fields of inquiry on both theoretical and practical grounds. The theoretical controversy started more vigorously immediately after World War II with the unprecedented surge of interest among economists particularly in the economic development of the emerging backward nations.

In the realm of economic development, attention is basically centred on the question of optimal allocation of given (and incremental) resources to ensure maximum feasible growth. To a large extent the question of optimum resource allocation is associated with the theory of international trade ; and there exists an age-long conflict between trade theory and growth theory. This conflict, as Hollis B. Chenery had pointed out as early as in 1960, emanates basically from differences behind the assumptions and orientation of the two theories.

According to the classical doctrine of international trade, growth is facilitated by specialization. Not only that the classical assumptions did not hold for most

less developed countries, the 'backwash effects' of international trade due to the creation of structural imbalances also condemned most such countries to stagnate in a vicious circle of poverty. Even the Heckscher-Ohlin version of the theory of comparative advantage, as a basis of development policy, came under heavy criticism because of its assumption of similar production functions and comparability of factors among the trading countries.

The pattern of age-long specialization of low-income primary producing countries resulted in such structural imbalances and rigid market imperfections that in most such countries factor prices failed to reflect opportunity cost and as a result market mechanism failed to function as a vehicle of resource allocation. Under these conditions, the growth theories were basically concerned with the endogenous determinants of growth and development, intersectoral interdependence, and the sequence of intersectoral expansion of investment and production. In addition, the growth theories were conditioned by certain historical economic facts that (i) the quality and quantity of factors of production change in the process of production over time, (ii) economics of scale is important in a number of sectors, and that (iii) both in consumption and production there exists dominant complementarity among commodities. These, in fact, were the other assumptions on which the growth theories were constructed.

The well-known balanced growth criterion enunciated by a number of growth theorists (e.g., Lewis, Nurkse, Rosenstein-Rodan) was logically derived from their theories in which horizontal and vertical interdependence between sectors played important role and where the consequent linkage effects resulted in the creation of what Scitovsky called "dynamic external economies". One of the critical assumptions behind the balanced growth criterion is the existence of elastic supply of certain factors. Where investable resources are fixed, as Paul Streeten argued, unbalanced growth becomes more important and facilitates rapid technological progress. Hirschman's argument for unbalanced growth is based upon economizing of entrepreneurial ability. Thus, the criterion of unbalanced growth is not a negation of that of balanced growth; it is the product of different assumption and orientation. Economic history provides irrefutable evidence of how vertical interdependence played important role in stimulating industrialization. Vertical interdependence is an important element in both criteria; through it operates the linkage effects of unbalanced growth, provided the market mechanism works efficiently. It is especially because of the absence of the latter that the criterion of balanced growth becomes more important.

It is not quite correct to allege, as has been done by many (including Chenery), that the growth theories 'totally ignored' the doctrine of comparative advantage since it was because of the total inadequacy of the static comparative advantage in initiating and sustaining growth that the growth theories focused attention on

dynamic comparative advantage which only economic growth can generate. Furthermore, the investment criteria that concomitantly emerged from the growth theories, namely the capital-labour and capital-output ratios, represented the essence of the Heckscher-Ohlin version of the theory of comparative advantage in respect of resource allocation that a country will benefit by adopting techniques that use more of its relatively abundant factor. Inter-sectoral and inter-project variations of capital intensity do not invalidate the logic of the argument, as is maintained by many, since it is the average capital intensity for the whole economy which matters most.

The balanced growth theory does not ignore the role of trade in economic development. On the basis of the consequences of the past pattern of international trade, it highlights the need for the reduction of excessive specialization in primary producing backward countries through diversification involving industrialization; and in the case of latter, if necessary, through import substitution, since it affects productivity via growth of skill and management, creates dynamic external economies, and ensures better terms of trade. The argument for diversification of the economic structure does not exclude the need for technological change in primary production, although external economies are more important in the industries sector; nor does it call for abandoning specialization in existing exportables. What it stresses upon is the fact that a diversified economic structure enables it to shift to new types of export or import substitution with changing trade conditions within the permissible limits of resource endowment, i.e., comparative advantage, which is substantially effected by technological change and progressive correction of factor price disequilibrium.

### III. TRADE AND ACCUMULATION MODELS

The theories which have explicitly dealt with *trade and accumulation*, far from being contradictory to some of the important conclusions of the growth theories discussed above, confirm more poignantly the role of the conditions of trade in economic development. In spite of the well-known adverse effects of import substitution through protection, its role in economic development is a historical fact; its effects on capital accumulation through distribution of income in favour of the saving groups, which is also a precondition for capital accumulation under free trade, is theoretically well founded. Promotion of capital accumulation under free trade, as Bert Ohlin has argued, requires that the countries have comparative advantage in capital-intensive commodities, that the level of their trade is high and rising, and that their saving function is positively sloped.

Important models of trade and capital accumulation (e.g., by Bensusan-Butt, W.A. Lewis) indicate not only how capital accumulation may open up trade between

countries with no trade, but also a sequence of development which may lead to overspecialization, especially in the primary export industries necessitating large capital investment in complementary services and related lines of production. *Ceteris paribus*, trade and capital accumulation may lead to the type of structural imbalance which engendered the development of the growth theories.

Conditions of trade and production play an important role in the long-run development of regions even in the *export base theories* of development (e.g., by D.C. North), according to which, a region, rich in natural resources with access to immigrant labour, will raise level of income and capital stock more rapidly when it exports natural resource-intensive product or material requiring only simple processing. The pattern of development in the oil-rich countries over the past decade is an example of export-base development. The continuation of this pattern of development in the long run, however, necessitates that (i) foreign demand continues to remain as strong and (ii) demand for similar product arises regularly over time.

One implication of this theory is that growth pattern is likely to persist for a long time only in countries with a large variety of easily exploitable natural resources. The sequence of development is likely to lead to the growth of vertically related industries subsidiary to export industries, as well as of locationally 'foot-loose' industries. In theory and practice, this counters and qualifies the prescriptions of the balanced growth theory, but only as a special case because of rich natural resources and most favourable conditions of trade. Generalization is impossible for a large number of low-income countries. Another implication of this theory is that without sustained prosperity of their export, countries having such export base growth may become economically 'stranded', besieged with the difficult problems of structural readjustment.

The so-called 'export-led' growth of Taiwan, South Korea, Hong Kong (Malaysia) and Singapore, strictly speaking, is not an example of export-base growth, since it is nowhere related to richness of natural resources, nor is it a case where export played the role of the leading sector. The model does not conform to resource allocation prescriptions of the classical comparative advantage, excepting the fact that the export-oriented industries were basically labour-intensive in conformity with their low land-man endowment ratio, even though the technique, especially in Korea, has started shifting more to skill-intensiveness.

The export-oriented industrialization of these countries represents, in the ultimate analysis, a process of development with an ad-mixture of resource allocation prescribed by both growth and trade theories. All of them have gone through a process of industrialization through vigorous import-substitution before the export industries started growing and export of manufactures taking, both quantitatively and qualitatively, the role of leading element in speeding up economic growth.

Not only the 'four' had outward-looking economies with substantially higher trade ratios, the preconditioning process which set the stage of export-oriented industrialization has also been the result of well-known historical, sociological, and political transformation. The transition from import substitution to export-oriented industrialization came at a point of time when both domestic and external conditions became extremely favourable; considerable industrialization through import substitution had engendered, via the scale effects, the elements which foster dynamic comparative advantage; and the switch coincided with the phenomenal upswing in international trade and investment. Undoubtedly, foreign aid and investment did play a big role in the process of their export-oriented industrialization.

The state undertook a committed and determined outward-looking strategy of development; import substitution was discouraged; a sort of free trade condition was created by making trade policy neutral to import and export; a high lending rate for investment kept the average capital-labour ratio for the country quite low, while a discriminatory low interest rate for export finance enabled exporters to keep export prices lower. Creation of free-trade zones, especially in the case of Malaysia, increased massive inflow of foreign investment, although technically the industrial growth due to it was rather shallow. The success in the export-market was also due to their remarkable achievement in the creation of an organizational framework for export promotion.

The state played another crucial role by adopting an open and committed policy for capitalist development facilitating rapid inter-penetration between the state and the rising capitalist groups. This created a vigorous entrepreneurial class and ensured, buttressed by supporting policy measures, the distribution of a major proportion of additional income from investment and trade in their favour—a precondition for capitalist accumulation.

This particular process of development and the peculiar conditions which spurred it up can hardly be replicated in most low-income oil-importing countries. And there are well-known arguments for not doing so. However, other countries can take certain lesson, though not altogether new, in development planning, such as the benefits that can be harnessed by reconciling trade and growth theories in formulating planning strategies and development programmes.

#### **IV. RECONCILIATION BETWEEN GROWTH AND TRADE THEORIES**

Reconciliation of contradictory elements in growth and trade theories in policy formulation is not an easy job since, in the first place, what appears as apparent contradiction in static analytical framework often ceases to be so in a dynamic analytical

framework and, in the second place, the policy prescriptions which seem simple and obvious to professional economists do not seem so to practical policy makers because of certain socio-political compulsions under which they operate. The latter are responsible for inconsistencies in policy formulation ; the policy makers are often faced with a bundle of given objectives in which many are contradictory. Sometimes exogenous factors, such as, changing facts of dominating international agencies in respect of development priorities, add new dimension of complications.

In most low-income countries, development programmes confront two sets of problems : the short-run problems of structural imbalance in factor markets and demand and supply imbalance in the commodity market, and the long-run disequilibrium in the balance of payments as their development process gets accelerated. In most low-income countries where the share of trade in the GNP is relatively small, the short-run problems necessitate following the prescriptions of growth theories in determining inter-sectoral priorities and targets, in overcoming bottlenecks and for achieving inter-sectoral balance. The inter-sectoral programmes are formulated accordingly and investment criteria are frequently adopted to minimize the use of scarce factors, an element of trade theory incorporated into the growth theory. Many countries have started to use the programming technique at both macro and micro level planning for formulation of sets of alternative feasible programmes. More frequently than not the exact implementation of plans thus formulated gets frustrated for both endogenous and exogenous compulsions for which blame is borne by the growth theorists for their alleged negligence of the trade theories.

The solution of the long-run problem necessitates attention to comparative advantage through increasing export at an appropriate rate. This can be, and is, integrated in short-run planning through determination of a perspective pattern of production and trade that maximize a pre-determined welfare function over time. Since plan periods are dated, they get influenced by uncertain and unforeseen circumstances in different periods ; resource-poor and externally more dependent countries fail to maintain rigidly inter-temporal continuity of their planning strategy.

Furthermore, given the inter-temporal continuity in their perspective strategy, the basic problem that most of these countries face is to reshape their initial comparative advantage which has been the cause of structural disequilibrium they are at pains to remedy. Production of new exportables and finding market for them is not easy. For one thing, this requires the rapid growth of the non-traditional sectors which in most countries calls for import replacement. And for another thing, it requires production of exportables, using the most abundant factor, which have fairly high income elasticity of demand in the developed countries as well as institutional framework for marketing of such products.

Such exportables are not numerous, and the promotion of such exports are not immune from vulnerability and instability. Not only they frequently face the barrier of widespread protection in developed countries, increased competition among the low-income countries also push down their prices in the export market. The greater the degree of trade dependence, the greater is likely to be the terms of trade effect on their real income. The situation may become that of an immiserizing growth with increased transfer of real income to developed countries.

Whatever the consequences may be in this rather inescapable pattern of development, there is no escape from a process of integrated industrialization through both import substitution, in spite of the concern of professional economists for static allocative efficiency, and export expansion. One way of avoiding possible immiserization is to link investment and trade through more involvement of the transnationals in economic development—a model which may not be feasible in many countries for both political and economic reasons. Another way is to form regional economic unions with plan harmonization which are not easy to implement because of formidable political and administrative barriers.

Meanwhile, the disequilibrium in balance of payments continues and gets accentuated because of the discriminating international monetary system which manages international liquidity in such a way that adjustment measures forced upon the low-income countries end in frustrating their strategy of development.

Such are the nerve-wreaking problems of development and trade which are more profoundly discussed by the learned participants in the seminar covering particular aspects in particular context. And when put together they give an excellent analysis of the global aspects of the problem which, it is hoped, will be of great theoretical and practical importance to both economists and policy makers.

## V. A SUMMARY OF THE MAIN PAPERS

The seminar started off with *Mrinal Datta Choudhury's* searching examination of the basic issues in export-led industrialization thesis. He starts with the argument that the growth theories of the 50s led to a rather naive application of essentially negative theoretical results of the theory of resource allocation, to the field of economic policy and planning; failed to handle the theorems of market failure 'in a creative manner'; substituted defective market mechanism with statism; and, therefore, removed market discipline 'from the industrial organization without creating a workable alternative'. One consequence of this process of development was that when the climate of international trade and specialization dramatically changed in the 60s many countries, notably India, failed to alter the mechanism of their control in conformity with the changing situation.

The 'new orthodoxy of the export-led industrialization strategy' was, according to him, the product of the intellectual vacuum created by the failure of the old orthodoxy and was not an improvement 'either in terms of analytical rigour or on the basis of its empirical foundation'. The export-led industrialization of certain countries, particularly of South Korea, which were initially outward-looking trade-dependent countries, had coincided with the period of world trade expansion and was sped up by supporting economic policies. However, in the case of South Korea, the industrialization strategy cannot be characterized in terms of exclusive categories of import substitution and export promotion. Free Trade Zone played an important role in Malaysia where the process of industrialization was dominated by foot-loose industries having little lasting effect on future growth ; and the creative entrepreneurial role which characterized South Korean development was absent in Malaysia.

Emphasizing the key role played by the entrepreneurial class in successful capitalist development, he concludes that in a developing capitalist economy this class needs to be both protected and promoted and state intervention may be productive or counter-productive in this respect. In the case of South Korea it was highly productive; and beyond this level of generalization Datta-Choudhuri does not go ; he considers it misleading to suggest possibilities of easy replication of individual country experiences.

Wahiduddin Mahmood argues that in the case of large countries 'manufacturing exports alone cannot revolutionize the situation' and that the prospect of such development for late comers may be radically worse' and maintains that the debate on that issue does not equally concern all developing countries. He also endorses the doubt expressed by critics on the possibility of sustained growth through export-led industrialization. According to him, export-led industrialization is not a 'grand solution' ; it is only one alternative strategy of development, and the appropriate strategy for any country is a function of its resource endowment and stage of development.

He finds the prevailing structure of Bangladesh's export inadequate for initiating a process of export-led growth, even though the country may have long-term comparative advantage in many labour-intensive manufacturing activities. Although, the tariff structure of Bangladesh is strongly biased in favour of import substitution and against export promotion and does not guide *ex-ante* investment decisions, he does not support the proponents of 'free trade' policy since their recommendation is not always based on correct comprehension and understanding of the problem. Protection in Bangladesh needs to be related to efficiency and not to its elimination altogether.

Of the limited choice open to Bangladesh, under the existing socio-economic conditions, the strategy of agriculture-led growth is the most appropriate which, however, does not preclude the possibility of using many lessons learnt from the successful cases of export-led growth.

*Muzaffer Ahmad* maintains that the establishment of the Export Processing Zone in Bangladesh has been based on a rather inadequate feasibility study. Since Bangladesh ranks very low in the available stability index involving some 70 countries of Asia, Africa and Latin America, there seems little or no prospect for inflow of private foreign capital in the near future. Given the political stability, the supply of foreign capital for development of export, he argues, is mainly governed by the motive of market expansion protection through oligopolistic production of differentiated products with some cost advantage. Besides the paucity of domestic capital, the demand side is governed by the benefits to be derived from the package of capital-technology-management skill. Because of the liberal incentives provided to investors by Bangladesh, the gain to be achieved from increased export and retained foreign exchange earning and earning through taxation is likely to be minimal. The only gain would seem to be the higher real payment to labour. The spill-over effects in terms of better management and higher skill is likely to be insignificant, and the possibility of diversion of trained labour from the domestic sector to Export Processing Zone may produce the reverse spill-over effect. The employment effect of the Export Processing Zone is also likely to be negligible because of slow and limited investment.

In this type of a model, *Muzaffer Ahmad* argues, there exists a conflict of interest between investors and the host government since the profit motive of the former may not coincide with the development objectives of the latter, more so if the latter is deficient in political skill and bargaining ability, and in consequence the end result may be socially sub-optimal.

*Muzaffer Ahmad* maintains that the creation of the Export Processing Zone in Bangladesh is mainly motivated by objective of (i) rehabilitation of private investment, (ii) re-cycling of Bangladeshi capital nested abroad in a safe zone; (iii) creation of more nests abroad for Bangladeshi private capital; and (iv) re-location of domestic export industries. He stresses upon the need for further careful examination of the economies of the Export Processing Zone before committing more resources in infrastructural development in a locality where the concentration of industrial capital is one of the highest in the country.

*J. S. Gulati*, while analyzing the international monetary problems, focuses attention on the increasing inequity in world liquidity generation and its consequence on the world monetary system and particularly on the low-income developing countries. Historically, the Bretton Wood arrangement generated international liqui-

dity through the creation of dollar liabilities, and after its break-down in 1973 the U.S. position has improved further. The generation of world liquidity, to a large extent, has become the prerogative of the U.S. monetary authority and the U. S. commercial banks. And the role of the IMF in this regard has become increasingly limited.

On the other hand, the inequity in the growth of payments imbalances has increased with the slackening of the world trade from the 70s. The balance of current account payments deficit of the oil-importing developing countries has increased drastically by about 9 times and those of the low-income countries by about 4 times between 1973 and 1982. Their external debt liabilities increased by about 5 times during the same period. These countries are compelled to depend almost exclusively on official bilateral and multilateral credit, more on the latter, for financing their deficits, the private commercial banking credit being virtually outside their reach.

Not only has the reserve currency country's liabilities abroad increased continually, commercial banks have also become the major source of funds for developed countries as well as for a handful of middle-income developing countries. Consequently, a new asymmetry has emerged in the access of balance of payment financing between these countries and the low-income and most middle-income oil importing countries.

For their balance of payments financing the latter countries are driven more and more to the World Bank and IMF who offer high-conditionality finance. The IMF imposes obligation on borrowing countries to undertake severe adjustment efforts to contain their domestic demand with exchange rate depreciation and import liberalization while no such obligation is imposed on the balance of payments surplus and reserve currency countries. Also the latter have become free of obligation to maintain the gold value of their dollar reserves. Thus, the deficit low and middle income countries are forced to take full burden of the corrective adjustment for maladies which are more often than not outside their control.

During the past decade, the Fund assets increased tardily mainly because of the reluctance of the developed countries to allocate additional SDR and their opposition to increase membership quotas. This, together with the relative decline in quotas, retarded the expansion of the Fund's conditional liquidity. In addition, the Fund has become increasingly inclined towards high conditionality financing. According to Gulati, the increasing dependence of world liquidity on reserve currency countries rather than on the IMF is a retrograde development of the 70s since the process has resulted in absolute control of the IMF by the reserves currency countries, especially by the U.S.A.

The principal features of the new monetary arrangement that has emerged today are (i) dominance of flexible exchange rates ; (ii) the expanding role of commercial bank financing of balance of payments ; and (iii) the relegation of the IMF to an almost peripheral role which are the consequences of the Jamaica agreement of 1976. The emerging situation, as Gulati concludes, has become ominous for the developing countries, more so for the low-income countries which are compelled to fight for the expansion of the role of the multilateral institutions in the generation of world liquidity as well as against the IMF's growing bias for increasing conditionality financing. The future efforts for monetary reforms aimed at making the system more responsive to the needs of the developing countries, according to Gulati, is unlikely to be more fruitful. A more fruitful arrangement is likely to be "the mutual cooperation among the developing countries at global, regional, and sub-regional levels."

*K. M. Matin*, starting with an elaborate but more or less similar analysis of the existing international monetary system including a critical appraisal of the Bretton Wood arrangement, reviews particularly Bangladesh's experience over the last decade in responding to international monetary problems. The low ratio of foreign trade to GNP in Bangladesh, argues Matin, gives a rather misleading picture of the extent of her dependence on, hence the levels of her interaction with, the world economic system, since the extent of existing saving and trade gaps together with the critical role that external assistance and inputs play in economic development, render the economy of Bangladesh extremely vulnerable to external forces.

Because of her import dependence Bangladesh's economic growth in the seventies was adversely affected by rising world inflation and import prices with deterioration of her terms of trade. In Bangladesh, payments deficit continued to rise and resource balancing became difficult because of the lack of access to international sources of finance in spite of some ten-fold increase in world liquidity due to highly inequitable distribution of additional reserves. In a hypothetical exercise Matin shows that had the international monetary system been operated according to agreed and established principles the growth of world liquidity would have been sufficient to provide Bangladesh with adequate financing. However, since the ideal condition did not obtain she was compelled to use 'high conditionality' finance of the IMF. Not only the forced short-term deflationary policies and import restrictions, involving change in its volume and composition, due largely to variation in the real values of different types of aid, adversely affected the growth of output ; the instability that stemmed from generalized floating and continued pegging of the Taka to Pound Sterling also involved considerable economic costs.

The pegged rate was frequently altered in an *ad hoc* manner, even though an index of effective rate was used as a basis for adjustment. As a result, Taka exchange rate with major currencies became considerably instable producing adverse effects

on economic efficiency, mainly because of the asymmetry in the currency denomination of Bangladesh's exports and imports. The narrow and inefficient market mechanism failed to reduce the adverse effects of exchange rate fluctuation through hedging.

The monetary authorities in Bangladesh resorted to frequent adjustment in the Taka-Pound peg with the intention of keeping the Taka-Dollar rate stable which, according to Matin, was a second best option. However, Matin argues that pegging of Taka to Dollar would have been a better option since from 1976 some 72 to 85 per cent of her total imports and 41 to 56 per cent of total exports were invoiced in U.S. dollar. It would have reduced the risk of loss both for importers and exporters, hence the inefficiency in the use of resources.

*S. R. Osmani's* searching analysis indicates that imported inflation as a predominant causal factor in the explanation of the inflationary pressure in Bangladesh during the past decade cannot be taken for granted due to certain well-known structural reasons.

World inflation in the early 70s, especially in the developed countries, was transmitted through capital account of the balance of payments. It was not so in Bangladesh; here the triggering element was the prices of internationally traded commodities which rose at the annual compound rate of 14 per cent while the corresponding rate of inflation was 14.4 per cent. The close association between the two rates, however, does not necessarily imply causality.

According to monetary theory, the transmission occurs through increased money supply due to rise in monetary base caused by improved balance of trade. This was not the case in Bangladesh since exchange control, import restriction, composition of import, import through foreign aid, asymmetric rise in import and export prices did not lead to any noticeable improvement in trade balance, while the overall balance of payments was governed more by aid than by prices, and the money supply was directly controlled by the central monetary authorities.

The monetary channel could not play a significant role in transmitting world inflation to Bangladesh since the impact of rising demand was unimportant because of inelasticity of import and export demand, low substitutability between traded and domestic goods, the low ratio of trade balance to total absorption and the like. The classical mechanism of pure price effects could not have been effective because the downward rigidity of wages and prices could not be regarded as an institutional datum and the relative price changes could take place without additive impact on inflationary pressure due to a minimum built-in rate of about 10 per cent inflation in the monetary policy of Bangladesh.

Imported inflation, according to Osmani, would seem to have been transmitted mainly through state response to the rising prices of imports. The argument is that rising import prices caused a big fall in the real income of the government; of the two policy options of absorbing this loss, viz., by reducing its expenditure or by shifting real resources from other sectors, the government chose the latter and implemented it mainly through large-scale deficit financing (the use of pricing policy was inadequate and casual) causing the supply of narrow money to rise at an annual compound rate of 20 per cent which was capable of explaining fairly well the inflation rate of 14.4 per cent. Osmani, however, concludes that the responsibility for inflation in Bangladesh could be shifted back to world inflation if it could be shown that the chosen response of the government was an optimal one among the feasible alternatives.

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# The Export-led Industrialisation Thesis : An Examination of the Basic Issues

by

MRINAL DATTA-CHAUDHURI\*

The subject of this paper is the large body of literature which has grown during the last decade and a half around a set of interconnected themes in the field of trade and industrialisation policies. This body of literature first came in the form of a critique of the strategy of industrial development through import-substitution, which appeared to be the dominant orthodoxy in development economics in the 50's. Inevitably, the critique moved on from the problems of development strategies to the issues of specific control mechanisms : quantitative controls *versus* regulations through prices, and even state interventions *versus* free trade. The general thrust of the criticisms was to contrast the performance of an interventionist regime operating on an essentially closed economy with that of a liberal regime promoting the growth of an open economy. Eventually some of these critics identified export-promotion as the engine of growth and canvassed the thesis of export-led industrialisation as the new cure for the poor and backward economies of the Third World.

The main difficulty of reviewing this literature is its enormous size and its extraordinarily wide coverage. There are purely analytical papers ; there are analytical works with selective empirical evidence from many countries ; there are country-studies and studies of international cross-sections. There are even some econometric exercises of hypothesis testing on the basis of data on international cross-sections and time-series. Moreover, some authors are cautious so that their remarks are usually appropriately qualified ; while others are bold and write with Messianic zeal. Therefore, it is hazardous to lump these economists together into homogenous groups having precise and unequivocal positions. Hence, in this brief paper, no attempt will be made to provide anything like a thorough review of any particular book or the ideas of any particular economist. Instead, certain ideas and propositions, which often run through the writings of many authors, will be taken up and examined for their analytical content and empirical relevance.

Although I shall not try to discuss individual authors, it is necessary to give a broad outline of the literature I am going to discuss here. In one sense it is easy to do ; because much of the research in this field was done under the sponsorship of a

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few institutions. First, a number of studies sponsored by the OECD Development Centre in the mid 60's under the leadership of Professor I.M.D. Little. The project included a number of country-studies, but the central theme of these studies was presented in a volume authored by Little, Scitovsky and Scott entitled *Industry and Trade in Some Developing Countries* (OUP, 1970). Then in the 70's a number of country-studies and cross-sectional analysis were sponsored by NBER under the leadership of Professors Bhagwati and Kruger. *Anatomy and Consequence of Exchange Control Regimes* by Professor Bhagwati provides a summary of their findings. The third landmark is the report on the Philippines economy prepared under the sponsorship of the ILO by a group of economists led by Professor Gustav Ranis of Yale University. The report was published under the title *Sharing in Development* (ILO, 1974). Finally, there are the writings of Professor Balassa, Dr. Westphal and others of the World Bank on individual countries as well as on the general theme of development strategies. This list is by no means complete. Moreover, it is not suggested that individual economists responsible for the works mentioned above have always been saying exactly the same thing. But the main ideas contained in these studies, indeed, add up to a powerful prescriptive thesis in development economics, and it is useful to examine these ideas.

I shall first take up the point of departure for these economists, which is their critique of the previous orthodoxy, i.e., the import-substituting industrialisation strategy under regime of quantitative controls. Then I shall examine the new model of export-led industrialisation. After that I shall go on to discuss the mechanism of State intervention or more generally the role of the State in the process of industrialisation. Finally, I shall take up the evidence coming from a couple of case histories, which these authors usually advance in support of their theses.

The OECD studies brought out in sharp focus the instances of inefficiencies in the use of scarce resources, which the pursuit of import-substitution gave rise to in several countries. When the value added by the newly established industries were computed in term of the prices of traded commodities prevailing in the world market, it was found to be very low in many cases, and in some extreme cases even negative. The implication is obvious. If these countries had continued to import these commodities from cheaper foreign sources, and had instead used their resources in production lines where they enjoyed comparative cost advantage, then they could have been better-off. Moreover, these economies in the use of resources could have led to a faster pace of economic development for their countries.

It was argued that these countries were wasting resources not merely in the field of investment choice ; but by running these industries behind a protective wall—free from international competition—they were creating a lethargic and inefficient industrial structure, which was never likely to have any incentive for either cost reduction or quality improvement.

These are valid criticisms applicable to many instances of grossly inefficient industrial units, set up in many parts of the L.D.C.'s in the pursuit of import-substitution. Hence, these concerted attacks on the dominant ideology of the 50's did serve a useful purpose in drawing our attention to the analytical and the empirical bases of these models of economic development. As we all know, the twin pillars on which the orthodoxy of the 50's was built were (a) the assumption of inelastic foreign trade transformation possibilities facing the non-industrialised economies, and (b) the diagnosis that the market mechanism was an inadequate allocator of resources particularly in the domain of investment allocation. With these two assumptions, it was easy to build theories of balanced growth and of the "big push". A large country like India could, and in fact did, pursue a strategy of balanced growth.

Economic historians can go on debating whether on the basis of the evidence available in the 50's, Prebisch and Mahalanobis were justified in assuming that the L.D.C.'s were facing inelastic demands for their exportables. But the fact remains that by the 1960's the unprecedented economic growth of the OECD countries had dramatically altered the climate of international trade and specialisation. Many of the L.D.C. countries, notably India, were not alert enough to alter the mechanism of their economic controls in conformity with the fast changing environment of international trade.

As far as the other pillar of the orthodoxy is concerned, it led to a rather naive application of the essentially negative theoretical results in the theory of resource allocation to the field of economic policy and planning. It provided the justification for instituting a whole apparatus of bureaucratic controls in essentially private-ownership market economies with very little regard for the logic of private profitability. In such a situation it was almost inevitable that licensing rules would be used to reduce competition and to create new barriers to entry, and that trade barriers would provide continued cushions for managerial inefficiency. Krueger has characterised such regimes as "rent-seeking economies".<sup>1</sup> One could perhaps find fault with her method of identifying and measuring such inefficiencies, namely by way of withdrawing scarce resources from a fully employed neoclassical production economy into rent-seeking activities. One may find it difficult to visualise the army of liaison-officers and bribe givers in the corridors of power constituting primary resources in limited supply. But her message is highly relevant. These crudely interventionist bureaucratic regimes succeeded in creating an artificial environment in the business sector so that gains and losses were perceived to be essentially the results of manipulations in the corridors of power. In fact, the major failure of development economics in the 50's can be traced to its inability to come to grip

<sup>1</sup>Krueger, Anne O., "The Political Economy of the Rent-Seeking Society", *American Economic Review*, Vol. 64, June 1974, pp. 291-303.

with the theorems on market failure in a creative manner. If free market was a bad allocator of investable resources, then one should be looking for regulation schemes which would correct the underlying defects in the signalling mechanism of the economy. But by substituting the evidently defective market mechanism by crude statism, it removed the market disciplines from the industrial organization without creating a workable alternative. The new industrial policies did not generate penalties for wasteful behaviour.

