CHAPTER 4

External Influence and Economic Governance

4.1 Introduction

When Bangladesh emerged as an independent nation in 1971, its economic possibilities were not considered favourable. Economic performance was proved extremely volatile in its first decade with negative growth in GDP (Gross Domestic Product) per capita (see Figure 7). Higher incidence of poverty, vulnerable fiscal position owing to massive losses from State Owned Enterprises (SOEs), along with fragile politics led the country to the brink of failure.

This prompted many observers to refer to the country as a “test case of development” (Faaland and Parkinson 1976). Limited domestic resources rendered Bangladesh dependant on foreign aid[1]. External resources however have yielded limited impact on the economy[2], an issue widely discussed in aid effectiveness literature (Burnside and Dollar 2000; Ahmed 1992; Islam 1992; Quibria 2010).

More importantly, post-liberation Bangladesh had experienced a secular deterioration in its terms of trade[3]. Thus leading to a realisation that the economy had to undergo reforms. Given the involvement of a large number of Donors and Development partners (D&DPs) in Bangladesh's development process, external pressures to undertake various reform measures existed.

The economy adopted a series of market-based reforms in the 1980s and 1990s, largely influenced by the Bretton Wood institutions– the World Bank (WB) and the International Monetary Fund (IMF) (Task forces 1991). The main objective of the reform agenda was to remove “excess” government controls, to promote market competition and to bring macroeconomic stability.

Partly owing to those reforms, alongside Bangladesh's own innovation in provisioning social services and concurrent favourable political changes during the 1990s, the economy transformed

1 Nevertheless, aid dependency is not entirely a post-liberation phenomenon (Sobhan 1982).

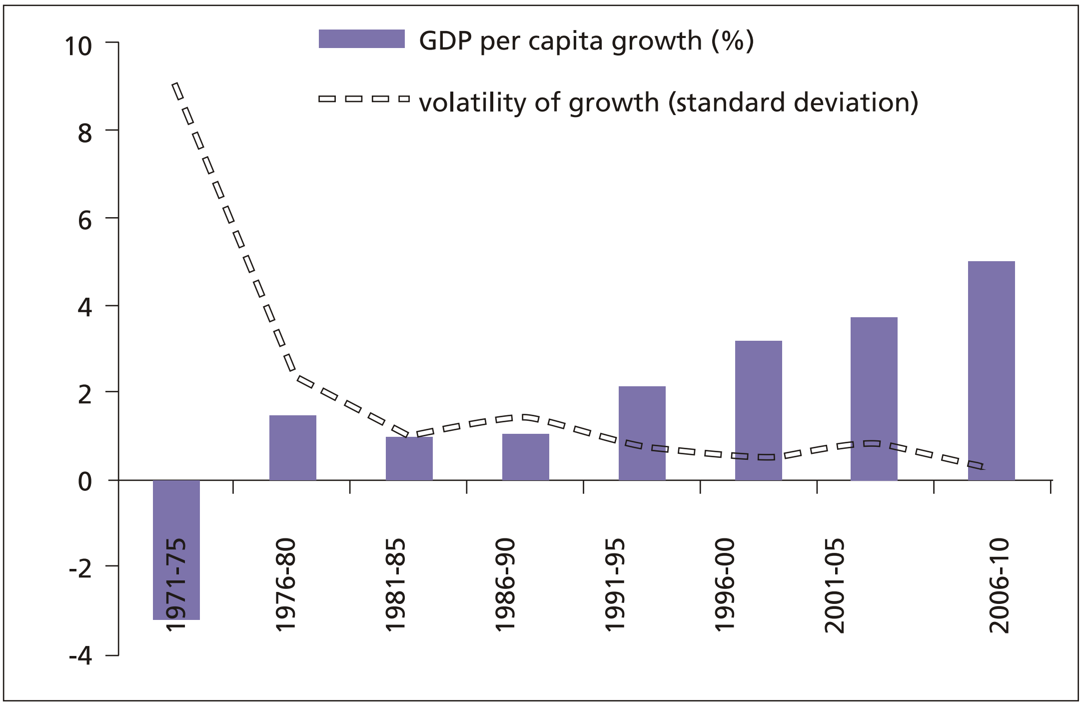
2 However, from the late 1970s to the beginning of the 1980s, there was a short-lived investment boom in both public and private sectors, owing, among others, to increasing flow of foreign aid, adopting a privatisation strategy based on lavish dispensation of cheap credit, and provision of other incentives such as highly protected markets for domestic industries (Mahmud 2001).

3 Bangladesh's terms of trade has deteriorated from a high of 155 in 1960 to 100 in 1970 and then continued downwards to 74 in 1978. And in 1981/82 its terms of trade was at its lowest points in two decades (Sobhan 1982).

from a state-owned (quasi-socialist) to a more market driven system. The post-reform era has seen steady GDP per capita growth with macroeconomic stability attained. Furthermore, the private sector has played a pivotal role in economic expansion, domestic resource mobilisation has increased and the country's social sector performed better than comparable income groups. Dependence on foreign aid has declined drastically and the economy is now near self-sufficient in many areas, including food production (See Figure 7, Also see Mahmud *et al*, 2008).

Figure 7

Growth and volatilities of GDP per capita: 1971-2010



Source: Based on World Development Indicators, World Bank

Nevertheless, Bangladesh still faces many economic and social challenges and it remains a least developed country with 31.5% of its population living below the poverty line (Household Income & Expenditure Survey [HIES] 2010) and lagging behind in achieving some of the Millennium Development Goals (MDGs)[4]. As discussed in subsequent sections, growth has not translated into concomitant changes in the country's governance and institutional qualities, scoring poorly in WB governance indicators and faring disappointingly in cross-country comparisons of institutional quality benchmarks, reflected in the 'Ease of Doing Business' indicators[5] (See Table 10).

Nevertheless, this exercise does not address how Bangladesh's development outcomes fare better than those of other countries with “better” governance (Devarajan 2008). As a result, many experts see Bangladesh as an outlier in the growth-governance discourse (Mahmud *et al* 2008d; World Bank 2007b).

4 In absolute numbers, over 45 million people in the country still lives below the upper poverty line and 26 million people are extreme poor (HIES 2010).

5 Although some micro indicators of Doing Business have witnesses some improvements in recent years.

Table 10

The state of governance and institutions in Bangladesh

Governance Indicators	Year	Percentile Rank	Governance Score
		(0-100)	(-2.5 to +2.5)
Government Effectiveness	2010	21.5	-0.84
	2000	32.2	-0.56
	1996	24.9	-0.73
Regulatory Quality	2010	21.5	-0.86
	2000	18.6	-0.87
	1996	16.2	-1.05
Control of Corruption	2010	16.3	-0.99
	2000	12.7	-0.96
	1996	27.3	-0.74

Source: Worldwide Governance Indicators, World Bank

Indicators	2012
Ease of Doing Business Rank	122
Starting a Business - Rank	86
Getting Electricity - Rank	182
Getting Electricity - Time (days)	372
Registering Property - Rank	173
Registering Property - Time (days)	245
Protecting Investors - Rank	24
Enforcing Contracts - Rank	180
Enforcing Contracts - Time (days)	1442
Resolving Insolvency - Rank	107
Resolving Insolvency - Time (days)	1460

Source: Doing Business, World Bank

Moreover, despite achieving economic independence in many areas, the country's external dependence on policy formation has not declined (*de facto*) in tandem. While the recent reform programmes (such as PRSP) allowed greater autonomy in the government adopting its own policies, influences are still owing to, according to some accounts, lack of policy ownership and internal capacity constraints, inter alia.

Rahman (2011), for instance, argued that policy ownership that the country has secured through PRSP is a 'guided ownership'. Choudhury (2010) observed that 'insufficient capacity to plan and manage development projects continues to remain a major challenge to improve aid effectiveness'. Due to GoB's capacity constraint and bottlenecks in project implementation and with lengthy and cumbersome donor procedures, on average 20% of annual external aid remain undisbursed which results an accumulation of over US$16 billion aid money in the pipeline (Choudhury 2010; The Daily Star 2012).

Is it due to lack of or limited policy ownership, or to the state's capacity constraints to implement various reforms? Or perhaps the very nature of political economy of reform that various reform measures have unleashed the scope for higher economic growth but at the same time they have had facilitated more avenues for corruption, thus deteriorating the country's economic governance indicators[6]. Other experts believe there is a mismatch between the D&DPs' market reform agenda and their governance expectations, given the political structure in developing countries (Khan 2009).

An economic inquiry could help understanding some of these concerns. There are numerous studies quantifying the reasons behind the relative success or failure of these economic reforms. However,

6 As Mahmud (2001) observed that economic liberalisation has undoubtedly reduced the scope for rent-seeking, for instance in the import licensing system, such behaviour has been increasingly replaced by other means of patronage politics. Financial extortion, including illegal collections of tolls and protection money, under political patronage has proved a growing phenomenon contributing heavily to the cost of doing business.

very little focus has been placed on the particular interplay between the D&DPs and national stakeholders within these reforms. Against this backdrop, this study attempts to disentangle elements that guided the economic reform process and pinpoint the conditions that generally determines what reform is acceptable and when it is expected.

The rest of the chapter is organised as follows. Section II concerns the methodology of the chapter. Section III offers a broader perspective of reforms, identifying the process and actors of various reform programmes and their impacts. Given the mixed outcomes of these reform initiatives, the study intends to explore two cases based on their sectoral performance where the interplay among the government, politicians, D&DPs and other stakeholders is substantial. Accordingly, in section IV two case studies on banking sector reform and energy price adjustment are presented. The final section concludes drawing, among others, some key points on the implication of economic reforms on the country's governance structure.

4.2 Methodology of the study

The research follows a case study methodology since a holistic and in-depth investigation is needed (Feagin *et al* 1991). Literature on case study methodology generally specifies three types of cases: exploratory, explanatory, and descriptive (Yin 1993). The explanatory case study evaluates whether programmes and projects are implemented as intended or designed, while also determining their outcomes and the reasons behind their ultimate success or failure (World Bank 1999). Secondary literature was extensively reviewed while key informants including policymakers, D&DPs, private sector stakeholders, regulators and academics were interviewed.

4.3 Reform and economic transformation: context, actors, process and impact

It is imperative to understand not only the trajectory of economic reforms and their impact, but also to identify the actors and process of reforms. As sectoral reforms impacts are captured in numerous studies (Akram 1999; Bhattacharya and Chowdhury 2003; Asian Development Bank 2005), here we focus more on the actors and their interplay in the process. One predominant feature of Bangladesh's economic reform (probably other countries as well for that matter) is that until a particular sector is hit by a crisis, the state apparatus, notably the politicians and bureaucrats, are generally reluctant to pursue reforms.

The context of wider economic reforms was set by severe terms of trade and macroeconomic crises in 1970s and 1980s[7] as well as declining trends in aid flows (Mahmud 2003, Sobhan 1982). The context and some salient features of D&DP-influenced economic reform are discussed in Box 1.

The remainder of the section briefly discusses the key reform measures undertaken since the country's independence in a number of priority sectors and areas. The literature on the various issues under this rubric is vast, so our discussion should be seen as nothing more than a birds eye view. This section is derived from secondary literature as well as insights drawn from key informant interviews.

7 Domestic savings that averaged 8 percentage of GDP during 1960-70 collapsed to -0.25 during 1972-76. The terms of trade had deteriorated from 100 in 1970 to 74 in 1978 (Sobhan 1982).

