# GAMES BANKERS PLAY IN DEVELOPMENT ADMINISTRATION : BANGLADESH EXPERIENCE

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Dedicated to

*NASREEN KHORASANI*

who is the centrepiece of my thought

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## ACRONYMS

| | |
|---|---|
| ADP | Annual Development Programme |
| BB | Bangladesh Bank |
| BBS | Bangladesh Bureau of Statistics |
| BCA | Bank Companies Act |
| BCCI | Bank of Credit and Commerce International |
| BOI | Board of Investment |
| DFI | Development Finance Institution |
| FSAC | Financial Sector Adjustment Credit |
| FSRP | Financial Sector Reforms Program |
| FY | Fiscal Year (July 1 - June 30) |
| GDP | Gross Domestic Product |
| GNP | Gross National Product |
| GOB | Government of Bangladesh |
| LDC | Least Development Countries |
| NCB | Nationalized Commercial Bank |
| PDB | Private Domestic Bank |
| RFP | Rural Finance Project |
| Tk. | Taka (Bangladesh Currency) |
| UNDP | United Nations Development Programme |
| USAID | United States Agency for International Development |

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# CHAPTER - I

## INTRODUCTION

## 1.1 OBJECTIVES OF THE STUDY

Banking is an age-old institution and bankers play an important role in the development of a country. Savings and investment are the prerequisites of development and main functions of commercial banks are to increase savings and to invest money in developmental activities. Development of banking sector and economic growth is correlated. In fact, bankers perform their duties according to the Government policies and decisions and these are changing frequently. Behaviour of the bankers are also influenced by other pressure groups within and outside Bangladesh.

This paper will seek to find out the impact of Government policies and decisions on the role of the bankers and its impact on economic development of the country. The purpose of the present study is also to examine and analyse how banking sector plays its role in investment to activate the prevailing stagnant position of Bangladesh economy; what politico-economic and other factors are influencing the banker's role and hampering this process of development. Accordingly the title of this dissertation is "GAMES BANKERS PLAY IN DEVELOPMENT ADMINISTRATION : BANGLADESH EXPERIENCE".

## I.II HYPOTHESES

The researcher has attempted to develop the study around the following assumptions :

(a) After liberation of Bangladesh, the political ideology was toward the nationalization and at present it shifted to denationalization and privatization. This change in the political ideology has influenced the banker's role.

(b) Economic reforms to handle the present investment crisis has implications for banking sector.

(c) Banking sector is organized and operated under different laws. These laws have, therefore, made banking system much more cautious in their dealings with the public as well as with other public or private organizations.

(d) Banker's role is influenced by pressure groups within and outside Bangladesh.

(e) Rapid technological change in the modern world has considerable impact on banking sector and its performance.

(f) Banker's role in investment for the development of Bangladesh economy need to be formed within the framework of autonomy and accountability of the banking sector under specific laws.

## I.III METHODOLOGY

Necessary materials have been collected by consulting different journals and books to reach the conclusion. The literature survey was conducted mainly in the library of University of Dhaka and in the library of Bangladesh Bank. Interview technique was also followed for this research purpose. Data and information used for the study therefore, are been generated mainly from the secondary sources.

## I.IV SCOPE OF THE STUDY

This study covers a vital and important area of Bangladesh economy. The researcher thinks that politico-economic analysis of banker's role in investment may be a useful contribution in understanding the real problems and issues involved with the present stagnant position of our economy. The study is essentially operational in that it seeks to contribute to the acquisition of knowledge which will be useful for designing banking and investment policy. Nonetheless, they may be useful for further study and future empirical research. Although the present study is primarily confined in Bangladesh context, it may provide useful insights and guidance for scholars to compare the role of banking sector in investment with other developed countries and a model can be developed which may be applied in the developing countries facing similiar problems.

In study depended basically on reviews of literature including published books, articles and documents and a large number of unpublished scripts. This study does not cover the whole banking sector. It embraces only the commercial banks.

This dissertation is a part for the Degree of Master of Philosophy. For this, dissertation on "GAMES BANKERS PLAY IN DEVELOPMENT ADMINISTRATION : BANGLADESH EXPERIENCE" has to be completed within a specified time frame.

## I.V OUTLINE OF THE STUDY

The *first* chapter presents the objectives of the study and justifies the title of this dissertation ; describes the hypotheses and methodology ; scope and outline of the study.

The *second* chapter describes a glimpse about banking sector and development of Bangladesh which includes theoretical framework for the analysis of the assumptions for the study and economic situation of Bangladesh.