Thus, the new body of literature on trade and development served us well in drawing our attention to the orthodoxy of the 50's. But, it seems, by concentrating its fire on the evident failure of the past orthodoxy it created an intellectual vacuum out of which the new orthodoxy of the export-led industrialisation strategy emerged in the 70's. To say the least, the new orthodoxy was not much of an improvement over the past orthodoxy either in terms of its analytical rigour or on the basis of its empirical foundation.

Obviously, it is built on the analogy of the concept of a "leading sector" in the process of economic development. The best known among the leading-sector hypotheses is the case of the railroad construction in the 19th century United States. There it was argued that in the absence of strong promotional measures by the State, these railroads would not have been built, because of the long gestation lags and of the problems of appropriability with respect to the potential returns to the economy at large. Once the railroads were built, a lot of idle resources in the remote parts of the country could be activated into productive use. Moreover, through its backward and forward linkages, the railroad industry could create the market for the expansion of a large number of other industries in the mineral, metallurgical, engineering and related sectors of the economy. This is an eminently testable hypothesis. In fact a number of researchers have done illuminating works on this thesis.<sup>2</sup>

But in the case of the "export-led industrialisation doctrine", the leading sector is not any particular sector of the production economy like railroads or transport, but a particular way of disposing of the outputs of many sectors of the economy. There are many economic and regulatory mechanisms through which these commodities can be channelled into external markets. Are all these ways of doing this beneficial to the country? Is it possible to compute the linkages for a column of final goods in the inter-industry accounting? If so, what meanings could be imputed to these measures?

It seems, at one level what the new doctrine is saying is true and obviously so. It can be stated as follows: If a country expand the outputs of its domestic indus-

<sup>2</sup>For a survey of the literature see R.W. Fogel, *Railroads and American Economic Growth*, (Baltimore, 1964).

tries on the basis of profitable market opportunities abroad, then it can enhance the welfare possibilities for its people as well as the growth possibilities for its economy. But the important questions are : how, in what manner and under what circumstances is such outcome possible, or for that matter, desirable ? Is it possible to have such outcomes under conditions of classical free trade ? Or, do they require special promotional measures ? If so, what are these ? Do the benefits materialise instantaneously ? Or, are there trade-offs between gains in the short-run and in the long-run ? Is the effectiveness of an export-promotion strategy dependent on the level and the nature of the industrial development already achieved, and on the particular environment of international trade prevalent at the period of time ? Unfortunately, the literature is rather weak when it comes to a systematic examination of these questions. Much of the writings in this area is based on enthusiastic appreciation of a few case histories of rapid industrialisation in the past two decades and on the implicit belief in the universal replicability of these experiences, as understood by these enthusiasts.

Next, I want to discuss the issues relating to the control mechanisms on which much has been written in this body of literature. The specific context in which these issues have been raised relate to trade policies and industrial licensing procedures, although at times the readers of this literature get a feeling that behind these lie certain implicit positions on free trade *versus* State interventions or more generally on the role of the State in the process of economic development. It is useful to start with the broader theme.

It is possible to detect in the works of some writers in this field the purist position of free trade and non-interventionism. Logically the strongest arguments for this come from the Hayekian position that it is neither possible to know in advance nor is it possible to measure accurately the costs and the benefits of any policy intervention. Therefore, the best option before a system-builder is to create conditions in which the individual initiatives can be activated by the prospects of high rewards in a freely competitive economy. While these may be maintainable arguments against socialism ; it is not clear that State-aided capitalism cannot do better than capitalism under a minimal state. In fact, the history of Japan during the last hundred years and those of contemporary South Korea and Brazil seem to indicate that such is the case. A close coalition of political power and organized business interests can provide insurance against a lot of potentially debilitating uncertainties and create a less wasteful mechanism of information processing and market coordination.

As regards the mechanism of economic controls, a fair amount of research in this body of literature relates to the comparison of the effects of quantitative controls with those of price-based controls like tariffs. The NBER research project, for example was based on ten under-developed economies using time-series analysis for individual countries and on intercountry comparisons. The project came

out with the conclusion that the use of quantitative controls have resulted in static (allocational) inefficiencies and dynamic loss (in terms of savings potentials and technological progress). In this brief article, it is not possible to go into any detailed examination of the analytical and the statistical basis of this conclusion extracted from such a large and diverse pool of data.

But it is important to examine more closely this finding. If it is true, why it is so. In the analytical framework implicitly (and often explicitly) used in these studies, it is always possible to establish a duality between quantities and prices or between quotas and tariffs. In that case, one would like to know why quantitative controls lead to worse performance. A part of the reason no doubt lies in the fact that governments take resort to severe quantitative restrictions on foreign trade when they face severe balance of payments problems; hence, QR-regimes reflect the underlying conditions of resource constraints. But even otherwise quota restrictions may generate inefficiencies. One kind of the problem has already been mentioned, i.e., the development of the rent seeking syndrome. But then the question arises as to why in the case of the price-based controls, the corresponding phenomenon of revenue-seeking does not develop to distort the perspective of the private sector. It seems, there are two main reasons why the policy planners may not be able to operate successfully a quantity-based control system. First, the political and administrative difficulties associated with operating an efficient rationing scheme implicit in any system of quota restriction. Second, the problem of informational deficiencies faced by the policy planner in an essentially uncertain world. If one knows, where the difficulties lie, it is possible to think of the various alternatives and choose the most appropriate reform measure. Discarding the QR's in favour of tariffs is one; the open auctioning of the quotas is another; the establishment of a closer cooperation between the industry associations and the concerned government departments with regard to information flow is another. The political and administrative dimensions of different policy-frameworks can be very different. What is workable in one context may not be workable in another.

For example, most observers of the Japanese and the South Korean scenes have been impressed by the importance of the informal structure of control in the process of economic regulation. Formal measures like notified tariff rates or quota restrictions reveal only a part of the overall mechanism of controls and of economic coordination. It is tempting to contrast these situations with the usual text book cases in terms of cooperative and non-cooperative games. But the underlying bases of these differences lie in the nature of the interacting relationship which exists between the State and the business interests or even between the State and the civil society at large.

Now let us examine the evidence coming from some of the successful case histories, which provide much of the background for the thesis of export-led indus-

trialisation. It is important to model these evidence into a coherent structure of socio-economic relationships, before one can claim universality for a strategy or raise the questions of its transferability.

South Korea is perhaps the most talked-about example of the success in the field of export-led industrialisation. Undoubtedly since the early 60's the growth performance of the South Korean economy has been spectacular ; and this growth process has been supported by a very high rate of expansions of its export earnings. The country received a large measure of foreign assistance in the form of loans and grants, but since the mid-sixties the share of foreign capital in the gross capital formation of the economy has been steadily declining. Even though the relative distribution of income worsened, the employment and real wages rose steadily to improve the lot of the poor. Thus from the status of a hopeless 'basket case' in the 50's, South Korea by the end of the 70's was knocking at the door of the rich nation's club, OECD. Now the question is what explains this miracle ? The proponents of the export-led industrialisation doctrine would have it that it was all the result of rejecting import substitution strategy in the early 60's and following instead the strategy of export-promotion. Some would even say that it all happened because South Korea created an almost free-trade conditions for its industrial economy.<sup>3</sup>

However, a careful review of the economic development of Korea during the last 50 years brings out the following facts : Before the Second World War under the Japanese occupation, Korea had attained a reasonably high measure of industrialisation. It was an outward-looking, trade dependent economy. For example in 1940, exports accounted for about two-thirds of the outputs of its manufacturing sector. The Second World War, the partition of the country, the Korean War and the brief period of international uncertainty and domestic confusion in the aftermath of that War inevitably halted the process of development. But by the early 60's South Korea regained the momentum, of course, in an altered international setting.

As regards the management of the economy and the polity, the post-war land reform destroyed the power of the landed aristocracy and by the early 60's power decisively shifted to a close-knit group of business elite and military chiefs.

Whatever one might say about the repressive character of the regime headed by Park Chung Hee, his commitment to economic development can never be in doubt. His strategy of economic development had three basic components : (a) reforming the economic structure to put the State and the public sector in control of the economy, (b) forging a close collaboration between the State and the business elite so that

<sup>3</sup>See I.M.D. Little, "The Experience and Causes of Rapid Labour-Intensive Development in Korea, Taiwan Province, Hong Kong and Singapore and the Possibilities of Emulation" in Edy Lee (ed.) *Export-led Industrialisation and Development* (ILO, 1981).

the development priorities were in consonance with the entrepreneurial interests and that both formal and informal methods of economic regulations could be used to guide the economy and (c) devising a discretionary and selective regulatory system to guide the allocation of resources in the desired direction.

Accordingly, the State began to own and control big banks and other financial institutions, and with reforms in the spheres of interest rates and tax measures, the State soon came to be in a position to control directly and indirectly nearly two-thirds of the total investment funds in the economy. The State used its enormous market power in the capital markets (a) to create a highly differentiated credit market for the private sector and (b) to embark on a massive plan of public sector investments not only in the infrastructures but also in the directly productive activities.

The successive five-year plans formulated by the government of the Republic of Korea outlined the priorities set for the economy in the fields of social overhead capital, selective import substitution of intermediate and capital goods, and of course, export promotion. Given the size of the country and the history of its industrial development in the pre-War period, the Koreans never thought of industrialisation in the context of an essentially closed economy. They were careful not to sacrifice the economies of scale or to cut themselves off from the sources of technological advancement. But they created a highly interventionist State apparatus, which used the various methods of formal and informal, direct and indirect instruments of control to regulate the pattern of industrial development.

Given its enormous power in the capital market, the State did not need to intervene all that much in the commodity markets, but indirect taxes were imposed to keep down the consumption of luxury goods—particularly the imported ones. With the growth of the economy, the government progressively liberalised the economy and removed trade barriers; but it is important to note that even in 1976, over 600 items of tradeables were subject to quantitative restrictions.

While it is undoubtedly true that the industrialisation programme of South Korea has been conceived in the context of an open economy, it is difficult to characterise their strategy in terms of mutually exclusive categories such as import substitution and export promotion. If one looks at the profiles of South Korea's imports over the years, it becomes clear that a combined strategy of import substitution and export promotion was shifting over time items from the list of imports to the list of exports. Paper, cement, iron and steel, chemicals, transport equipments etc. progressively moved from import category to the export list. And all these were achieved through selective State intervention.

South Korea was also lucky in this important phase of their industrial development. It coincided with the period in which world trade expanded on an unprece-

dent scale and a number of industrial products and processes were relocated away from the high wage developed economies. Garments, electronics, products of light engineering and shipbuilding industries, for example, were becoming uneconomical in Japan and given its proximity and traditional links the shift to Korea was easy and natural. South Korea also benefited from their traditional links with the Japanese trading houses in marketing their products abroad. Over time, they imitated the practices of the Japanese business organisations and set up their own trading houses. This particularly organizational form of information processing, risk sharing and market coordination seems to be ideally suited for the success of a vigorous drive in the external markets. The role of the South Korean State in promoting the growth of these new organizations cannot be overemphasized.<sup>4</sup>

It is useful to contrast the South Korean experience with that of Malaysia, another East Asian country often cited as an example of export-led industrialisation. Like Korea, Malaysia has also been for a long time a highly trade dependent economy. In 1961, exports accounted for more than 50 per cent of the country's gross domestic product (GDP). At that time tin, rubber and timber accounted for about 70 per cent of the country's exports earning. During the 70's the phenomenal price increase put crude petroleum in the position of the country's major export earner. At the same time, Malaysia also embarked on a substantial industrialisation programme so that during the 70's, the value added by the manufacturing sector grew at the average rate of 12.5 per cent per annum. To a considerable extent this growth of manufacturing activities were attributable to the growth of manufactured exports. According to a World Bank study, about 20 per cent of the Malaysia's gross manufacturing outputs in 1976 was due to exports.

It is important to note that by the standards of the L.D.C.'s, the tariff levels in Malaysia had always been rather low. Therefore, the kind of trade barriers and protection measures prevalent in many developing countries were relatively inconspicuous in this country. An important vehicle of his industrialisation strategy was to set up free trade zones (FTZ's). The FTZ's are specially cordoned-off industrial estates where the trade barriers applicable to the rest of the economy do not apply. The government agencies develop land, build roads, telephone links and other urban infrastructures and often construct buildings and sheds so that companies can establish production units within these zones with a minimum of delay. Export-oriented industries, particularly foreign companies producing essentially for the export markets, have an obvious advantage in locating their production units within FTZ's because they can import producers goods free of import duties or quantitative restrictions.

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<sup>4</sup>For a more detailed discussion of the South Korean case see M. Datta-Chaudhuri, "Industrialisation and Foreign Trade: The Development Experiences of South Korea and the Philippines," in Edy Lec (ed.), *op. cit.*

Moreover, the government of Malaysia offered tax holidays upto 10 years to foreign firms coming to set up production units within the FTZ's. This, together with the favourable labour laws, induced a number of foreign firms particularly in the electronics and garment industries, to locate their processing units within these FTZ's.

One difficulty with this particular brand of export-oriented industrial development is that the new industries are essentially foot-loose and almost entirely owned and managed by foreigners. They have established very little inter-industry or market linkages with the rest of the Malaysian economy. For example a recent survey of the FTZ's of Malaysia reveals that for every dollar of exports the firms located in the FTZ's on the average imported inputs worth two-third of a dollar in 1978.<sup>5</sup>

In its own terms, the industrialisation drive of Malaysia within the FTZ's in the 70's had a fair measure of success. The FTZ's created over 80,000 new jobs and contributed substantially to the export earnings of Malaysia. During the 70's manufactured exports in real terms grew at the average rate of 14 per cent per annum. Although after making correction for the required import-bill, the rate of growth of net exports would become correspondingly lower. But even then it is a substantial achievement.

But it is possible to argue that this industrialisation process has not yet made any lasting impact on the future growth of the Malaysian economy. In the growing phase of the world economy, the large firms of the industrialised economies were looking for relocation of certain labour-intensive processes in low-wage countries. The generous tax concessions and favourable labour laws made Malaysia attractive to these firms. But the kind of equipments etc. required to set up processing units for silicon chips or units for garment manufacturing on the basis of essentially imported inputs are simple enough to keep these industries truly foot loose. Some observers have even described these processing units employing cheap female labour as "international sweatshops".

Perhaps the main reason for this particular pattern of export-led industrial growth in Malaysia can be traced to the priorities outlined in Malaysia's New Economic Policy. The NEP which came in the wake of the racial riots in 1969, placed the correction of racial imbalance in the job markets and in the ownership patterns at the top of social priorities. This inevitably put the domestic entrepreneurial class, which is overwhelmingly Chinese in origin, at a disadvantageous position. Perhaps, it was felt that the foreign firms were more likely to contribute to the

<sup>5</sup>See M. Datta-Chaudhuri, "The Role of Free Trade Zones in the Creation of Employment and Industrial Growth in Malaysia" (mimeo.) ARTEP, ILO, 1982.

society's equalisation goals than domestic entrepreneurs who would have to be largely Chinese.

It seems, the creative role played by the newly emerging entrepreneurial class in the process of the industrial development in South Korea, for obvious reasons, was absent in Malaysia. In both countries, the State played a decisive role in shaping the pattern of industrial development through a variety of direct and indirect measures designed to influence the profitability of private entrepreneurs. Given the priorities and the perception of the people who managed the State apparatus, both the countries were successful in their own terms.

Thus, in the process of successful capitalist development, a key role has to be played by the entrepreneurial class. As Schumpeter described it, the terrain in which the entrepreneurs have to battle is not merely the classical environment of price competition over homogeneous commodities, it is over new products, new techniques of production, new ways of collecting and processing market information and new ways of organizing business. When one says that the creation of free trade conditions by a minimal State will automatically bring about rapid capitalist development everywhere, one is merely asserting an article of faith. Recent experiences with successful capitalist developments in countries like Japan and South Korea show that the State can play an important supportive role. In a developing capitalist economy, the entrepreneurs need to be both protected and promoted. Certain types of market organizations and certain kinds of State interventions cushion them against prohibitive risks, help them to coordinate decisions, and create conditions in which they would strive for cost-reduction and quality improvement. Certain other kinds of interventions can be counter productive. It can be seriously misleading to go beyond this level of generalisation and suggest possibilities of easy replication of individual country experiences.

There is no doubt that in the case of the so-called 'super-exporters', the contribution of manufactured exports to the growth of industrial output and GDP have been remarkably impressive. Not only that, the quality of growth has also

# Possibilities of Export-led Growth in Bangladesh

by

WAHIDUDDIN MAHMUD\*

*Development Economist* : Has your country thought of developing labour intensive exports ?

*Local Technocrat* : Oh yes, we are trying to export as much labour as possible.

## I. A CASE FOR EXPORT-LED GROWTH STRATEGY

In the 1950s and 1960s, the thinking on economic development was dominated by the so-called 'structuralist' view of development. According to this view, foreign trade can play only a limited role in the development of the present-day under developed countries, who should therefore try to achieve self-sufficiency through industrialisation.<sup>1</sup> By the late 1970s, however, exports of manufactures from a number of developing countries had become an important element in their industrialisation and economic development. This led to a re-emergence in the seventies of the idea of foreign trade as an 'engine of development'. The proponents of this so-called export-led growth strategy cites in particular the example of the four East Asian countries and city states (namely, South Korea, Taiwan, Singapore and Hong-kong) which have been able to achieve, through the pursuit of outward-looking trade policies, very high rates of industrial growth and still higher rates of growth of manufactured exports.

There is no doubt that in the case of the so-called 'super-exporters', the contributions of manufactured exports to the growth of industrial output and GDP have been remarkably impressive. Not only that, the quality of growth has also

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<sup>1</sup>The 'structuralist' argument has been put forward in many different contexts. Thus, Professor Mahalanobis' planning model for India, the two-gap theory of aid, the structuralist explanations of Latin American inflation—all these have in common one underlying assumption, namely, that there exist only limited possibilities for transforming the domestic product-mix through foreign trade.

been exceptional in terms of employment expansion and income distribution.<sup>2</sup> It is also claimed in support of the outward-looking trade policies that such policies, by increasing the labour-intensity of production, have resulted in these countries in increased factor utilisation and allocative efficiency.

The critics of the export-led growth strategy, however, view with considerable suspicion the argument that the few success stories can be replicated in other developing countries through the pursuance of outward-oriented policies alone. They argue that the 'late-comers' may face radically worse prospects than the early-starters who benefited from the exceptional boom in the world trade in the sixties. It is also obvious that in the case of very large countries, manufacturing exports alone cannot revolutionise the situation. Critics also doubt whether long term sustained growth is possible through export-led industrialisation strategy. The transition from an export-oriented sub-phase to mature growth, it is argued, may prove difficult.<sup>3</sup>

The debate on inward-looking versus outward-looking trade policies does not of course equally concern all developing countries. Among other things, it would depend on the stage of development a country has reached. In most of the successful cases of export-led growth, there had been an increase in agricultural productivity and a period of easy import substitution before export expansion started in earnest. For other developing countries at a lower stage of development, posing a sharp dichotomy between import-substitution and export-led growth as alternative industrialisation strategies can be misleading. Thus the issue is an important one for some South-East Asian countries like Thailand, Malaysia and the Philippines who have already achieved considerable growth of manufacturing output and are now poised to join in a "second wave" of export-led growth following the pattern of the four 'super-exporters'. This can be seen from some of the development indicators shown in Table I. Judged by these indicators, however, the idea of export-led growth in Bangladesh's context would appear to be almost a non-starter. I am not entirely sure whether the organisers of this seminar have invited a paper on this topic because they genuinely feel that the issue is an important one for Bangladesh at the present stage of her development, or simply because the topic has of late become fashionable.

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<sup>2</sup>See I.M.D. Little, "The Experience and Causes of Rapid Labour Intensive Development in Korea, Taiwan Province, Hongkong and Singapore" in E. Lee (ed.), *Export-led Industrialisation and Development*, ILO.—ARTEP., Bangkok, 1981.

<sup>3</sup>See E. Lee, "Export-led Industrialisation in Asia: An Overview" in E. Lee (ed.), *op. cit.*

TABLE I  
DEVELOPMENT INDICATORS AND LEVEL OF EXPORTS OF  
SOME ASIAN COUNTRIES, 1979

	Per Capita GNP (US \$ 1979)	Proportion of Manufacturing in GDP ( % )	Value of Manufactured Exports (million US \$)	Export Per Capita (US \$)	Manufactured Exports Divided by Total Exports ( % )
Bangladesh	90	8	662	7.44	63
Burma	160	10	363	11.03	12
India	190	18	6998	10.62	60
Sri Lanka	230	21	981	67.66	8
Pakistan	260	16	2056	25.80	58
Indonesia	370	9	15590	109.10	2
Thailand	590	19	5288	116.22	25
Philippines	600	24	4601	98.52	34
Malaysia	1370	16	11077	845.57	21
South Korea	1480	27	15055	398.28	89
Singapore	3830	28	14233	5930.42	46

Source : Estimated from *World Development Report 1981*, World Bank.

## II. BANGLADESH'S EXPORT PERFORMANCE IN THE SEVENTIES

After the break-up with Pakistan, Bangladesh was faced with a precarious balance of payments situation. This was partly the result in earlier years of a lower volume of exports, as measured at constant prices, and partly the result of the disastrous adverse turn in the terms of trade. Between 1969/70 and the mid-seventies, Bangladesh's terms of trade fell by nearly 50 per cent mainly is a result of the lagging price of raw jute and jute goods in the world market. There was also a sharp decline in the volume of exports because of the disruptions in domestic production and the loss of market in former West Pakistan. By 1975/76, the volume of exports had recovered to some extent, but was still about 40 per cent lower than the 1969/70 level, when measured at constant 1975 world prices (see Table II).

Table III below outlines the level and composition of exports from Bangladesh since 1973/74. Exports are divided into the so-called traditional and non-traditional

items.<sup>4</sup> The data show how heavily Bangladesh's export earnings are concentrated in a few traditional items. With the exception of marine products, the present list of major export items is unlikely to form the basis of a sustained export drive. Experts share skepticism in their view of the long-run prospects for jute which

TABLE II

ITEMWISE EXPORTS FROM BANGLADESH IN 1969/70 AND 1975/76  
(VALUED AT 1975 CONSTANT DOLLAR PRICES)

(million US dollars at 1975 world prices)

	1969/70 Exports			1975/76 Exports
	Pakistan	Foreign Countries	Total	
Raw jute	—	195.32	195.32	120.69
Jute manufactures	31.64	206.52	238.16	189.66
Hides and skins (including leather)	6.18	23.94	30.12	29.66
Tea	25.83	—	25.83	18.62
Paper and paper board	25.34	—	25.34	1.46
Grains	13.48	—	13.48	—
Matches	8.13	—	8.13	—
Fish	—	6.08	6.08	11.86
Other primary products	6.37	4.77	11.14	10.12
Other manufactured products	58.95	16.62	75.57	
<b>Total</b>	<b>175.92</b>	<b>453.25</b>	<b>629.17</b>	<b>382.97</b>

Source : W. Mahmud, *The Foreign Trade Balance of Bangladesh Before and After Independence*, Planning Commission (mimeo.), 1979.

Notes : The f.o.b. taka value of 1969/70 exports to Pakistan and foreign countries is first converted into value at 1969/70 international dollar prices. The differentials in f.o.b. taka price between exports to Pakistan and to foreign countries are taken into account. All of 1969/70 exports are then revalued at 1975 dollar prices on the basis of international price indices.

<sup>4</sup>Such a classification is often followed in the official export statistics ; see, for example Bangladesh Bank, *Annual Export Receipts*, various annual numbers.

TABLE III  
 TRADITIONAL AND NON-TRADITIONAL EXPORTS FROM BANGLADESH  
 1973/74 AND 1977/78

	(in '000 US dollars)	
	1973/74	1977/78
<b>Traditional Items</b>		
Jute manufactures ..	160,076	249,499
Raw jute ..	106,763	101,314
Hides and skins ..	18,296	44,348
Tea ..	12,391	40,849
Fish, shrimps & frog legs ..	12,745	19,459
<b>Sub-total</b>	<b>310,271</b>	<b>455,469</b>
<b>Non-traditional Items</b>		
Spices, vegetables & oil-cakes ..	669	1,879
Crude materials ..	783	4,598
Sugar & molasses ..	20	6,217
Naptha ..	—	4,351
Chemical compounds ..	99	3,182
Paper & newsprint ..	3,494	6,839
Petroleum products ..	—	1,540
Handicrafts ..	57	1,825
Other primary products ..	1,335	2,510
Other manufactures including semi-manuf.	1,441	2,595
<b>Sub-total</b>	<b>7,898</b>	<b>35,536</b>
<b>Total</b>	<b>318,169</b>	<b>491,005</b>

Source : Estimated from *Annual Export Receipts, 1977/78*, Bangladesh Bank.

faces severe constraints from the side of both domestic supply (e.g., competition with rice) and external demand (e.g., competition from synthetics). The two other traditional items—tea and leather—also suffer from supply inelasticities, although in both cases there is some potential for increasing export earnings through quality improvements and the upgrading of the extent of domestic value added. In the face of these supply rigidities, any major impetus for export growth over the longer run must emerge from the identification and development of new exportables.

Compared to the traditional items, non-traditional exports have shown more dynamism in recent years. Starting from an extremely narrow base, these exports have grown at a relatively rapid rate, thus accounting for an increasing share of total export earnings.<sup>5</sup> This has led to some optimism, often expressed in official discussions, regarding Bangladesh's long-run export prospects. A closer look at the so-called non-traditional export items would however reveal that there is little ground for such optimism.

A large proportion of non-traditional exports are primary commodities originating in crop-agriculture or the livestock sector (i.e., vegetables, spices, crude materials, etc.). For these items, as for the greater proportion of traditional exports, the binding constraint on export growth will remain the level of domestic supply.<sup>6</sup> As for the manufactured items in the list of non-traditional exports, these are quite different in their characteristics, from the labour-intensive manufactured exports that have traditionally provided the initial impetus for export-led growth in low-wage developing countries. For most of these commodities (e.g., newsprint, paper), capacity was initially created behind high tariff barriers to meet the domestic demand of an integrated Pakistan market (see Table II). Since independence Bangladesh has experienced considerable difficulties in finding alternative export markets for these products, primarily as a result of poor product quality. Moreover, many of these products (e.g., paper, chemicals) earn foreign exchange at an excessively high domestic cost as is found in a recent Boston University study.<sup>7</sup> Such manufactured exports cannot therefore be considered an element in a process of export-led growth based on genuine comparative advantage.

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<sup>5</sup>For a detailed discussion on the performance of non-traditional exports, see A.R. Bhuiyan, *Non-traditional Exports of Bangladesh, Trends, Performance and Prospects*, Bureau of Economic Research, Dacca University, 1982.

<sup>6</sup>A few countries have been successful in achieving high rates of export growth through a deepening and broadening of their primary exports (Malaysia, for example). The primary exports of these countries are however mainly based on mining and plantations rather than on peasant farming.

<sup>7</sup>Boston University Center for Asian Development Studies, *The Industrial Comparative Advantage of Bangladesh* (mimeo.), June 1980; see also A.B.M. Md. Azizul Islam, "Comparative Advantage of Bangladesh within the Manufacturing Sector," *The Bangladesh Development Studies*, Autumn 1979.

It would appear from the above analysis that the bulk of the existing industrial capacity in Bangladesh, with the exception of the jute industry, is not suited for the export market. It is reasonable however to expect that Bangladesh would have long-run comparative advantage in many labour intensive manufacturing activities, as indeed is shown by the Boston University study mentioned earlier. How far such exports can be pushed into the international market, after domestic capacity is created, is of course a different matter and would depend on a complex interplay of many factors—both domestic and external. We shall not go into hazardous guesses about how these factors will work in Bangladesh's case, but a few general observations can be made from the experience of some East Asian countries. It has been noted that among these countries, there is a significant difference in the pattern of export expansion both as regards the degree of dependence on foreign factors and the product-composition of manufactured exports.<sup>8</sup>

The export growth in Malayasia, for example, resembles more the Singapore pattern, rather than the Taiwanese or South Korean pattern, in that the bulk of export expansion has been through a reliance on foreign direct investment and international sub-contracting arrangements. In this pattern, the increase in exports has been closely tied to the growth of Free Trade Zones and the locational decisions of the multinational corporations (MNCs). Such a pattern may seem attractive to a country like Bangladesh suffering from a scarcity of both domestic capital and indigenous entrepreneurs. The size of the country is however a significant factor here. A given inflow of foreign capital can yield much larger per capita benefits in a country like Malayasia, with its relatively small population (13 million), than in a substantially larger country like Bangladesh. It should also be noted that, with the mushrooming of Export Processing Zones in many developing countries in recent years, it has become increasingly difficult to attract MNCs for locating their offshore operations.

In the second pattern of export expansion (i.e., the Taiwanese or South Korean pattern followed by Thailand and Philippines), there has been less reliance on foreign direct investment, which is also reflected in the product-composition of manufactured exports. While in the former pattern, electronic equipments and machinery components have accounted for the major part of the increase in manufactured exports, in the latter pattern, textiles and clothing have been the key export item. Plastic and wood products, footwear and handicrafts have also been important export items in countries following the latter pattern of export expansion. It is possible that in time Bangladesh will be able to acquire comparative advantage in many of these labour-intensive manufacturing activities. We may however notice that textiles are upto now an important import item in Bangladesh instead of being an exportable. This is perhaps an indication that the so-called easy or primary phase of import substitution is not yet over in Bangladesh.

<sup>8</sup>For a detailed discussion on this, see E. Lee, *op. cit.*

### III. TRADE POLICIES AND THE STRUCTURE OF INDUSTRIAL INCENTIVES

The foreign trade regime of Bangladesh is characterised by a system of exchange controls, a reliance on both tariff and quota for limiting exports, and *ad hoc* export incentive measures in the face of persistent deficits in the balance of trade. There is also a narrow but free market for foreign exchange operating under the so-called Wage Earners Scheme.<sup>9</sup> The system of exchange controls with an overvalued domestic currency results in high margins of domestic price over c.i.f. import price, thus providing protection of import-competing industries.<sup>10</sup> A part of this 'scarcity premium' is appropriated by the treasury through import duties and the rest accrues to the import-license holders in the form of windfall trading profits. To the extent that imports are financed by export earnings, the premium on imports (either in the form of import duty or of abnormal trading profits) represents in effect an equivalent income transfer from domestic exporters, through an overvalued domestic currency. Viewed in this way, the so-called Wage Earners Scheme (WES) is essentially a device to enable migrant workers to earn the scarcity premium on remittance-financed import.<sup>11</sup> Similarly, under the recently-introduced Export Earners Scheme (EES), eligible exporters receive a certain percentage of the f.o.b. value of their exports at the premium exchange rate prevailing in the WES market.