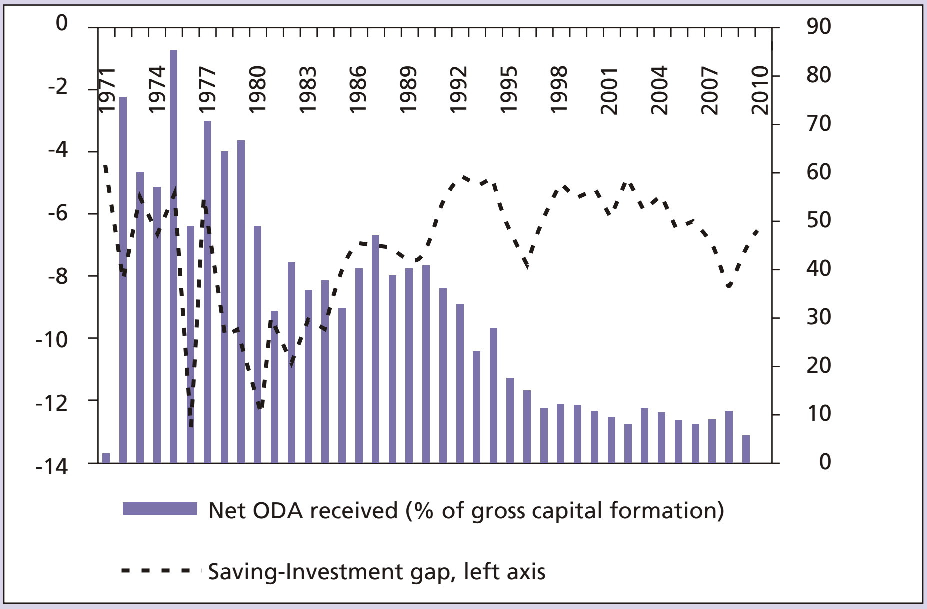
Box 1

External influence and economic reform

Given the scarcity of domestic resources, reflected in the savings-investment (S-I) gap, external resources were required immediately after independence (See Figure 8).

Figure 8

Saving- investment gap and Official Development Assistance (ODA) share of investment in Bangladesh: 1971-2010



Source: Based on World Development Indicators, World Bank

A 'Bangladesh aid consortium' was formed with the World Bank soon after independence (Sobhan 1982). Conditionalities were tagged with aid by the D&DPs from the very beginning as reflected in World Bank (1975): "the willingness of donors to continue providing aid in generous amounts to Bangladesh will no doubt depend on the implementation of satisfactory economic policies and measures". Given the continued pressure on its economy, particularly on its exchange rate, owing among others to the first oil shock, Bangladesh first used the compensatory financing facility of the IMF in fiscal year 1974. The then government was initially reluctant to meet the IMF's conditions on monetary and fiscal stances. However, in May 1975 it revised its position devaluing the Bangladesh Taka by 56% (Muhammad 2005).

After the regime change in the mid 1970's, there was a policy shift in favour of private sector development. The reforms were supported by resources from the WB and other bilateral donors. The initial phase witnessed four key reforms: reduction of restrictions on investment; momentum of denationalisation of SoEs; limited reduction of tariffs and non tariff barriers; and incentive packages for the emerging ready-made garments sector.

However, a major set of reforms emerged through implementation of a package of Structural Adjustment Programmes (SAP) in the 1980s and Enhanced Structural Adjustment Facility (ESAF) in the 1990s. Bangladesh is one of the first 35 countries which adopted the Bretton Woods institutions' guided SAP (1986-89) and ESAF (1990-93). Tied to loans, SAP was designed to encourage borrowers to remove “excess” government controls and promote market competition while the ESAF was devised to support macroeconomic policies. In fact, Bangladesh was not the only country that experienced terms of trade shocks during the 1970s, as a large number of countries that were severely affected by two oil shocks in 1970s also adopted similar policies, influenced by the IMF and the WB.

Apart from the WB and IMF, reforms in Bangladesh have been influenced by other D&DPs. ADB is another key player in the reform process, with a strong focus on numerous areas such as agriculture, energy, capital market, transport, urban development, private sector development and governance. The United States Agency for International Development (USAID) financed a number of key reform projects, including the Financial Sector Reform Project and the institution of the Rural Electrification Board. The Department for International Development's (DFID) (now known as UKAID) focus has been on basic social services, private sector growth, and governance and strengthening institutional accountability. Japan International Cooperation Agency's (JICA) major projects include agriculture and rural development, transport, power and energy, private sector development and governance.

Aid Paradigms, development assistance and policy reforms shifted markedly in the past 40 years. The role of bilateral donors has declined but multilateral ones remain an important component of external influence upon the country.

The policy reforms in the 1980s were mainly directed towards withdrawal of food and agricultural subsidies, SOE privatisation, financial liberalisation and withdrawal of quantitative import restrictions. The early 1990s saw the launching of a more comprehensive program of macroeconomic reforms aimed at transitioning to an open economy (Mahmud et al 2008).

In the 1980s, D&DPs' focus was policy reform to create room for private sector development. In the 1990s, more stringent conditions were tagged to address the governance issues. However, there has been a major shift in reform programmes following the formulation of the Poverty Reduction Strategy Paper (PRSP) in the early 2000s. PRSP provides the crucial link between national public actions, donor support, and the development outcomes needed to meet the United Nations' MDGs.

Global norms and best practices

Global norms and best practices have also played a certain role in influencing Bangladesh's economic reforms and policies. The country's external sector reform and policies with respect to trade reform is largely influenced by the World Trade Organization's (WTO) rules and regulations. Moreover, banking sector reform has been heavily influenced by BASEL norms that have a goal of maintaining financial stability by setting common standards for banking regulations. Global development agendas such as the MDGs have exerted significant influence on the reform and policy-making process in Bangladesh.

4.3.1 Privatisation

The economic inefficiency of public enterprises nationalised during the 1972-75 periods placed a fiscal burden for the state, diverted limited resources from growth-enhancing public spending to unproductive subsidies, and affected the country's industrial competitiveness (Akram 1999). Influenced by the WB and IMF, the government embarked upon privatisation programmes and public sector reforms. In the first phase of privatisation (during 1975-1981), 255 public enterprises were divested. During the second phase of privatisation (during the early 1980s), 261 public enterprises were denationalised (Akram 1999).

Although there was a brief reversal in the privatisation policy in the early 1980s when 27 textile mills and 33 jute mills were returned to their original Bangladeshi owners under the industrial policy of 1982 (Uddin 2001). Since the inception of the Privatisation Board which was upgraded to the Privatisation Commission in 1993, 74 public enterprises have been privatised (Sobhan 2002). However, in an apparent shift from the earlier industrial policy, the current government in its new plan stressed on strengthening SoEs in order to both supplement and compete with the private sector (The Daily Star 2010).

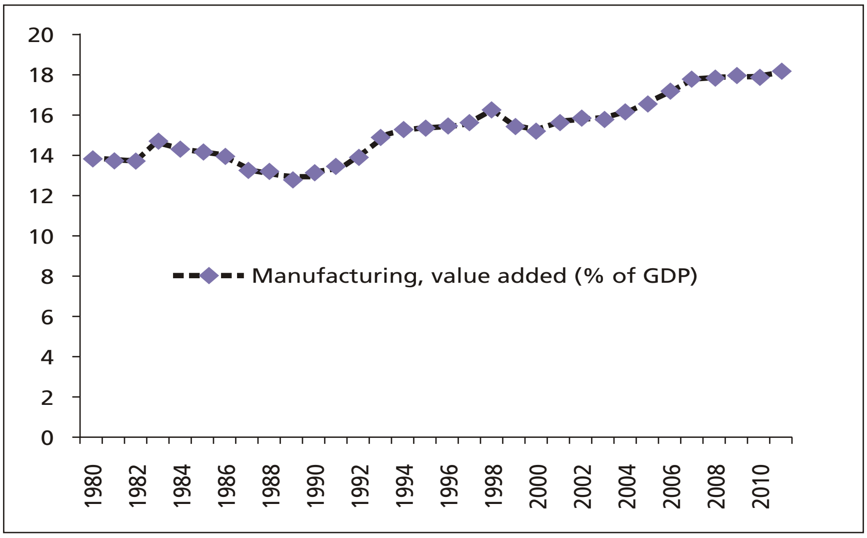
Politicians faced a dilemma when embarking upon privatisation, since the process benefited their allies in terms of resource transfer from public to private hands, but encountered significant resistance from organised labours. Moreover, business people often linked to the incumbent government supported SoE reform, often deriving commercial benefits in their favour.

The results of privatisation are at best mixed. Humpery (1987) observed that the privatisation policy and related regulatory liberalisation have had a beneficial effect on industrial growth and have encouraged private investment. Other studies reveal that instead of augmenting new investments, higher industrial growth and generating additional employment opportunities, privatised units run at losses or are diverted resources to other use. In many instances, the new owners engage in speculative businesses or develop project land commercially for housing and shopping complexes (Ahmed 2000). A leading economist of Bangladesh called them 'invisible privateers' (Sobhan 2002a). Although the privatisation process slowly began to reduce asset stripping from enterprises, the privatised entities proved only marginally better in terms of efficiency, due to the deficiency of regulatory agencies and property rights. Nevertheless, the separation of economic from political rents reduced the most damaging types of predatory rents in the economy (Khan 2010).

Figure 9 shows that privatisation has had modest effect on the country's manufacturing activities, with the sector's growth largely due to Ready-Made Garments (RMG) manufacturing (which has little to do with privatisation of SoEs). However, the paradigm shift in economic philosophy which was influenced by D&DPs and coupled with the state's commitments for private sector led growth, allowed for this sector's (RMG) emergence where the state was directly involved[8].

8 A favourable international rent environment facilitated by Multi Fiber Agreement in technology transfer overcoming various market failures to this to happen (Khan 2012).

Figure 9
Share of manufacturing value added in GDP: 1980-2011



Source: Based on World Development Indicators, World Bank

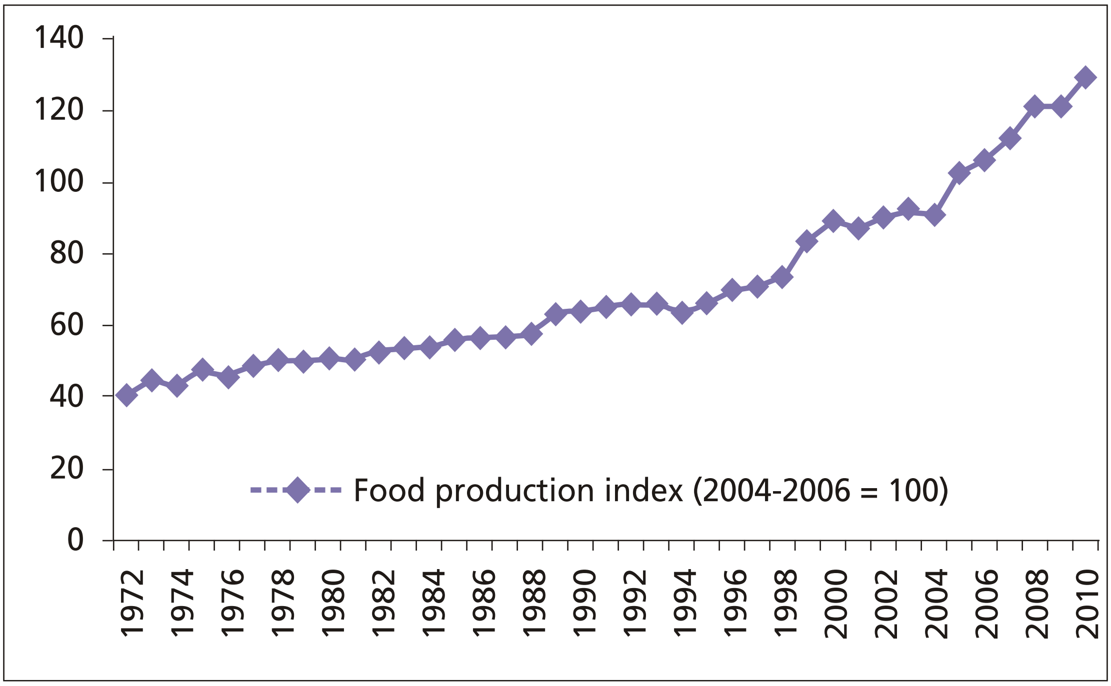
4.3.2 Agriculture sector reform

Agriculture sector reforms were introduced against the backdrop of food shortage and the country's increasing dependence on food aid. Pressure from the main aid donors USAID and WB, domestic concern over subsidy and awareness of the ineffectiveness and inefficiencies of public interventions propelled reforms in the 1980s (Cabral *et al* 2006). By the late 1970s, about one third of the entire development budget was being consumed by agricultural input subsidies (Mahmud *et al* 2008). In the first phase of reform in the early to mid 1980s, agriculture input subsidies were cut back and domestic trading of inputs were liberalised. The second phase in the late 1980s to early 1990s of reforms saw agriculture inputs imports liberalised and private trading of agriculture introduced.