The *third* chapter deals with the historical background of the banking sector during British-Indian era (1757-1947), Pakistan era (1947-1971) and Bangladesh era (1971-June 1996).

The *forth* chapter explores the forces of change in banking policy and its impact on banker's behaviour as well as on economic growth of Bangladesh which includes Government policy on nationalization, denationalization and privatization of commercial banks ; its decsion regarding financial sector reforms program and banking laws.

The *fifth* chapter analyses the thoughts regarding financial system development efforts by the Government and its relationship with economic growth of the country ; fragile banking sector and trends in investment and savings.

The *sixth* and the last chapter includes the concluding remarks about the significant role played by the bankers in the development of Bangladesh through analyzing the hypotheses of this study.

# CHAPTER - II

## BANKING SECTOR AND DEVELOPMENT OF BANGLADESH : A GLIMPSE

**DEVELOPMENT**, in broad sense, is a social process in which individuals participate as member of different institutions. This means that institutions have determining impacts upon human willingness and ability to participate in the development process. Development is a process of change from existing status to a better one[1]. Among the myriad of institutions forming a society, banks and financial institutions constitute the economic system of society and determine how resources are owned, allocated and distributed among the members of society.

Of all the institutions which make contributions to economic development, none does the job more significantly than the banking sector. It is because money and banking sector is the repository of money. Having accepted this, let us take a look at the groundwork for theories concerning the relationship between financial sector development and economic growth as laid by Gurley and Shaw (1960)[2].

Gurley and Shaw provided a three-stage analytical description of the process of financial development. In the first stage, money backed entirely by government debt is the only financial asset. In the second stage of financial development, direct claims-money backed by private debt appears. Finally, the third stage involves a proliferation of financial claims issued by financial and non-financial institutions. According to Gurley and Shaw, with no other financial asset other than money, such as exists in the first stage of financial development, the financial system restrains the efficient allocation of resources, thereby hindering economic growth. "Development of financial techniques creates alternatives to face-to-face loans that increase, for borrowers or lenders or both, the gains from trade in loanable funds" (1960)[3]. Such techniques discussed by Gurley and Shaw include information collection and dissemination and intermediation, both of which are argued to play a major role in increasing allocation efficiency and thereby economic output.

Ronald Mckinnon (1973)[4] and Edward Shaw (1973)[5] extended the Gurley-Shaw (1960) analysis to the problem of economic growth in underdeveloped and developing economies. Both authors offered similar theoretical analysis of the institutional restraints imposed on economic growth by the governing authorities of many developing countries, and supported the prescription of financial liberation as the proper policy for promoting economic growth. The essential element of the Mckinnon-Shaw model for financial development is the existence of institutionalized financial repression. Financial repression primarily takes the form of an administratively determined interest rate-ceiling on demand deposits.

Vicente Galbais (1977) introduced another defining characteristic of developing economies to the analysis put forth by Mckinnon-Shaw. Galbais argued that developing economies are fragmented economies where old and new technologies coexist, simultaneously using scarce resources with varying degrees of efficiency and yielding wide disparities in rates of return to investment between sectors[6]. As argued by Galbais, the lack of a sufficiently advanced intermediation mechanism, as a result of institutionalized interest-rate constraints, impedes the resources allocation mechanism, resulting in continued investment in the old, low-efficiency sector at the expense of the modern, high-efficiency sector. Gabais' two-sector model of capital intermediation provided insight into understanding the efficiency effects on output of an improvement in an economy's allocative mechanism. In underdeveloped economies characterized by the suppression of private financial markets and costly external borrowing, the commercial banking sector assumes the dominant role in the process of reallocating resources from the backward sector to the modern sector within an economy.

A primary assumption characteristic to both the Mckinnon-Shaw and Galbais models is the non-existence of capital markets and more specifically, the only available financial asset is commercial bank demand deposits. Therefore, the ability of an economy to increase its productive capacity is determined primarily by the rate of accumulation of demand deposits. The implication is that the existence of deposit interest rate ceilings restrict the accumulation of demand deposits, thereby reducing the volume of loanable funds available for productive investment. Following from these theoretical assertions the growth of the commercial banking system, reflected in the volume demand deposits, is a critical variable in influencing the productive capabilities of less developed countries and therefore an important instrument of economic growth.

Jung (1986) analyzed the relationship between real per capita GNP (or GDP depending upon availability) and two alternative proxy variables for financial development[7]. Jung found evidence supporting causation leading from financial development to economic growth. Other investigators, such as Jao (1976) and Wai (1980), also found positive relationship between economic growth and the development of the financial or monetary, sector in developing economies.