The trade regime, discussed above, generates industrial incentives which are highly product-specific and depends largely on *ad hoc* policies. The government can provide differential protection to import-competing industries by varying the import quotas and (or) the commodity-specific rates of duties.<sup>12</sup> Domestic industries are also provided protection through the allocation of import licenses which give them access to imported inputs and machinery at the official exchange rate. Protection is also provided through differentials in the sales tax on imported vis-a-vis

<sup>9</sup>For an analysis of the foreign exchange market in Bangladesh, see W. Mahmud and S.R. Osmani, "Impact of Emigrant Workers' Remittances on the Bangladesh Economy", *The Bangladesh Development Studies*, Monsoon 1980.

<sup>10</sup>Cf. A.R. Bhuyan and W. Mahmud, *Domestic Prices of Imports in Bangladesh, An Analysis of Trading Margins under Exchange Control*, Planning Commission, Dacca, July 1979.

<sup>11</sup>Since the inception of the scheme in 1974, the WES premium rate has mostly varied in the range of 25 to 35 per cent, indicating the underlying extent of overvaluation of taka. In recent months, however, the price of foreign exchange in the WES market has come down very near the level of the official exchange rate. This is most likely to be a symptom of the on-going recession in the economy rather than a true reflection of the underlying structural imbalance in foreign trade.

<sup>12</sup>For a discussion on the role of import duties in the case of import under licenses and under the WES, see W. Mahmud and S.R. Osmani *op. cit.*

domestically produced goods. On the export side, besides the EES, incentives are provided through various financial and fiscal instruments.<sup>13</sup>

There has been virtually no systematic study to quantify the net effect of the above policies on the degree of effective protection provided to various industries. There is however ample evidence to suggest that in many ways the present structure of industrial incentives is not conducive to guide investment into socially profitable channels. In this respect, the results from the Boston University study, mentioned earlier, are both illuminating and disconcerting ( despite many methodological and data limitations of the study ). Many industries, particularly those consumer goods industries that are highly intensive in the use of imported inputs, are seen to have either no comparative advantage.<sup>14</sup> To a large extent, this reflects the highly inefficient industrial base that Bangladesh inherited from the Pakistan days. What is more disconcerting is that some of these inefficient industries continue to enjoy high rates of protection under the present tax structure ( e.g., perfumes and cosmetics, soap, plastic products, knitting hosiery, industrial chemicals, etc. ). Entrepreneurs can thus make very high financial profits in sectors which actually incur economic losses. On the other hand, many sectors which are seen to have long-run comparative advantage enjoy relatively low rates of protection. (Some notable examples are cotton textiles, footwear, bicycles, industrial machinery of certain types, pumps, etc.)<sup>15</sup>

In its net effect, the present system has also a strong bias against export *vis-a-vis* import-substitution. A recent World Bank study estimates the effective exchange rates (EERs) for exports by taking into account the overall impact of the export incentives provided by the EES and the tariff rebate system. For non-traditional exports, the EER ( i.e., taka received by exporters, including export incentives, for each US dollar of export earnings ) is estimated to have increased from taka 17.1 in 1977/78 to taka 18.9 in 1980/81. Compared to the official exchange rate ( taka 15.1 in 1977/78 and taka 15.8 in 1980/81 ), this would imply a subsidy at the rate of nearly 20% for both years. In contrast, the EERs for imports must be much higher as indicated by the very high ratio of domestic purchasers' price to c.i.f. price of imports. A Planning Commission study estimates that the ratio of wholesale domestic price to c.i.f. price is as high as 2.37 for all imports and is even higher for imported consumer goods.<sup>16</sup> This would suggest a large differential in gross revenues between production for the domestic market and production for export.

<sup>13</sup> On this, see A.R. Bhuyan, *op. cit.*

<sup>14</sup> See Azizul Islam, *op. cit.*

<sup>15</sup> Cf. Boston University, *op. cit.*

<sup>16</sup> Cf. Bhuyan and W. Mahmud, *op. cit.* The World Bank's estimates of EERs for imports are much lower, since these estimates are derived by taking into account import duties only, while ignoring any scarcity premium accruing to the import license-holders.

The indications of existing distortions have prompted many experts—including those in the IMF and other world bodies—to suggest that Bangladesh should move towards a 'free trade' regime by devaluing its currency and reducing government intervention (fiscal or otherwise). Unfortunately, such policy prescriptions are not always based on any comprehensive understanding of the problem of ensuring efficient resource allocation in Bangladesh's context. There is undeniably a strong case for reducing anti-export distortions in respect of manufactured exports facing potentially elastic demand in the world market. But for most of the traditional or primary exports which suffer from supply inelasticities, a general export subsidy would only result in increasing taka prices and windfall profits to exporters. In some cases, it may even lead to a misallocation of resources (such as an excessive shift of land from rice to jute). A straight devaluation, with the existing rates of tariffs, would also have inflationary effects, raising the price of many wage goods. It would also do little to rectify the highly distorted structure of incentives (protection) provided to different types of import-competing industries.

The 'free trade' argument, in its crude version, also ignores the need for providing differential incentives to industries (whether producing for the domestic market or for export) which have genuine *long-run* comparative advantage.<sup>17</sup> The need is for relating protection to economic efficiency and not for eliminating protection altogether. There will also be a need for reviewing the specific subsidies from time to time to avoid excessive protection leading to excessive profits. It is important to ensure that there is no discrimination against activities that either do not exist or are not significant in Bangladesh yet. As the system operates at present, the tariff structure has tended to become a mechanism by which the *ex-post* profitability of investment is ensured, rather than itself being an instrument for guiding investment decisions *ex-ante*.<sup>18</sup>

Given the extremely low rate of domestic savings in Bangladesh, a reform in the tariff structure has to be achieved without the erosion of the extremely narrow government revenue base. For mobilising savings, it will be necessary on equity grounds to impose high rates of taxes on 'luxury' or inessential consumption.<sup>19</sup> However, the policy of attempting to tax the consumption of luxury goods solely through the import duty system has, perversely, increased the private profitability

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<sup>17</sup> The role of government intervention in an export-led growth strategy has been a topic of considerable controversy. It has been persuasively argued by many that in the case of successful export-led development, there has been less of a reduction of government provided incentives than an elimination of undesirable biases in these policies; see, for example, E. Lee, *op. cit.*

<sup>18</sup> This point has been repeatedly made by the visiting World Bank missions.

<sup>19</sup> See W. Mahmud, "Development Strategy and the Problem of Food Supply in Bangladesh", *The Bangladesh Development Studies*, Winter-Summer 1980.

of domestic production of these items. In such cases, comparable taxes on domestic production will be required so as not to create excessive protection in these sectors.<sup>20</sup> In general, when quantitative restrictions are imposed on imports, the resulting scarcity premium on imports should be appropriated by raising the import duties so that there is no excessive premium attached to import licenses ( which is often a source of corruption ).

#### IV. THE SEARCH FOR A LABOUR-INTENSIVE GROWTH PATH

Economic development can follow alternative patterns : it can be agriculture-based or industry-led, it can be employment oriented or based on capital-intensive technology, it can emphasise the role of private sector or that of public sector, and it can be inward-looking or outward oriented. The choice between following an import-substitution strategy or an export-led one is only one element in an overall strategy for economic development. It would be naive to think of the complex problem of development in terms of any 'grand solution', whether it be an export-led growth strategy or otherwise. The appropriateness of a development strategy and the relative importance of the different elements within this strategy would of course depend upon such factors as natural endowment, acquired skills, the level of industrialisation and the institutional development of the economy concerned.

It must be emphasised that, given the existing socio-economic condition Bangladesh has very limited options regarding the choice of a development strategy. As technical background to the Draft Second Five Year Plan (1980-85), the Planning Commission undertook an exercise to analyse the development alternatives facing Bangladesh in respect of some well-defined growth constraints (e.g., external deficits, the resource gap, the skill constraint, etc.)<sup>21</sup> The quantitative findings of the exercise make inescapable—despite many data limitations—certain conclusions of fundamental importance to the shape of development in Bangladesh in the immediate medium-run period.

First, a continued annual GDP growth rate of 5% to 6% is feasible, but only under optimistic assumptions regarding the efficiency in capacity utilisation, aid availability, export expansion and savings mobilisation. The growth of GDP at this rate can be achieved only through a rural-agricultural-employment orientation of the development strategy, taking all realistic advantage of the labour-using technology. In Bangladesh's context, such a growth strategy is essential not only

<sup>20</sup>Similarly, in the case of exportable inessential consumer items, sales tax may be imposed on the domestic sale of such items, thus raising the price in the domestic market.

<sup>21</sup>See W. Mahmud and S.R. Osmani, *The Macro-Model for the Second Five Year Plan : Some Preliminary Results*, Planning Commission, June 1980.

for increasing employment and providing basic needs, but also for meeting the resource constraint and the balance of payments constraint.

Second, increasing foodgrain output at a rapid rate, by taking advantage of the modern seed-fertilizer technology, is crucial to the success in attaining GDP growth at the above rates. The target of attaining self-sufficiency in foodgrains within, say, 8 to 10 years' time is a realistic one that fits well within the overall growth strategy in respect of increasing employment and keeping the incremental capital-output ratio (ICOR) low.

Third, a programme for attaining self-sufficiency in food, along with the projected growth in other agricultural and service sectors that must accompany a 5% to 6% GDP growth, would limit the scope of industrialisation in the short and medium run. To put it in a different way, if foreign capital is available to fill the savings-investment gap arising from a 6% GDP growth rate, and if self-sufficiency in foodgrain is taken as a target, industrial output need not grow faster than 7% to 8% annually to maintain the balance of payments.

How would one fit the idea of export-led growth to the development strategy outlined above? The first thing to consider is the initial position. Among the countries which have experienced successful export-led growth since the early sixties, South Korea started with the lowest level of per capita income. Yet, Bangladesh today is at a much lower level of development than South Korea was in, say, 1960. This can be easily seen from the various socio-economic indicators presented in Table IV. Both in South Korea and Taiwan, there had been a 'green revolution' before rapid industrialisation began. The potential for increasing agricultural productivity remains largely unexploited in Bangladesh and indeed offers the only chance for her to break out of the vicious circle of poverty.

TABLE IV

COMPARATIVE SOCIO-ECONOMIC INDICATORS FOR SOUTH KOREA  
(1969 AND 1970) AND BANGLADESH (1979)

	South Korea		Bangladesh
	1960	1979	1979
GNP per capita ( US dollars 1979 )	402	1480	90
Share of manufacturing in GDP (%)	14	27	8
Density of population ( per sq. km. )	257	386	617
Adult literacy rate (%)	71	93	26
Urbanisation rate (%)	28	55	11

Sources : Estimated from *World Development Report 1981*, World Bank.

In the discussions on export-led growth, the links between the growth of labour-intensive manufactured exports and the rapid increase in employment are often emphasised.<sup>22</sup> In the agriculture-led growth strategy we have outlined for Bangladesh the growth of manufactured exports cannot be expected to play any major role in employing the rapidly increasing labour force. ( This will be so even if industrialisation is export-led.) Instead, employment will be mostly generated in production for the domestic market, especially in food production and allied activities. It is the labour intensity in these activities that will crucially determine the quality of growth in terms of generating employment and alleviating poverty.

In an employment-oriented growth strategy, the demand for the products of small-scale sector would increase rapidly, so that this sector must play a crucial role.<sup>23</sup> Government support policies to help small units must therefore be an essential element in the industrialisation strategy to be pursued. The present structure of industrial incentives are in many ways biased against small firms. Small-scale enterprises mostly buy domestically produced machinery while the large-scale sector in most cases is privileged to buy machinery from the foreign market at cheaper than domestic market prices because of an overvalued exchange rate.<sup>24</sup> The small-scale sector is also discriminated against in respect of access to institutional credit. Thus, if there is a case for reversing the bias against export industries, there is even a stronger case for reducing the bias against the small-scale sector.

There are undoubtedly many positive lessons to learn from the experience of those countries which have been successful in achieving export-led growth. Like South Korea and Taiwan, Bangladesh must avoid costly import-substitution and take full advantage of whatever possibility exists for expanding manufactured exports. The experience of these countries also show how efficiency in factor utilisation can be greatly improved by adopting capital-saving techniques, introducing multiple shifts and dispersing small-scale manufacturing activities in rural areas. In the long-run, a country like Bangladesh with an extremely high population density and a poor resource base can achieve high standards of living only through industrialisation and the expansion of trade in manufactures. In the more immediate future, however, the major impetus to growth must come from the increase in agricultural productivity. Even within this agriculture-led growth strategy, the growth of exports must play a significant role. But the overall pattern of growth can hardly be called 'export-led' in the sense in which the term has come to be used.

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<sup>22</sup>See, for example, Little, *op. cit.*

<sup>23</sup>For an excellent empirical study on this, see BIDS, *Report on the Small Scale Industries Project*, Dacca, 1981.

<sup>24</sup>I owe this point to Dr. Rashid Amjad (ILO.—ARTEP.), p. 11.

# Export Processing Zone in Bangladesh

by

MUZAFFER AHMAD\*

## I

As an adjunct to the policy for promoting private investment and in the hope of increasing export and employment, Bangladesh has in the recent past moved to enact a provision for the establishment of Export Processing Zone (EPZ) "for the purposes of setting up export oriented industries." This was done in spite of the fact that jute goods manufacturing units, the primary and dominant export industry of the country needed no such zones and were designed to be spread all over the country for the beneficial effects of the geographical dispersal. Thus it may be deduced that the policy makers had other than indigenous raw materials in their view for processing in EPZ, though local raw materials were not excluded. Direct foreign private investment is logically the target of such a policy, but the policymakers has extended facilities more directly to Bangladeshi-owned capital nested abroad and hopefully awaiting to be recycled on receipt of due encouragement.

The zones, so created under such policies, have been called by many names, viz., Free Trade Zone (FTZ), Investment Promotion Zone (IPZ), Free Export Zones (FEZ), Export processing Zone (EPZ). The differences in nomenclature merely underscores the primary goal of such zoning policy. The implementation of such policies consist of development of an industrial estate for establishment of manufacturing units financed by foreign capital from abroad which is encouraged to flow into the country by a suitable package of investment incentives and simplified 'one-stop' administrative action.

## II

The government of Bangladesh enacted a law to create an EPZ Authority and entrusted it with certain functions which may be classified as below :

- (a) Physical development :
  - (i) to take possession of land and develop it ;

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(ii) to develop and provide infrastructural facilities (i.e., roads, sewerage etc.), building space, utilities (i.e., electricity, telecommunication, etc.) and warehouse facilities.

(b) Approval of applications :

(i) to process application for setting up of an industry in the zone in accordance with the principle laid down by the government and accord permission to an applicant if he satisfies the requirement ;

(ii) to obtain approval of any other governmental authority if it is so required.

(c) Allocation of land :

(i) to sale, lease or rent out land and building spaces.

(d) Provision of facilities :

(i) to provide custom bonded facilities for importation of building materials, packaging materials, raw materials, semiprocessed or other goods ;

(ii) to provide necessary banking facilities within the zone ;

(iii) to assist in transportation of imported goods and of finished goods for export and to liaise with concerned authorities for this.

(e) Sanction of employment of foreign national :

(i) to sanction employment of foreign nationals.

It may be noticed that the Act provides for facilitative and promotional function and is silent about management, administrative and control functions of the authority.

Principles and procedures for setting up industries in EPZ has also been elaborated in detail. The industries to be set up are classified into three categories according to ownership :

(a) A : 100% owned by foreigners including Bangladeshi nationals ordinarily resident abroad ;

(b) B : Joint venture projects ;

(c) C : 100% owned by Bangladeshi entrepreneurs who are also residents of Bangladesh.

The government has imposed the following conditions to all three types of industries :

(a) The entire product is to be exported outside Bangladesh and in case it is sold into Bangladesh, it has to be paid for in foreign exchange ;

- (b) Bangladeshi goods and materials imported into EPZ has to be paid for in foreign exchange and be subject to usual export formalities ;
- (c) All imports into EPZ for production purposes are to exempted from all kinds of taxes, duties and tolls ;
- (d) All outputs and export will not be subject to levy of taxes or duties ;
- (e) Income, profits and gains are exempt from taxes for five years and would enjoy rebate of 50% of income tax attributable to export sales after that period ;
- (f) A foreign technician shall be exempt from the payment of income tax up to 3 years under certain given conditions.

In addition, 'A' type industry has to meet the following conditions :

- (i) Total investment cost has to be met from own foreign exchange resources ;
- (ii) Working capital requirements are to be met from imported funds in convertible foreign currencies or export proceeds ;
- (iii) 95% of the export proceeds may be retained in convertible foreign currency account or remitted abroad and the balance of 5% will be released at the end of financial year after deduction of liability, if any.

The 'B' type industries are to operate under the following conditions :

- (i) Cost of machinery and spare parts are to be paid for by foreign partner from their own resources ;
- (ii) All raw material cost is to be so provided by foreign partner ;
- (iii) Local currency cost and balance of working capital may be contributed by local partner who will be allowed local currency borrowing from banks ;
- (iv) Only that portion of export proceeds that represent cost of imported items would be remittable on verification as would be dividends payable to foreign partner.

The 'C' type industries are to operate under the following condition :

- (i) Machinery, spare parts, raw materials and other imported goods as well as salary of foreign technicians are to be financed under non-repatriable foreign exchange, wage earners scheme, export performance license etc. ;
- (ii) Cash foreign exchange allocation is limited to net foreign exchange earned and surrendered ;
- (iii) Export proceeds are to be surrendered in full to Bangladesh Bank.

These indicate the primacy of two conditions. First, the degree of control on foreign exchange earning varies inversely with the proportion of import of foreign exchange for setting up and running the industry. Second, the outputs are meant for exports and, because of the first condition, imported raw materials are preferred. Hence, Bangladesh merely wants to contribute a location and supply labour to the extent wanted by the enterprises. Comparing the 'C' type industry in EPZ with export industry elsewhere in Bangladesh, the advantage of 'C' type unit in EPZ is the 50% rebate on tax on income attributable to export sales. This is given in consideration of absence of help in foreign exchange for setting up the industry. In addition the B type industry in EPZ enjoys the allowance for immediate remittance of foreign exchange from export proceeds to the extent of import financed by foreign partner in addition to the tax benefit mentioned earlier. Similarly, the 'A' type industry in EPZ enjoys facilities for remittance of sales proceeds in proportion to their contribution of foreign exchange for construction and operation of the unit.

It may be concluded that Bangladesh government with an intent to make faster strides in its industrialisation process and being conscious of the fact that its own foreign exchange availability is a serious constraint, opted in favour of foreign private investment including those by Bangladeshis normally resident abroad. This is an admission of the fact that efforts for domestic mobilization of resources are largely ineffective. This is a recognition of the fact that borrowing capital in the international markets in order to obtain machinery, expertise and technical knowledge is next to impossible. More importantly, this is a reflection of the fact that aid inflow holds no prospect for such development in Bangladesh in near future. Soft aid goes to soft sectors and is largely dissipated without much of an impact. Given this reality and the compulsion for developing industries, Bangladesh looked towards foreign private capital, but inwardly recognised limited prospect of such an effort. Thus, logically the target group became the Bangladeshis who nest abroad a saving and joint venture possibilities. Bangladeshis, having developed industries locally under conditions of pampered assistance at times to the extent of 98% of investment resource (much more in reality), would normally find conditions more attractive in non-EPZ zones. Thus the feasibility of EPZ itself is questionable.

### III

It may not be out of place to look into the political feasibility of direct foreign private investment in Bangladesh. It is recognised that direct foreign private investment in developing countries are highly sensitive to political risk. Political risk is defined to originate from political change and result in unanticipatable discontinuities in business environment.

In September 1977, a Fortune Market Research Study on locational decisions was published. One thousand US manufacturing firms were asked to name three out of thirteen given factors that was considered by them to be most important in locating a processing facility abroad. Political stability was a consistent first choice of the group. Sixty-seven per cent of 100 largest industrial firms indicated this to be a prime factor, so did seventy-three per cent of the next 400 large industrial firms as well as seventy-four per cent of the following 500 large industrial units. It is of interest to note that only 36% of the firms considered financing and tax concessions to be an important factor. Even availability of unskilled/semi-skilled/skilled technical workers did not score much support. Proximity to markets (60%) and proximity to raw materials (41%) were considered relatively more important. If this behavioural analysis of the US firms is to be taken seriously, then in attracting direct foreign investment the role of political risk is of utmost importance.

Even though political risk has ranked very high in foreign private investment decisions, there seem to be an absence of a sophisticated method of calculating political risk. This branch of analytic exercise is of recent origin. Arthur S. Banks and Robert B. Textor published in 1963 a book entitled 'A Cross-polity Survey' wherein they attempted an indexation of political stability by the time variable, but they gave little indication of other factors they considered. About the same time, Bruce Russell working on political and social indicators utilised two indicators for political stability, viz., political death per 1 million population and changes in the chief executive of the government. This indicator was further developed by Charles L. Taylor and Michael C. Hundson who refined the stability criterion concerning violence to include protest demonstration, riots, armed attacks, deaths, governmental sanctions and external intervention. They refined the executive stability criterion to indicate irregular executive change, executive adjustment, renewals of tenure and regular executive transfers. Later, Ivo K. Fierabend and Rosalind L. Fierabend created a seven point scale and applied it to 30 types of political activity to index the stability of political climate. Even though these measures have a noticeable subjective element yet this method has been applied in recent times for political risk assessment by large multinational companies.

In a recent study 70 developing countries of Asia, Africa and Latin America were investigated for assessment of political instability. The data on political event was collected from newspaper reports and reports of Bureau of Intelligence and Research of USA for the years 1971-79 inclusive. An ascending order of weights in geometric series was given to the events ranked as per severity of changes attained. Countries that were indexed 200 or less were considered stable, or moderately stable, those with more than 200 but less than 501 were considered unstable and those with score of more than 500 were considered highly unstable. Indices for only a few countries are reported below :

Kuwait	1
Tunisia	10
Morocco	25
Venezuela	49
Egypt	70
Malaysia	106
Turkey	148
Thailand	371
Philippines	482
Pakistan	796
Bangladesh	1070*
Cambodia	2550

**Note :** \*Computed separately applying the same method for 1972-80.

**Source :** Muhiuddin, K. G., *A Cross Country Prediction Model for Political Risk Assessment by American Mining Corporations Operations in Developing Countries* (Unpublished Ph. D. thesis, UCLA).

An indexation for Bangladesh was made and the score was higher than that of Pakistan. If this is to be taken seriously, then it may indeed be concluded that political feasibility of EPZ is questionable. This is underscored by the fact that new direct American foreign investment and political stability index showed high negative association : the higher the political risk measured by the index of political instability the lower is the level of new direct foreign investment.

#### IV

We may leave aside the question of feasibility as such, and proceed to recapitulate the logic for desirability of private foreign investment for development of exports. It has been recognised that direct foreign investment represents a package of capital, technical knowledge and managerial skill. The foreign firms can only be induced to make direct investment only if the excess cost of producing in an

alien location is less than the benefit it gains from being tied to actual process of production and distribution. Empirical studies indicate that such investments are associated with oligopolistic power to produce differentiated products for market protection/expansion. This fact was brought home by an analysis by a German Institute on motives for foreign investment, given political stability in host countries. The most important motive is marketing, either by circumventing trade barriers or through acquiring new markets ; related to this was the cost advantage. As mentioned by the firms, higher profits or financial incentives were only of minor consideration. This is the supply-side story of foreign private investment.

The demand side of the story is much less articulated and is often concluded with the statement about paucity of domestic capital. It has almost always been assumed that the package of capital—technology—management skill is beneficial to the host country. It can indeed be argued that if the foreign firm produces an export product, which was produced earlier by a domestic unit, through diversion of resources and sells it at a higher price but the difference is remitted abroad as dividend (and rent for knowledge) and pays the domestic factors of production the same price, direct foreign investment would lead to no gain for the host country. If there is no gain from direct foreign investment the demand should be zero. Thus in order to realise the gain from direct foreign investment, certain conditions have to be met, viz., (a) higher real payment to domestic factors of production ; (b) net increment in export and retained foreign exchange earnings. One of the ways the host country gains is through pre-emption of taxation rights. Bangladesh government has been liberal to the extent of virtually surrendering right to capture a share of both the earnings of foreign capital and rents of the technical knowledge. Thus the only source of gain seems to be higher real payment to labour.

It has been pointed out that there is another kind of 'spill-over' social benefit which the investing company generates through training of labour which becomes available to the economy. There is also possible productivity gain in domestic units through demonstration effect of better management and higher skill. The first is conditioned by the assumption that the training is financed by the investing company and not by the workers directly or indirectly through acceptance of a wage which is less than marginal product and/or that there is over-provision of relevant training in relation to the investing company's need. However, there could also be reversal of gain when the investing company attracts the trained labour and executives from domestic firms, creating the necessity for high-cost training anew. This is more likely to be the case in Bangladesh.

A more basic issue is the contradictory attitude of the foreign investors and the government. It should be kept in mind that the foreign investing company is a profit seeking institution, and it bears no responsibility for making any contribution to

development of the host country except that which is incidental to its production process and which is required for appropriate public relation within the political administrative environment. Thus the primary interest of the government to posit direct foreign investment as an input in the development process of the country reflects the basic ignorance of the situation by the government. This is, however, not to deny that under certain circumstances the direct foreign investment can make direct inputs for development despite their need for profit maximisation. But that largely depends on the state of the economy, political skill and bargaining ability of the host country.

Because of the divergence in the objective, the maximization of private profit by the foreign investors cannot ensure the socially optimal result for the host country. Stretten and Johnson has argued that even within the constraints imposed by the need to maximise private profit by the foreign investors, as long as he works towards long-run competitive equilibrium, it is profitable for host country to accept in the short-run a socially sub-optimal position. This concession to private profit motive is conditioned by the prevalence of a socially ideal income distribution. This assumption is unreal not only because of rigidities prevalent particularly in a developing traditional economy but also because of the fact that direct private foreign investment is often associated with oligopolistic/monopolistic enterprises.

A source of contradiction has also been located in the geo-economics of the situation. The host country is interested in a social optimum over a period covering the economic activities within its borders. The foreign investing concern is working at an optimum for its global operation. These two optimising processes do not generally provide any unique answer and that is where the zero-sum game ensues.

## V

It is pertinent to ask about the prospect of direct foreign private investment (DFPI) in an EPZ located in Bangladesh. The pattern of DFPI is known. It is well known that the private capital waiting to be invested abroad is of limited magnitude. The book value of the current stock of direct foreign private investment is impressive but a significant part of new investment is reinvested profits. Of the available fund for direct private investment, developed countries themselves take a big slice of investment. Of the rest, the Latin American manufacturing industries seem to have a favoured position. The Asian countries, get only a negligible share and of that share the "client economies" and to a certain extent India pre-empt almost all. Thus the prospect of getting significant share of DFPI is not bright. The chance has further been reduced by the continued crisis of the western economies which face conditions of recession

and/or stagnation. Even the petrodollars get recycled to developed countries through international banking system and holds no hope for LDCs as such.

It has been mentioned that motive in locating investment abroad is extension of market. Bangladesh, in spite of large population, does not hold any hope of market expansion of significant nature primarily because of very low per capita income. Since EPZ is meant to cater to external markets, the locational condition (between Malaysia and Sri Lanka) does not offer any major market openings for Bangladesh.

We have noted earlier that cheap unskilled labour does not register as an attraction for DFPI, contrary to our expectation. The explanation lies in the fact that the new growth-industries are said to be intensive in skilled-labour and, therefore, advantage of low wage and plentiful supply of unskilled-labour is at best marginal.

The conclusion that can be drawn from this deductive analysis is that the prospect of direct foreign private investment in EPZ is certainly not very bright in general terms. One may look into the prospect of attracting emerging multinationals from developing countries. The Indian multinationals would not find any locational advantage in coming to EPZ in Bangladesh; the same would be true of Pakistan. The only group that seems to show some interest is the South Korean group in the apparel sector for reasons of circumventing EEC quota restriction. This is the case even with liberal provision for payment and remittances of dividends, for use of technology, for managerial services, interest on loan, overhead charges etc. In spite of such liberal approach, Bangladesh for economic and political reasons does not hold any significant attraction for direct foreign private investment.

## VI

Since employment expansion has been mentioned as an objective of industrialisation, we may look into the prospect of employment in EPZ. Following from the earlier explanation, if investment in EPZ zone is slow and limited, the impact on employment would be insignificant.

Before we proceed further, it may be necessary to distinguish between employment in EPZ venture and employment as an indirect result of the operation of the EPZ. Indirect employment effect will have to take into consideration: (a) net increment or decrement in investment in non-zone area along with the production technology used there; (b) net impact of employment generation in EPZ and its consequential impact on consumption and use of idle resources in non-EPZ

zones. It is seen from the analysis of the intent as reflected in the Act and procedures, the basic approach is to create an enclave to process imported raw materials or intermediate goods for export. In that case the production linkage with non-EPZ units would indeed be marginal and insignificant having no impact on employment creation. If the units in EPZ would use raw materials and services formerly used in a non-EPZ location in Bangladesh, this is not likely to create any additional employment; under assumptions of better labour efficiency in open market conditions, this may indeed reduce employment. Only if there is a significant net increase in the use of resources from non-EPZ locations in Bangladesh, and if production condition permits expansion of supply, then and only then we may expect a significant increase in indirect employment. The secondary impact on employment through increase in income would depend on the nature of wage goods and production condition of wage goods within the country.

Leaving aside the indirect employment impact, the direct employment impact would depend on investment made and technology defined in terms of capital-output ratio. We have earlier mentioned that investment prospect seem to be discouraging. It has been well established that foreign investors use "capital-intensive unskilled labour-saving technologies irrespective of environments in which they make investments". The reasons for this are easy to find. First, incentive structure for the industries in the developing countries make capital cheap and the unskilled labour is generally more expensive in efficiency terms. Second, alternative technology suitable for labour-surplus conditions are not generally available and a degree of monopoly power of the foreign investors make it unnecessary to develop labour-intensive technology. Third, highly standardised nature of the product and well-tried-out techniques lead to technological rigidity and allows little variation in capital-labour ratio. Research studies by Frances Stewart confirm that multinational corporations have almost never modified their core plant or process or product to accommodate more employment.