There was broad political support for such reforms, as high population density and land scarcity left Bangladesh with little option but to augment food production, which also proved a key political issue both in rural and urban areas. Although the subsequent abolition of the food rationing system was a politically difficult decision in light of the politically vocal urban middle class being its main beneficiary (Mahmud *et al* 2008). Nevertheless, the military and police, too powerful a group to alienate, continue to get subsidised food (Cabral *et al* 2006).

Agricultural reforms in the 1980s were successful in at least two dimensions. First, there were clear savings for the government from cutting subsidies on agricultural inputs. Second, input dealers and farmers responded by increasing usage of fertiliser and augmenting the ground water irrigation, rapidly outstripping the area under surface irrigation. These combined effects allowed the green revolution varieties of rice to be adopted, and for land to be cropped more than once a year (Cabral *et al* 2006). Food grain production in Bangladesh has increased from around 10 million tons in 1971 to 34.5 million tons in Fiscal Year 2011/12 (World Food Programme [WFP] 2012) (also see Figure 10). The country is now nearly self-sufficient in rice production.

Figure 10
Food production index of Bangladesh: 1972-2010



Source: Based on World Development Indicators, World Bank

Nevertheless, Bangladesh as a least developed country is not required to fully liberalise the agriculture sector. The experience of this sectoral overhauling shows that the country benefited from phased implementation of reforms which allowed for learning, monitoring and adjustment to developments in the markets (Cabral *et al* 2006).

4.3.3 External sector reform

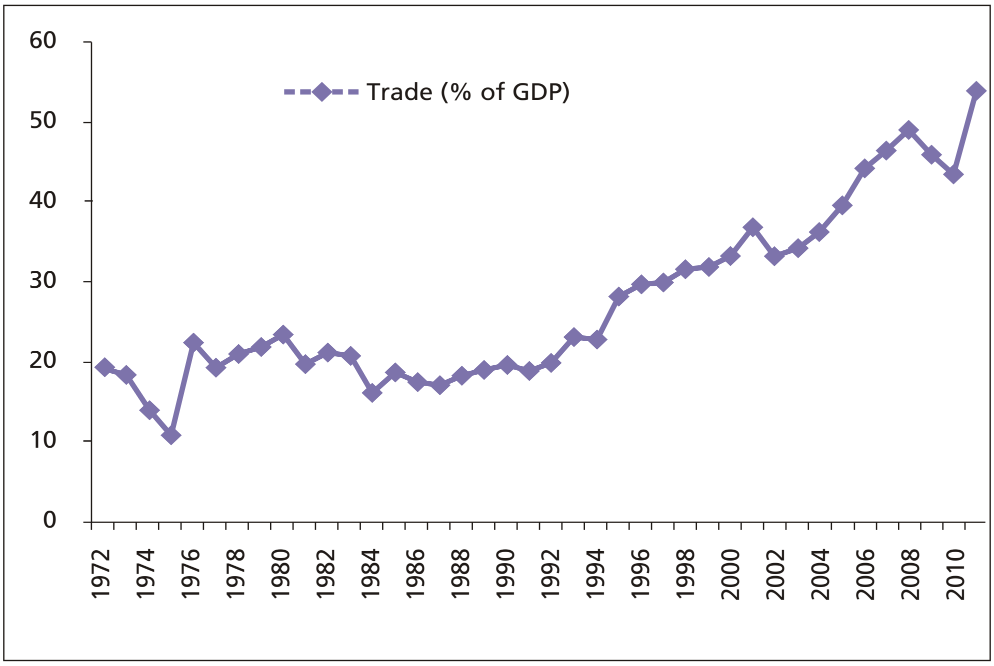
The external sector development in Bangladesh was suppressed during the 1970s, owing to the reign of the 'license raj' and the dominance of SOEs. The industrial policies were developed on the basis of 'import-substitution industrialisation' to protect domestic industries from external competition. Consequently, trade and investment policies were also inward looking.

The external sector reforms in Bangladesh started with a moderate liberalisation in 1980s by abolishing the import licensing system. Since 1985, export policy reforms were implemented in trade, exchange rate, along with monetary and fiscal policy incentives aimed at increasing effective assistance to exports (Raihan 2008). Bangladesh followed a 'fixed exchange rate' system until 1979 when the Central Bank, Bangladesh Bank (BB), pursued a managed floating exchange rate regime. The currency underwent a large scale devaluation to make export competitive and to discourage imports, thus gradually erasing the premium on import licenses.

Reforms towards trade liberalisation in fact followed a logical sequence: the relaxation and withdrawal of import quota restrictions along with the unification of the exchange rate and devaluation of the domestic currency during the late 1980s, followed by large reductions in import tariffs in the first half of the 1990s (Mahmud *et al* 2008).

As a result of reforms, between 1991-1992 and 2004-2005, the unweighted average tariff rate fell from 70% to 13.5%. Similarly, the import-weighted average tariff rate declined from 42.1% to 11.48 % in 2003-04 (Raihan 2008). The revenue effects of tariff reductions have been more than offset by the growth of imports (Mahmud 2004). Nevertheless, Bangladesh still has protective tariff rates for a number of sectors, notably agriculture. Largely owing to reforms, the country's trade to GDP ratio increased from less than 20% in 1980s to 50% in 2011 (Figure 11).

Figure 11
Trade to GDP ratio of Bangladesh: 1972-2011



Source: Based on World Development Indicators, World Bank

4.3.4 Financial sector reform

Prior to the initiation of structural reforms in the 1990s, Bangladesh's financial system constituted typical examples of what McKinnon (1973) and Shaw (1973) dubbed "financial repression". The sector, both the market and institutions, in the two decades of post independence period faced major structural problems, evident both in banking and other components of money markets as well as capital markets.

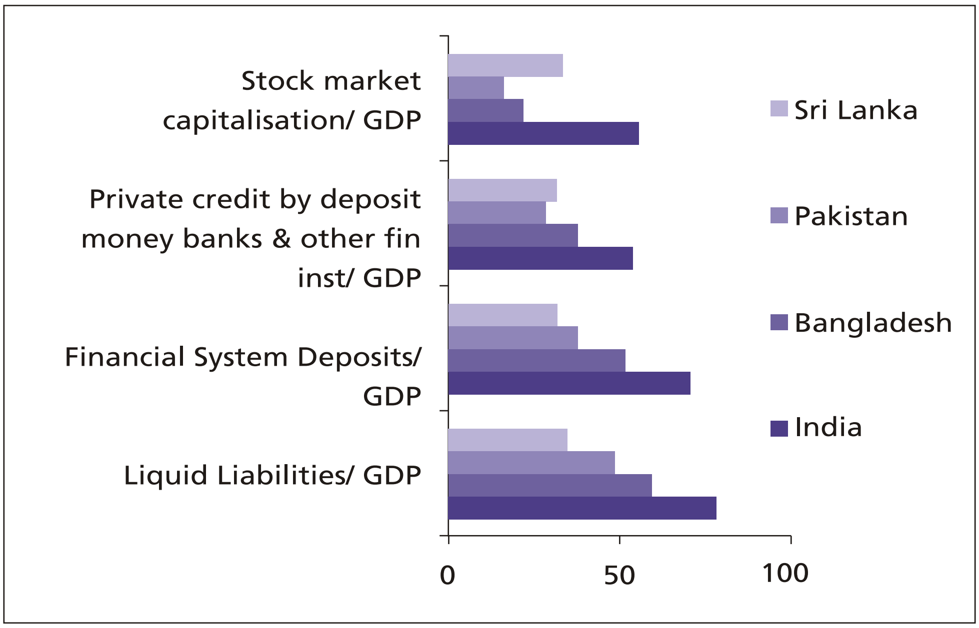
To overcome these problems, financial sector reform was initiated in 1982 with the de-nationalisation of commercial banks, followed by the establishment of the "National Commission on Money, Banking and Credit" in 1984. However, major reforms in the sector were launched in the early 1990s.

The WB Consultative Mission provided a Financial Sector Adjustment Credit (FSAC) under which the Financial Sector Reform Programme (FSRP) was initiated. In line with these reform initiatives, the ADB formed the Capital Market Development Programme (CMDP) following the stock market crisis in 1996. The second round of reforms begun in late 2001 aiming to strengthen the central banking functions, with the Central Bank Strengthening Project in 2003 jointly funded by the WB and GOB.

More recent reforms in the financial sector were undertaken in 2004 with WB funding and guidance under the 'Enterprise Growth and Bank Modernization Project'. Aside from donor influenced reforms, global financial norms and best practices, notably BASEL Norms on capital adequacy, have influenced the financial sector's policy reform (Nachane and Islam 2010).

Figure 12

Key financial sector indicators of selected countries, 2009



Source: Based on Financial Sector Database, World Bank

The financial sector reform, notably bank denationalisation, faced severe hurdles from organised labours but gained political support as the process benefited business allies of political parties. While various market based reforms were initiated in the capital market, regulatory reforms in this segment of financial sector proved more difficult, due to the 'insider trading' often involving the regulators and politically-affiliated investors.

Financial sector reforms offer a mixed bag of results. The capital market remains weak with regulatory failure was apparent in the stock market crash of 2010-11 (Ibrahim Khaled Committee Report 2011 as cited in Alam n.d.) and virtually no corporate debt market (Nachane and Islam 2009). The banking sector has performed far better, particularly in the past decade. The sector fares well *vis-a-vis* its South Asian peers in many key indicators (See Figure 12, BB annual reports and section IV). Nevertheless, the impact of reforms on the state owned banks has been less than satisfactory, largely due to the lack of consistent political commitments.