Information available on capital invested per employee in the Asian EPZ indicate that the process is indeed highly capital intensive.

	US \$ Per Employee
Prai, Penang, Malaysia (1974)	26,425
Pubu Terejak, Penang, Malaysia (1974)	10,067
Prai, Wharves, Penang, Malaysia (1974)	4,836
Bayan, Penang, Malaysia (1974)	3,698
Marives, Philippines (1975)	11,721
Masan, South Korea (1975)	3,940
Taichung, Taiwan (1975)	2,881
Mantze, Taiwan (1975)	2,711
Koohising, Taiwan (1975)	1,296

Source : Pacific—Asia Resource Center, 1977.

The capital intensity varies with the product. In Bangladesh the experience of Shilpa Bank and Shilpa Rin Sangstha indicate that per employee capital investment has been a minimum of US \$ 10,000 and generally about double that sum. A survey of foreign affiliates in the sixties indicate a sum of US \$ 18,000 per employee. Given such information, it is unlikely that EPZ would create more employment per dollar of investment.

## VII

The EPZ is said to be the most rigorous expression of the export-led growth policy and has at times been indentified as a reaction to the limitation of import-substitution policy for industrialisation. The success of import substitution policy depends on ability to expand comparative advantage zone for deomestic product and continuous expansion of domestic market to absorb expanding productive capacity. Many developing countries seem to have followed policies that did not succeed in creating such pre-conditions. Further, the foreign aid policy pursued by the developed countries did not promote self-sustained growth as the real resource flow into the developing countries were much below the critical minimum as well as misdirected. Such a situation prompted some governments to adopt a policy of

promoting the role of private foreign investment. This was considered necessary because of the dominance of established manufacturers/exporters of the advanced countries in the markets of export goods from the developing countries. In other words, these countries wished to follow a policy of cooperation but a second fiddle had to play as they were unable to stand up to the competition from established business houses. One would, however, expect that the terms of cooperation would normally be dictated by the stronger party, i.e., the multi-nationals. Thus the precondition of success of a policy for export augmentation through foreign private enterprise primarily depends on the fact that profit/sales/return maximisation policy of the multinationals dictate such an effort and in that sense is largely endogenous to the host country.

EPZ, to be economically justified, has to be argued on the following terms :

- (a) It is more desirable to promote processing industry than to invest in other sectors if such an investment calls for a diversion of resources.
- (b) It is more desirable to promote export industries in particular compared to other types of industries.
- (c) It is more desirable to make concessions to capital than to other factors of production, particularly labour.
- (d) It is more desirable to make concessions to foreign private capital than to domestic capital.
- (e) It is more desirable to make special physical and administrative arrangements rather than general arrangement for manufacturing units.

The general set of planning studies seem to indicate that the long-run returns on the average are higher from investment in physical and social infrastructure ; whereas short and intermediate-run returns are higher from investment in agriculture. However, such global statements hide many useful details. There are a class of industries which aid or promote investment in the sectors mentioned above. But export for the sake of maximising export through any set of industries can only be supported if we assume that the value of foreign exchange is nearly 'infinite', i.e., our need for foreign currency in relation to our ability to earn foreign currency is so disproportionate that it makes sense to augment export earnings at any cost. This strong assumption will be hard to substantiate.

Promotion of export industry is desirable so long as the net foreign exchange earned has value that is higher than alternatives uses possible under given conditions. In other words, we are away from the zone of immiserizing export growth. Because of the lack of studies and identification of alternative policy package, it may at best be said that we do not know the zone of beneficial export industry, while at the same time it should be noted that the attraction of

'immiserizing export' industries are likely to be higher for foreign private investors as it indicates very favourable terms of operation for his venture.

To attract capital, relative return to it has to be increased, i.e., relative to alternative locational and sectoral possibility. Given that impressive locational advantage exists in Malaysia, Singapore and Colombo, Bangladesh in such a competitive situation can only hope to attract foreign private capital at a highly concessional terms, i.e., at a great cost which in turn may require depressing returns to other factors of production, given the fact that the export prices may be dictated by international competition. We have no figures to play with but it appears that it may call for significant differential on returns to capital for diversion from nearby locations, unless we assume that Bangladesh would get non-competitive industries only. But the information available from Sri Lanka and information on applicants for EPZ indicates that it is not the case. This leads us to conclude that given international competition in output and capital market, relative prices of other factors would have to be held low at a great social cost in order to attract capital. This certainly is not desirable.

The EPZ plan is said to be directed towards foreign private capital. The government seem to be ready to extend concessionary terms to that source of capital compared to domestic capital. This discriminatory pricing of capital is possible, if we assume absence of linkages between the two capital markets. On the face of it, it seems that it may indeed be the case. However, once we recognise that it is possible to export capital from Bangladesh in various forms, (e.g., underinvoicing of export goods, overinvoicing of import goods etc.) and they can reappear as foreign private capital in EPZ zone for differential return, it can only be argued that under conditions of classical economic analysis development of domestic industries would be greatly hampered, dislocated or over-costed. Thus the success of EPZ may indeed cause failure of other industrial efforts in the country.

In order to promote industry in general and export industry in particular a generalised preference may be less expensive than special administrative and physical arrangement which involves additional cost of special arrangement and cost of distortion that it causes.

## VIII

In concluding the presentation, it may as well be desirable to address a pertinent query. If EPZ does not hold much of a prospect, why has it been launched with such a fanfare? The answer to this, like most of policy questions, lie in the politico-economic situation of the country.

The government being eager to show its allegiance to the dogma of free enterprise has to take steps for the rehabilitation of private capital. EPZ has been created without much of a serious debate. This policy initiates the full acceptance of free enterprise philosophy. Second, it created the opportunity for the Bangladeshis to recycle their nested 'capital' into a zone where they could feel safe. Third, it created the incentive for the sponsored capitalist group to create more 'nests' abroad to be recycled to the zone in the name of a son who is normally resident abroad. Further, it created incentive for relocation of export industries.

Given all these, the response is still poor. Only 56 applications have been received so far of which 26 are for garments, 4 for electronics, 5 for specialised textiles, 2 for agarwood, 1 for leather products and 3 for fish-processing. It is to be noted that of these only 2 are from Bangladeshi nationals normally resident abroad and 20 are said to be joint ventures and 34 are from Bangladeshi nationals resident in the country. Government has given approval to 1 in the A category (100% foreign ownership) and 3 in the C category (100% local ownership). They have further allowed 4 in the joint venture category and 4 in the local ownership category to operate 'temporarily' outside EPZ zone. Of these the predominant sector is garments manufacturing, a sector which was doing well even without EPZ. Economies of EPZ thus requires further careful examination before we block more local money in infrastructural development in a locality which has the highest concentration of industrial capital in the country.

# Bangladesh and The International Monetary System

by

K. M. MATIN\*

## INTRODUCTION

The international monetary system affects most economic activities, both directly and indirectly. Over the last decade a series of developments, both political and economic, have led to considerable disarray in the system. This disarray is viewed differently by different groups of countries. The industrialised countries, the oil exporters and the oil importing developing economies, are all unhappy with the existing system for different reasons. The dissatisfaction of the last group in particular, stem from its powerlessness to reform the system or to neutralise its direct and often adverse impact on their economies.

This paper attempts an assessment of Bangladesh's interaction with the international monetary system and the effects that flow from it. In this context, international monetary problems, which impinge directly or indirectly on Bangladesh, are examined in Section I. Section II highlights the vulnerability of Bangladesh economy to external developments in order to place the interactions in proper perspective. The third section evaluates Bangladesh's experience over the last decade in responding to international monetary problems and the costs and benefit of operating within the system.

## I. THE INTERNATIONAL MONETARY SYSTEM

The present international monetary system is plagued by considerable problems. The problems are many and varied, differing substantially in their impact and relevance to various groups of countries. It is burdened with world wide inflation, fuelled largely by an uncontrolled explosion in international liquidity. It has arrangements for a limited but "conditional" funding role of the IMF, with

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inadequate specification of rules on the process of payments adjustment. It now incorporates a changed exchange rate regime, largely of an *ad hoc* nature. These are some aspects of the system which are of direct concern to a country like Bangladesh.

There is no doubt that the international monetary system established at Bretton Woods, was a product of its time. It reflected accurately the underlying economic and political conditions of the immediate post war period.<sup>1</sup> The international framework was based on a simultaneous consideration of monetary and financial issues with income, employment and trade questions. The Bretton Woods institutions, however, separated monetary from financial question to the extent of placing the former within the jurisdiction of the International Monetary Fund (IMF) and the latter (i.e. long term capital flows) within that of International Bank for Reconstruction and Development (IBRD). Income and trade questions, were to be compartmentalised into a separate International Trade Organisation, which was envisaged but not established.<sup>2</sup> In effect, therefore, the international framework of the system was born incomplete.<sup>3</sup>

Despite many shortcomings, the system worked remarkably well over the 1950's and 1960's. It presided over an unprecedented boom in world trade. This success could not be ascribed to its technical perfection. Rather, it has to be attributed to a favourable underlying economic situation which was consistent with the institutions and rules of the game. The situation comprised of the fact that the system was centered on U.S.A., in the sense that its institutions and currency pervaded the international monetary system, just as its economy dominated the world.<sup>4</sup> It was assumed at Bretton Woods, that U.S. would continue to export capital to capital-deficient countries in Western Europe by virtue of its continuing trade surplus.<sup>5</sup> In fact until the mid-1960's, U.S. provided the

<sup>1</sup>It however failed to perceive the rise of Europe and Japan as economic powers, as also the needs and interests of developing countries.

<sup>2</sup>The Havana convention setting up ITO was never ratified. Instead GATT became its substitute, later. The question as to why such intimately-linked-issues (like trade and money finance) were to be placed in charge of separate institutions has been answered in [9]. He attributes it to rivalry between Treasury and State departments of U. S. administration in 1954. Morgenthau as Treasury Secretary, and close friend of the President had the upper hand in emphasising monetary and financial issues only.

<sup>3</sup>The separation of trade questions from money and finance in the form of GATT and IMF/IBRD, also created compartmentalisation and anomalies especially as IMF decisions were taken in isolation from changes in GATT's trade regime.

<sup>4</sup>This is similar to the way, U. K. institutions and currency dominated the Gold Standard of pre-war years.

<sup>5</sup>When developing countries arrived in large numbers on the scene in mid 1960's, the existing system was inadequate to meet their capital needs. This inadequacy has been a recurring problem since.

major financial mechanisms, most of the export surplus and virtually all of the capital goods needed for investment. Such a coincidence of location, permitted considerable control of U.S. over the international environment which was conducive to stability, even if not equity.<sup>6</sup> The dominance of U.S.A. declined, as other economic powers began to assert themselves. Export surplus was no longer the monopoly of the U.S.<sup>7</sup> With the onset of the 1970's as disequilibrating mechanisms became more acute, weaknesses of the Bretton Woods system became more apparent. While Anglo-American dominance of financial institutions continued, current account surpluses came to be located mostly in the OPEC countries, with productive capacity in capital goods in OECD and some newly industrialised developing countries, but not in OPEC. The resulting pressures led to the breakdown of Bretton Woods system in two specific areas:<sup>8</sup> the gold-based reserve system and the exchange rate arrangement. This breakdown and subsequent international monetary problems had significant effects on the world economy. This section will focus on three aspects of the problems that are deemed to have definite implications for the Bangladesh economy. They are : growth in international liquidity and consequent inflation, the lack of explicit rules for financing-cum-adjustment of payments imbalance and their inequitable effects, and the floating exchange-rate regime.

#### Growth in International Reserves

The reserve supply system as envisaged in 1944 was based on gold as the ultimate reserve asset with a fixed dollar price.<sup>9</sup> However, since the U. S. dollar was convertible in to gold, earned interest, and was directly useable for transactions, it became the *de-facto* reserve asset. But this reserve arrangement broke down because of an inherent dilemma in the system. It was argued [22] that the fixed price of gold implied that the demand for reserves would grow faster than the supply of gold.<sup>10</sup> Thus a liquidity shortage would emerge, unless the U. S.

<sup>6</sup>Developing countries did gain from the phenomenal growth in world trade over the 1950's and 1960's. But this gain occurred inspite of the inequities of the Bretton-Woods system. Principles of reciprocity in trade, distribution of reserves, obligations of adjustment and access to finance have all had inequitable effects on developing countries.

<sup>7</sup>The Gold-based reserve system was strained as U. S. financed its trade deficits with its dollar liabilities. As the Gold-Dollar ratio fell from 3.54 in 1959 to 0.16 in 1971, confidence in dollar-convertibility was seriously undermined.

<sup>8</sup>The system was originally characterised by arrangements in six areas : market convertibility, supply of reserve assets, provision for capital flows, management of the system, payments adjustment mechanism and exchange rate arrangement.

<sup>9</sup>Traditionally cited "international reserves" of a country consisted of not only gold and US dollars which are primary reserve assets but 'also reserve positions in the fund' and 'special drawing rights' (SDRs) created in the 1970s.

<sup>10</sup>World reserves actually grew at less than half the rate of growth in world exports over 1950-68 [6].

ran continuous balance-of-payments-deficit to supply additional reserves in the form of dollars. But deficits were expected to progressively undermine confidence in the dollar's convertibility, as the ratio of gold to dollar fell drastically. The inevitable did happen. Of the \$ 8.5 billion increase in world reserves (over 1949-59), \$ 7 billion was provided through U.S. deficit. Over the period 1969-72, world reserves more than doubled, increasing by an amount greater than rises over all previous years, as a result of deliberate U.S. policy.<sup>11</sup> Liabilities resulting from deficits thus rose from US \$ 17 billion in 1969 to \$ 90 billion in 1972. The result was suspension of dollar-gold convertibility in 1971.

Even before this event, it had become clear by the mid-1960s, that inadequate growth in gold-stocks constrained increases in reserves in the face of rapid growth in trade. In 1967 Special Drawing Rights SDRs<sup>12</sup>, were established as a new reserve asset to be created under the auspices of the IMF to overcome this constraint on world liquidity. Since the potential for 'seigniorage gains' from creation of SDRs was considerable, developing countries had sought a link between creation of new SDRs and development assistance, (i.e., the SDR-link.) Despite the logic of the position, developed countries opposed it on grounds that if international liquidity was expanded on the basis of developing countries' need for 'aid', it would be highly inflationary. The international community (in this case, the Fund) agreed to allocate the newly created SDRs in line with existing IMF-quotas i.e., implying a more regressive distribution of SDRs than envisaged by SDR-Link proposal.

Ironically, it was the failure of IMF to create adequate SDRs rather than its creation on the basis of aid-requirement, that led to the very global inflation that was feared. In place of SDRs, there occurred an uncontrolled explosion of international liquidity in the 1970's under private auspices. Virtually all of this increase was contributed by the market's revaluation of gold and the growth of Euromarket-credits. The value of world reserves grew more than tenfold. The lack of international control over the expansion of reserves led to considerably greater inequalities than those implied even by the regressive distribution system of IMF-quotas. Most of the developing countries suffered, especially the poorest amongst

<sup>11</sup>This explicit policy was devised in 1968 by Republican pre-election task force chaired by Prof. Haberler, with the objective of forcing other OECD countries to accept dollar devaluation.

<sup>12</sup>Its nature has undergone several changes. Originally there was a restitution requirement whereby 30% of cumulative allocations of SDRs were to be maintained. Interest rate set low at 1.5%, was to be credited to countries holding more than their allocations & debited to those holding less. In 1979 the rate of interest charged for SDR use was raised to 80% of the weighted average market rate of interest of five currencies in SDR basket. Restitution requirement was reduced to 15%. Transfers were also liberalised.

them.<sup>13</sup> More importantly, this unprecedented growth in effective level of reserves, reduced pressure from more influential IMF-members to raise quotas or create new SDRs.<sup>14</sup> In fact, quotas and SDRs contributed only 1% and 2% respectively, to the total increase in reserves over the 1970's when the extent of payment imbalances were the greatest and the need for liquidity, the most pressing.

Table I highlights the growth of international reserves from 1969 to 1981 at a rate faster than world trade.

TABLE I  
GROWTH OF INTERNATIONAL RESERVES ( SDR Million )

	1969	1973	1978	1981
Total	78.9	255.1	548.9	983
Gold	39.1	114.5	230.9	572
Foreign-Exchange	33.0	122.6	288.1	385
IMF Reserve	6.7	7.4	19.3	27.6
SDRs	3.1	10.6	10.6	21.6

Source : Computed from [26].

\*Reserve position in the Fund

\*\*SDR's were allocated from 1970.

Nearly 62% of the increase in reserves occurred as a result of revaluation of gold and 34% on account of foreign exchange, most of which accrued as Eurocurrency credits. Since expansion in international liquidity stemmed from the private market, there was no international control over its use, disposition and distribution. As only 10% of total gold holdings were with developing countries,<sup>15</sup> and 90% of all borrowing from international markets went to eleven high-income

<sup>13</sup>Creation of liquidity under IMF auspices (e.g., SDRs and quota increases) would have provided 22% of the increase to non-oil exporting developing countries and 10% to oil exporters. Instead, the actual increase in reserves of the 1970's has gone to oil exporter to the extent 4% and to non-oil developing countries to the extent of 6% (i.e., a total of 10% to LDC) instead of 32%.

<sup>14</sup>The call by Group of 24 for a substantial increase in SDR allocations to meet difficult conditions, went unheeded.

<sup>15</sup>The Most Seriously Affected countries held 1.6% of total monetary gold (India held half of this) and Least Developed Countries held 0.2% (of which 60% was held by Afghanistan). The distributional implications are obvious.

countries<sup>16</sup> the distributional impact was extremely adverse for low income developing countries. In fact, if reserve increases equivalent to that resulting from gold revaluation had been undertaken through new issues of SDR, developing countries as a whole would have obtained additional reserves (i. e., additional to what they actually obtained) of about \$100 billion,<sup>17</sup> with more than \$ 70 billion accruing to oil-importing developing countries.

It has been argued elsewhere [13] that even the sudden increase in oil prices in late 1973, was triggered largely by the "fantastic explosion of liquidity" over 1969-72 period.<sup>18</sup> More recently, it has been empirically demonstrated [10] that the recent increase in international reserves helped to precipitate world-wide monetary expansion which "was an important causal factor in world-wide inflation". The relationship was not only statistically significant but was one of unit elasticity. The argument used to justify the causal relationship between growth in international reserves and inflation contained two basic elements. First an expansion in reserves was said to increase the monetary base and given a stable money multiplier, resulted in an expansion in total money supply. The second element extended the quantity theory of money to the world as a whole, whereby growth of money caused prices to rise.

However, this empirical evidence has been questioned on two grounds. First, that it did not demonstrate a definite "direction" of causation. It was conceivable that international reserves actually responded to inflation,<sup>19</sup> rather than being caused by it. Second, it may actually have been a function of fixed (quasi-fixed) exchange rates and thus may not be applicable to the subsequent period of free-floating.<sup>20</sup> Both these issues were examined in a subsequent study [13], for the world as a whole, and separately for industrialised and developing countries. For the period up to 1977, 'direct unidirectional casual relationship' was demonstrated

<sup>16</sup>All 11 countries (except Philippines) had per capita incomes in excess of \$ 1100 See [24].

<sup>17</sup>Refer [ 4 ; 5 ] for an evaluation of reserve gains to developing countries if SDR creation was the mechanism for reserve growth rather than revaluation of gold. Three alternative estimates have been derived.

<sup>18</sup>Refer [ 23 ] where Triffin has argued this case. It is worth pointing out that recent OECD study has shown that in 1970, Saudi Arabia's oil price of \$ 1.30 barrel implied a decline of 50% compared to 1960. Despite some increase in oil prices in 1970, inflation in OECD countries and devaluation of U.S. dollar in 1972, led to fall in oil prices in real terms. Rise of oil prices could thus be seen as an effect of inflation rather than its original cause.

<sup>19</sup>Demand for international reserves has been shown to be a function of prices, among other variables [13].

<sup>20</sup>This is because of the argument, that if exchange rates were free and market determined, then reserves would not be a causal factor in the inflationary process, since the connecting link through money supply would be broken. Payment imbalances would be observed through exchange rate changes, with the monetary base, unaffected.

for the industrialised countries<sup>21</sup> but not for the developing ones. As for the period of floating exchange rates, it was found that the causal relationship was weakened, but not eliminated, over the 1973-77 period as compared to pre-1973. The expansion of global liquidity without any international control, was thus a significant contributor to world inflation.<sup>22</sup>

This explosive increase in world reserves and the form in which such increase took place, had two other effects. It created greater inequality in the distribution of international liquidity with low income developing countries being deprived of additions to their reserves which would have accrued, if growth had taken place under international auspices through SDRs or increase in IMF quotas. More growth in the form of short-term assets coupled with greater integration of financial markets of industrialised countries, led to speculation and flows of 'hot money' which made it difficult to sustain fixed exchange rates.

#### **Regime for Financing and Adjustment of Balance of Payments**

The Bretton Woods system was perhaps most deficient with respect to facilities and rules about balance of payments financing and adjustment. This deficiency related to the provision of supplementary financing, as also to the lack of guidance on the obligations for initiating adjustment as well as the techniques to be used for such adjustment. The IMF was established not only as a source of supplementary financing, but also as a machinery to oversee the process of adjustment. It is nearly axiomatic that countries with payments deficit, face the options of either financing or adjusting to the disequilibrium. 'Adjustment' implied an immediate reallocation of productive resources through changes in relative prices, incomes, and exchange rates in some combination, which naturally involved economic costs. At the macroeconomic level there could be a fall in the level of employment of resources, an increase in the rate of price inflation or both. At the micro level, there may be a decline in overall productivity of resources because of distortions introduced, as well as due to frictional costs of the type that are inevitable in reallocating resources. The magnitude of the costs are not only a function of the economic conditions but also of the specific strategy used for adjust-

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<sup>21</sup>The link between increase in reserves (e.g., Euro-Dollars) and increase in money supply has been questioned in [21] on the ground, that effect of monetary base is small. This reason, if valid, could reduce the 'unit elasticity', without eliminating the relationship altogether.

<sup>22</sup>Many alternative explanations for increased inflation in the 1970's in OECD countries have been provided. This includes the explanation based on a shifting of Phillips curve relationship due to a decline in money illusion, a synchronisation of economic up-turn of OECD countries, and the shift to flexible exchange rates [25].

ment.<sup>23</sup> Therefore the chief characteristics of adjustment costs is that they are borne currently, irrespective of the future.

The costs of financing, on the other hand, have to be borne in the future, when reserves will have to be replenished and foreign debts repaid. A greater volume of exports will have to be generated.

The choice between financing and adjustment is, therefore, reduceable to a choice between reducing absorption: production ratio today or tomorrow. In most cases this is not an either-or-option. In fact, there is and can be a continuous trade-off between the extent of adjustment and the degree of financing used in response to a given disequilibrium.

The existence of country's free choice with respect to the adjustment-financing ratio is however predicated on the availability of financing. Countries constrained by lack of finance are forced to adjust quickly, with attendant costs.

The balance-of-payments-financing-regime implicit in the original Bretton Woods has influenced its subsequent development. While the need for liquidity was adequately understood then, the importance of an upper-limit on its extent was over-emphasized.<sup>24</sup> This was on the grounds that excessive financing could lead to laxity and irresponsibility in economic management. It was believed that for political and other reasons, governments attached a high discount rate to future costs as compared to present costs. Thus the greater the availability of finance, the stronger would be the bias towards avoidance of adjustment through financing. This view was underpinned by considerable optimism about the prospect of monetary stability. Payments imbalances were expected to be moderate. In actual fact, they turned out to be far less stable in the immediate post-war years and IMF resources proved inadequate to the task.<sup>25</sup> The inadequacy became critical for developing countries as quotas provided to them on the basis of a complicated formula were not only very small, but increases

<sup>23</sup>Costs vary depending on whether the strategy relied more heavily on income changes via variations of monetary and fiscal policy (expenditure-reducing policies) or on relative price changes via a change in exchange rates or direct restrictions on trade or capital (expenditure-switching). It also depends on whether adjustment is undertaken over a short period or over long term.

<sup>24</sup>The provision for very limited financing at Bretton-Woods reflected the national concern of a surplus country like U.S.A. whose political dominance undermined the U.K. (Keynes') proposal of a clearing union creating 'bancors' for lending to deficit countries to be repaid, when external imbalance had been reversed.

<sup>25</sup>Most nations were devastated by war. Their capacity to export was damaged, their need to import was enormous and their monetary reserves were depleted. Thus outside the IMF, U.S.A. disbursed \$ 26 billion through Marshall Plan, to deficit countries in Europe over 1946-49.

in the value of its basic unit were also not forthcoming. Industrialised countries, on the other hand managed to overcome the insufficiency of liquidity through access to alternative arrangements.<sup>26</sup> To date there has been only eight upward revisions of quotas. The ratio of quotas to world imports has thus fallen from 10% in 1960-65 to 4% in the 1970's. Such decline has been most inimical for the least developed developing countries like Bangladesh, since growth of world liquidity under private auspices bypassed them. Thus the payments-financing-regime clearly implied a severe financing-constraint for Bangladesh.

With regard to the issue of adjustment, Bretton Woods was not explicit on two crucial questions : first, which country had the responsibility to initiate adjustment and second what techniques and policies should preferably be used to effect such adjustment.<sup>27</sup> The lack of specific obligation to adjust led to the development of assymetry in the system. While deficit countries were forced to adjust under threat of depletion of reserves with insufficient alternative financing, adjustment for surplus countries could not be enforced.<sup>28</sup> Assymetry existed even within the group of deficit countries. Industrialised economies with access to alternative sources of finance and middle income developing countries with access to commercial sources could reduce its burden of adjustment. But low income developing countries like Bangladesh, with little alternative finance, ended up with the greatest obligation to initiate adjustment.

On the issue of techniques and policies to be used for adjustment, the IMF Articles of Agreement only desired that countries "avoid competitive exchange depreciation" and that they "correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity".<sup>29</sup> As access to IMF-financing came to be governed explicitly by policy conditionality,<sup>30</sup> the techniques policies to be used for adjustment, came to be specified by the IMF.<sup>31</sup>

<sup>26</sup>European Payments Union provided access to payments financing over 1950-58. In the 1960's the larger industrial countries obtained credit through network of central bank swap lines as well as special arrangements with Bank for International Settlements (Basle-type arrangements). More recently European Monetary Union has provided access to borrowing, whose value is a 'multiple' of IMF-quotas of individual EEC countries.

<sup>27</sup>This was not because Keynes and White overlooked these issues. In fact, first drafts contained elaborate provisions. But as U.S. assumed itself to be a permanent surplus country and Britain a deficit one, conflict of national interest whittled away the provisions during negotiation [8 ; 9].

<sup>28</sup>Reserve currency countries, even in deficit, could avoid asset settlement of their deficits.

<sup>29</sup>IMF Articles of Agreement Act I (iii) and (v).

<sup>30</sup>Decisions of Board of Executive Directors in 1948 and 1952 permitted conditions, defined as specific policies to overcome payments problem. This was accepted mainly as a means of securing financial participation of US [7] for discussion on evolution of conditionality.

<sup>31</sup>In so doing it ignored the possibility of structural surpluses and thus the corresponding structural deficits, the latter's correction being intimately linked with that of surpluses elsewhere.

The implications are clear. The techniques and policies for adjustment devised by the IMF affect deficit countries, and will be enforceable only on those that seek financing from the IMF. It is inevitable that countries bypassed by the process of reserve-creation, like Bangladesh, with few alternative sources of financing will be the most vulnerable. The problem of this vulnerability emanate from the characteristics of the standard policy package of IMF, for various reasons. First, the level of financial resources available from conditional facilities are small compared to the payment-needs. Second, adjustment under conditionality has to be conducted over very short periods of time leading to high costs in terms of foregone output. Third, while changes in exchange rates (i.e., depreciation) has been an integral part of most packages,<sup>32</sup> the Fund's analytical framework is based on financial programming (involving credit ceilings etc, ) but with fixed exchange rates. For this reason the framework provides no answers to two critical questions : (i) how is the degree of overvaluation determined ? and (ii) what is the optimal pace of adjustment from overvalued rate to the equilibrium rate of exchange ? This implies that decisions on devaluation are of an *ad hoc* character, with no comprehensive programming framework that includes inter relationships between the rate of exchange and monetary and real sectors of the economy. Yet devaluations are insisted upon on the basis of a dogmatic article of faith. Fourth, deflationary credit-squeeze is an essential part of the financial policy package. This accentuates the contractionary impact of devaluation itself.<sup>33</sup> In addition credit-restraint could have an adverse impact on production. Fifth, all fund policy packages discriminate against the state sector, and social objectives, but favour growing privatisation as a matter of faith. In other words, countries overwhelmingly dependence on IMF's conditional finance, is most subject to their ostensible rules of the game.

**Generalised floating :** This was initiated in March 1973, and was sanctified by the international community in Jamaica in 1976, in the form of Second Amendment. Floating was thrust upon the world economy by virtue of capital-market integration, the pressures of 'hot-money'-flows across borders and the absence of policy harmonisation amongst the major economies. It was felt that flexible exchange rates would be conducive to adjustment problems. Yet the volatility and fluctuations in bilateral exchange rates has surprised its advocates. Various reasons have been put forward for this excessive instability. As exchange rates were determined in asset markets which are volatile, it fluctuates in excess of changes in underlying conditions. Destabilising speculation accentuates these effects

<sup>32</sup>Nearly half of all conditional policy packages have involved devaluation.

<sup>33</sup>By directly increasing the price of tradeables in terms of domestic currency, devaluation deflates the real value of financial assets and nominal factor incomes [15]. The expansionary effect expected from the shift in relative prices in favour of tradeables may not be forthcoming on account of the supply rigidities in an economy like Bangladesh.

of changes. Changes in monetary policy and shock effects from the real sector, also affect exchange rates. Irrespective of the reasons, such erratic fluctuations in exchange rates have created enormous problems for developing countries.

## II. EXTERNAL DEPENDENCE OF BANGLADESH

The extent of external dependence of the Bangladesh economy will ultimately determine the impact of its interactions with the international monetary system. *Prima facie* Bangladesh would appear to have a low level of interaction with the world economic system, in view of the low degree of importance of foreign investment to her economy and small proportion of foreign trade to GDP, by comparison with many other developing countries. Yet it is true, that these indicators mask the strategic and critical significance of external linkages to the Bangladesh economy. This is largely a result of certain structural characteristics of the economy. Low levels of domestic savings, deficit in availability of foodgrain, undiversified manufacturing sector with inadequate capacity to produce import substitutes and poor export capability, has rendered the economy vulnerable to changes in the international monetary system.