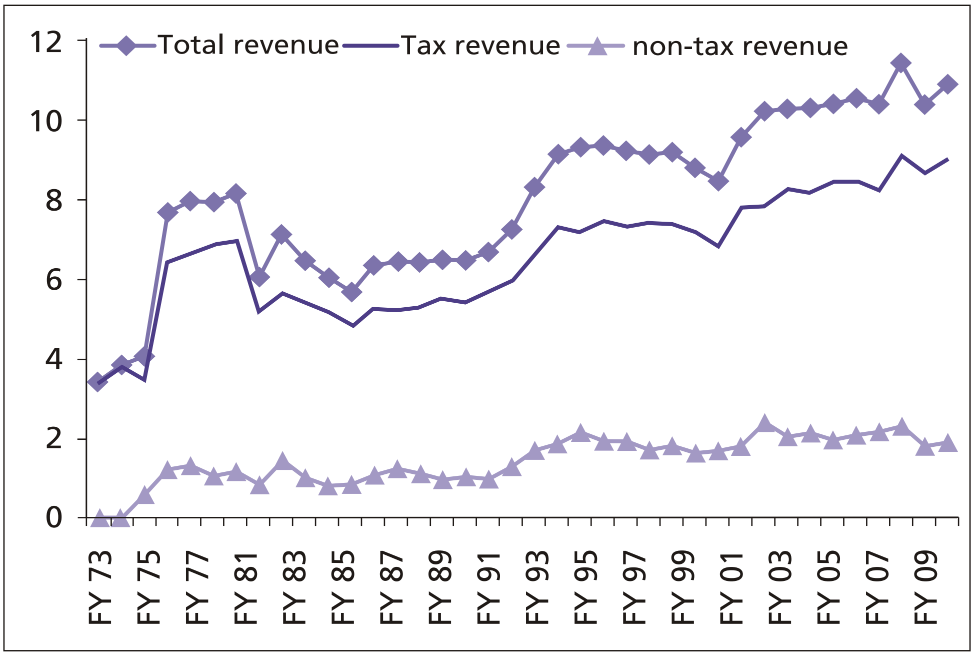
4.3.5 Public resource mobilisation and fiscal reform

As a continuation of structural reform, Bangladesh adopted D&DP-led programmes (policy framework paper (PFP), which asked for, among other things, efficiency of resource use and raised rates of domestic savings and investment. The reforms were introduced in different areas along with public expenditure polices and public resource mobilisation.

To increase government revenue, different reforms were proposed including expansion of value added tax, reforming direct tax, strengthening the tax administration, pricing adjustment of public goods and services. Simultaneously, the public expenditure policies sought budget deficit reduction along with government expenditure rationalisation. These asked for reforms aimed to reduce the growth of current expenditure and subsidies, while along with cutting down administrative costs, and improving project aid utilisation and reducing the SOE's operating deficits (Bhattachariya and Titumir 2001).

As a result of public resource mobilisation efforts, the tax-GDP ratio showed some improvement during the 1990s (Figure 13), but until now remains very low compared to other developing countries. Mahmud *et al* (2008) observed that tax reform is politically expensive and political actors are reluctant to choose hard measures against tax evasion. In fact, political settlements determine patterns of resource mobilisation lying at the heart of economic development (John and Putzel 2009). Exorbitant tax evasion arises from collusion between political and business elites and the top levels of government and this also channeled to fund political stability in developing countries (Khan 2004). Mahmud *et al* (2008) pointed out that the public expenditure reforms were somewhat successful but high wastage and inefficiency in the delivery of public services occurred.

Figure 13
Revenue mobilisation (% of GDP) in Bangladesh: 1973-2010



Source: Based on the 6th Five Year Plan, Government of Bangladesh

4.3.6 Infrastructure, energy and utilities reforms

Bangladesh's reform experience in infrastructure and utility has been less pronounced. D&DPs have been keen to reform these sectors, in which the ADB was a key player, with other actors including Organization of the Petroleum Exporting Countries (OPEC), the WB and bilateral donors (Norway, Netherlands, Kuwait). Reforms in these sectors were introduced much latter compared to other sectors, which is not uncommon as state control in infrastructure and energy often occurs in developing economies. While opening up the telecommunications sector has helped penetrate the service rapidly, the coverage levels of electricity, water and transportation and other services in Bangladesh are among the lowest in South Asia. In fact, Bangladesh has one of the worst infrastructure facilities in Asia (See Table 11). However, it should be noted that there is a high correlation between access to utilities and level of income (Figure 14).

Prices for some utility services- particularly electricity, gas and water- are set below the costs of provision. While successive governments had reformed various aspects of energy and utility services, notably generation and distribution in the power sector, they had been reluctant to reform energy prices until recently, previously fearing a possible backlash from the voters and consumer rights groups.

Table 11

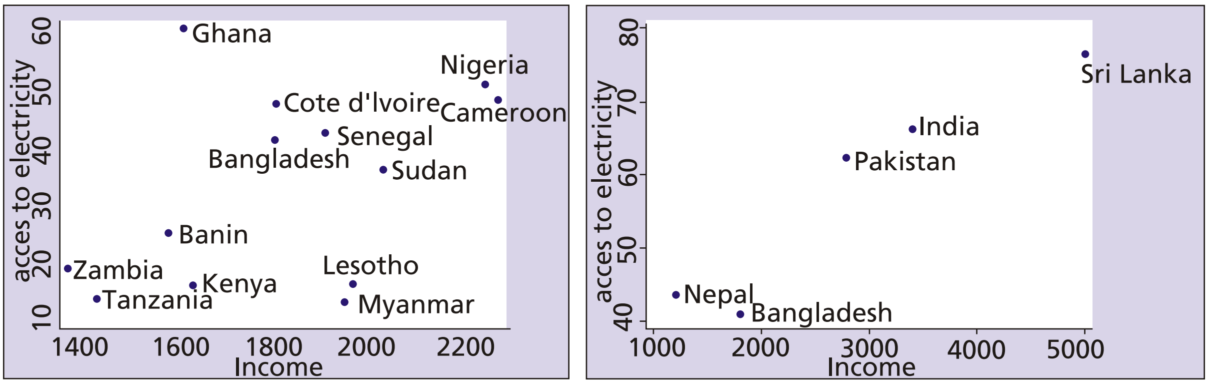
Comparison of Bangladesh's infrastructure quality with key selected economies and regions

Region/country	Overall infrastructure	Road	Railroad	Port	Air transport	Electricity supply
Bangladesh	2.2	2.8	2.3	2.6	3.4	1.9
India	2.9	2.9	4.4	3.3	4.7	3.2
Pakistan	3.1	3.5	3.0	3.7	4.2	2.5
South Asia average	2.9	3.1	2.8	3.4	4.2	2.8
Asia Average	3.8	3.7	3.6	3.9	4.6	4.1

Source: ADB 2009.

Figure 14

Nexus between access to electricity and per capita income: Bangladesh *vis-à-vis* low similar income group (left panel) and South Asia (right panel)



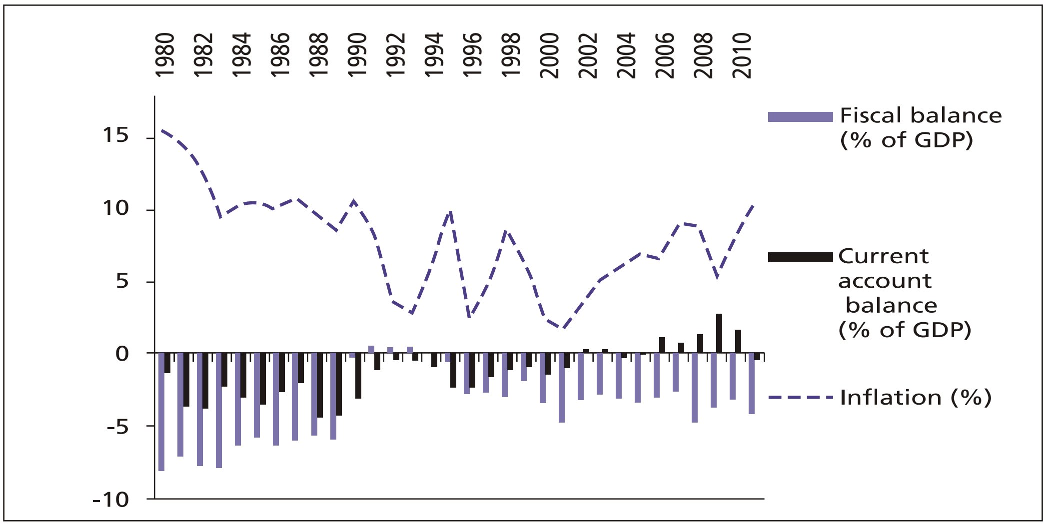
Source: Based on World Development Indicators, World Bank

Moreover, investors do not show long-term interest in investing in these sectors[9] due to two main reasons. First, the GoB exhibits capacity constraints related to procurement management skills and subsequent implementation of projects (Choudhury *et al* 2010). The key informant interview also suggests that energy and infrastructure sectors suffer from gross governance problems. Second, there is a political uncertainty given the shorter time horizon of incumbent governments. Thus the risk premium for private sector financing for power generation is high. Khan (2012) observed that good governance reforms in many developing countries that have tried to directly tackle these characteristics have generally failed to reduce risk premiums.

To sum-up, although sectoral performance has been mixed, the economic reform has helped stabilise the Bangladesh economy. In fact, the most defining feature of reforms is probably attaining macroeconomic stability (see Figure 15).

Figure 15

Trends in key macroeconomic variables: 1980-2010



Source: Based on World Economic Outlook, International Monetary Fund

As far as sectoral performance is concerned, SOE privatisation did not facilitate manufacturing sector take-off in a significant way. However, the paradigm shift to private sector-led development has helped in the emergence of dynamic growth sectors such as RMG. The supporting reform in the external sector through a number of incentives such as undervalued currency (which also helped remittance flow growth), bonded warehouse facilities, helped the export sector significantly.

Agricultural sector reforms have been instrumental in achieving near self-reliance in food production. The banking sector's key indicators have performed better. However, utility, energy and infrastructure reforms have been politically challenging to pursue.

Given the mixed outcome of D&DP influenced reforms, we study two areas banking sector reform and energy price adjustment in the next section.

9 An estimate shows that the sector is in need of US$9 billion investment to increase power generation to 11,500 MW by 2015. The GOB plans to invest about US$1 billion and expects about US$8 billion investment from the private sector (Choudhury *et al* 2010).

4.4 Case study

4.4.1 Banking sector reform in Bangladesh

Financial sector reform was one of the key elements of the D&DP-guided Structural Adjustment Programme with banking is a dominant sub-sector of the country's financial system undergoing massive reforms. It is widely recognised that banking reforms have largely been successful compared to other segments of the financial sector (Ahmed 2012a; Nachane and Islam 2009).

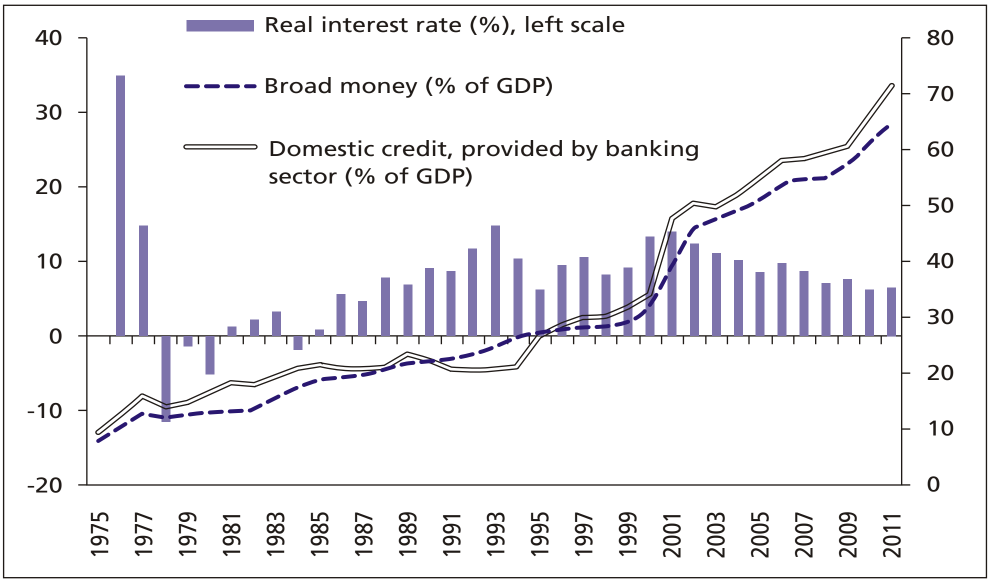
Key banking sector indicators such as share of non-performing loan (NPL), capital to risk weighted assets ratio (CRAR) and broad money to GDP ratio (also known as financial depth) have seen steady improvement over the past decade. In fact, the sector fares well *vis-à-vis* its South Asian counterparts. (See Table 12 and Figure 16)

Table 12
Selected banking indicators of key economies of South Asia, 2009-10

	Bank Deposits/ GDP	Bank Credit/ Bank Deposits	Bank ROA	Bank ROE	Bank Z-Score
India	69	70	1.3	20.2	8.75
Bangladesh	52	74	1.8	21.7	8.2
Pakistan	35	70	0.2	1	5.28
Sri Lanka	31	98	0.1	14.5	14.5

Source: Financial Sector Database, World Bank and Annual Report 2010-11, Bangladesh Bank

Figure 16
Trends in broad money, credit and real interest rate in Bangladesh: 1975-2011



Source: Based on World Development Indicators, World Bank

However, the financial health and governance structure of state-owned/public sector commercial banks (NCBs/SCBs) remains a threat to the sector given that they still constitute more than a quarter of the industry. Moreover, the creation of the Banking and Financial Institution Division (BFID) at the Ministry of Finance in 2009 poses a serious risk to the sector, inducing the central bank's independence (Ahmed 2012). The government with the politicians in particular generally adhered to the key reforms that resulted in a win-win situation for those concerned.

At the same time, given the sector's immense importance in achieving political objectives (a mechanism for automatic monetisation of fiscal deficit, among others), political interventions remains the key challenge in sustaining success in this sector. That said, it is imperative to understand the political economy of reform in the banking sector drawing some lessons for other segments of the financial system.

Rationale and objective of the case study

Economic historians observed that the most successful economies tend to be those that developed sophisticated financial systems at an early stage (Patrick 1966). Therefore success in this sector will largely define the shape of financial architecture that could emerge in the economy in the near future. The specific rationales behind the study of this sector are: 1) External influence has been relatively higher in this sector; and 2) Political economy of reform in the banking sector is critical to understanding the emergence of the overall architecture of the country's financial system.

As discussed in preceding sections, while the reforms in various segments of the economy were undertaken owing to external influence as well as domestic realisation, the key objective here is to understand under what circumstances reform worked in the banking sector through the interplay between D&DPs and the local actors.

Sectoral overview: Banking sector

The financial system of Bangladesh comprises the Bangladesh Bank (BB) at the apex regulatory body for the country's monetary and financial system, numerous financial intermediaries[10], money, debt, and stock markets. The system is heavily dominated by banks, with the banking sector constituting four State Owned Commercial bank (SCBs), 30 private commercial banks (PCBs), nine foreign commercial banks (FCBs) and four development finance institutions (DFIs).

These 47 banks operate throughout the country with 8522 branches (Bangladesh Bank 2011). Prior to reforms the sector was overwhelmingly dominated by SCBs. Even in the early 2000s the NCBs/SCBs constituted 47% of industry assets and half of the industry deposits. However, over the years the PCBs emerged as a dominant player in the sector constituting 58.8% of industry assets (See Table 13). Given the country's underdeveloped equity and debt markets, banking is the key source of credit and investment for the economy.

10 Financial intermediaries include commercial banks, specialised banks, non-bank financial institutions (NBFIs), and microfinance institutions (MFIs), the last constituting a very special feature of the Bangladesh financial system. For details see Nachane and Islam (2009).

Table 13
Industry asset and deposit shares of various types of banks in Bangladesh

	% of industry assets		% of industry deposits	
Bank Types	**2001**	**2010**	**2001**	**2010**
NCBs/SCBs	46.5	28.5	50.93	28.1
DFIs	9.5	6.1	5.64	4.9
PCBs	37.2	58.8	36.58	60.9
FCBs	7.8	6.6	6.85	6.1
Total	100	100	100	100

Source: Bangladesh Bank Annual Report 2011

Political economy of banking sector reforms

The reform programmes initiated under various auspices focused on several dimensions, most notably SCB privatisation, entry of new private and foreign banks, recovery of NPLs, interest rate deregulations, BB's increased autonomy, enhancing prudential regulation and supervision, rationalisation and merger of bank branches, and improvements to the money market.

a) First phase of reform (1980-90): denationalisation and private participation

The banking system operated until the end of the 1980s with the aim to achieve the fiscal objectives of supplying cheap money to the SOEs and a number of priority sectors (Raquib 1999). However, given the changing perspective towards denationalisation and private participation, the initial phase of banking reform (1980-90) focused on the promotion of private ownership of commercial banks and denationalisation of NCBs.

While donors supported denationalisation from the very beginning, the compulsion to adopt reform measures was not strong until the mid-1980s. This was largely due to inappropriate accounting and reporting systems, which delayed the adoption of reform measures (Task Forces 1991). As the weakness of the system exposed, the government transferred three NCBs in the private sector during 1984-86[11] and four PCBs were granted licenses in the early 1980s[12]. This two pronged approaches of denationalisation and private banks licensing was an acceptable equilibrium for the concerned stakeholders, i.e, D&DPs, politicians, private sector bar organised labours (who opposed banking sector liberalisation).

This round of reform from 1982-1990, however, was largely unsuccessful due to the unprecedented influence of vested PCBs and NCBs interest groups, which resulted in a loan default culture. Moreover, the pervasive political patronage of the military government in allocation of resources choked the banking sector (Bhattacharya and Titumir 2001). Nearly 30% of NCB loans became non-performing in 1986 (Watanagase 1990). Although the National Commission on Money, Banking and Credit which was constituted in 1984 submitted a long list of recommendations to the

11 Uttara Bank, Pubali Bank and Rupali Bank.
12 Arab Bangladesh Bank, National Bank, Islami Bank and IFIC Bank.

government in 1986 for which subsequent a number of steps were taken such as fixation of recovery targets for NCBs, prohibiting defaulters from getting new loans, the deterioration in banking efficiency could not be stemmed (Task Forces 1991).

b) Second phase of reform (1990-2000): market based pricing of financial products and private participation

Given the poor outcome of earlier reforms, wide ranging banking reform measures were undertaken under the aegis of the WB's Financial Sector Reform Project (FSRP) in the 1990s. The focus of reforms, among others, have been on gradual deregulations of the interest rate structure, providing market oriented incentives for priority sector lending and improvement in the debt recovery environment (Task Forces 1991).

Moreover, a large number of private commercial banks were awarded licenses in the second phase of reform. Although second generation banks have addressed many demand side issues, such as, development of a wide range of financial products and services[13], the measures have not been successful in addressing the banking sector's key problems. These include high NPL ratios both in SCBs and PCBs, the deterioration of credit allocation index[14], and lack of enforcement of the capital adequacy and other regulatory requirements[15]. Furthermore, changes in the interest rate flexibility were unable to create the kind of competition desirable among NCBs and PCBs. Thus FRSAC/SAP did not bring about the desired outcome in the sector (Bhattacharya and Titumir 2001) with the WB itself admitting that the project was unsuccessful. However, the WB alone was not to blame for the poor outcome of the FSAC as a lack of government ownership and political will to make the reform successful were observed[16].

Thus the reform agenda emphasised economic deregulations rather than broadening prudential regulation and supervision (Bhattacharya and Titumir 2001). Moreover, after the expiry of FSRP in 1996, the government formed a Bank Reform Committee (BRC), which submitted its recommendations in 1999. While the then government partially acted on some of the recommendations of the BRC, a large part of them went unaddressed (Bhattacharya and Chowdhury 2003).

c) Third phase of reform (2000s onwards): risk-based regulations and supervisions, private participation

Since denationalisation, greater private participation and market based pricing of financial products did not generate the anticipated results even until the late 1990s, largely due to the absence of firm supervision and effective economic regulations of BB, the focus had shifted to risk-based regulations and supervisions in early 2000s. The BRC observed that the supervisory and regulatory forbearance of BB has been one of the main reasons for the accumulated banking

13 That includes commercial banking through both conventional and Islamic mode, merchant and investment banking, SME and retail banking, credit card and off-shore banking. The second generation banks also played leading role in syndicated and structured financing (Rahman 2012).

14 The flow of credit to national priority sectors (such as agriculture, small and cottage industries) also declined during 1990-1999. Moreover, the relative share of rural banking has declined after the adoption of banking reform measures (Task Forces 2001).

15 Minimum capital requirement of the banks was also fixed at 8 percent of risk weighted assets since 1996 according to international standard practice and till 1998, both NCBs and PCBs were suffering from capital inadequacy (Task Forces 2001).

16 There was a law put in place to improve bank supervision, bank operating practices and method of debt recovery but commitment to enforce these laws has been dilatory and lacked resolved (Bhattacharya and Titumir 2001).

problems. While the issue of regulation and supervision was spelled out in FSRP and the banks adopted BASEL I norms in 1996, it was indeed the reforms in post 2000 that had a de *facto* focus on risk-based banking supervision including strengthening of the Central Bank.

The most important development in 2000s has been the banks, notably PCB and FCB commitments towards the implementation of Basel II, in which banks are required to maintain a CRAR of 10%. While the SCBs struggled to maintain the ratio, in the past few years they have shown some progress. The overall banking sector success in following the adoption of international best practices, has led to the BB's strong commitment to implement the BASEL-III norms[17].

Moreover, there has also been a strong public opinion including civil society against the defaulters, which along with political commitments facilitated enactment of a number of new laws, regulations and instruments to curb NPLs.

Moreover, the Central Bank Strengthening Project (CBSP) initiated in 2003 focused on effective regulatory and supervisory system for the banking sector, particularly strengthening the legal framework, automation and human resource development and capacity building of BB by strengthening the research department, prudential regulations and bank supervision, accounting and auditing.

The Enterprise Growth and Bank Modernisation Project was adopted in 2004 by WB to help the government achieve a competitive private banking system through a staged withdrawal through divestment and corporatisation of a substantial shareholding in the three public sector banks (Rupali bank, Agrani bank and Janata bank), and divestment of a minority shareholding in the largest SCB Sonali Bank.

However, owing to the nexus between the politicians and businesses these banks' performance has not improved in line with reform objectives. The recent SCB scams indicate that the reforms have not been able to disentangle the state from direct controlling over those banks to achieve their political objectives (see box 3). Private participation in the banking sector continued during this phase. However, a number of leading experts on banking opposed the granting of new private bank licenses in 2012, as the BB decision was widely believed to be influenced by the political interest of the current government rather than economic need (Ahmed 2012a; Mohiuddin 2012).

Assessment/ Impact of reform

Banking sector reform, notably denationalisation, faced a strong resistance from trade union/organised labours, but political support favoured various reforms in the sector as the entry of private players provided them with considerable incentives, irrespective of military or political governments. This has also led to the growing nexus between private businesses and politicians.