TABLE II

	1959/60	1969/70	1972/73	1974/75	1977/78	1980/81
1. Foodgrain Production as% of Food Availability	94	87	78	82	88	90
2. Gross National Savings as% of GDP	7.6	7.2	2.1	1.0	3.6	5.3
3. Exports as% imports	117	74	48	25	36	28

Source : [12 ; 20].

It is quite obvious from the foregoing table that the country's structural characteristics have been undergoing a secular change. Production as a proportion of food availability has not only been falling but availability per capita has also been declining. Domestic savings has been rising slowly, but continues to be at a point which is insufficient to support levels of investment necessary to keep per capita income constant. Exports have been financing a decreasing share of imports, varying between a quarter and a third for most of the 1970's. All this, coupled with a narrow undiversified industrial base, has made Bangladesh highly dependant on imports (food and non-food) and in turn on inflow of external resources for financing imports and supplementing domestic savings.

The dependence on imports is considerable. As a proportion of GDP, imports have risen from 10% in 1972/73 to 22% in 1980/81. This aggregate figure, obscures the critical nature of this dependence. Imported foodgrain constitute on average, 12-13% of total availability in the country while the public distribution system has relied fully on imports. However, the importance of imported cereals is far greater in the market for foodgrain than is apparent from its share in total availability. This is because only a small proportion of total production constitutes marketable surplus. Thus imports channelled through the public distribution system and open market operations are crucial in determining market supplies and prices. In fact, over most of the 1970's a growing segment of the population (even in rural areas) have become dependant on imports of food, for consumption.

The agricultural sector which is predominant in its contribution to GDP also relies on imports, even if relatively less dependent than other sectors of the Bangladesh economy. Most of the important development programmes in this sector like the distribution of fertiliser, irrigation and pesticides depend on imports. Labour intensive rural works programme relating to infrastructure like embankments canal excavation, roads and bridges, depend on imported food.

The manufacturing sector depends on imports both for expansion of productive capacity and for utilisation of existing capacity. Thus present and future industrial production is affected by availability of imports. The two major manufacturing industries of the country in terms of employment of industrial labour, is dependent on imports for full utilisation of capacity. The handloom industry relies wholly on imported cotton, yarn and dyes, while jute mills depend on imports of spare parts. The entire chemical industry as well as the country's only steel mill depend on imports of raw materials and intermediate inputs. The expansion of productive capacity in manufacturing sector and increases in capacity of infrastructure, is also dependent on imports. Domestic substitutes of intermediate inputs or capital goods are virtually non-existent.

In addition, the budget is dependant on counterpart funds from commodity aid as well as revenue from imports. Thus the level of external assistance and imports is a critical factor for the budget.

The nature of the economy's import dependence is summarised by some indicators in Table III below :

Bangladesh's interactions with the international monetary system should be viewed against this backdrop in order to obtain an appropriate view of her situation *vis-a-vis* international monetary problems.

**DIMENSIONS OF THE ECONOMY'S DEPENDENCE ON IMPORTS**

	1972/73	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81
1. Imports as % of GDP	10	11	10	19	13	17	17	23	22
2. Imports as % of Exports	209	248	391	326	190	272	253	327	349
3. Imported Food as % of Food Availability	22	12	17	10	6	11	8	18	10
4. Import Duties as % of Total Revenue	31	30	22	29	29	32	33	36	32
5. Import Duties as % of Total Tax Revenue	37	38	28	26	27	40	42	45	44
6. Imports of Fertiliser as % Dist. Fertiliser	62	39	82	77	9	57	83	68	41

Source: [ 23 : 25 ]

### III. IMPACT OF INTERNATIONAL MONETARY PROBLEMS

This section analyses the impact of the operation of the international monetary system on the Bangladesh economy. It is shown that the shift to increased levels of world inflation resulting in a sharp rise in import prices and deteriorating terms of trade has had adverse effect on the growth of the economy. The effect on resource balance could not be offset, because of lack of access to additional financing, despite a tenfold increase in world liquidity. As a result of highly inequitable distribution of additional reserves and no alternative financing, Bangladesh was compelled to use 'conditional' resources from the IMF. The consequent short-term deflationary policies affected her growth and development. On top of these problems an additional source of external disturbance stemmed from generalised floating. The continued pegging of taka to the pound sterling<sup>34</sup> and an inadequate flexible exchange rate policy was another source of considerable economic costs.

#### Effect of World Inflation

Bangladesh suffers from a chronic structural imbalance in trade as a result of her dependence on capital and other imports for development and economic growth. Her limited capacity for exports and low levels of savings (cited in section II) make her highly dependant on a programmed inflow of external resources to finance imports and investment. The pervasiveness of this dependence, makes the management of the economy difficult, in the face of adverse shifts in prices, exchange rates and resource inflows all distinctly and definitely affected, by the operation of the international monetary system.

There can be no doubt that over the 1970's, deterioration in terms of trade has been a major economic problem for Bangladesh. Such deterioration has resulted mainly from rises in import prices in the face of constant and sometimes increased export prices, as is shown below.

TABLE IV  
TERMS OF TRADE  
(1972/73=100)

	1974/75	1976/77	1978/79	1980/81
Terms of Trade	63.4	61.1	76.8	62.9
Import Price	144.8	183.1	219.0	283.9
Export Price	123.5	111.8	167.5	178.6

Source : [ 12 ].

<sup>34</sup>The peg was changed in January 1983, after the author had argued in favour of a shift to dollar-peg, through this paper, at the BEA Conference in November 1982.

Between 1972/73 and 1974/75 there was an increase of 94% in import prices and a decline of 40% in terms of trade. If one relates changes to 1969/70, the Bangladesh economy had to absorb an increase of 270% in import prices by 1974/75 [20]. This comprised a definite shift from the 1960's, when terms of trade was not only relatively stable but also improving [18 ; 19]. While it is true that real market forces did contribute to differential changes in import prices, the distinct shift to higher levels of international inflation in the 1970's, played a major role in Bangladesh's deteriorating terms of trade. In addition, the depreciation of pound Sterling *vis-a-vis* the US dollar over 1973 to 1975 also contributed to this decline, as four-fifths of total exports of the period was denominated in sterling.<sup>35</sup> Import prices weakened slightly over the next three years, though continuing to remain at levels substantially higher than 1972/73. Despite this, dollar terms of trade continued their decline in 1975/76 and 1976/77 as a result of falling export prices.<sup>36</sup> There was slight improvement thereafter, but terms of trade declined again in 1980/81.

Sharply rising import prices and declining terms of trade implied that Bangladesh had command over fewer real resources. The resulting problem could be eased if the international monetary system, whose malfunction created the difficulty, had also ensured access to additional financing. This would give Bangladesh the option of replacing the lost real resources by imports financed with additional foreign savings. Such a possibility would have permitted the economy to undertake investments with the objective of altering the composition of output towards increased production of tradeable goods, without reducing domestic absorption. As compared to the foregoing option, the other alternative amounted to automatic adjustment through direct income effects (i.e., reduced real income and spending or absorption of resources) with a decline in consumption and investment—a process which involved considerable hardship for a poor country like Bangladesh.

### Inequitable Benefit from Liquidity-growth

The very characteristics of the international monetary system which engendered inflation (i.e., privatised expansion of global liquidity) also constrained Bangladesh from tackling the problem of deteriorating terms of trade through access to additional reserves. This became inevitable because of two basic inadequacies of the international system. First, there was no mechanism for even protecting the existing real levels of capital inflow to developing countries (not even to least developed ones like Bangladesh). In the face of global inflation, the absence of such arrangements made it difficult to protect existing import capacity. Growth in export receipts also failed to ensure an increase in real imports. Second, the manner

<sup>35</sup>This is the terms-of-trade effect of generalised floating on Bangladesh. For an estimate refer [16].

and form in which the international monetary system created additional liquidity in the 1970's to match excessive imbalances in payments, effectively prevented Bangladesh from obtaining adequate financing. This was because its distribution implied a degree of inequity much greater than the standards of inequity implicit in the Bretton Woods system.<sup>36</sup> It was definitely ascribable to a malfunction of the international monetary system, as it constituted retrogression from agreed international norms. Had international community used the agreed instrument of SDR for expanding reserves,<sup>37</sup> Bangladesh would have had access to more finance and thus the option not only to sustain 1972/73 levels of import, but also to fund a slight growth in their real levels. This is evident from Table V.

If there was international control over the entire increase in international liquidity, Bangladesh could at least have benefited in proportion to her share in total IMF-quotas (i.e., 0.37%). As total liquidity expansion was of the order of \$ 900 billion over 1971 to 1981, it would have implied an inflow of \$ 3.3 billion over the decade. A part of this would no doubt have constituted "conditional liquidity". The balance would have been accessible unconditionally implying perhaps a reduced need for availing conditional finance from the IMF than has actually been the case.<sup>38</sup> In fact, estimates made of the "possible accrual" of liquidity to Bangladesh if the actual increase in liquidity of \$ 900 billion was undertaken by IMF rather than by private market is shown below :

<sup>36</sup>Existing quotas could have been substantially enhanced or new facilities like oil facility could have been expanded, or new allocations of SDRs could have been undertaken. In all cases developing countries would have access to their agreed share i.e., to the extent of their IMF-Quotas.

<sup>37</sup>Distribution of and access to additional liquidity (conditional & unconditional) should be in accordance with agreed IMF quotas i.e., 22% for oil importing developing countries, 10.2% for oil exporters and the rest for developed countries. While this agreed distribution could be itself regarded as inequitable, violation of this agreed minimum norm is exceptionally so.

<sup>38</sup>Bangladesh entered into conditional facilities like Standbys in 1974, 1975, 1979, 1983 and Extended Fund Facility in 1980.

TABLE V<sup>39</sup>

**ADEQUACY OF FINANCING ACCRUING FROM POTENTIAL IMF FACILITIES**  
( \$ MILLION )

	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81	Cumulative Total
1. Cost of Importing 1972/73 quantities	1076	1560	1331	1156	1115	1292	1606	2768	
2. Actual Imports	925	1402	1265	864	1349	1556	2352	2524	
3. Shortfall	151	158	66	292	—	—	—	244	911
4. Cost of Importing 72/73 quantities + 10% growth	1132	1630	1400	1221	1188	1375	1706	3044	
5. Shortfall	207	228	135	357	—	—	—	520	1447
6. Allocation of SDRs	179	279	—	—	—	152	1069	194	1873
7. Coverage of Shortfall (6) as % of (3)	118	176	—	—	—	—	—	—	205
8. Coverage of Shortfall (6) % of (5)	86	122	—	—	—	—	—	—	129
9. Additional IMF facilities	74	132	—	—	282	241	45	300	1074
10. Coverage of Shortfall (6+9) as % (3)	167	260	—	—	—	—	—	—	323
11. Coverage of Shortfall (6+9) as % (5)	122	180	—	—	—	—	—	—	203

It is evident from declines in terms of trade that Bangladesh's actual value of imports must have proven insufficient to import all of 1972/73 quantities.<sup>40</sup> If slight growth in real imports is assumed, the shortfall would be much greater (as shown in row (5)). The striking revelation of Table V is that actual growth in international liquidity was sufficient to provide Bangladesh with access to adequate financing, if the international monetary system had only operated according to a agreed and established principles of equity.

It is necessary to evaluate the costs to Bangladesh of this failing of the system, in order to highlight the significance of international monetary problems to her

<sup>39</sup>Accrual of liquidity to Bangladesh is based on : (a) issuance of SDRs by IMF, equivalent to total increase in liquidity resulting from revaluation of gold (i.e., \$500 billion) (b) establishment of enlarged facilities at IMF for recycling OPEC surplus to deficit countries equivalent to Eurocredits (i.e. \$ 400 billion).

<sup>40</sup>Row (1) was estimated by applying relevant year's prices to import quantities of 1972/73. Since the economy had not reached production levels of 1969/70 (last normal year) those import quantities would be on the low side (except food).

development. The costs of deteriorating terms of trade stem from two sources. First, the automatic reduction in domestic absorption, consequent on deterioration of terms of trade, involve current costs of adjustment. Second, in order to avoid sudden shock-adjustment, Bangladesh would need some official balance of payments financing from IMF. This would entail certain specific policies, resulting from, conditionality, that are not in harmony with country's national objectives and development goals.

If all else remained constant, deterioration in terms of trade would lead to a fall in domestic absorption. This potential fall in current absorption could be offset if external finance became available. In view of the extremely low levels of per capita income and inequity in its distribution, a drastic decline in current aggregate absorption would have an adverse effect on the growth potential of the Bangladesh economy. The extent of this cost can be gauged from a quantitative estimate of the potential reduction in total domestic absorption arising from Bangladesh's declining terms of trade. Estimates of the potential fall is given below, in terms of percentage of GNP.

TABLE VI  
POTENTIAL CHANGE IN ABSORPTION (% OF GNP)

1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81
-5.4	-2.2	0	0.5	1.1	-1.5	-1.9	-3

The periods up to 1974/75, from 1974/75 to 1977/78 and from 1977/78 to 1980/81 could be seen as three distinct phases, in terms of 'potential' change in absorption. The first period shows a drastic total decline in absorption of 8.3% of GNP as compared to a slight improvement in the next period and deterioration in the more recent phase.

This reduction would have been reflected in growth of GNP, if it was not offset by increased output in the agricultural sector, as also by successful policies with the help of some additional financing. Put in another way, the point to note is that Bangladesh's growth of GNP would have been higher than it actually was, if the terms of trade had not deteriorated or if access to finance was not less than it would have been when the deterioration took place.

In nominal terms, inflow of external finance has risen over time with the exception of 1976/77, but real value has declined and is yet to achieve 1972/73 levels.

Actual capital inflow into Bangladesh is shown in the table below :

TABLE VII  
REAL VALUE OF CONCESSIONAL EXTERNAL FINANCE

	1972/73	1974/75	1976/77	1978/79	1980/81	1981/82
Nominal Value	551	901	553	1030	1147	1236
Real Value	551	484	307	494	450	402

Source : Computed from [ 12 ] by deflating the three types of assistance with their most relevant import price deflators.

Inadequate external finance implied the need to control the extent of deficits warranted by a particular level of deterioration in terms of trade. Most countries spread their efforts, to restrain the extent of deficit, over more or less all items of international accounts. But countries like Bangladesh find it difficult to do so, as demand and supply of exports are price inelastic, direct private foreign investment is not susceptible to profit expectations, as capital inflows are not market-determined and thus cannot be induced, and as factor-income payments and debt repayments to foreigners are contractual and fixed. Consequently, Bangladesh is compelled to undertake variations in imports through exchange control and trade restrictions, for reasons of balance of payments. This use of exchange and trade control instruments to vary imports, does result in a direct relationship between import capacity<sup>41</sup> and actual imports, though not necessarily a one-to-one relationship.<sup>42</sup> Since restrictions are used to control imports as an aspect of balance of payments policy, and domestically produced import substitutes are unavailable there has been a tendency for imports to determine output. Consequently changes in import capacity affect the economy's growth potential adversely.

In this context, it is useful to assess whether drastic reductions in import capacity had differential impact on imports of different categories. Normally such variations would depend on the extent of differential changes in import prices and differential price elasticities. But Bangladesh's exchange control mechanism and the lack of substitution possibilities (between domestic goods and imports) do not

<sup>41</sup>Import Capacity is composed of export receipts, worker remittances, aid, and changes in reserves.

<sup>42</sup>Even under exchange control, many of the policies used to affect imports have been of 'cost-type, which are less direct e.g., tariffs, surcharges, license fees, differential effective exchange rates etc.) resulting in a lag between a change in import capacity and in import expenditures. With comprehensive exchange control there can be slippages and even deliberate dips into reserves. Therefore imports become a function of current and lagged import capacity.

allow such a relationship. Instead, the discretionary decisions of exchange control authorities and changes in real value of disbursement of various types of 'aid' have come to determine the extent of variations among different categories of imports. It is contended here that steep but differential increases in import prices, fluctuating food-import expenditures, and variations in real value of disbursement of three types of aid have destabilised the structural composition of imports. For Bangladesh, the worst hit has been imported intermediate inputs. This is for three reasons. First, virtually all imported capital goods are a direct function of the extent of project assistance. Second, most intermediate inputs (apart from raw cotton, cotton yarn, crude oil, fertilisers etc.) are financed by own export proceeds. Consequently the variability of Bangladesh's exports and the purchasing power of its receipts, has a major impact on imports of intermediate inputs. Third, when food imports rise excessively, own export proceeds are used to finance a part of this import. In addition, debt servicing obligations have a prior claim on free foreign exchange.

TABLE VIII  
SHARE OF INTERMEDIATE INPUT IN TOTAL IMPORTS (%)

	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80
All Bangladesh	30	24	27	34	32	40	38
Excluding Some*	13	5	7	10	7	16	14

\*Excluding fertilisers, crude oil, petroleum products, raw cotton which are financed mostly by foreign aid.

Source: [27].

The compression of intermediate imports has serious repercussions on actual output of the economy. For the industrial sector, capacity utilisation has been found to be a function of the extent and availability of imported input [11]. Compression of imports in an economy as externally dependent as Bangladesh, is thus likely to have a significant adverse effect on its potential for growth and development.

#### Costs of Conditional IMF Financing

The costs evident from the foregoing analysis is further enhanced by using IMF's conditional funds. The burden imposed by IMF-Conditionality appears much more onerous in view of the small net inflow of finance from the Fund.

Table IX not only highlights the meagre inflow of resources but also the fact that Bangladesh used only a fraction of whatever funds were available from IMF-facilities, as a member. In addition most of it was from high-conditionality source,

such that Bangladesh was subject to IMF-conditionality in six of the ten years since 1972/73.

With regard to low conditionality source like the compensatory finance facility, it is learnt that Bangladesh has been unable to avail its resources to the maximum, as its export short-fall has never equalled that sum. In other words, despite the drastic fall in the purchasing power of exports, IMF's drawing criteria based on nominal export receipts prevented sufficient drawings. Even under high-conditionality facilities, stand-by arrangements provided resources that were a fraction of the sum available under upper-credit tranches of the Fund. Again, it appears that Bangladesh could not satisfy the IMF-criteria of 'balance of payments need' to the extent necessary to obtain full drawings. This is paradoxical in the light of earlier discussions on her balance-of-payments' compulsions to compress imports. While it is difficult to pinpoint the exact reasons for this situation without detailed investigation, one can speculate on possible explanations. Procedurally after Bangladesh makes a claim for upper credit tranche facility, IMF mission reviews the basis of that claim. Very often this has amounted to an exercise in trimming of the claim. This was possible, partly because of the lack of preparedness on the part of Bangladesh agencies not dealing directly with the Fund, as only a handful of officials in Bangladesh Bank and Ministry of Finance are made aware of government policies in respect of the IMF. But perhaps more important is the long-lag between claim and Fund-agreement, which results in automatic compression of imports. It is very likely, that such compression influences the final estimate on "need". Whether the resulting situation can be regarded as an inefficient policy response on the part of Bangladesh authorities is a moot point, which cannot be resolved without more information. Nevertheless it is clear however, that dependence on the Fund and consequent costs of conditionality was not warranted by the actual level of financing received. In fact, this level fell short of what was theoretically available from the Fund. Net inflows from the IMF was marginal as shown in Table IX. For that alternative sources should have been used, to avoid conditionality.

In evaluating the actual and potential costs of conditionality this should be borne in mind. In the absence of any definitive or detailed work on the effects of Fund-conditionality on the country, the discussion that follows is necessarily tentative. In all negotiations on conditionality, Bangladesh's point of contention with the IMF has been on two issues, among others. They relate to exchange rate depreciation and restraint on domestic credit expansion. For the IMF both are articles of faith...the panacea for balance of payments problem.

Exchange rate depreciation has been urged on Bangladesh since 1972. In a war-ravaged economy, with supply capacities impaired, transport facilities destroyed, import-substituting (including food production capacity) and export capability damaged, how could IMF justify the need for devaluation? Bangladesh

TABLE IX  
USE OF IMF-FINANCING FACILITIES

	1972/73	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81	1981/82
1. Net Inflow of Resources (SDR) Million	62.66	32.79	52.80	73.66	-7.94	-0.75	-3.46	73.69	169.11	43.53
2. Net Inflow as % of Deficit on Current Account	(%)23.2	7.1	6.5	10.1	—	—	—	6.6	11.4	2.5
3. IMF-finance outstanding, as % of Facilities Available	(%)25.1	38.2	34.9	45.5	64.6	52.9	52.1	46.0	49.0	37.8

Source : Computed from data from Bangladesh Bank (Research Department) Register of Transactions with IMF.

government was naturally opposed to this Fund-demand until April 1975 [17]. As expected, the devaluation of 58% did not make a significant contribution to improving the position. Price inelasticity of imports led to increases in total import bill without offsetting increases in export receipts. In addition since real value of aid was lower than 1972/73, import volumes had to be compressed with adverse effect on production. The lack of positive effect on export receipts could be for two reasons. As Pound or dollar denominated export-prices were not reduced in line with devaluation,<sup>43</sup> export prices did not fall for the importers. This prevented any volume-effect even on jute goods which could be regarded as relatively price-elastic. Second, even if foreign prices were reduced, price elasticities of demand for raw jute and elasticities of supply for other exports were so low, that increased export receipts were unlikely. This affected the trade balance adversely. In addition there was a contractionary effect of devaluation, as the rise in domestic-currency prices of traded goods reduced real absorption.

The other issue of restricting domestic credit expansion also had adverse implications. For an economy like Bangladesh, credit has to be regarded as an important instrument of production. Its restriction reduces demand but at the same time can have a negative impact on supply. The net effect on balance of trade and payments is thus an empirical matter and could easily be negative, if the latter outweighs the former effect. There are three possible channels through which credit affects production in the economy. First, there is the indirect link between credit and overall aggregate demand in a Keynesian situation of unused capacities. Second, there is a direct link between working capital availability and current production and third, there is a link between credit, investment and future production. It is evident that credit-squeeze could have negative impact on present and future production. Therefore, restraint on domestic credit should certainly not be uniformly applicable for all entities, since it could 'crowd-out' the high-productivity sectors that could make a net contribution to domestic supply. The bias in sub-sector credit ceilings in favour of private enterprises, does not necessarily overcome this problem. In Bangladesh, there is sufficient evidence to suggest highly inefficient use of at least investment credit by the private sector [20a]. Therefore, the contractionary effect of devaluation is accentuated by that of domestic credit restraint.

In addition, such a policy package has usually to be implemented over a very short period. It has been shown [14] that a more gradual approach to adjustment leads to lower negative impact on development and growth potential. This is because such a process, allows the inherent dynamic behaviour of the economy (i.e., in terms of leads and lags) to operate. If undertaken over a short period, deflation has greater undesirable effects on output, employment and factor income.

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<sup>43</sup>One of the aims of 1975 devaluation was to eliminate the need for subsidy to BJMC. Foreign prices were thus expected to be left unaltered in order to obtain a 58% increase in 'Taka' proceeds of exports.

Bangladesh not only suffered the effects of conditionality but has, on occasions found it difficult to implement such a package. This happened in the case of recently-suspended Extended Fund Facility of the IMF. The three-year extended fund loan of SDR 800 million was suspended in mid-1981, because the country's credit creation was judged as excessive by the Fund i.e., the performance criteria on credit had been breached. Surprisingly it was not resumed subsequently, even though total credit expansion was brought into line.<sup>44</sup> In fact, in July 1982 the Fund cancelled the facility altogether only to be replaced in the subsequent year, by a Stand-by arrangement. For Bangladesh this meant worst of both worlds since under the latter, the programme period was shorter (12 months instead of 36 months), finance provided was smaller and repayment had to be quicker, without any substantive change in conditions. This clearly implied considerable inefficiency of the authorities in the management of country's relations with the Fund. Without a detailed study however, it is difficult to analyse the reasons behind such apparent inefficiency. The only point that can be made is that if Bangladesh had to undergo the cost-of-conditionality, it should have been under a renegotiated Extended arrangement, rather than a newly-negotiated Stand-by. This is because the nature of the conditions (as delineated above) are similar but the duration over which adjustment-action is undertaken is shorter, and the resources fewer.

It is evident that global-inflation-led deterioration in terms of trade, inequitable distribution of unrestrained liquidity expansion and 'conditional' financing, has imposed considerable costs on the Bangladesh economy.

#### **Effect of Generalised Floating<sup>45</sup>**

Bangladesh entered the regime of generalised floating in March 1973, with the Taka pegged to the Pound sterling. Under the par-value adjustable peg exchange rate regime, pegging implied fixity of exchange rates of Taka with all major currencies over the duration of the peg. This was no longer possible. Pegging with floating pound sterling implied automatically changing exchange rates of Taka *vis-a-vis* other major currencies. For example, over the three years of March 1973 to March 1976, the Taka peg with the Pound was not altered except for 58% devaluation in May 1975. Yet the Taka value of other currencies fluctuated, sometimes wildly, as a result of generalised floating of third country currencies. Since April 1976, Bangladesh undertook a more flexible exchange rate policy, by frequently altering the pegged rate with pound sterling.<sup>46</sup> The basis of such changes were *ad-hoc*,

<sup>44</sup>While a very large proportion of EFF arrangements were suspended at one stage, or another, most of them were resumed or re-negotiated. Bangladesh's failure to re-negotiate was thus unusual. While the June 1981 ceilings were breached, the Sept. 1981 one on total domestic credit expansion, was met.

<sup>45</sup>This section draws largely from [ 16 ].

<sup>46</sup>There were 38 adjustments (both upward and downward in Taka exchange rate with pound sterling over a period of 64 months (i.e., an average of more than one change every two months).

though the objective [1] seemed to be the prevention of Taka import costs from fluctuating. This was thus undertaken by focussing mainly on stabilising the Tk. dollar rate, which has been shown to be successful [16].

However, since August 1979, the authorities began to use an index of effective exchange rate<sup>47</sup> as a basis for estimating the need for adjustments, with pound sterling continuing to be the intervention currency. It is evident from actual adjustments in pegged value that they were not undertaken wholly in line with changes in the index. The *ad-hoc* nature of alterations in the peg, continued. This imparted a considerable degree of instability to the Taka exchange rates with major currencies, and consequently to the Taka import costs and the trade balance.

It is the contention of this section that a good part of the problems emanating from this exchange rate policy stemmed from continuing the tradition of pegging Taka to pound sterling. It is suggested here that a reasonably firm dollar-peg would not only have provided increased stability to Taka-value of 75% of import payments and 40% of exports receipts, but also reduced the costs emanating from exchange risk in Bangladesh's foreign transactions.

An examination of the actual Taka exchange rates for major currencies (e.g., \$, £, DM, ¥ etc.) prevailing since March 1973 reveal a high degree of instability in those rates. Such instability was a function not only of autonomous fluctuations in exchange rates between third country currencies (e.g., £ *vis-a-vis* \$, DM & ¥, \$ *vis-a-vis* DM and ¥ and so on), but also of *adjustments* in the peg (i.e., changes in nominal Taka exchange rates for pound sterling) undertaken by Bangladesh authorities as part of its exchange rate policy.

It is interesting to observe that when Bangladesh made only one adjustment in Tk = £ peg over the first 36 months after generalised floating, the monthly Taka exchange rate of the Dollar, Deutsche Mark and Yen fluctuated considerably. Revaluations and devaluations of Taka *vis-a-vis* those currencies occurred frequently. The computed instability indices for nominal exchange rates indicate values of 17.9, 16.4, and 18.3, for dollar, deutsche mark (DM) and Yen (¥), respectively. Over the next five years (1976-81), under a more active exchange rate policy, instability of Tk. = \$ exchange rate decreased substantially to 6.2 while those of DM and ¥ were also relatively stabilised as is evident from Table X.

While pursuing such a policy, the authorities revalued the Tk. = £ rate on several occasions starting with April 1976. Such revaluation must have implied

<sup>47</sup>The effective exchange rate index used by Bangladesh Bank was a simple arithmetic average using four major currencies dominant in currency denominations of Bangladesh's export and import transactions i.e.,  $EER = \sum w_i r_i$  where  $\sum w_i = 1$  and  $r_i$  is indexed to a base March 1973. The weights  $w_i$  are : US dollar (0.57) U.K. pound (0.29), Deutsche Mark (0.9) or Japanese Yen (0.5).

lower taka proceeds (since foreign prices were unaltered) from exports, which contributed to an increase in subsidy to jute sector, the avoidance of which was the original purpose of devaluation. If the authorities had pursued a policy similar to the adjustable peg system with respect to pound sterling over this period (i.e., 3 changes instead of 38) the degree of instability would have been higher for all rates except the Tk. = £ rate as is seen from Columns (5) (6) and (7) of row (2). The comparative indices of instability would have been as follows :

TABLE X  
INSTABILITY INDEX FOR NOMINAL EXCHANGE RATES

Period	Under Actual Changes in Tk=£				Under Hypothetical changes in Tk=£ (i.e. 4 changes only)		
	Tk=£ (1)	Tk=\$ (2)	Tk=DM (3)	TK=Y (4)	TK=\$ (5)	TK=DM (6)	TK=Y (7)
1 March 73—March 76	8.4	17.9	16.4	18.3	17.9	16.4	18.3
2 April 76—Dec. 81	10.2	6.1	7.5	8.8	9.5	7.0	8.4
3 March 73—Dec. 81	9.0	13.6	12.3	11.8	18.2	15.8	14.5

Source : Exchange rates of Tk=£ were obtained from Bangladesh Bank for Tk=\$/DM/Y market rates provided in IFS were used to compute.

Note : The instability index used here was (*Standard Error of Estimate*) X 100) based on linear trend equation.

In short, it appears that variations in the Taka-Pound peg may have been undertaken with the objective of stabilising the Tk=dollar rate as is evident from instability indices given in Columns (1) and (5) in row (2) of Table X. It is clear that if Tk=£ rates were changed infrequently, instability in other rates would have been higher. While the attempt to stabilise Tk. = \$ could be justified, one can question the validity of this indirect method.

It is obvious from Table XI that Effective Exchange Rates (EER) were also more stable in that period (April 76—Dec. 81). However, such stability in EER could have been achieved with lower (or negligible) instability in Tk=\$ rate if a dollar peg had been used. Stability in Tk=\$ rate with increased stability in EER would have stabilised both, the import bill as also the trade balance.