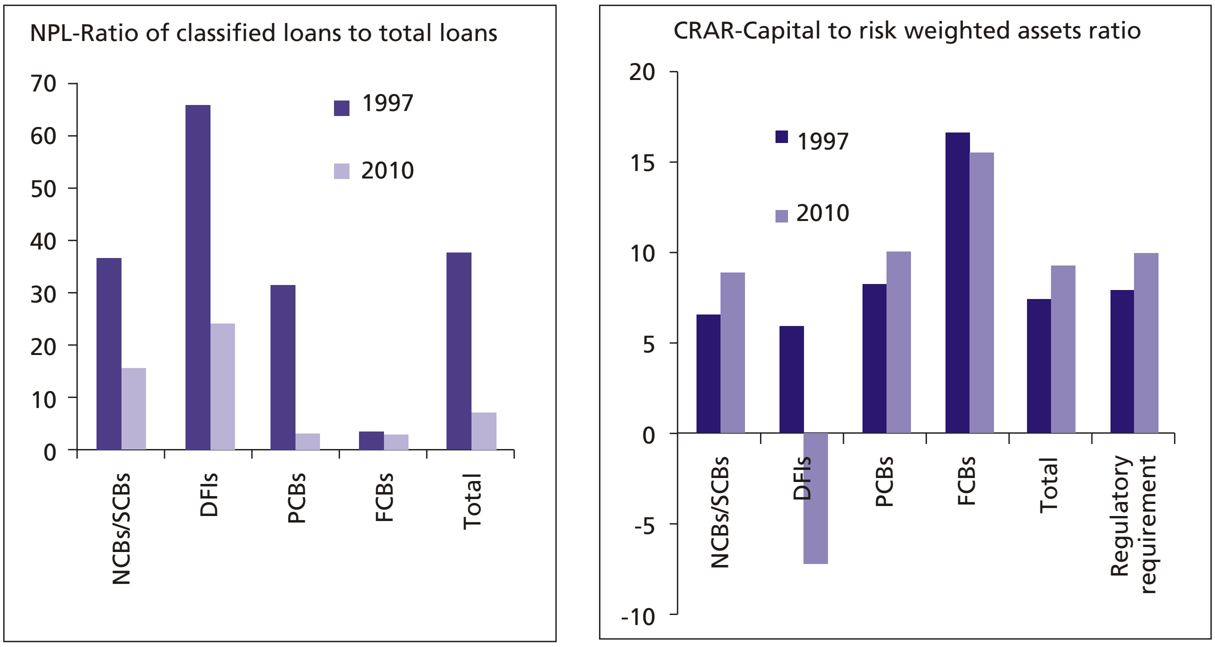
However, in the absence of an effective regulatory mechanism, the banking sector reform had limited impact on its key indicators including competition and loan default until mid-1990s. With

17 BASEL III is the third installment of the Basel Accords (after Basel I and Basel II) that was developed in response to the deficiencies in financial regulation revealed by the late-2000s financial crisis.

both public and private sector banks failed to improve their financial health, the reform focus shifted to risk-based regulations and supervisions in the late 1990s and early 2000s, thus allowing the sector to perform better (See Figure 16, Figure 17 and Table 12).

Figure 17

Performance of two key indicators- NPL and CRAR- of banking sector during 1997-2010



Source: Bangladesh Bank Annual Report, various years.

A relatively well functioning banking system has helped the Bangladesh economy to maintain its macroeconomic stability in the post-reform era. Micro indicators show that loan classification systems and capital adequacy standard have a favourable impact in improving the banking sector (Figure 17). This is largely due to BB's adoption of the BASEL regime, with 40 out of 47 banks in compliance with Basel-II consistent requirements by the end of June 2011 (IMF 2011).

Nevertheless, problems still persist in SCBs/NCBs where implementation of reform has been difficult, largely owing to political reasons (See Box 2). Moreover, certain areas of the banking sector are still consistent regarding problems. High interest spreads, money market volatility, balance sheet problems of SCBs, central bank's limited autonomy, political interference in allocation of credit and overall governance problems are some of the key drawbacks to the country's banking system.

Box 2

Institution of Banking and Financial Institution Division (BFID): Hijacking the success of banking reforms?

The Banking and Financial Institution Division (BFID) has been created under the Ministry of Finance to ensure financial sector development. This decision of creating a separate division was taken by the Cabinet in 2009 giving BFID the responsibility to deal local banks and other financial institutions, particularly the state-owned ones. The major functions of BFID include, formulation and updating of laws, rules, and policies relating to banking, insurance and the development of capital markets and future markets.

Experts however fear that the creation of BFID could open an avenue for greater government intervention in the financial sector, especially in the banking sector (Ahmed 2012b). The successive governments have already delegated autonomy to state banks, and more autonomy was given to the BB over the years in line with D&DP influenced reform with several committees formed by the government in the post 1980s favouring greater autonomy of the Central Bank. There is however genuine concern that interference in the banking sector could escalate through BFID. A majority of the interviewees felt that it could impede the banks' independence, including that of the Central Bank- one of the hard-earned successes of the three-decade long banking reforms.

SCBs are generally used as an important channel for automatic monetisation of fiscal deficits. Higher fiscal deficits are partly responsible for incumbent's politically motivated projects. While the government faces opposition from both the D&DPs and the local actors such as the opposition party, civil society, etc to augment fiscal deficits, greater autonomy to the banks has been a bar to automatic financing of deficits. Thanks to the BFID, the government now faces little resistance to borrow from the banking system. For instance, four SCBs have faced severe fund crises as a result of large loans to Bangladesh Petroleum Corporation (BPC), the country's lone fuel importer. The fuel import rise in recent years is to support controversial rental power plants. BPC's accumulated losses have also resulted in higher NPLs for SCBs, forcing the government to issue special recapitalisation bonds to allow write-down of some of these NPLs (IMF 2011). The government borrowed an unprecedented average of Tk 1.24 billion a day from the banking channel during the first 120 days of the 2011-12 year, totaling Tk 225 billion (New Age 2011).

During the current government's tenure, a growing stress on the country's financial system has taken place thereby subverting the BFID stated objectives. The entity did little to arrest the regulatory failure in several segments of the financial sector, including the stock market manipulation in 2010-11, sucking-up millions from small savers by the multi-level marketing companies and the misappropriation of over Tk 3,500 crore through fictitious loans by a little known private business outfit from a SCB. The interviewees of this research believe that in each of these instances the perpetrators have either given the opportunity to misappropriate funds or been kept above the law due to their political affiliations.

As discussed in the preceding sections, while the banking sector started to witness the benefits of reforms, the creation of BFID threatens to undo some of the hard earned gains of the over three decade long reforms in this sector. This has particular implications for the SCBs, which are still not fully compliant with risk based regulations, reflected in shortfalls of CRAR and the higher share of NPLs *vis-à-vis* PCBs and FCBs.

As the public banks are not within the de facto purview of the supervision of the BB, their weak compliance with prudential regulations is a serious risk to the stability of the banking system with experts recommending immediate and drastic correction. In addition to efforts to improve their performance, these banks should be brought under the central bank's regulatory supervision and must be required to comply with all prudential norms in a time-bound manner (Ahmed 2012b). IMF also stressed that there is a need for timely finalisation of the draft amendments to the Bank Companies Act, aiming at strengthening bank governance and oversight, thus allowing BB sole authority of prudential regulations (IMF 2011).

Case conclusion

Like most other sectors, accumulated problems in the banking sector led to a wide range of reforms. However, political will has been the key to proceed with reforms which, in turn, is a function of economic incentives. While the denationalisation process faced significant roadblocks, particularly from organised labours, entry of private sector players in almost all phases of reforms in the sector helped overhaul the sector. However, the first two phases of reforms did not bring any measurable outcomes, highlighting the fact that wholesale liberalisation without instituting an effective regulatory structure is not the answer to the cumulative problems of bank nationalisation.

Nevertheless, the sector turned around in the late 1990s and early 2000s when the D&DPs shifted their focus to risk-based regulations and supervisions. International best practices such as BASEL norms have also played a critical role in bringing order to the sector.

However, the experience of SCBs indicates that the success of reform could be reversed if politicians and their aligned business groups find room to channel the outcome entirely in their favour, overlooking the national interest. The sector remains critical for the incumbent government for automatic monetisation of fiscal deficit financing politically favoured risky lending.

The banking sector is arguably one of the most important avenues to create rent, an essential element of political settlements, politicians therefore unlikely to loosen their grip over it. Going forward, the challenge for the D&DPs along with steady focus on risk-based regulations and supervisions is to find a way to dismantle the state machineries directly controlling the finance.

The reform experience in the banking sector also offers a broad lesson for other segments of the financial system that without instituting an effective regulatory architecture, market based reforms could do more harm than good, the lesson thousands of investors learnt, albeit painfully, during the two episodes of stock market crashes (during 1996 and 2011).

4.4.2 Case study: Energy price adjustment in Bangladesh

The adjustment of energy prices is a contentious issue owing substantially to political economy considerations. The service provision of electricity and other utilities is institutionally embedded within the state, particularly in developing countries. This has led to extensive politicisation of such service provisions, also known as clientelism[18], leading to artificially depressed prices, over-employment, political manipulation of investment priorities, as well as a lack of managerial autonomy and technical competence (Foster *et al* 2006).

18 Narrowly defined, clientelism is a social order which depends on relations of patronage. Political clientelism describes the distribution of selective benefits to individuals or clearly defined groups in exchange for political support (Hopkin 2006).

Bangladesh's power sector has proven no exception. In fact, despite having experienced significant reforms since the mid-1990s, the sector is still marred with a plethora of economic and governance problems (Khan, F. 2010). More importantly, successive governments' have hesitated to undertake any major reforms in energy pricing, in fear of becoming unpopular with their electorate and losing their vote bank (Mahmud *et al* 2008).

However, faced with severe fiscal and macroeconomic constraints as well as pressure from D&DPs, the current government started to adjust oil and electricity prices since assuming power in 2009, with electricity tariffs being adjusted upward five times in the past three years.

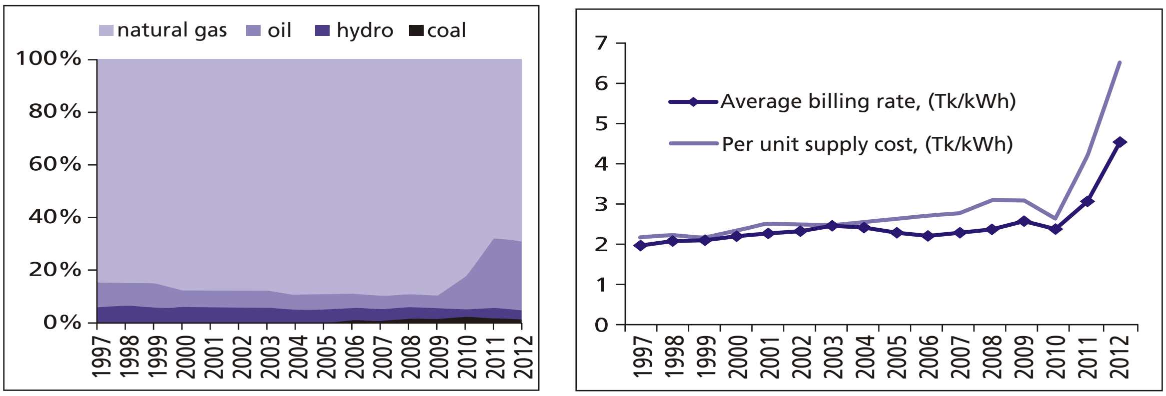
In fact, the government pledged to the D&DPs to introduce an automatic pricing formula, eventually a full pass-through of fuel prices in line with international markets and reduce fuel and electricity subsidies. These commitments were made to comply with the conditions tagged with the recent IMF's credit (IMF 2012). Moreover, the ADB's loan on infrastructure for power transmission was linked to the power tariff adjustment (Rahman 2012).

Figure 18 shows that the supply cost of electricity has increased sharply in recent years owing, primarily, to changes in fuel mix in electricity production. This has a direct link to the current government's ambitious plan to augment the supply of electricity[19] to bridge the marked gap between the sector's supply and demand. While the government's energy road map targets electricity production from various fuel sources, in recent years the sector's dependence on fuel oil increased sharply from 5% in 2008-09 to over 20% in 2011-12.

Increasing reliance on fuel oil has inflated the supply cost of electricity thereby forcing an upward adjustment of power tariffs. The average cost of electricity generation shot up to Tk. 6.42 per unit from Tk 2.63, after fuel oil-run plants began electricity generation from the end of 2010[20]. As a result, the oil import bill is expected to be around 5% of GDP in FY12- roughly doubling as a share of GDP over the past two years (IMF 2011).

Figure 18

Fuel mix of electricity production (left panel) and supply cost and tariff of electricity (right panel)



Source: Based on BPDB

19 Under the yearly power generation plan, the GoB has taken initiatives to produce 9426 MW of electricity between 2010-15 (MOF 2010).