The instability of taka exchange rate over time has several significant implications for the economy, by virtue of its adverse effect on economic efficiency. The costs could stem from misallocation of resources and wasteful movement of factors from discouraging participation in external sector to sub-optimal level, and increased

TABLE XI  
INSTABILITY OF TAKA'S EFFECTIVE EXCHANGE RATES

	Pre 1973	Post 1973	Period I	Period II
Nominal	1.590	13.402	14.605	3.362

Source : [ 16 ].

Notes : Effective Exchange Rates are calculated by using geometric averages of bilateral exchange rates weighted by the shares of currency-denomination in trade, used by Bangladesh Bank ( i.e. \$=57% ; £=29 DM=9% Y=5% ). Instantly index used is standard error of exponential trend.

$$EER = \sqrt[n]{(r_{it}/r_{i0})^{w_i}}$$

Where :  $r_{it}$  is the Taka price of currency  $i$  in time  $t$  relative to base period March 1973

:  $w_i$  is share of currencies  $\sum w_i = 1$

:  $P_{it}$  is price level of  $i^{\text{th}}$  currency-country at time  $t$  and  $P_t$  is price level of Bangladesh.

Period I : March 73—April 76, II : April—76 Dec. 81.

variability of trade balance leading to planning problems. These costs and their impact on Bangladesh economy depend on various factors. The currency denomination of exports and imports, the nature of the domestic financial and foreign exchange market, supply rigidities and price responsiveness of factors and output, the state of balance of trade and the inflationary potential of import prices, are some of them that will determine the extent of economic costs associated with instability of Taka's exchange rate.

The currency of invoice for exports and imports, introduce a new dimension to the effects of exchange rate variability for developing countries.<sup>48</sup> This is because such invoicing practice differs from those usual for developed countries. An examination of the currency denomination of Bangladesh's trade transactions reveal that major currencies comprise more than 95% of total transactions. They are the U.S. dollar, U.K. pound, German D-Marks and Japanese Yen, in that order. However there is a crucial assymetry between export and import transactions as is apparent from Table XII.

This shows that imports are overwhelmingly invoiced in U.S. dollars in the range of 76% in 1980/82 with pound sterling being the second most important currency. The situation is reversed in the case of exports where pound sterling clearly dominated as currency of denomination to the extent of 80% up to 1975/76 but reducing gradually to 50% by 1981/82.

<sup>48</sup>This stems from the fact that both imports and exports are invoiced in currencies of third countries. In contrast, developed countries' exports are invoiced in currency of home country, thereby avoiding one source of instability. Refer [ 3 ].

TABLE XII

## DISTRIBUTION OF CURRENCY-DENOMINATION OF TRADE TRANSACTIONS

		£ Stg	US\$	DM	JYen
1974/75	Export	90.4	5.9	0	0
	Import	39.3	50.4	1.5	1.7
	Total	64.8	28.15	0.7	0.8
1976/77	Export	57.5	41.3	0.6	0
	Import	21.3	72.2	2.8	0.3
	Total	39.4	56.8	1.7	0.15
1978/79	Export	67.6	29.0	0.03	0.1
	Import	18.3	77.7	3.7	1.8
	Total	42.9	53.3	1.8	0.9
1980/81	Export	50.6	38.9	1.8	0.2
	Import	8.5	76.1	4.9	4.2
	Total	29.5	57.5	3.8	2.2

Sources : Bangladesh Bank, Department of Statistics.

Note : Import transactions exclude loans & grants as currency of invoice is not available. Bangladesh Bank feels that there will be no substantial change, even/if they are included.

The foregoing indicates that any instability in Taka's exchange rate with the Pound will have a considerable effect on exporters but little on importers. The volatility of Taka-dollar rate on the other hand, will not only critically affect the taka cost of import but nearly two-fifths of the export receipts.

It has been contended that the degree of instability of exchange rate is not necessarily a useful indicator of instability in Taka receipts or Taka costs. This is argued on the ground that depreciation of a particular third currency is often accompanied by increases in price level in the home country of the currency. This stabilising effect is likely to be absent in the case of Bangladesh since her geographic trade share, even with developed countries, do not correspond with the distribution of currency-denomination of trade. USA, UK, West Germany and Japan together constitute not more than 30% of Bangladesh's exports and 47% of imports as compared to more than 90% for both in terms of currency denomination. This implies that the link between price level and (floating) exchange rate changes of a trading partner, is broken. Thus the extent of instability apparent from variability of Takas' exchange rate, indicates the true degree of instability in cost that is transmitted.

Many of the adverse effects of such fluctuation could be reduced, if the costs of hedging were not excessive. Unfortunately in Bangladesh, where financial markets

are rudimentary, and foreign exchange markets lack depth, firms and individuals find it difficult to protect themselves against exchange rate instability. Facilities for discounting bills are insufficient, forward foreign exchange markets are thin and exchange control regulations are too numerous to permit 'hedging' at reasonable cost. Moreover, the short duration of forward exchange markets (i.e., 3-6 months), fluctuation in forward rates and restrictions on its use by exporters and importers, make 'hedging' a problem.

Supply rigidities and specificity of factors, make reallocation of factors and inputs difficult. Thus movement of resources in response to change of Taka prices due to short-run exchange rate variability, would imply costs. There would be costs if such movement took place, as well as if investment did not move into tradeable goods sector due to uncertainty resulting from instability of exchange rates.

In addition, the country has suffered from adverse effect of foreign exchange risk in external transactions. This effect has several facets. First, the mismatch between currency denomination of export proceeds and those of imports and debt-servicing obligations, imply significant financial costs in using the export proceeds for undertaking these payments. This is because in the early years nearly three-quarters of export receipts were in pound sterling while 75% of imports and debt-servicing obligations were in U.S. dollars. Substantial loss was therefore incurred over most of the 1970's as the pound depreciated against the dollar. This risk could have been considerably reduced if the authorities undertook forward foreign exchange cover in the international market. But this was not done. Even at present, foreign exchange risk is applicable for nearly half the proceeds from exports.

Second, the portfolio of reserves placed among different currencies, was subject to the same risk, to the extent that their currency distribution deviated from the composition of currency denomination of import-payments. The portfolios were also subject to changes in asset-value of reserves due to capital appreciation/depreciation arising from fluctuating exchange rates. The currency composition of reserves is shown in Table XIII. In the initial years currency distribution of reserves fluctuated between two extremes ; the dollar denominated component moved between 55% and 22% as compared to 63% and 35% for pound sterling. This distribution did not correspond to the currency composition of payments. Considerations of yield seemed to have played an important role in allocating reserves between currencies. In fact, the holding of pound sterling in excess of payment requirements was dictated partly by the accrual of export receipts in that currency, but more importantly due to considerations of yield especially upto 1979/80. Though it is difficult to quantify the net effect of such reserve distribution, the lack of forward-cover must have contributed to costs in terms of both exchange loss and transactions cost, which may have more than offset the gains from yield.

TABLE XII  
CURRENCY COMPOSITION OF FOREIGN EXCHANGE RESERVES (%)

	1972/73	1973/74	1974/75	1975/76	1976/77	1977/78	1978/79	1979/80	1980/81
Pound sterling	92.8	1.4	35.3	39.1	35.8	27.6	63.9	54.6	40.2
US Dollars	7.2	98.1	55.1	44.8	37.0	42.1	22.8	24.2	50.4
Deutsche Mark	—	0.5	9.6	16.1	15.3	14.2	8.7	19.1	5.5
Japanese Yen	—	—	—	—	11.8	16.0	4.6	2.1	3.9

Source : Accounts Department, Bangladesh Bank.

In view of the characteristics of the Bangladesh economy, instability in exchange rates (i.e., Taka values) is clearly undesirable. Its reduction is imperative. But it is also true that taka exchange rates of all major currencies cannot be stabilised at the same time, as they are a function of floating of third country currencies. It has been shown that the authorities had altered the Taka peg with the Pound frequently, with the intention of stabilising the Tk = dollar rate. This was clearly a second best option in the light of facts. If stabilising the Tk = dollar rate was considered important for reasons cited earlier, pegging Taka to the dollar, would have permitted greater flexibility for policy making. A fixed rate of Taka with the U.S. dollar would have yielded fixed, stable and predictable import costs (at least for 75%) and export receipts (for 39%) as also relatively stable EERs. Importers and exporters would be subject to greater certainty of Taka costs and receipts,<sup>50</sup> suffer less from foreign exchange risk (in using export proceeds for import payments) and avoid wasteful movements of resources or fluctuation in output. Pegging to the dollar would also imply fixed exchange rates with all dollar pegging countries. Moreover, such pegging would have led to relatively more stable Taka exchange rates with many other currencies. The failure of the authorities to shift to Taka-dollar peg has involved the economy in costs that were avoidable.

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<sup>49</sup>This advantage of stability could have been provided to exporters if invoicing in dollars was made mandatory. Notwithstanding this, under a Taka-dollar peg there would be considerable incentive for exporters to shift to invoicing in dollars, both due to stability of Taka proceeds and for shifting foreign exchange risk to foreign importers.

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# Asymmetries, Old and New in International Finance : International Monetary Reform Efforts and Low Income Countries

by

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No international arrangement is perfect, no matter how much time, effort and thought are spent in hammering it out. Firstly, every agreed arrangement involves compromises among negotiating countries, and these compromises are made usually less out of conviction than out of recognition of one's relative strength as compared to others on the negotiating table. Secondly, every arrangement is bound to get out-dated quite fast, despite efforts to anticipate events and situations in the future. To be concrete, the Bretton Woods Agreement, laying down international monetary arrangement, was possible to reach because the various sides to the negotiations ultimately made compromises, some more than others. Since it was none other than John Maynard Keynes who yielded ground after ground under American pressure to reach the agreement, there could be little argument about what actuated the compromises he felt impelled to make. The fact that the arrangement, worked out at Bretton Woods, started showing clear signs of its inadequacy in the late 60s and ultimately collapsed in the early 70s demonstrates how future developments become difficult to accommodate beyond a point in old arrangements.

The monetary arrangements that have evolved since the collapse, in 1973, of the Bretton Woods Agreement are an outcome of not one overall agreement but a series of agreements worked out over the years, beginning with the Jamaica meeting of the Interim Committee of the International Monetary Fund, in January 1976, when it was agreed to accept that member countries enjoyed freedom to adopt the exchange rate arrangement of their choice. They were, at the same time, placed under the obligation to "collaborate with the Fund and other members to ensure orderly exchange arrangements and to promote a stable system of exchange rates". To ensure the latter, the Fund was authorised "to exercise firm surveillance over the exchange rate policies of the members and to adopt guidelines for the members with

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respect to these policies".<sup>1</sup> The Jamaica agreement, in effect, only put a stamp of approval on the system of managed floating which had already come to stay, having been in operation among the major trading countries for almost three years since the beginning of 1973, and which the countries with a major voice in the Fund decision making, particularly the United States, were in absolutely no frame of mind to give up in favour of the old system of fixed exchange rates.<sup>2</sup> Also, what was agreed upon in Jamaica marked only a beginning of the newly emerging monetary arrangement, an arrangement whose principal features today are: (1) the dominance of flexible exchange rates ; (2) the expanding role of private banks in the financing of balance of payments; and (3) the relegation of the International Monetary Fund to an almost peripheral role in balance of payments financing.

I propose to concentrate in this paper on how the monetary arrangements, as they have evolved since 1973, affect low income countries, the grouping to which all of us on the sub-continent belong. In my presentation, I propose to discuss the various issues arising out of the monetary arrangements currently obtaining under two major headings : (i) payments imbalances and adjustment action ; and (ii) generation of world liquidity. It is necessary, however, to be clear about the current international economic situation to be able to form a clear judgement about the relative significance of the various issues that emerge from my presentation. I shall, therefore, start with a review of the recent international economic developments.

### The International Setting

As the World Bank's Development Report for 1981 sums up, "the 1980s have begun on a sluggish note".<sup>3</sup> Even during the 1970s, growth of output in the industrial market economies was erratic and slow compared to what was achieved in the 1960s. But in 1980 and 1981, growth in these countries had slumped even further, to a third of the average for the 1970s. While inflation rates in these countries showed some signs of slackening in the early 80s unemployment reached record high levels, which revive memories of the Great Depression. The slow-down in growth of output experienced by the developing countries was considerably less, though it was substantial for low-income countries. Per capita growth rates in low income countries were more than halved (from 1.8 per cent to 0.8 per cent between the 60s and 70s). Alongside, inflation rates experienced by the developing countries have been quite high.

<sup>1</sup>See *IMF Survey*, January 19, 1976.

<sup>2</sup>See I.S. Gulati, *International Monetary Reform, its Background, Present Status and Future Outlook*, Indian Economic Journal, July-September 1977.

<sup>3</sup>See *World Development Report*, 1981, p. 8.

The general slow-down in growth of domestic output during the 70s and early 80s has been accompanied by a slackening in the growth of world trade. Again low income countries seem to have been the worst sufferers. While for industrial market economies growth of exports slowed down from 8.4 percent in the 60s to 5.9 percent in the 70s, and for middle income developing countries the pace slackened from 5.4 percent to 4.3 percent, for low income countries the slow down was precipitous, with growth of exports declining from 5.0 percent in the 60s to a negative rate of 1.0 percent in the 70s.

While their export earnings have been slow or stagnant, the prices which the low income countries have had to pay for their imports have been rising sharply. According to World Bank's calculations, the purchasing power of the exports of these countries declined by 24 percent between 1970 and 1980.<sup>4</sup>

Perhaps the most disturbing development of the 1970s was the worsening of the balance of payments for the non-oil developing countries in general. The worsening trend was sharply accentuated between 1978 and 1981. Thus the balance of payments deficit on current account of the non-oil developing countries was \$11.6 billion in 1973, \$28.3 billion in 1978 and \$99 billion in 1981. During the same period, the current account balances of industrial market economies showed a remarkable capacity to recover from any major shock. Taken together, they moved from a surplus in 1973 of \$17.7 billion to a deficit of \$3.7 billion in 1981, with a surplus of \$29.8 billion in 1978 and a deficit of \$44.8 billion in 1980. The surplus of the oil exporting countries fluctuated between \$2.9 billion in 1978 and \$115 billion in 1980. The surplus for 1981 was \$70.8 billion and the IMF projections for 1982 place it at only \$25 billion. Low income countries had a relatively small deficit of \$4 billion 1973 which almost doubled immediately after the first round of oil price increases. By 1977, however, they were able to reduce their deficit to \$3.6 billion. After the second round of oil price increases in 1979 the deficit has again been mounting and that too quite sharply—it was \$14.3 billion in 1981 and is projected at \$15 billion for 1982.<sup>5</sup>

An important aspect of the payments situation of low income countries has been that all along their combined deficit as a percentage of their export earnings was the

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<sup>4</sup>See *World Development Report*, 1981 pp. 21-22. Because of the deterioration of their export prices relative to those of others, low income countries hardly shared at all in the growth of world trade during the 70s. As the World Bank puts it, "to the extent the imports depend on export earnings, they (low income countries) can import little more at the end of the decade than they could at the beginning—this in the face of a more than one quarter growth of their population." More recent assessment shows outright decline in the volume of imports by low income countries, amounting to 2 percent in 1980 and 7 percent in 1981. See *IMF Annual Report*, 1982, p. 30.

<sup>5</sup>See IMF, *World Economic Outlook*, 1982, pp. 61-65.

highest among the various analytical groups within the broad category of non-oil developing countries. Even in 1973 and before, their payments deficit was as high as a quarter of their export earnings. In 1980 and 1981, it was almost three-quarters of export earnings. Viewed in relation to export earnings, deterioration of the payments position of low income countries has clearly been the sharpest.

Occurrence of payments deficits year after year in the 70s resulted, quite naturally, in the accumulation of sizeable external debts by the non-oil developing countries. Their long-term debts which added up to \$97 billion in 1973 rose to \$437 billion in 1981. The projections for 1982 place the figure at \$505 billion. For low income countries, the jump would be from \$22 billion in 1973 to \$80 billion in 1982 which, as a percentage of export earnings, would work out to 228, again the highest for the various analytical groupings among the non-oil developing countries.<sup>6</sup>

Accumulation of large external debts by non-oil developing countries has been accompanied as well as caused by higher than proportionate increases in debt service payments because of both a sharp increase in interest rates and shortening of the maturity structure of debt. For all non-oil developing countries, debt servicing rose from \$15.3 billion in 1973 to \$94.3 billion in 1981, which as a proportion of export earnings rose from 14 percent to 21 percent. It must be added, however, that for low income countries the increase in debt servicing ratio has been the lowest, from 12.6 percent in 1973 to 13.5 percent in 1981. This was so because the access of low income countries has continued to be restricted very largely to official credit.<sup>7</sup>

Private commercial banking credit has remained virtually outside the reach of low income countries despite its phenomenal growth practically all through the 70s and early 80s. Indeed, the expansion of international lending by private commercial banks has probably been the single most dramatic development of the 70s, particularly of the second half of the decade. Euro-dollar deposits at the end of 1982 exceeded one trillion dollars.<sup>8</sup>

Although international commercial lending has shot up dramatically, access to it to the low-income countries has been severely restricted. Indeed, it is hardly worth mentioning except to underline that this is a source of finance virtually untap-

<sup>6</sup>See IMF, *World Economic Outlook*, 1982, p. 171.

<sup>7</sup>In fact, in between years debt service ratio for these countries had registered a substantial decline. It had declined to 7.3 percent in 1979, even though the ratio of external debt to their exports in 1979 was somewhat higher than in 1973. Recent escalation in the debt service ratio is possibly attributable to a hardening of the terms of their recent borrowings, though the source of these borrowing has continued to be official credit.

<sup>8</sup>This excludes inter bank lending. Gross deposits, inclusive of inter bank lending, should be close to \$ 2.5 trillion, if not higher, by the end of 1982.

pable by this group of countries. Though the non-oil developing countries, as a group, accounted for about a fifth of the lending, it is very significant that three countries ( Brazil, Mexico and Argentina ) from Latin America together owed over one half of this credit.<sup>9</sup> The vast majority of non-oil developing countries, both middle income and low income, had little or no access to this source for either direct or indirect (i.e., through projects) balance of payments financing even though, as was noted earlier, they faced serious, continuing worsening of their payments position. Low income countries continued to depend almost exclusively on official, bilateral as well as multinational, more on the latter, credit to cover their deficits.<sup>10</sup>

To sum up, the overall international economic environment in recent years, developments in output, trade and finance have been such as have had the effect of pushing non-oil developing countries in general, and low income countries in particular, more and more to the wall. It is with this background in mind that I propose to discuss the major aspects of recent international monetary developments and offer my assessment of the present situation from the point of view of low income countries.

#### **Payments Imbalances and Asymmetrical Adjustment Obligations**

To every dollar of deficit in a country's balance of payments on current account, there has to be, as we all know, a corresponding surplus in the balance of payments of another country ( or group of countries ). There has, therefore, to be a synchronous transfer on capital account from the surplus countries to the deficit countries for the overall balance of payments to balance. But to say this much is not going very far. Indeed it tells us little about either how deficit countries raise funds externally to cover their deficits, how surplus countries place their external surpluses or how these surpluses get routed to the deficit countries. Nor does it tell us anything about how the surplus as well as deficit countries seek to readjust their trade and financial flows to rectify their current account imbalances over the longer run.

One of the major concerns in international monetary reform has always been to work out a system or arrangement under which not only is the obligation to take appropriate, timely adjustment action accepted by all countries with payments imbalances but also the obligation is so shared between the surplus and deficit countries that the burden which such adjustment action imposes, is distributed equitably among countries. This was a concern voiced at the negotiations preceding the Bretton Woods Agreement and it has also been a major concern in more recent years,

<sup>9</sup>With the addition of three other countries, one from Latin America, Chile, and two from the Far East, South Korea and the Philippines, the six countries together accounted for 70 percent of the bank credit to non-oil developing countries as on end-December, 1980.

<sup>10</sup>See *World Development Report*, 1981, p. 57.

particularly since it was realised that the Bretton Woods System was on the verge of collapse.

The further issue in later years has been that while speaking of symmetrical obligations for adjustment action, it is argued that reserve currency countries also need to be brought under the umbrella of international adjustment discipline. Otherwise, a reserve currency country, it is felt, could go on incurring payments deficits without undertaking any adjustment action and place practically the entire burden of adjustment on the reserve accumulating and reserve decumulating countries.

Indeed the major preoccupation of the reform efforts undertaken during the 4-5 years immediately preceding the breakdown of the Bretton Woods System in 1973 was to work out an arrangement under which the reserve currency countries (at that time, there really was only one such country, namely, the United States) also accepted the obligation to undertake adjustment action like any other deficit country on the grounds that they too were incurring liabilities abroad to achieve a payments balance and that the unregulated expansion of these liabilities created problems for the smooth working of the international monetary system. That efforts in this direction did not succeed is in itself a matter worth careful examination, but it is something that I do not wish to pursue here. For my present limited purposes, it should suffice to note that the expansion of foreign exchange reserves (i.e., in the liabilities of the reserve currency countries to the monetary authorities of other countries) between end 1973 and end 1981 was more than twice the expansion which took place in the preceding 20 years.<sup>11</sup> Although there has, at the same time, been some tendency to diversify foreign exchange holdings among a number of reserve currencies, the share of the U.S. dollar in foreign exchange reserves has still remained rather large at above 70 percent (it came down from 78.4 percent in 1973). Not only has very little been achieved by way of imposing some sort of discipline on the reserve currency countries, the experience of the past decade goes to demonstrate that reserve currency countries are subject to far less control today than they were under the Bretton Woods System.

### **Continuing Domination of the Dollar**

Under the Bretton Woods System, the U.S.A., as the principal reserve currency country, undertook to maintain the gold value of the dollar at 1/35th of an ounce till almost the end. Dollar convertibility imposed on the U.S.A. this obligation. This operated as a sort of check on the expansion of the U.S. liabilities

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<sup>11</sup>Indeed, if one were to compare the expansion in foreign exchange reserves, with the line drawn at the end of 1969, the expansion since then has been 22 times the expansion before that.

abroad. Since 1973, however, there is no obligation whatsoever on the U.S.A., or any other reserve currency country, to maintain the gold value of its currency. Nor has any other effective obligation been placed on reserve currency countries except the very vague requirement under Article IV of the amended IMF Agreement, to follow the guidelines and be subject to Fund surveillance with respect to exchange rate policies. Given this position, there is little reason why a reserve currency country should be unduly perturbed at the expansion of its currency liabilities abroad and the concern is probably even less if and when all reserve currency countries expand their external liabilities more or less in concert.<sup>12</sup>

The points to note, in our context, regarding monetary developments in recent years are three. Firstly, whatever diversification has taken place in the currency holdings of monetary authorities has been from the dollar into a few of the other developed country currencies, notably Deutsch Marks and Swiss Francs. Secondly, the extent of this diversification has been only marginal in that it only slightly slowed down the expansion in dollar liabilities abroad. As against a 200 percent expansion of total foreign exchange reserves, the expansion in dollar holdings of the monetary authorities was of the order of 170 percent so that the overwhelming domination of the dollar has remained more or less unaffected. Thirdly, the massive growth, at the same time, of Euro-dollar banking has, very largely, meant the expansion of dollar denominated deposits and lending outside of the United States but principally by branches, subsidiaries and affiliates of the U.S. banks, so that the dominant position of the dollar can be said to have remained virtually unaffected.

Thus after all the swings in exchange rates and movement of funds across national frontiers over the past 10 years since the collapse of the Bretton Woods, the dollar can still be said to hold its firm sway on the world monetary scene. At the same time, a few of the other stronger developed country currencies have also started sharing with the dollar the benefits of reserve currency status. No less important it is to note that with the massive spurt in Euro-dollar banking operations the commercial banks have become the major source of funds for the industrial market economy countries and a handful of middle income developing countries. At the same time, practically all low income and most middle income developing countries with extraordinarily large payments deficits have remained virtually excluded from access to commercial bank finance.

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<sup>12</sup>No doubt, there will still remain the danger of movement away from reserve currencies into gold (and even other stockable commodities) although gold has now been divested of any formal status in the international monetary system. One could possibly argue that, therefore, reserve currency countries cannot altogether throw caution to the wind. But that is not the same thing as observing proper internationally agreed rules and regulations.

### Emergence of a New Asymmetry

As a result, a new asymmetry has emerged. This is the asymmetry in the access to balance of payments finance between industrial market economy countries and a handful of middle income favourites on the one hand and the low and most middle income developing countries on the other. While the former have access to commercial bank finance for meeting their payments deficits, the latter have none and are, therefore, driven more and more to institutions like the World Bank and the International Monetary Fund, offering mostly high conditionality finance.<sup>13</sup> The Fund has, as we know, lately swung sharply towards high conditionality financing, obliging borrowing countries to undertake severe adjustment actions to contain domestic demand along with import liberalization and exchange rate devaluation. Even the handful of middle income developing countries which enjoyed access to commercial bank finance directly may gradually be forced to use the instrumentality of the Fund for their future external finance. The recent case of how Mexico has been forced to resort to the IMF is, in my judgement, a pointer in that direction.<sup>14</sup>

Thus, we now face a situation where countries, which, by any objective assessment, are faced with sharply increased payments deficits for reasons almost entirely outside their control—IMF's own most recent assessment shows that the increase in oil prices and the weakening of primary commodity prices accounted for more than two-thirds of the entire increase in the aggregate current account deficit of the non-oil developing countries between 1978 and 1981<sup>15</sup>—are being obliged to take on the entire burden of adjustment action. The justification being offered is that the deficits faced by these countries are not sustainable because they are not temporary and reversible, and that therefore these countries must perforce take on the full burden of the corrective adjustment action, regardless of whether or not the deficits they face arose as a result of factors within their control.

It is worthwhile noting at this point that the argument used after the first round of substantial oil price increase (1973-74) was that since the payments deficits

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<sup>13</sup>In the past few years, for instance, all drawings from the International Monetary Fund have been made by non-oil developing countries which is in sharp contrast to the position that obtained until mid 1970s. Of the Fund credits outstanding at the end of 1977, 49 percent were accounted for by industrial countries; the proportion had declined to 4 percent by the end of 1981. The share of low income countries rose from 11 percent to 37 percent in the same period.

<sup>14</sup>Mexico's financial crisis illustrates how a country can get into difficulties financially for reasons altogether outside its control, namely the decline in the price of its oil exports and sharp rise in interest rate on its external debt, and still be forced into a course of economic policy which, though of little immediate impact, fits in with the ideological biases of the Fund and the countries which dominate its decision making.

<sup>15</sup>See IMF *Annual Report*, 1982, p. 29.

arising in consequence were substantial and likely to persist for some years they would have to be accepted in the short run, and that therefore deficit countries should not attempt to eliminate their deficit by each taking recourse to deflationary demand policies, import restriction and exchange rate depreciation because such action would serve only "to shift the payments problem from one oil importing country to another and to damage world trade and economic activity". Instead, a forceful case was made for sustained international cooperation "to ensure appropriate financing without endangering the smooth functioning of private financial markets and to avert the danger of adjustment action that merely shifts the problem to other countries".<sup>16</sup> However, when it came to the second round of substantial oil price increase (1979-80), by which time commercial banks had clearly established their ability to finance not only the other external funding requirements but also the deficits of the industrial market economies—thus, during the 3-year period, 1978 to 1980, while deficits of all the industrial market economy countries added up to \$ 106 billion their international market borrowing amounted to \$ 270 billion—the tune had altogether changed and the burden of the song, right from the start, was that the deficits faced by the countries not being temporary and reversible ought to be tackled by strong adjustment action in the form of deflationary demand management and exchange rate action even though it must have been clear that such action would only accentuate the recessionary conditions already obtaining because of the recent deflationary and beggar-thy-neighbour protectionist policies of the industrial market economies.<sup>17</sup>

I would submit that the position as it has evolved, particularly over the past three years, on the world economic scene is extremely ominous for the developing countries, more so for low income countries, in that on the pain of inaccessibility to external finance to cover their payments deficits they are being asked to shoulder the entire burden of corrective adjustment action even though it is generally accepted that the major part of the payments deficits which have currently emerged have little to do with the domestic economic policies of these countries and are entirely attributable to extraneous circumstances.

What is very unfortunate about the inequity of the high conditionality now being demanded of the developing countries is that this demand is being spear-headed through the International Monetary Fund, an institution which, all said and done, is still a part of the United Nations framework and could be said to subscribe

<sup>16</sup>See *IMF Annual Report*, 1974.

<sup>17</sup>Thus while in the period following the first oil shock three quarters of the resources the Fund made available involved low conditionality, in the period after the second oil shock over three quarters of the Fund's lending commitments involve high conditionality calling for rigorous adjustment policies. See Sidney Dell, *On being Grandmotherly: The Evolution of IMF Conditionality*, Princeton, 1981 and I. S. Gulati, *IMF Conditionality and Low Income Countries*, Puna, 1982.

to the broad development perspective of the United Nations Organization. In fact, as we shall note presently, the slant of the whole set of policies being pursued by the Fund raises strong suspicions that, given the complete domination over its decision making by the industrial market economic in general and the U.S.A. in particular, there is little chance of the development perspective reasserting itself, at least not in the near future, in the formulation of policies in regard to the world monetary arrangements through the fora provided by this institution.

### **Increasing Inequity in World Liquidity Generation**

The question of world liquidity is intimately connected with that of balance of payments financing in the sense that, other things remaining the same, the larger the payments imbalances the greater should be the need for international liquidity through which to finance the payments imbalances.

Under the world monetary system, as it evolved over the years after the Bretton Woods Agreement, international liquidity was generated through the creation of dollar liabilities. This arrangement conferred an enormous economic benefit on the United States as the sole reserve currency country. As the London Times put it editorially, the U.S.A. could on the strength of this position, go on "spending, investing and soldiering abroad as if the nation were still the overwhelming economic power that it was immediately after World War II". Thus, during the 1960s, though the U.S. surplus in its balance of payments on current account added up to \$33.3 billion, its additional investment abroad (portfolio and non-portfolio put together) added up to \$ 76 billion. During the same period, the increase in the foreign exchange reserves of the countries other than U.S.A. was of the order of \$16.9 billion.<sup>18</sup>

After the breakdown of the old monetary system and the emergence of a new monetary regime since early 1973, the U.S. position has improved further in the above respect. Between 1973 and 1979, although the U.S. current account surplus was of the order of only \$5.1 billion, its additional investments abroad added upto \$307.1 billion (sixty times the current accounts surplus as against two and a quarter times in the preceding decade). During these seven years, the foreign exchange reserves of the countries other than U.S.A. increased by \$ 213 billion.

It can be noted that under the system now obtaining the U.S.A. has been able to invest abroad on a very much greater scale than in the past, absolutely as well as relatively. This phenomenally larger investment abroad by the U.S.A. has been

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<sup>18</sup>See *Economic Report of the (U.S.) President, 1982* and *IMF Annual Report, 1982*. In matching U.S. investments abroad and increases in foreign exchange holdings of other countries allowance has to be made for the fact that only a part (70 percent) of these holdings is currently held in dollar.

made possible not only because of the accumulation of foreign exchange reserves by other countries but also because of the expansion of international commercial banking under the U.S. leadership.

Whatever may be one's assessment of the liquidity needs of the world monetary system, based largely is on floating exchange rates, we cannot overlook that the experience of the past few years has clearly demonstrated that to meet these liquidity needs the system relies as preponderantly on the U.S.A., and a handful of other reserve creating countries with freely usable currencies, as it did under the old system of fixed exchange rates. The role of the multilateral financial institutions in the generation of world liquidity has so far been only restricted to the International Monetary Fund which has been allowed to play an increasingly limited part in this regard. Before 1973, generation of world liquidity was almost altogether the prerogative of the U.S. monetary authority; since then it is being undertaken jointly by the U.S. monetary authority and the U.S. Commercial banks, with some contribution by a handful of other industrial market economies.

Between 1973 and 1981, Fund related assets namely, SDRs and Reserve Positions in the Fund, increased by SDR 13 billion whereas the foreign exchange reserves increased by SDR 202 billion. While at the end of 1973 the proportion of Fund related assets to total non-gold reserves including Fund related assets was 13 percent, it declined to 11 percent in 1981. This decline in the relative position of Fund related assets took place despite the second SDR allocation, spread over the three year period, 1979 to 1981.

The reasons why Fund related assets have expanded rather tardily (as a percentage of the current accounts imbalances they declined from 0.26 to 0.15 over the same time span) are well known, namely, (1) the reluctance of the developed member countries with major voice in the Fund's decision making, to allocate additional SDRs and (2) their opposition to the expansion in membership quotas.

The first allocation of SDRs was agreed upon in 1969. That was for 9.3 billion SDRs. The next allocation could be agreed upon only in 1978 and this was for 12 billion SDRs. Proposals for any further allocation of SDRs, even though the bulk of it (almost 60 percent) is appropriated by the developed member countries, are meeting with the strongest opposition from these countries, particularly, the U.S.A. which enjoys a virtual veto over major decisions in the fund.<sup>19</sup> Thus

<sup>19</sup>The current U.S. share of the SDR allocation works out to 20.64 percent (equivalent to its quota in the Fund) which is more than twice the share of low income countries viz., 9.8 percent. But the U.S. opposition to SDR allocations has to be understood in the larger context of liquidity generation. The gain to the U.S.A. from the generation of dollar liabilities, official or banking, is between 60 and 70 percent whereas its gain from SDR allocation is only 21 percent. Naturally, therefore, it prefers liquidity generation through SDR allocation to be as limited as possible. Other reserve currency country gains are also much larger from liquidity generation other than through SDR allocation.

towards the close of 1981 SDRs accounted for less than 5 percent of the total non-gold foreign reserves of the Fund members.

On the matter of Fund quotas, although the dominant view in the Fund has been to rely primarily on quota subscriptions as a source of financing for the Fund operations,<sup>20</sup> there has always been considerable prevarication and hesitation, despite the decision to review the position every three instead of five years.<sup>21</sup> The last increase in quotas, which was agreed upon in 1979 became effective towards the end of 1980, raised them from a total of SDR 40 billion to SDR 60 billion. The demand for a further substantial quota increase is facing utmost resistance, which again is spearheaded by the U.S.A.

The Fund, as we know, provides unconditional and conditional liquidity. Unconditional liquidity is supplied through the allocation of SDRs as well as by the generation of Reserve Positions in the Fund. Conditional liquidity is made available through the extension of Fund credit to members on terms and conditions which are not uniformly the same. Hence, the distinction between low conditionality and high conditionality. Access to members to both types of conditional liquidity is in accordance with their quotas. Since quotas themselves have declined in relative terms, even expansion in the Fund's conditional liquidity has been slow. Still in its rather tardy attempt at expanding access to its credit, the Fund has inclined increasingly towards high conditionality financing.<sup>22</sup>

In spite of all the objections that one can genuinely raise against the manner in which the Fund disposes of its credit, conditional as well as unconditional, one has to look at the slow expansion in Fund liquidity in the context of the total world liquidity. While the sharing of the gains of generating non-Fund liquidity is altogether between the few strong industrial economies, with the rest of the world altogether excluded, there is still this much to be said for the Fund liquidity that it lends itself to a much broader, though quite regressive, sharing of gains. Viewed in this manner, the increasing dependence on reserve currency countries for the generation of world liquidity rather than on the International Monetary Fund is to be regarded as a clearly retrograde development of the 1970s.

<sup>20</sup>See *IMF Survey*, October 13, 1980.

<sup>21</sup>This was done possibly in recognition of the fact that over the years the Fund's relative position has become weaker with quotas falling out of line with the growth in world trade. In 1948, quotas stood at 16 percent of world imports; in 1980 the proportion had fallen to less than 3 percent. Since quotas have remained the major source of finance for the Fund's operations, this relative decline has naturally affected adversely the Fund's capacity to provide balance of payments assistance.

<sup>22</sup>The consequence is that with the ratios of quotas to trade having declined considerably it does not take a very large deficit to move a country, particularly a small, low income country from low conditionality tranche to high conditionality tranches. See Sidney Dell, *op. cit.*

Earlier on in the Paper I referred to the compulsions under which non-oil developing countries were being driven to the Fund for high conditionality financing. This is particularly so with respect to low income countries which have little access to Euro-dollar markets. There are two major reasons why these countries are being driven to high conditionality Fund financing. Firstly, with the relatively rather slow growth in Fund quotas, the countries in need of Fund credit exhaust their low conditionality entitlement fast and are forced into high conditionality borrowing. Secondly, the expansion within the Fund of its financing facilities has been such that relatively less is now available on low conditionality.<sup>23</sup>

So the developing countries have to fight on several fronts. They have to fight for the progressive expansion of the role of the multilateral institutions in the generation of world liquidity and at the same time fight against the International Monetary Fund's growing bias for conditionality financing as the poorer of its member countries have been forced by circumstances beyond their control to resort to it for balance of payments cover.

### **Concluding Observations**

I am sorry to be unable to draw a less distressing picture of the current state of international monetary reform efforts. Will the future efforts succeed better? It depends. One thing I could venture to say is that future efforts at reforming the international monetary system in a manner more responsive to the needs of the developing countries are unlikely to bear better fruit than in the past through the fora that an institution like the International Monetary Fund provides. I could even add that efforts, however small, at mutual cooperation in matters of not only trade but also international finance among the developing countries at global, regional and sub-regional levels may well be quite fruitful. After all, judging from the expansion in South-South trade even in non-oil items, the modest efforts at mutual cooperation have not at all been disappointing. However, the fact that past efforts did not quite attain the ambitious targets that were set for them certainly points to the need for greater, not lesser commitment to programmes for cooperative action.

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<sup>23</sup>The IMF Managing Director has, in one of his recent addresses, described how recent Fund assistance has been "going entirely to developing countries—and often to poorer among them". These according to him, "are the countries with the most severe payments problems. Also, they have little, if any, access to commercial sources of finance. The financing needs of the industrial countries and many of the stronger developing countries, on the other hand, have been taken care of by means of recycling through the commercial markets".

# Imported Inflation as a Stimulus to Inflationary Pressure in Bangladesh

by

S. R. OSMANI\*

## Introduction

Rapid inflation has become a worldwide phenomenon in the last decade. There are many who believe that this inflationary surge in the world economy has a common origin. Domestic inflations of individual countries are conceived in this point of view as the outcome of international transmission of the common disease through the various linkages of trade and finance. This view has a particular appeal to the politicians who find it very convenient to be able to blame an exogenously generated inflation, over which they have no control, for the inflation from which their own people suffer. We shall try to assess in this paper the validity of this point of view in the specific context of Bangladesh.

The facts of the last decade apparently provide an impressive evidence in support of this view. In Bangladesh, a moderate rate of inflation of only 3 to 4 per cent prior to liberation, transformed into an annual rate of 14.4 per cent in the period between 1972/73 and 1980/81.<sup>1</sup> But this upsurge was not a unique experience for Bangladesh. For the countries belonging to the low and middle income groups a creeping rate of inflation of only 3 per cent of the earlier decade transformed radically into a galloping one of 11 and 13 per cent, respectively, in the period 1970-79.<sup>2</sup> The

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<sup>1</sup>This rate of inflation is based on the cost of living index of industrial workers. It slightly understates the rate of inflation for the decade of the seventies as a whole, as the first two years of high inflation are excluded here. Taking 1969/70 as the base, the compound rate of inflation up to 1980/81 turns out to be 17.1 per cent. Other measures of inflation also give a more or less similar picture. Between 1972/73 and 1980/81, the GDP deflator has risen at the compound rate of 13 per cent and the index of wholesale prices by 14.9 per cent (Table I).

<sup>2</sup>The corresponding rates for the industrial market economies are 4.3 and 9.4, respectively. [7. pp. 134-5].

timing and the magnitude of this acceleration throughout the world was much too synchronous to escape the suspicion that transmission across the borders must have played a major role.<sup>3</sup>

Apart from these facts, there is also an impressive body of theory to support this view of exogenous inflation. One of the basic propositions of the so-called "monetary approach to the balance of payments" states that the long-run domestic inflation of a small country with a fixed exchange rate must conform to the level of world inflation. Any domestic measure to influence the rate of inflation will merely affect the balance of payments.<sup>4</sup>

But neither fact nor theory is quite as simple as that. Although the world as a whole witnessed an acceleration in the rate of inflation, there was considerable diversity in the experience of individual countries. Around a median rate of 10.8 per cent, the range of variation in the average annual rate of inflation among the low income countries during 1970-79 was from 4.4 per cent in Guinea and Afghanistan to 31.4 per cent in Zaire.<sup>5</sup> The rate of 15.8 per cent experienced by Bangladesh during this period was itself one and a half times as high as the median rate of the low income countries; and of the 36 countries classified by World Bank in this category, only three had a higher rate of inflation. One must then ask, is this variation due to the fact that some countries are inherently more helpless than others in the face of imported inflation? Or is it the case that some countries have been able to shield themselves well enough, while others have compounded the problem with their own follies? If the latter is true, one must then ask the next question: can one blame imported inflation as a predominant factor or at all as an important factor in explaining the inflation in individual countries?

As for theory, it is important to realise that the monetary approach to balance of payments is built on a number of (mostly implicit) structural assumptions that do not quite conform to the realities of a country like Bangladesh. As we shall see, in a fragmented economy such as Bangladesh where foreign exchange is tightly

<sup>3</sup>That this is more than suspicion is confirmed by some recent cross country statistical exercises whose results are nearly summarised by Cline as follows, "For the non-oil-exporting developing nations as a group, domestic inflation doubled from 1972 to 1974 (rising from 14 per cent to 28 per cent). Imported inflation accounted for at least half, or more probably near the entire amount, of this increase. Moreover, import price inflation was systematically the more significant factor when set against wage inflation or excess demand" [ 5, pp. 229-30 ].

<sup>4</sup>There are of course a great many qualifications to this proposition. But these relate mostly to the nature of short-run dynamics and lags of adjustment rather than the long-run solution itself. For a particularly lucid exposition of this approach. See [ 16 ].

<sup>5</sup>The range of variation among middle income countries (in the non-communist world) was even bigger. It varied from 5.5 per cent in Singapore to 242.6 per cent in Chile [ 7, pp. 134-5 ].

controlled, imports are largely aid-financed, bank credit is directly rationed by the Central Bank and where there is very little substitutability between traded goods and domestic goods, it is not easy for an external inflationary impulse to find its way into the domestic economy. The predominance of imported inflation cannot therefore be taken for granted.

The ideal methodology for assessing the role of imported inflation would be to embark upon a comprehensive causal analysis of inflation in order to isolated the effects of various causal factors and to see the significance of external impulse relative to other factors. But the requisite data do not exist for a long enough time period to undertake the statistical exercises required for such an analysis. We shall therefore adopt the following alternative methodology.

A number of possible channels can be identified through which imported inflation can be transmitted into the domestic economy. We shall examine each of these channels in turn and try to assess the extent to which transmission could have occurred through them in the context of Bangladesh. Our findings will be basically qualitative in nature, and theoretical arguments will substitute for hard data which often do not exist. In the process, we hope to be able to at least clarify the issues involved, if not always to offer definitive answers to the questions posed.

### **Transmission Channels**

Inflationary impulse may be transmitted through either the current account or the capital account of the balance of payments. Recent studies show that the acceleration of world inflation in the early seventies was due mainly to the inflow of foreign money through the capital account.<sup>6</sup> This inflow was part of a process of global outpouring of dollars that came out of the United States in anticipation of a devaluation, during the final throes of the Bretton Woods system. A part of this hot money also came to some of the developing countries, swelled up their reserves and pushed up their money supply. But this effect was felt only in the more industrialised developing countries where private capital could hope to find profitable investment opportunities. The war-ravaged economy of Bangladesh in the early seventies was not exactly an ideal abode for foreign private capital. Movements in the capital account cannot therefore explain the acceleration of inflation in Bangladesh. It is true that Bangladesh faced the severest pressure of inflation in those early years. But

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<sup>6</sup>See the statistical exercises carried out by Bhalla (1981) and other contributors in Cline and Associates (1981). These exercises also reveal that transmission of inflation through capital account constituted the first phase. The second phase starting from 1974, was characterised by transmission through the trade channel.

it was due almost solely to the huge fiscal deficits incurred for relief and rehabilitation purposes.<sup>7</sup>

One must then look into the trade account to find any evidence of imported inflation. The triggering element here is the rising prices of internationally traded commodities, rather than inflow of capital. Between 1972/73 and 1980/81 the average price of commodities imported by Bangladesh rose by an annual compound rate of 14 per cent, which was very similar to the rate of domestic inflation.<sup>8</sup> Correlation of course need not imply causality, but the proximity is close enough to merit serious consideration. There are a number of channels through which higher world prices can push up the domestic prices of an economy which maintain a fixed exchange rate. We can broadly classify these channels under the following three heads: impact on money supply, impact on aggregate demand and pure price effects.<sup>9</sup>

### **Impact on Money Supply**

This is the channel that is emphasized most by the monetarists. Higher world prices reduce the demand for imports and raise the earnings from exports leading to an improvement in trade balance which in turn results in accumulation of reserves. The resulting increase in the foreign assets component of the monetary base leads to an expansion of money supply and hence to higher domestic prices.

But one can easily identify a number of structural features of the Bangladesh economy which may be expected to impede the full play of this chain of causation. To begin with, higher world prices need not lead to an improvement in the balance of trade. The reasons are not far to seek. According to theory, higher import prices reduce the real cash balance in the hands of the public who are believed to have a stable demand function for money; so they try to rebuild their real balance by cutting down expenditure. Import demand is also reduced as a result of this across-the-board cut, leading thereby to an improvement in the balance of trade. But even if we grant a stable demand function for money to the people of Bangladesh and expect them to rebuild their real balance by cutting down expenditure, we cannot expect to see a reflection of this parsimony in the demand for imports. There is an

<sup>7</sup>Between 1971/72 and 1972/73, the rate of inflation as measured by the cost-of-living index of middle income families was 47 per cent. In the subsequent two years the rates were 38 per cent and 67 per cent respectively [ 8, p. 267 ]. This was also the period when money supply expanded exceptionally fast; and public sector borrowing from the banking system accounted overwhelmingly for this expansion of money supply (Table VII).

<sup>8</sup>The correlation coefficient between the import price index and the rate of inflation as measured by the cost-of-living index of industrial workers turns out to be 0.70 over the period between 1972/73 and 1980/81. See (Table I).

<sup>9</sup>For an excellent theoretical discussion of the various channels of transmission. See [ 14 ].

elaborate system of exchange control and import licensing to regulate the flow of imports into Bangladesh. The bulk of the imports are intermediate goods, capital goods and essential consumer goods such as foodgrains and edible oils which are imported as part of government's overall plan and depend hardly on the choice of the final consumers. The limited range of imported consumer goods over which a freedom of choice can in theory be applied, are already severely restricted in supply and there always exists an unsatisfied demand for them. Under these circumstances, a cut in expenditure induced by reduced real balances is not very likely to affect import demand.

The balance of trade may also improve, however, through higher export earnings made possible by rising export prices. But in reality, the export earnings of Bangladesh could not keep pace with import demand (Table III). This happened because the otherwise ubiquitous world inflation of the seventies was not fully reflected in the prices of Bangladesh's exports. While her import prices rose at an annual compound rate of 14.2 per cent, her export prices rose at the rate of only 7.5 per cent (Table I). Some peculiar features of the world market for jute, the main export item of Bangladesh, are mainly responsible for this asymmetrical impact of world inflation on her import and export prices.<sup>10</sup> Given these structural bottlenecks in both import and export trade, it is of little surprise that the trade balance of Bangladesh improved in just one year (Table III) and that too in a year in which import prices actually fell and export prices rose only marginally (Table I).<sup>11</sup>

However, one cannot infer merely from the ex-post behaviour of trade balance that rising world prices did not actually tend to improve it. In a predominantly aid-financed trade regime, any tendency towards price-induced improvement may be swamped by higher volume of imports allowed by larger volume of aid. The incidence of price-effect will then fall not on trade balance but on the overall balance. And improvement in overall balance is actually what is required by theory, since this is what ensures accumulation of reserves. But even if one deals with overall balance rather than trade balance, one cannot find any systematic influence of world

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<sup>10</sup>The sluggishness in the price of jute and jute products was mainly due to the fact that an upper limit was imposed on their prices by the rise in the prices of their synthetic substitutes. And as it happened the price of synthetics rose much less than the general price level in the industrialised countries. This sluggishness in the price of synthetics was in turn due to the fact that these are mostly by-products whose prices can be kept down by absorbing the burden of adjustment in the pricing of the main products. For a fuller discussion of these issues. See [ 1 ].

<sup>11</sup>It is interesting to note that the coefficient of rank correlation between the balance of trade (import minus export) (Table III) and a weighted index of export and import prices (Table I) is .95 for the period between 1972/73 and 1980/81. It shows that the higher the world prices, the larger is the deficit in the balance of trade and this relationship is highly significant.

prices.<sup>12</sup> Overall balance improved in only three out of the nine years between 1972/73 and 1980/81 (Table III), and this seems to have had more to do with a availability of aid than with prices. For instance, in 1976/77, the year of the largest improvement in trade balance, import prices actually fell and in theory this should have stimulated import demand. But in reality, imports were seriously restricted by a drastic reduction in the availability of aid. The restrictions were so severe that even the overall balance went into a huge surplus.

Finally, one other structural feature should be mentioned which can impede the flow of transmission through the monetary channel. The theory assumes that the accumulation of reserves resulting from an improvement in the overall balance automatically leads to an expansion in money supply. This is thought to be particularly true in the developing economies where sterilisation is made difficult by the absence of a well-developed money market. But precisely because of these weaknesses of the traditional instruments of monetary management, the central banks of such countries resort to direct control of money supply through a rigid system of credit rationing. Bangladesh Bank has also been relying mainly on this method. Given such control, there is no reason to expect any accumulation of reserves to lead automatically to an expansion of money supply.

We can sum up the discussion so far as follows : (1) higher world prices cannot be expected to improve the balance of trade of Bangladesh due to the special structure of import trade on the one hand, and sluggish export prices on the other; (2) even if the trade balance improves, overall balance may not, as the latter is influenced more by the availability of aid; and finally, (3) even if the level of reserves goes up, the pressure on money supply may be resisted by the application of credit rationing. Thus the monetary channel of transmission is very unlikely to have played any significant role in importing world inflation into the domestic economy of Bangladesh.<sup>13</sup>

#### **Impact on Aggregate Demand**

This may be described as the Keynesian channel of transmission. Imports fall and exports rise in response to higher world prices leading to an improvement

<sup>12</sup>The rank correlation coefficient between the overall balance of payment (Table III) and an weighted index of export and import prices (Table I) for the period between 1972/73 and 1980/81 turns out to be a statistically insignificant .28.

<sup>13</sup>In fact, as Table VIII shows the changes in net foreign assets imparted an additive impact on the monetary base in only three years during 1972/73 to 1980/81. Looking at overall liquidity, it may be seen from Table VII that in only 4 out of the ten years between 1971/72 and 1980/81, the foreign sector contributed positively to the expansion of liquidity. Moreover, in three out of these four years, it was only a minor factor compared to domestic credit expansion.

in trade balance. Reduction in imports comes about through a switching of demand towards domestic products, and the rise in export earnings further augments this demand. There is thus a net increase in the aggregate demand for domestic goods and services ; and unless the monetary authority happens to be pursuing a contractionary policy at the same time, higher demand will push up the prices of domestic goods.

But the switching of demand is not a very likely outcome in Bangladesh, as there is very little substitutability between traded goods and domestic goods. In the late seventies, the ratio of total imports to GDP in current prices varied between 16 and 22 per cent. During the same period, it has been estimated that, the ratio of non-competitive imports to GDP was of the order of about 15 per cent [ 10, p. 77 ]. This leaves very little room for switching demand from the trade sector to the domestic sector. The consequence of all this is to make for a highly inelastic import demand, so that the expenditure on imports may even rise with a rise in import prices. It is of course true that export earnings will also rise in response to higher world prices. The net effect on aggregate demand will depend upon the relative magnitudes of increased import expenditure and additional export earnings. If (a) the trade balance is initially in equilibrium, (b) export and import prices rise in the same proportion and (c) export and import elasticities are also the same, then higher import expenditure will just balance increased export earnings and the net effect on aggregate demand will be zero. But it is unrealistic to assume the initial position to be in equilibrium. In a typical developing country such as Bangladesh, imports always exceed exports due to the flow of aid. Under such conditions, even if export and import prices rise in the same proportion, the rise in import expenditures will exceed the value of additional export earnings. The net effect on aggregate demand will therefore be deflationary. This is analogous to an argument due to Richard Cooper that in an aid receiving developing country, the impact of devaluation is more likely to be demand-deflationary rather than inflationary as the traditional absorption approach to devaluation would suggest [ 6 ].

The deflationary impact of higher world prices is likely to be strengthened in the case of Bangladesh as here export prices have risen much more slowly than import prices. This must have made it more difficult for her increased export earnings to keep pace with increased import expenditure. The persistently widening trade gap expressed in domestic currency ( Table III ), is strongly indicative of the net deflationary effect of higher world prices.

Thus the Keynesian channel of transmission is also very unlikely to have allowed importation of world inflation into the domestic economy of Bangladesh. One may also note that the quantitative impact of any transmission of inflation through this channel would in any case be rather small since the balance of trade in real terms has accounted over the years for only about 4 to 5 per cent of total absorption in Bangladesh ( Table II ).

**Pure Price Effects**

As the prices of imported goods rise in the world market, their prices in domestic currency also rise in a country that maintains a fixed exchange rate. If these imports are final goods, there is an immediate rise in the price index ; if these are intermediate goods, the prices of domestically produced final goods go up through a cost-push effect.<sup>14</sup> This is the meaning of imported inflation that is most easily understood by both the common man and policy makers. The channel of transmission is direct and the impact of world inflation seems inexorable.

Yet a deeper reflection would show that there is nothing inexorable about it. For one thing, most of the imported consumer goods account for a negligible proportion of the total budget of the majority of people in Bangladesh. Of the imported consumer goods that have some bearing on the cost-of-living index of the common man, the most important ones are foodgrains and edible oils ; but both these items are sold to the people at a subsidised price. Thus only a small proportion of the 14 per cent rate of inflation in the cost-of-living index can be explained, if at all, by the direct price effects of a 14 per cent rise in the import price index.

Secondly, be they consumer goods or intermediate goods, it is by no means certain that any rise in the world price will be passed on automatically to the domestic market. The operation of rigid exchange control has created a situation where most of the imported commodities are sold at a scarcity premium. A report of a working group on the distribution of essential commodities showed that the mark-up over import prices varied between 80 and 400 per cent in 1974 [ 9, p. 187 ], A subsequent study by Bhuyan and Mahmud [ 3 ] showed that the average wholesale mark-up over landed costs was 67 per cent for consumer goods and 61 per cent for intermediate goods. Such high mark-ups clearly indicate the existence of substantial scarcity margins ; and with such margins in existence, the rise in import prices up to a point is more likely to be absorbed in the form of reduced margins than to be passed on to the final users.

More importantly, even if it is granted that the domestic prices of imported goods rise in consonance with the rise in world prices, one should only witness a realignment of relative prices rather than a rise in the general price level. The price of imported final goods and of domestic goods using intensively the high-priced imported raw materials would rise relative to the rest of goods and services. But the general price level would not rise. Yet it is a common belief that the commodity boom of the early seventies culminating in the four-fold rise in the price of oil in 1974 sparked off a cost-push inflation in the industrialised coun-

<sup>14</sup>In addition, as the prices of imported goods go up, the price of import-competing goods also generally experience a sympathetic rise. But this is not a very important factor in Bangladesh, as there are very few import-competing goods here.

tries. The resulting rise in the prices of manufactured goods further aggravated the cost-push pressure in the developing countries which had to import those manufactured goods in addition to the high-priced oil. How does one reconcile this view of a cost-push inflation with the theoretical proposition that the rise in import prices should result merely in a realigned structure of relative prices rather than a upward pressure on the general price level? This question is particularly relevant in the case of Bangladesh where, as we have seen, neither the monetary channel nor the Keynesian aggregate demand channel could have provided an independent inflationary stimulus to the general price level, while changes were taking place in the relative prices. If inflation were to occur due to higher import prices, then the change in the structure of relative prices itself had to release forces that would push up the general price level. A mechanism is therefore required whereby changes in relative prices can bring forth changes in the absolute price level.

The mechanism which is usually believed to do the trick is the downward rigidity of prices which in turn is caused by the downward rigidity of money wages. As the prices of certain commodities rise due to higher world prices, the prices of other commodities do not fall. Therefore in order to bring about the necessary realignment in relative prices, the absolute prices of the commodities affected by higher world prices have to rise much more than would have been required in a regime of flexible prices. The new equilibrium of relative prices is thus established at a higher level of general prices than before. In this way, what initially started as a change in relative price, ends up by raising the general price level as well.<sup>15</sup>

But there are at least two reasons why this classical mechanism cannot be invoked to explain the experience of Bangladesh. First, the downward rigidity of wages and prices as an institutional datum cannot be accepted as easily in the case of Bangladesh as in the case of developed industrialised countries. The majority of labour force in agriculture, services and small industries is unorganised and is therefore unable to artificially keep up their money wages in the face of genuine economic pressure.<sup>16</sup> Secondly, in a situation where some inflation is taking place in any case due to other reasons, relative price changes can take place without any additive impact on the inflationary pressure even in the presence of downward rigidity. For, in such a situation, non-inflationary adjustment of relative prices does not require that some prices should actually fall but merely that some prices should rise slower than the others. But has such a situation prevailed in Bangladesh,

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<sup>15</sup>Of course, there has to be an accommodating increase in money supply in order to make this general price increase possible. This accommodation is however normally assumed to be offered in most cases, in order to prevent unemployment that might otherwise occur.

<sup>16</sup>Almost all of the organised labour belongs to the industrial sector which employs barely 10 to 12 per cent of the entire labour force. The percentage of organised labour will be much less than this, as there is very little organised labour in the small-scale industrial sector.

i.e., can one maintain that some inflation would have occurred in any case even in the absence of higher import prices? I would submit that it has. Whatever one feels about the importance of imported inflation in Bangladesh, no one can deny that other factors are also responsible. The simplest way to appreciate this fact would be to have a brief look at the way monetary policy operates in this country. As mentioned before, credit rationing is the chief instrument of monetary control applied by the Bangladesh Bank. A global credit ceiling is postulated every year on the basis of certain assumptions, one of which is the permissible rate of inflation which at times may be as high as 10 per cent. A certain minimum rate of inflation is thereby built in the system which, much like a self-fulfilling prophecy, will certainly materialise unless the monetary authorities fail to reach their target ceiling which they seldom do. It is therefore safe to assume that certain amount of inflation would have been there in any case even without higher import prices. Therefore, the rise in import prices should have been followed merely by a realignment of relative prices. The general inflationary pressure could only be accentuated in such a situation if the adjustment in relative prices was resisted, and that could happen if there was resistance to the fall in real wages (and not just money wage) in certain sectors, occasioned by the fall in their relative prices. But there is little evidence to support the view that the labour force in Bangladesh is strong enough to resist a fall in real wages. There have been periods in the last decade when real wages in both agricultural and manufacturing sector actually fell (Table VI).

The upshot of this argument is that because of the absence of any significant resistance to the fall in real wages in Bangladesh, changes in relative prices can take place in a non-inflationary manner, provided there obtains an otherwise inflationary environment. Since such an otherwise inflationary environment did exist in our view, specially because of the manner in which monetary policy has been pursued, the rise in import prices should have brought about the necessary realignment in relative prices without any additive impact on the inflationary pressure.

### **Government's Response to World Inflation**

Our conclusions so far have been negative on the whole as regards the importance of imported inflation in Bangladesh. But we shall now argue that it was after all a significant factor in instigating the inflationary spiral here. The particular transmission mechanism that has been at work is not one of those that are emphasised most in conventional theory—it is the response of the government to the rising prices of imports. Government's policy response has of course been important everywhere in the world in shaping the ultimate impact of world inflation on the domestic economy of individual countries.<sup>17</sup> But this has been parti-

<sup>17</sup>For a concise review of policy responses in the developing countries, See [ 4 ].

cularly so in Bangladesh, as here unlike in most other countries, the major incidence of rising import prices has fallen directly on the government itself.

We are not in a position to measure the exact magnitude of this incidence. But the severity can be appreciated easily enough by looking at the structure of trade and industry in this country. The bulk of the modern industrial sector in Bangladesh has been under public enterprise throughout the last decade.<sup>18</sup> These enterprises are the major users of the industrial raw materials and capital goods that had to be imported from the rest of the world at increasingly inflated prices. A large portion of the imported construction materials were also used by the Government.<sup>19</sup> Of the imported consumer goods, the two major ones, namely, foodgrains and edible oil, are both imported by the government and distributed to the public at subsidised prices. The direct incidence of higher import prices of the two major agricultural inputs, namely fertilizer and irrigation equipment, also fall on the government.