20 While gas supply shortfall has forced some power plants to operate at a suboptimal capacity (only 68 percent of its capacity can be used), this primary fuel still constitutes nearly 70 percent of fuel source of electricity. Electricity tariff in Bangladesh would have been much higher than the current level had gas prices been not heavily subsidised- weighted average gas prices are set at less than half their economic value. The other sources, hydroelectric and coal power, comprise approximately 5% of total power generation.

This ad hoc price adjustment has caused severe distortions in the electricity market. While the government and the D&DPs are in favour of fuel price rationalisation, the other actors notably the consumer right groups, strongly oppose this ad hoc price adjustment.

Given the fiscally un-sustainable fuel mix at present, loom as to whether the government will be able to diversify its fuel sources of electricity by attracting large investment in gas production and developing indigenous coal resources or importing coal resources from overseas.

Against this backdrop, this section studies energy price adjustment by focusing on the trajectory of reform in the sector and understanding the interplay among various actors. Despite higher generation capacity, there remains considerable uncertainty as to whether the D&DP-influenced reforms would be able to supply cost-effective electricity. This is largely due to the inherent problems of the country's political and governance structures, which some scholars analysed in the framework of 'political settlements' (Khan 2010; Khan 2012) that ultimately bar implementation of long term investment projects.

Rationale of energy price adjustment

Energy pricing reform is imperative for various reasons. First, the sector traditionally absorbs large subsidies that do not directly benefit the poorest segments of the country. With extreme poor households' share in total electricity consumption at less than 0.1%, energy subsidy is highly regressive in Bangladesh (International Institute for Sustainable Development [IISD] 2012).

Secondly, long term investment including FDI in the sector largely depends on rationalisation of pricing, as allocation of capital requires a balanced return and risk. The present price of gas for instance does not provide sufficient cash flow to support further gas exploration.

Thirdly, the energy price adjustment process should also be analysed from an efficiency perspectives with low or subsidised electricity pricing and other utility services discouraging consumers' to use them efficiently.

Finally, power sector is one of the areas where the external influence has not solved the fundamental problem of the sector- rational pricing of electricity due to the nature of political settlement in Bangladesh. So it is imperative to study the sector by examining the interplay of various actors involved in energy sector reform.

Energy sector: reforms and outcome

At the heart of many energy sector shortcomings is the pricing of primary energy (gas, oil, coal) and final energy products (electricity) which, in turn, functions of a number of economic and governance variables. Hence, it is important to understand those issues comprehensively. Reform in the sector is one of the ways to assess what policies have and have not worked in the past, towards understanding the sustainability of current policies on energy pricing. This could also help in understanding the roles of various actors including the government, D&DPs, organised labour, private sector and consumer groups and their interplay in the process.

Energy sector reform generally follows a three pronged approach- public sector overhauling, gradual liberalisation with an expanded private sector role and regulatory reform. Before initiating reform, the vertically integrated government power utility Bangladesh Power Development Board (BPDB) was solely responsible for electricity generation, transmission and distribution throughout the country.

It was only in the mid 1990s that the sector witnessed a major policy shift, when the government in consultation with a large number of D&DPs including ADB, WB, DFID, JICA, Kreditanstalt für Wiederaufbau of Germany, and USAID, launched a reform project on Power Sector Reforms in Bangladesh (PSRB) (ADB 2005).

The PSRB contained four key objectives: (i) the separation of sector regulation and operation; (ii) the autonomy and commercial orientation of the sector entities; (iii) unbundling generation, transmission, and distribution; and (iv) increased private sector participation.

Reform in the power sector has increased private participation particularly in power generation. The sector's commercial performance improved significantly in reducing power distribution losses and in the operational performance of transmission system. The regulatory body Bangladesh Energy Regulatory Commission has also been formed whereby private and public sectors now have equal share in power generation.

The ruling party has shown interest in reforming electricity generation and transmission which gives them opportunities to align their political and economic interests. During the past BNP government's tenure (2001-06), considerable focus was placed on increasing transmission capacity and it was widely reported that served their interests given their business allies' involvement in the sector. However, their priority to increase electricity transmission above generation capacity proved to be a wrong move in light of the chronic load shedding that prevailed.

Increasing electricity generation capacity has been a major focus for the current government. When the AL government assumed power in January 2009, the effective capacity of power generation stood at approximately 3500 MW. The government has added approximately 4000 MW new capacity in various forms, including liquid fuel based, gas based or dual fuel plants.

BPDB's generation report shows that as of June 2012, the total generation capacity was 7500 MW while actual generation was between 4400-5000 MW[21]. A small number of business players with close relationships to the government have been awarded most of the power generation projects[22] (Khan 2012d).

Despite this apparent success, the key informant interview and leading power sector experts feel that the main objective of the power sector reforms agenda remains unfulfilled (Khan, F. 2010). Even if some of the power generation constraints and transmission are addressed, expensive power seems to be the only solution (Tamim 2012). To find an answer to the unfulfilled objectives of such reforms, it is essential to examine the political economy of power mix.

21 Bangladesh Power Development Board Website provides real time as well as time series data about power generation. Available at http://www.bpdb.gov.bd/bpdb/index.php?option=com_content&view=article&id=151&Itemid=118

22 Also see Power Generation Project up to 2015, available at http://www.bpdb.gov.bd/download/New_Generation_Planning.pdf, accessed on 20 July 2012.

Political economy of fuel mix: actors and interplay

As discussed in the preceding section, the major objective of power sector reform remain unfulfilled due to the lack of rationalisation of energy prices which, in turn, is a function of appropriate fuel mix. Experts argued that power sector reform programmes in Bangladesh and the region missed the point that electricity is a secondary energy, with countries ignoring the need to ensure the supply of primary fuel in electricity generation (Khan 2012). Generation of electricity is generally adopted based on the principle of the least-cost expansion plan, which involves choice related to appropriate fuel mix and technology.

However, it is not only the government who determines fuel mix. The D&DPs, politicians, consumer groups and civil society organisations are some of the key actors in deciding the fuel mix for electricity generation.

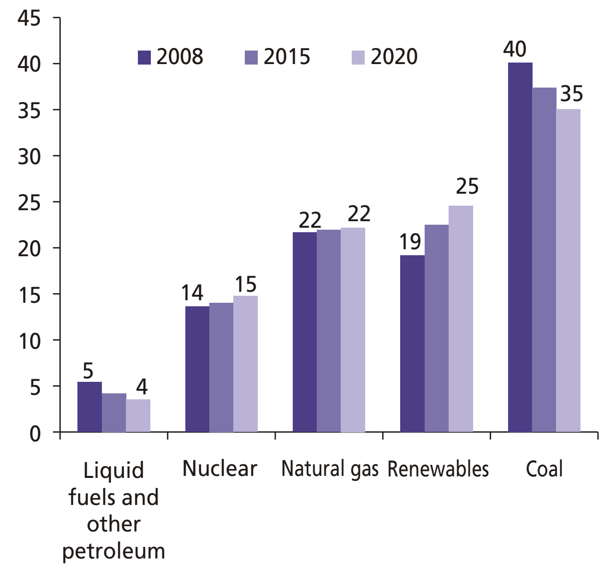
According to the Power System Master Plan (BPDB 2010), the forecasted demand for electricity is 19,000 MW in 2021 and 34,000 MW in 2030. The plan suggested a fuel mix comprising 30% domestic coal, 20% imported coal, 25% natural gas including LNG, 5% liquid fuel and 20% nuclear, renewable energy and power import (also see Table 14). It is not unusual that preference is heavily skewed towards coal at 50% since coal globally produces approximately 40% of electricity, followed by natural gas (22%), renewables (19%), nuclear (14%) and liquid fuels and other petroleum (5%) (See figure 19). Coal is the main source of primary energy in both China and India. Even one-third of the United States' electricity is generated by coal.

Table 14
Phase-wise generation expansion plan

- Immediate: 6 -12 Months
  - Rental and Quick Rental Plants (liquid fuel)
- Short term: 18 - 24 Months
  - Peaking Plants (liquid fuel)
- Medium term: 3 - 5 years
  - Combined Cycle Plants (Gas or dual fuel)
  - Peaking Plant (Gas or dual fuel)
  - Coal fired steam plants
- Long term: beyond 5 years
  - Liquefied Natural Gas based Combined Cycle Plants
  - Domestic/Imported Coal Power Plant
  - Gas/Oil based Peaking Plant
  - Nuclear Power Plant
  - Renewable Energy

Source: Power System Master Plan, Bangladesh Power Development Board

Figure 19
Global power mix (in %)



Source: Based on World Energy Mix Interactive, National Geographic Website

23 See International Energy Agency (IEA) website, available at http://www.iea.org/stats/index.asp

The stock of primary energy indicates that Bangladesh has comparative advantage in producing electricity from coal and gas. The country has an estimated 16.6 trillion cubic feet (Tcf) of recoverable gas reserves left in its 23 gas fields as of January 2012[24].

However, apart from electricity generation, gas is being used in households and in producing fertiliser and other industrial outputs. The total coal reserves in the five coal fields of Bangladesh are estimated to be 2.9 billion metric tons and with a conservative recovery rate of 30 percent, the available reserve could translate to about the energy equivalent of 20 tcf of natural gas[25].

While natural gas remains the dominant source of primary energy, the price of this form of hydrocarbon is being kept under-priced by successive governments, primarily, not to upset the middle class vote banks (IGS 2009). In the absence of price signal in the market the sector faces considerable constraints to meet the growing demand not only in electricity generation, households and industrial activities are also constraints by the unreliable supply of gas.

Currently about 600 MW power cannot be generated due to gas supply shortage (Tamim 2011). While BAPEX has shown significant success in exploring natural gas, the lack of finance, technology and political will bar the entity from expanding its capacity. While D&DPs and the government favour greater involvement of international oil companies in natural gas exploration, such actions often face strong opposition from civil society organisations.

Bangladesh's transition to a diversified fuel mix, particularly coal-based electricity production, faces considerable hurdles from all the actors bar consumer groups. A large number of interviewees felt that due to environmental concerns the D&DPs, left-wing political parties and civil society organisations are not in favour of producing electricity from coal with existing technology[26].

However like the gas sector, the elected governments do not have much incentives or capacity under the competitive clientelist political settlement to develop long-term infrastructure projects (Khan 2012).This lack of political and social consensus, governance issues and D&DPs reluctance bar the country's electricity generation with the least cost fuel input of coal.

As a result, the sector has had little success in developing coal and gas-based base load power plants over the past three and a half years. The government cancelled submitted bids for five coal-fired power plants in July 2012, which were estimated to generate approximately 2,500 MW of electricity, a major setback to offering low-cost electricity from base-load power plants. The politicians, the government agencies and private sector players have given more focus to rental power plants which rely on oil as a primary fuel and can be materialised within 6 months to a year.

Consequently, the government licensed nearly three dozen high-cost oil-fired power plants to enhance electricity generation in the last three years. However, given the higher fuel costs in the international markets, these power plants run at 47% capacity on an average (New Age 2012).

24 A report indicates that Bangladesh has 16.59 Tcf of gas left in 23 fields. According to the Hydrocarbon Unit the country's estimated gas reserve was 28.20 Tcf in November 2011 (Financial Express 2012b).

25 Unpublished Document of Dhaka Electric Supply Company Ltd. (DESCO), available at www.fkk.weebly.com/uploads11/2/5/7/1257637/desco.docx

26 Our interview with D&DPs also confirms that they don't support coal fired electricity plants for environmental concerns.