The immediate consequence of the rise in import prices was thus a big fall in the real income of the government. This reduction was accentuated by the fact that while it suffered the consequence of world inflation in the form of higher import prices, it did not enjoy the corresponding benefit in the form of higher export prices. There has been a 38 per cent decline in the terms of trade between 1972/73 and 1980/81 (Table I). This decline in the terms of trade represents a net loss of real income inflicted by world inflation on the economy of Bangladesh. And as explained before, the bulk of this loss has fallen directly on the shoulders of the government. To see how the government responded to this loss in real income is crucial to an understanding of the inflationary process in Bangladesh.

Faced with this loss of real income, the government could do one of two things—it could either absorb this loss by cutting down on its expenditure or try to maintain its level of real income by shifting resources away from the other sectors. The government clearly did not accept the first option as is shown by the fact that the share of government expenditure in the total absorption rose from the range of 9-10 per cent in the early seventies to about 16-17 per cent in the recent years (Table IV). Part of it was of course made possible by increased flow of foreign aid, but as we shall see, it also involved a diversion of resources from other sectors. However, the traditional instruments of fiscal policy were not used a great deal in effecting this transfer; the ratio of revenue receipts to GDP has remained

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<sup>18</sup>After the nationalisation programme of 1972, the share of public enterprise in the modern industrial sector became an overwhelming 92 per cent in terms of fixed assets and 80 per cent in terms of value added. See, [ 15 ].

<sup>19</sup>An estimate for 1976/77 shows that nearly 43 per cent of all construction activities in the country was undertaken by the public sector. See, [ 12 ].

more or less constant in the range of 9-10 per cent after 1974/75 (Table IV). Two other options remained open to the government to effect the required transfer. One was to pursue a pricing policy that would shift the incidence of higher import prices to the final users and the other was to impose a general inflation tax.

In practice, the pricing policy has been used rather sparingly. Price control has been used fairly extensively in the nationalised sector. During the period 1972-75, the product varieties subject to price control accounted for 75 per cent of production value and 71 per cent of sales value of that part of the nationalised sector which produces mostly for the home market [ 15 ]. Prices have been revised upward from time to time, but these were neither quick nor adequate. For instance, while the petroleum prices have been raised seven-fold in the last seven years, these increases have come with a considerable lag in the wake of changes in world market. As a result, the petroleum sector has often been a major borrower from the banking system. Apart from the Petroleum sector, the other major sector corporations which rely heavily on imported inputs are Textile Mills Corporation, Engineering and Steel Corporation and Chemical Industries Corporation. The combined net profits of these three sectors show an absolute decline over the years even in current prices (Table V), which means that in real terms their profits have dwindled even more. Apart from other factors, the failure to revise their product prices in keeping with the input costs must have been significantly responsible for this performance.

The same inadequate use of pricing policy is also in evidence in the government sector proper. Although precise estimates are difficult to come by, it is well known that every year a fairly large proportion of total expenditure has to be devoted towards subsidising foodgrains and agricultural inputs. The magnitude of subsidy in relation to the budgetary resources can be seen from the fact that during 1972/73 and 1973/74, the entire deficit on the revenue account would have been eliminated if the subsidies on foodgrains were abolished. Besides, subsidies on agricultural inputs accounted for about a third to half of government expenditure on the crop and livestock sectors [ 13, p. 37 ]. It is true that the proportion of subsidy has come down over the years; yet in 1980/81, the subsidy on foodgrains was about 35 per cent of unit cost and that for fertilizer was about 32 per cent [ 8, p. 106 ].

The government has frequently resorted to large-scale deficit financing to mobilise the resources which it refused to procure through its pricing policy. The public sector enterprises too had to seek large amount of bank credit to tide over their cash-flow problems generated basically by an inadequate pricing policy. These borrowings have been the major force behind the rapid expansion of money supply in the last decade. The supply of narrow money has risen between 1972 and 1981

at an annual compound rate of 20 per cent which explains fairly well the 14 per cent rate of inflation after taking account of real GDP growth and some degree of monetisation. We cannot undertake here a comprehensive causal analysis of the expansion of money supply. But two indicators should be adequate to establish the preponderance of Government credit as a causal factor. As Table VIII shows, Bangladesh Bank's net credit to the Government has accounted for over 80 per cent of the base money for most of the years. Moreover, changes in this component are seen to have been the major force in pushing up the level of monetary base. In fact, but for some countervailing factors in some of the years, government's fiscal operations would have raised the base even higher. Similarly, looking at the combined balance sheet of the monetary system as a whole, Table VII shows that total government sector credit, including fiscal operations and credit to the nationalised sector, predominantly explains changes in liquidity. We do not of course wish to contend that the entire amount of public sector borrowing is to be explained by the effect of rising import prices coupled with a non-adaptive pricing policy. But we do maintain that the major response to rising import prices was to borrow more than to adjust prices.

The foregoing analysis shows that in response to higher world prices, deteriorating terms of trade and the consequent loss in real income, the government of Bangladesh has tried to shift the burden of loss to the people by imposing the inflation tax. This is precisely the mechanism through which world inflation did after all find its way into the domestic economy.

Let us finally address ourselves to the popular question, can world inflation be blamed for our domestic inflation? In a sense, it cannot be, as we have seen that it was only because of a particular policy response of the Government that world inflation could be transmitted inside the Bangladesh economy. If the Government had made the suitable adjustments in relative prices, it would not have been required to resort to inflationary financing to the extent that it has. One might therefore say that if anything is to blame, it is the particular policy response of the government, rather than world inflation as such.

But that is not the end of the argument. If one can show that the chosen response was also the optimal one given the feasible alternatives, then of course the responsibility can be shifted back to world inflation. But was this really the optimal response? This question brings in a whole lot of issues that cannot be discussed here. But it will help clear one's perspectives to note that the different alternatives open to the government actually represent different social combinations of sharing the loss of real income inflicted by world inflation. If the government had chosen to absorb the loss by cutting down its expenditure, the losers would have been the beneficiaries of government expenditure at the margin, which would normally

mean expenditure of the lowest priority. If, instead, it had made the appropriate adjustments in relative prices, the losers would have been the consumers of the goods delivered by the government—for example, the urban population enjoying subsidised ration, consumers using petrol and mill-made cloth, as well as farmers using fertiliser and irrigation equipment. The losers in the option the government actually chose are theoretically the population as a whole, since inflation is supposed to be a general tax. But in reality it is the weak and the unorganised who typically suffer most from a persistent inflation.<sup>20</sup> Which of these social combinations is socially the optimal one for sharing the loss in real income? I cannot venture to answer this question here. But one can perhaps say without any fear of contradiction that the government chose the softest and politically the most convenient option. It is this political expediency which in the final analysis allowed the inflation in the outside world to be imported into the domestic economy.

### Summary and Conclusions

The double digit inflation experienced by Bangladesh in the seventies was not a unique experience for the country. The world as a whole had entered a new era of uniquely synchronised inflation of unprecedented magnitude. The ongoing inflation in the outside world was clearly transmitted into the economy of Bangladesh, pushing up the moderate inflation of 3-4 per cent of the earlier decade to a rate of about 15 per cent in the seventies. But none of the transmission mechanisms usually discussed in the literature can explain this phenomenon. The operation of various structural and policy induced bottlenecks such as inelastic import demand, preponderance of aid financed imports, asymmetric impact of world inflation on the prices of imports and exports, and the control of money supply through direct credit rationing, meant that neither the monetary channel nor the Keynesian aggregate demand channel could build up inflationary pressure within the economy of Bangladesh. Under the circumstances, higher world prices could only generate inflationary pressure if there was any resistance to the changes in relative prices necessitated by higher world prices.

As it happens, there did exist considerable resistance to the process of realignment of relative prices. But it was not of a type that is normally witnessed in the developed industrialised countries. In such countries, the resistance comes from the workers in the sectors which face a decline in relative prices. This resistance emanates from their desire to protect either their money or real wage that may be

<sup>20</sup>There is some evidence to suggest that the relative position of the fixed income group, namely wage and salary earners, has worsened over the years vis-a-vis the self employed persons in the urban areas. This is quite an expected outcome in an inflationary environment. The distributional significance of this piece of statistics lies in the fact that the former belong mostly to the lower income groups, while the latter come mainly from the upper income brackets. See [ 11 ].

threatened with a decline resulting from the fall in the relative price of the products they produce. But downward rigidity of neither money wage nor real wage seems to be empirically borne out by the experience of Bangladesh. The resistance, therefore, could not have come from the sectors threatened with a decline in relative prices.

Odd though it may seem, the resistance actually came from the sector which should have experienced a rise in relative prices. This sector was government itself operating either directly or through the nationalised industrial sector. The resistance was directed against allowing relative prices to rise. In order to make the resistance a success, the government had to resort to heavy borrowing from the banking system. Such government borrowing represents the largest source of the increase in money supply which in turn adequately accounts for the observed rate of inflation.

World inflation was thus translated into domestic inflation through government's reluctance to bring about the required changes in relative prices. This was not however the only policy option open to the government. It was of course politically the most convenient option, since the burden of adjustment fell in this case on the relatively weak and unorganised sectors of the economy. The other options, such as absorbing the loss of real income through a cut in expenditure or allowing the requisite realignment of relative prices to work itself out through an appropriate pricing policy, would have perhaps shifted the burden to the politically more volatile segments of the society. Thus in the ultimate analysis, it was the dictates of political expedience which allowed the world inflation to be transmitted inside.

TABLE I  
 RATES OF INFLATION IN BANGLADESH  
 1972/73—1980/81

Price Index	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81	Annual Compound Rate of Growth (per cent)
1. Cost of living index of industrial workers	193.5	268.3	430.7	364.6	354.0	419.2	457.5	525.4	568.3	14.4
2. Index of wholesale prices	178.5	249.6	393.8	359.5	361.8	407.4	446.4	501.5	541.0	14.9
3. GDP deflator	100.0	140.6	240.5	183.1	177.2	203.6	216.8	249.2	264.0	12.9
4. Import prices index (dollar price)	100.0	152.8	194.8	186.2	183.1	179.4	218.0	250.3	289.3	14.2
5. Export price index (dollar price)	100.0	103.7	123.5	107.1	111.8	127.7	167.5	200.9	178.6	7.5
6. Barter terms of trade	100.0	67.9	63.4	57.5	61.1	771.22	76.8	80.3	61.7	-5.9
7. Weighted index of import and export prices (dollar price)	100.0	138.7	180.5	167.9	164.0	165.0	204.2	239.4	265.0	13.0

Notes and Sources :

1. The base year for the cost of living index and wholesale price index is 1969/70.
2. The first three series are compiled from Statistical Year Book 1975 and 1980, Monthly Bulletin of Statistics, June 1982 and IBRD (1982).
3. Import and export price indices are based on dollar prices. These are taken from IBRD (1982), Statistical Appendix, Table 3.4.
4. In estimating the weighted index of export and import prices, the dollar values of exports and imports as given in IBRD (1982), Statistical Appendix, Table 3.1, have been used as weights.

TABLE II  
SOME MACRO-AGGREGATES OF BANGLADESH ECONOMY  
( Values are in crore Taka )

	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81
1. GDP at current market prices	4511.2	7108.6	12574.1	10745.8	10536.1	13029.0	14477.4	17245.0	19506.2
2. Total absorption in current prices	4768.3	7595.1	13226.9	12159.6	11077.0	14416.1	16079.5	19786.7	22630.6
3. Total absorption in constant 72/73 prices	4768.0	5291.8	5433.1	6166.5	5970.7	6708.3	6989.2	7374.6	7786.7
4. Value of imports at current prices	542.7	738.8	995.1	1894.4	1252.3	2142.1	2494.4	3692.4	4368.8
5. Value of exports at current prices	285.6	252.3	342.3	480.6	711.4	755.0	892.3	1150.7	1334.4
6. Balance of trade at current prices	-257.1	-486.5	-652.8	-1413.8	-540.9	-1387.1	-1602.1	-2541.7	-3034.4
7. Balance of trade at constant 72/73 prices	-257.1	-234.9	-204.9	-297.9	-23.8	-310.1	-312.6	-453.6	-363.2
8. Ratio of trade balance to total absorption at constant prices	.05	.04	.05	.05	.004	.05	.04	.06	.05

Notes and Sources :

1. The GDP figures in row 1 are taken from IBRD (1982), Statistical Appendix, Table 2.5.
2. Total absorption in current prices is the sum of GDP in row 1 and balance of trade in row 6.
3. Total absorption in constant prices is the sum of GDP at constant prices and balance of trade in constant prices as given in row 7. GDP at constant prices has been taken from IBRD (1982), Statistical Appendix, Table 2.2.
4. Import and export values are c.i.f. and f.o.b. values respectively, and have been taken from Annual Balance of Payments (various years) published by Bangladesh Bank. In this publication, imports are shown in f.o.b. values. The freight and insurance cost shown separately in the services account have been added to arrive at c.i.f. values.
5. The import and export price indices in Table I have been used to calculate import and export values and hence trade balance in constant prices.

TABLE III  
ANNUAL BALANCE OF PAYMENTS OF BANGLADESH  
( Values are in crore Taka )

	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81
1. Exports (f.o.b.)	285.6	252.3	342.3	480.6	711.4	755.0	892.3	1150.7	1334.4
2. Imports (c.i.f.)	542.7	738.8	995.1	1894.4	1252.3	2142.1	2494.4	3692.4	4368.8
A. Balance of Trade (1-2)	-257.1	-486.5	-652.8	-1413.8	-540.9	-1387.1	-1602.1	-2541.7	-3034.4
3. Services	16.2	- 5.2	21.9	4.9	- 45.1	- 48.1	- 41.5	6.2	24.3
4. Private Transfer	26.7	15.4	30.7	43.3	93.5	171.4	218.1	325.1	619.6
B. Current Balance (A+3+4)	-214.2	-476.3	-600.2	-365.6	-492.5	-1263.9	-1425.4	-2210.5	-2390.5
5. Official Foreign aid (net)	201.8	384.1	733.3	1203.9	752.6	1204.6	1631.9	1966.0	2012.5
C. Basic Balance (B+5)	-12.4	- 92.2	133.1	- 161.7	- 260.1	- 59.3	206.5	- 244.5	- 378.0
6. Short-term capital	-15.7	- 15.1	- 29.2	- 0.3	0.6	- 8.6	107.5	50.9	19.2
7. Errors and Omissions	-12.9	15.8	- 11.3	52.3	- 53.7	33.9	56.3	- 58.8	77.1
D. Overall Balance (C+6+7)	-41.0	- 92.9	92.5	- 109.7	218.2	- 16.8	155.3	- 252.7	- 281.7

Source : Annual Balance of Payments (various years).

SUMMARY OF CENTRAL GOVERNMENT FINANCE

(Values are in crore Taka)

	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81
1. Revenue receipts	223.6	393.9	683.7	1028.4	979.5	1297.4	1581.3	1574.7	1857.9
2. Revenue receipts as percentage of GDP	5.0	5.5	5.4	9.6	9.3	10.0	10.9	9.1	9.5
3. Total government expenditure	610.9	746.2	1065.5	1519.0	1798.5	2255.9	2615.1	3407.9	3916.5
(i) Revenue expenditure	213.1	346.2	565.5	636.0	769.3	940.7	1087.8	1235.9	1446.8
(ii) Annual development programme	397.8	400.0	500.0	842.6	998.9	1266.0	1483.0	2082.0	2364.5
(iii) Food for works	—	—	—	40.4	30.3	49.2	44.3	90.04	105.2
4. Total Government expenditure as percentage of total absorption	12.8	9.8	8.1	12.5	16.2	15.6	16.3	17.2	17.3
5. Deficit financing	278.2	404.26	443.3	558.6	538.7	646.7	640.7	932.8	1455.8

## Notes and Sources :

- Revenue receipts consist of both tax and non-tax revenue. The figures are estimated actuals and are taken from Budget Estimates, Ministry of Finance (various issues).
- The figures of both revenue and annual development programme are estimated actuals. The former is taken from Budget Estimates (various issues) and the latter from Economic Review 1980/81, Planning Commission.
- The food for works expenditures are based on revised budget estimates.
- GDP in current prices has been taken to calculate row 2 and total absorption has been taken from Table I to estimate row 4.
- Estimates of deficit financing were supplied to us by the Bangladesh Bank. These estimates include government borrowing from the banking system as a whole, i.e., both Bangladesh Bank and Commercial Banks. The period of reference is from 1st July to 30th June, except for 1971/72 which refers to the period 16th December 1971 to 30th June 1972.

TABLE V  
FINANCIAL PERFORMANCE OF MAJOR PUBLIC INDUSTRIAL SECTOR CORPORATIONS  
( Net profits in crore Taka )

	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81
1. Bangladesh Jute Mills Corporation (BJMC)	-332	-239	-285	-525	-953	-611	1167	401
2. Bangladesh Sugar and Food Industries Corporation (BSFIC)	63	107	-19	8	55	63	212	297
3. Bangladesh Steel and Engineering Corporation (BSEC)	60	87	73	79	49	110	158	126
4. Bangladesh Textile Mills Corporation (BTMC)	163	125	60	-138	-80	47	-189	-110
5. Bangladesh Chemical Industries Corporation (BCIC)	25	125	-189	185	41	47	51	92
6. Total	-21	-157	-360	-391	-888	-344	1399	806
7. Combined net profits of BSEC, BTMC and BCIC	248	337	-56	126	10	204	20	108

Source : IBRD ( 1982 ), Statistical Appendix, Table 5.5.

TABLE VI  
WAGE RATES : MONEY AND REAL

	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81
1. Nominal wage index of agricultural labour	100.0	141.7	191.7	186.9	188.6	198.9	229.7	263.9	298.5
2. Nominal wage index of industrial (production) labour	100.0	136.3	153.7	164.0	172.2	246.1	315.6	—	—
3. Cost of living index of industrial workers	100.0	138.7	22.6	188.5	183.0	216.7	236.5	271.6	293.7
4. Real wage index for agricultural labour	100.0	102.2	86.1	99.2	103.1	91.8	97.1	97.2	101.6
5. Real wage index for industrial labour	100.0	98.3	69.0	87.0	94.1	113.6	133.5	—	—

## Notes and Sources :

- Row 1 is based on daily money wage rates (without food) of agricultural labourers (country average), as published in the various issues Monthly Bulletin of Statistics.
- Row 2 is taken from Statistical Yearbook 1980.
- Row 3 has been prepared from the cost of living index of industrial workers as given in Table I, by putting the figure for 1972/73 to 100.
- Cost of living index of industrial workers has been used to deflate agricultural wage rate, in the absence of a more appropriate deflator for the entire period.

TABLE VII  
**SOURCES OF CHANGE IN DOMESTIC LIQUIDITY**  
 ( Values are in crore Taka )

Price Index	71/72	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81
1. Change in Total Liquidity	..	153.2	289.9	227.5	58.1	180.6	311.5	440.6	631.7	769.9
(a) Narrow money	..	62.5	246.0	120.8	-27.8	81.8	136.7	247.4	162.8	527.2
(b) Time deposits	..	90.7	43.9	106.7	85.9	98.8	174.8	193.2	468.9	74.2
2. Sources of Change in Liquidity										
A. Domestic Credit Expansion		98.2	271.5	330.3	212.6	278.8	224.3	480.9	443.5	1018.4
(i) Government sector	..	146.8	236.3	277.6	246.5	227.6	52.5	280.5	266.4	520.7
(a) Fiscal operations	..	72.7	110.4	172.3	25.5	135.4	6.4	109.5	-2.2	268.9
(b) Nationalised sector	..	74.1	125.9	105.3	221.3	92.2	46.1	171.0	268.6	251.8
(ii) Private sector	..	-48.6	36.2	52.7	-33.9	51.2	171.8	200.4	177.1	497.7
B. Foreign sector	..	125.8	-61.7	-83.2	146.5	-22.6	85.4	-116.0	173.9	-305.5
C. Residual items	..	-70.8	80.1	-19.6	-301.0	24.4	-1.8	75.7	14.3	-111.5

**Notes and Sources :**

1. The figure for 71/72 and 72/73 are from Annual Report (1971-73) of Bangladesh Bank and IBRD (1982), and the rest are from Bangladesh Bank Bulletin of December 1981 ( Table on Monetary Survey).
2. The figures upto 73/74 refer to the last Friday of June and the rest refer to the 30th June.

TABLE VIII  
MONEY SUPPLY, BASE MONEY AND SOURCES OF CHANGE THEREOF  
(Values are in crore Taka)

	72/73	73/74	74/75	75/76	76/77	77/78	78/79	79/80	80/81
1. Money supply (narrow money)	577.0	745.1	717.3	799.1	935.8	1183.2	1346.0	1873.2	2079.2
2. Base money	371.8	424.6	409.4	462.2	546.3	686.8	856.2	1043.9	1335.3
3. Money multiplier	1.55	1.75	1.75	1.73	1.71	1.72	1.57	1.79	1.56
4. Sources of change in base money									
i) BB's net credit to govt.	224.5	387.1	440.5	563.2	456.9	567.2	551.4	829.8	1417.9
ii) BB's net credit to banks	48.2	99.7	111.4	101.9	121.3	281.3	385.3	738.4	942.4
iii) BB's net credit to private sector	25.6	19.1	14.4	13.1	12.4	17.5	22.9	30.3	31.3
iv) Government currency held by public and bank	23.1	27.6	33.9	30.9	330.9	37.0	42.2	48.8	56.8
v) Net non-monetary liabilities of BB	81.1	69.2	-295.6	157.9	137.6	120.6	195.3	341.3	396.5
vi) Net foreign assets of BB	71.5	-39.8	104.8	-89.1	62.4	-45.5	49.6	-262.0	-716.9

Note and Sources :

- All figures are compiled from the Tables on Monetary Survey in Bangladesh Bank Bulletin, December 1981. The figures upto 1973/74 refer to last Friday of June and the rest refer to the 30th June.
- BB stands for Bangladesh Bank.

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## DISCUSSION ON PAPERS\*

### Session I : Export-oriented Growth

Papers Presented By : M. Datta-Chaudhury  
: Wahiduddin Mahmud

Opening the discussion *Q.K. Ahmad* (BIDS) pointed out that Singapore, Hongkong, South Korea and Taiwan did not offer much by way of lessons that might help countries like Bangladesh. He said that Singapore and Hongkong were city states and Taiwan and South Korea had benefited from their strategic locations in the context of the politics of cold war. All those countries could take advantage of fast expanding world trade of the sixties. In recent years these countries faced problems of serious technological dependence. According to *Q.K. Ahmad*, implementation of export-led growth strategy in Bangladesh would be an unwise step at a time when the world economy was characterized by severe crisis such as recession, unemployment and high inflation. He recognised the positive role which could be played by export but it must be supported by the development strategy based on reality. Hence he recommended an agriculture based development with emphasis on rural non-agricultural activities.

*A. Samad* (Planning Commission) congratulated M. Datta-Chaudhury for his excellent survey on export-led growth strategy for industrialization. But he also accused him of not giving much of a conclusion. He stated that for building a technological base and for increasing productivity export-led development offers us an alternative. However, he also pointed out that the terms of trade had been deteriorating very sharply during the last two years.

*Rehman Sobhan* (BIDS) discussed the premises of socio-economic-political climate of export-oriented development strategy and its applicability to Bangladesh. As successful models he referred to Taiwan, South Korea and Brazil. He said that all these countries had military fascist regimes which brought about a high degree of concentration of resources in the hands of bourgeoisie. That, according to *Rehman Sobhan* was a distinctive socio-political feature of export-led development. He pointed out that the East Asian countries successfully followed that strategy during 1960s when world trade was expanding, but in 1982 trade was facing trouble because of recession. He said that there were many countries in 1982 with more

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\*Based on minutes prepared by the rapporteurs—Editors.

professional experience to attract foreign investors. Rehman Sobhan suggested that Bangladesh should concentrate on rural development so as to achieve self-reliance in food sector. He also spoke in favour of greater cooperation among the developing countries, particularly among the countries around Bangladesh.

*K.M. Matin* (BIDS) said that India, being one of the emerging leading industrial countries got interesting experience useful for us since her socio-economic conditions are more similar to ours than other nations. He observed a very strong correlation of development with the adult literacy ratio. So he emphasized that investment in human capital development should be given the highest priority.

*M. A. Taslim* (Dhaka University) said that the countries following export-led growth had some common features such as the leading role of entrepreneur, political stability and property right. Export-led development strategy could not succeed in 1980s when the world economy is facing a recession. Moreover, he said, Bangladesh was not so strategically located as to exploit the global politics.

*M: M. Akash* (Dhaka University) started his discussion by presenting some data which showed that import substitution and export promotion strategy of South Korea actually led to the building of 'inefficient' industries. And these inefficient industries were financed through foreign aid, foreign grants and commercial banks to serve the interest of multinational companies and developed countries.

According to *A. Rab* (Planning Commission), it was the government which with her strong support and policies made the export-led strategy successful in South Korea and Malaysia. The debate on import substitution and export promotion was not meaningful because it was the profit for which entrepreneurs invest in some particular sector. He recommended restructuring of the prices which was the signal to the investors.

In reply, *M.D. Chowdhury* (Delhi School of Economics) said that while he wrote his paper, he did not exclude agricultural development. It was not wise to bring them as a substitute of export promotion to achieve self reliance. Then he confessed his awareness of the difficulties in pursuing this strategy in the coming years due to adverse international environments. In reply to Rehman Sobhan he said that if we opt for the capitalistic development then we must accept the domination of the bourgeoisie.

**Session II : Export Processing Zone**  
**Paper Presented By : Muzaffer Ahmad**

*Al-Hossaini* (Planning Commission) opened the discussion emphasizing the need of foreign capital in view of serious balance of payment deficit. But, he said,

since official assistance was not adequate, nor was there a steady flow of foreign capital the EPZ issue could not be belittled. According to him, changes in government, which do not disturb the basic economic policy, does not hamper industrialization. It was premature to conclude that EPZ would be wasteful and it had no future in Bangladesh.

*M. Mahbubullah* (Chittagong University) felt that the question of employment might be discussed on the basis of its direct effect or on the basis of its indirect effect such as the linkage effect. He quoted a South Korean author to show that their type of industrialization had created a host of social problems such as shortage of housing, increase in pubs, environmental pollution, deterioration of law and order and increase in the number of unmarried mothers etc.

*Moinul Islam* (Chittagong University) said EPZ was not likely to have any significant effects on employment generation. It would also enhance the flight of capital. He doubted whether Bangladesh had any surplus skilled labour for the successful implementation of EPZ.

In reply *Muzaffer Ahmad* (IBA, Dhaka University) said that in his paper he tried to show what were the probable problems that might follow after the EPZ had been established and what might be the remedies.

### Session III : International Monetary Problems

Papers Presented By : **I. S. Gulati**

: **K. M. Matin**

Referring to I. S. Gulati's (Centre for Development Studies, Kerala, India) paper *Rehman Sobhan* stated that the present International Monetary Crisis threatened the viability of the system and the world might witness the monetary crisis experienced in 1930s. Rehman Sobhan said that the IMF showed a unique degree of impotence when the U.S. froze the Iranian assets. He said that the IMF should be restructured and reformed in favour of the Third World Countries.

*A. Samad* (Planning Commission) said that lower resource availability might also be blamed for inflation in Bangladesh. He argued that isolated action by a single country was not possible because of interdependence.

In reply *I. S. Gulati* agreed that the developing countries have not taken adequate safeguarded against the adverse effects of the International Monetary System. The oil surplus had been recycled mainly through the commercial banking system. The role of IMF had been reduced to a supervisor of the developing world. It is not clear to I.S. Gulati why the socialist countries were not participating in the international monetary system. In conclusion he said that the IMF should be restructured and reformed in favour of the Third World countries.

**Session IV : Imported Inflation****Paper Presented By : S.R. Osmani**

Opening the discussion *A. Ghafur* (BIDS) said that the post liberation inflation was related to massive reconstruction, and supply of working capital to the nationalized industries. That had led to budgetary deficit and borrowing from Central Bank which increased money supply. He also underlined the fact that rapid changes in relative prices disrupt production. Therefore, in the interest of the economy the relative price adjustment by the government had to be orderly.

*Rashed Amjad* (ARTEP, ILO, Bangkok) argued that in the capitalistic or mixed economy, prices not only reflect scarcity but also income distribution at a given time. Any change in the prices meant a change in real income. And such adjustments depend on bargaining power.

*Nurul Amin* (Jahangirnagar University) contested the recommendation of S.R. Osmani in favour of the withdrawal of subsidy. He argued that the wage and salary earners suffered most from the distributional aspect of inflation.

*M. A. Taslim* (Dhaka University) said that the particular topic had become fashionable in early 1970s. However, no good econometric work had been able to establish the relationship between domestic and imported inflation.

*Ataul Haque* (Chittagong University) criticized S. R. Osmani for using the cost of living index published by World Bank to measure inflation which seems to be incorrect. He also underlined major constraints because of which we could not take the advantage of world inflation.

*Muzaffer Ahmad* (IBA, D.U.) thought that it was not imported inflation but domestic policies which had created inflation. Usually it is deficit financing through which government serves the purpose of certain interest groups.

In reply *S.R. Osmani* (BIDS) said that he tried to analyze what the government did without becoming concerned with what was right or wrong. He also wanted to find the causes of sudden jump in inflation rate. But he was convinced that it was the government policies through which the inflation was transmitted in our economy. He said that government always followed those policies which were politically most expedient. He stressed on money supply as the determinant of inflation. The struggle for income share alone could not explain inflation. Whatever the mechanism, it cannot lead to inflation without an increase in money supply.

In his concluding address as the President of Bangladesh Economic Association, *M. Akhlaqur Rahman* (Jahangirnagar University) expressed his happiness at

the fact that a large number of economists gathered themselves in order to participate in the seminar. He praised all the papers for their high academic quality. He also thanked all the participants.

He said that the countries having 30 to 40 per cent trade share to GDP could think of implementing export-led development strategy but a country like Bangladesh could not expect export sector to play a leading role since our trade share was only about 10 per cent. Citing historical evidence he said that it was difficult to initiate export-led development without having many years of experience.

He criticised the role of World Bank and IMF for aggravating the international financial crisis. The growth philosophy, which was initiated in 1960s, was mainly in the interest of the USA and other western industrialised countries. Commenting on a remark by I.S. Gulati that Soviet group was arguing to go back to gold standard, he said that Soviet group had their own political and economic reasons for going back to gold. He observed that our recent policy changes were mostly based on World Bank dictates. He stated that the recent denationalisation programme was the result of the influence of World Bank. He criticized that programme as a violation of people's mandate. He suggested that if we followed the line of import substitution and export expansion then in 20 years time we would not be dependent on IMF or World Bank.