Given the government's inability to diversify fuel mix in line with its Power System Master Plan, consumers are experiencing relatively better electricity services yet with much higher tariffs (The Daily Star 2012c). On the contrary, the least-cost generation expansion plan with appropriate choice of fuel mix could have given the consumers' affordable electricity (Table 15).

According to Tamim (2012b), along with efficiency improvement, using mainly indigenous primary fuel (50% coal, 30% gas, 8% renewable including hydro) and imported liquid fuel (12%), the average electricity production cost can be maintained at Tk.4/kWh. However, the provision of least-cost electricity in the context of Bangladesh is not only a function of economics, but also of the sector's governance structure (see Box 3).

Table 15

Comparison of tariff for different types of coal and gas

Primary Fuel	Price (USD/ MT or USD/ MCF)	Tariff (USD/ kWh)	Tariff (BDT/ kWh)	Tariff (USD/ kWh)
Domestic Coal	116	0.05	4.12	0.05
Indian Coal	70	0.04	3.09	0.04
Indonesian Coal	170	0.07	6.04	0.07
Domestic Coal (> 600 MW)	116	0.04	3.14	0.04
Indian Coal (> 600 MW)	70	0.03	2.35	0.03
Indonesian Coal (> 600 MW)	170	0.06	4.60	0.06
Natural Gas (Local Price)	1	0.01	0.93	0.01
Natural Gas (International Price)	7	0.08	6.70	0.08
Natural Gas (Local Price) (CC)	1	0.01	0.53	0.01
Natural Gas (International Price) (CC)	7	0.05	3.83	0.05

Source: fkk.weebly.com/uploads/1/2/5/7/1257637/desco.docx

Box 3

Expensive solution to electricity problem and governance structure of the power sector

Our analysis shows that while it is possible to provide cost-effective electricity, the power sector's governance structure is a major barrier.

The interviewees of this research projects highlighted a plethora of governance issues concerning the sector: longer maturity time of projects (often taking longer than scheduled time); large public sector procurement; lengthy procurement processes; weak contract enforcement; higher technical system loss; weak network system; collusion and corruption; extremely poor internal governance; higher levels of investment risk; policy uncertainty with change in government; bureaucrats' risk-averse approach fearing future charges of corruption. In addition, the quick rental power plants are not only economically inefficient, but also breeds problems like corruption.

The market based reforms have been less than effective in addressing such governance issues. Yet more importantly, there is perhaps an inherent limitation of market based reforms in addressing them. This is not to say that reforms are unnecessary, but that they are probably incompatible in the context of Bangladesh (and other developing countries for that matter). The reasons are extensively analysed in Khan (2010, 2012).

The base load power plants/ IPP investments, for instance, are key to supplying cost-effective electricity. However, they are difficult to materialise owing to governance problems. The D&DPs with capacity to finance infrastructure and power projects, insist on transparent procurement guidelines and bidding procedures in the power sector. However, the sector is controlled by a small number of bidders based on personal relationships with political insiders (Khan 2012). Thus, while leveraging political connections some companies could secure power projects, they face difficulties in financing them (Bibiyana 1, Bibiyana 2 and Meghnaghat 2, for instance) as with an underdeveloped capital market, the financing for large infrastructure and power projects generally come from the international agencies.

Our discussion with a number of D&DPs also confirms the view that owing to governance problems, they are unable to utilise available funds for power projects. Moreover, in the competitive clientelism, those projects do not get commitments from politicians as their regimes are too short to materialise those projects (Khan 2012).

It is therefore not surprising that even after three and half years of the current government, the power sector has been unable to make any significant headway in materialising IPPs/base load power plants, resulting in high-cost electricity with rapid growth in rental power plants. The government's guarantee to protect the BPDB's solvency (single buyer of electricity and supplier of fuel) prompted short-term projects with greater private participation. However, in the case of IPPs investors are not convinced that either the government or its agencies (bureaucracy) are capable of protecting their long-term investment leading to higher risk-premium for long-term infrastructure projects.

Case conclusion

There is a consensus between the D&DPs and the government to rationalise energy price, adjusting electricity tariffs upward. However, the current approach does not offer a cost-effective solution as far as electricity services are concerned. Reform in various aspects of the power sector, notably transmission and generation of electricity, has fulfilled some reform objectives, yet this has been achieved by accommodating political interests. The sector faces significant governance challenges which are the key barriers to generating electricity with an appropriate fuel mix, an important determinant of affordable electricity.

To offer electricity at a competitive price in the medium to long term, there is a need for large-scale investment both in gas and coal sectors, two critical primary fuels where Bangladesh's sizable reserves enable comparative advantage. However, the current governance structure which is a function of the country's political settings, has proven a challenge to attracting the requisite investments and therefore establishing base load power plants.

Market based reforms have been of little help in this regard, as Khan (2012b) observed "that the problem in the power sector is that long-term contracts and calculations are difficult when the political settlement has features of competitive clientelism with short time horizons of the ruling coalition and with low and declining governance capabilities of the bureaucratic organisations who regulates the investment in these sectors."

Thus, while in the last three and a half years, the government, its agency bureaucracy and their close business allies have increased electricity generation capacity markedly, this increased capacity could not be exploited fully due to lack of coal and natural gas supply. Although the oil based rental power plants should have been phased out by this time to allow other primary fuels notably coal to augment its share, these plants are likely to maintain their share in the next few years, increasing supply cost of electricity and undermining the fundamental objective of the power sector reform.

4.5 Conclusion and the way forward

The analysis indicates that key reforms in the Bangladesh economy were introduced in periods of severe economic constraints. Cross-country experience also suggests that significant changes generally emerge from crisis, yet, there must also be a political response to crisis (Cabral *et al* 2006). This research indicates a similar pattern that any reform that presents the potentiality of political gains, either through rent or increasing vote banks - will find support from the politicians. However, political incentive alone has proven inadequate unless there is a firm commitment from politicians and the commensurate capacity of bureaucrats.

The influential actors involved in the process of economic reform are namely: D&DPs, politicians, private sector, bureaucrats and organised labour. D&DPs have been the key players in promoting as well as influencing the reform agenda in Bangladesh. Politicians' support for reforms on the other hand has varied widely, wherein some cases they facilitated reforms and in others, they did not make firm commitments. The business interest groups comprised largely of the private sector and businessmen-turned politicians, often influenced reform to secure their vested interests.

Whenever decentralisation becomes the proposition of any reform, bureaucrats had a tendency to resist it, as this might have affected their activities and in turn result in relinquishing control over the sector. Organised labour opposed reforms, often liaising with political parties. However, over the years their influence has declined to a large extent because the politicians who control them, have been given substantial incentives to facilitate reform.

Politicians showed commitments towards key reforms of private participation, privatisation, economic openness, macroeconomic stability, agriculture reform and public resource mobilisation, inter alia. The state played a significant role in mobilising internal resources, by cutting subsidies and mobilizing tax and other revenue, however tax evasion and public spending leakages remain rampant.

The government hesitated to reform in certain areas which are politically costly such as energy price adjustment. Their lack of commitments towards reform measures such as modifying the fuel mix in favour of coal and developing other large infrastructure has emerged as a key challenge for sustaining growth. This is largely due to the short time horizon of any ruling political party, declining governance capabilities of the bureaucratic organisations and the market-based reform's limitations in improving governance capabilities. The case study on the energy price adjustment significantly highlights these facts.

With regard to D&DPs' policy advocacy, denationalisation and privatisation policies have worked in some sectors but simultaneously have not produced measurable change in others. The banking sector case study indicates that privatisation including private participation, may not be a solution to the problems accumulated through nationalisation, unless emphasis is placed on regulation and supervision. The adoption of international best practices played an important role in improving regulatory quality in the banking sector.

The study also suggests that the reform's continuation of success is uncertain if the nexus between politicians and businessmen find ways to channel reform gains to serve their vested interests. As observed by Mahmud (2001), if there is a demand in the political system for illegal incomes and rent-seeking, economic reforms alone will not be the remedy.

As far as reforms' impact on good governance is concerned, the study identifies a number of facts. First, in line with the burgeoning body of research (World Bank 2010, Khan 2010, World Bank 2007b), it suggests that the D&DP guided reforms have had little impact in improving overall governance structure of the economy. Nevertheless, their sectoral impacts are mixed. The case study on the banking sector reform clearly suggests that liberalisation does not automatically improve governance quality. However, governance quality in private banks has improved, particularly in the post-2000, thanks to the adaptation of the global best practices as well as grating more autonomy to the Bangladesh Bank to regulate the sector.

Second, the case study on energy price adjustment is a revelation of more complex issues concerning growth and governance. Some of the reform objectives concerning governance have fulfilled- system loss in the power sector has declined and a regulatory body has instituted. Nevertheless, market-based reform in energy and utility sectors have been unsuccessful in improving overall governance quality, thereby precluding the long-term investment in the sector critical for cost-effective electricity production.

The reason being, as also identified by Khan (2012) that the D&DP guided market-based reforms and their governance expectations do not serve the vested interests of political elites. This has generated tensions between politicians and the D&DPs, depriving the power sector of urgently needed financing and other large infrastructure projects, the Padma Bridge most notably, which could be another interesting case study in this discourse. The absence of a mature financial system as well as the country's saving-investment gap, compels Bangladesh to depend on D&DPs for a vast array of infrastructure and power projects that otherwise might not be possible.

That said, there are limitations to economic reforms. Rodrik *et al* (2002), Alcala & Ciccone (2004) and Kaufmann *et al* (2007) indicate the importance of institutional features such as corruption, rule of law and general governance issues such as political accountability, quality of bureaucracy etc. in determining whether the outcomes of reform would be beneficial. In retrospect, the reform advocacy of the 1990s which urged developing countries with weak institutions to undertake economic reforms with the implicit assurance that political progress and good governance would follow as a consequence, has proven to erroneous (Nachane and Islam 2009).

Going forward, economic reform is a lengthy and continuous process and while Bangladesh has made significant strides, more still needs to be done. The country's future challenge to growth could arise from its governance challenges, as it is already being witnessed in power and infrastructure sectors.

At low level of development, governance has apparently not been a major constraint to growth, as comprehensively argued by a number of scholars. Moreover, sectors such as agriculture and informal sector activities were not affected by governance constraints (Mahmud *et al* 2008). However, for the next phase of growth, reforms in the financial sector notably equity and debt, and capital market liberalisation, energy sector particularly coal and gas based base load plants, the infrastructure sector and other modern urban sectors will be critical.

D&DPs role could be even more important as they remain the preferred source of financing for large projects. However, the WB, ADB and other development partners' greater emphasis on governance performance as the major determinant of fund allocation poses an enormous challenge in this regard.

What are the solutions to the growing mismatch between D&DPs reform agenda and their governance expectations? Our interview with experts suggest that there is a need for compromise by both government and D&DP stakeholders to find a workable solution. Since D&DPs have acknowledged that their governance reform expectations were overambitious, they should revisit their rigid criteria in fund allocation by placing higher weight on sectoal performance than governance criteria. Given the market-based reforms limitations in addressing governance problems in sectors such as energy, utility and infrastructure, owing to political constraints, D&DPs should study the 'political settlement' within Bangladesh arising from competitive clientelism of the post-1990s, when they recommend governance reforms in these sectors.

Moreover, given the limitation of market enhancing governance capabilities (to make markets more efficient by reducing market transaction costs) in Bangladesh, this is also the right moment to contemplate the need for alternative thinking on governance, such as growth-enhancing governance capabilities (Khan 2008, Khan 2009)[27]. However, further research is needed in this regard.

27 According to Khan (2009), growth-enhancing governance capabilities are capabilities that allow developing countries to cope with the property right instability of early development, manage technological catching up, and maintain political stability in a context of endemic and structural reliance on patron-client politics. Khan (2012) has gone as far to question the applicability of the market-enhancing governance agenda where developing countries such as Bangladesh are concerned.