Theoretical assertions imply the importance of financial growth to economic development in developing economies. In economies characterized by the lack of a private securities market, the role of the commercial banking sector assumes the dominant role in the effective allocation of resources for productive purpose. Because of the relatively high reserve requirements on commercial bank demand deposits, strategies encouraging the redistribution of assets from the informal financial sector, with zero or low reserve ratios, to the commercial banking sector will reduce the total volume of production lending and, therefore have a dampening effect on economic output.

The banking system is the most effective tool in the hands of the state for keeping the various economic forces within control as well as for the overall economic development in a country. Under the given set of guidelines of the Central Bank, banking system throughout the contemporary world helps keep the money market stable, augments savings and investment, fights recessionary trends and inflation by manipulating their interest rates and their lending and investment policies. Banks raise capital from shareholders, obtain lines of credit from various other national and international sources and, most important of all, receive deposits from clients.

Commercial banking has assumed newer dimensions and has come a long way from the above original concept of banking. Most of today's commercial banks do not confine their activities to merely lending and savings. They go further. They consciously and deliberately take on investment and other socially beneficial activities. Commercial banks play a crucial role in facilitating trade and commerce, increasing national savings and investment, helping increase employment opportunities and alleviation of poverty. There have emerged quite a large number of specialised commercial banks which make deliberate endeavours for helping particular disadvantaged groups in the society. These are not much of a profitable proposition. Yet commercial banks do these as a matter of service to the people and the society. It is therefore, clear that banks today constitute a most organized social force, backed up by monetary capabilities, which can perform almost unlimited number of activities that go to directly benefit the masses. Bankers will undoubtedly have to adjust to these new situations.

Due to characteristics typical of less developed economies, the role of the commercial banking system has been emphasized as a critical factor in promoting economic growth. The effectiveness with which commercial banks perform the primary function of intermediation between savers and borrowers is a critical variable in the economic output equation.

Bangladesh being placed in the lower category of Least Developed Countries (LDCs) and beset with thousand and one basic problems still unresolved, the question of development is far more complex than in any other comparable situation. Before going to discuss her banking sector and investment, it would not be irrelevant to draw a sketch of Bangladesh and her economy.

The emergence of Bangladesh on 26 March, 1971 as an independent state exemplifies an unprecedented struggle for freedom marked by intrepid sacrifices, unflagging determination and love. Following a historical journey of epic-proportions, through untold miseries and sufferings, massive movements and protest, and finally vigorous armed struggle against Pakistani military the people achieved their victory on 16 December, 1971.

A low-lying country, Bangladesh encompasses an area of 55,977 square miles or 1,47,570 square kilometres with a population of 111.4 million according to the census of 1991. GDP per capita is US $224 (1994)[8]. The economy is predominantly agrarian. Though Bangladesh possesses one of the most fertile lands it has been marginally a food-deficit area owing to low per acre yield, paucity and mis-utilization of capital as well as lack of necessary inputs. Agriculture sector's contribution is nearly 35 per cent of GDP[9]. Industrialization has hitherto been small in scale and scope. Bangladesh is also known to have a tradition of cottage industries. Industrial sector's contribution to GDP is 11 per cent[10].

Once proverbially and justly apotheosized as 'Golden Bengal', Bangladesh often presents a tragic scenario characterised by poverty and death. With a view to improving the quality of life of people the Government of Bangladesh has embarked upon massive development programmes throughout the country with the participation of banking sector.

Bangladesh has moved a long way in the field of Banking. Banks and financial institutions are now perceived as partners in the development process. Prior to independence of Bangladesh, excepting for National Bank of Pakistan in which the Government had a minority interest, all other commercial banks were wholly owned and managed by the private sector. Even the State Bank of Pakistan and the Development Finance Institutions (DFIs) were jointly owned by the Government and public. Generally speaking, banking laws and practices prevalent at that time were modelled on the traditions of conservative British banking. By and large, banking institutions were free from public criticisms excepting for their role in creating 22 wealthiest families and making disproportionate allocation of financial resources for the development of the then West Pakistan at the cost and neglect of the then East Pakistan. This discriminatory policy subsequently gave birth to the political demand for nationalization of banking and financial institutions.

With independence, however, things changed very rapidly. Immediately after liberation of Bangladesh the control and management of all the schedule banks were taken over by the Government through The Bangladesh Banks (Nationalisation) Order, 1972[11]. Even since the nationalization of banks in the wake of liberation struggle, the

Government of Bangladesh has played a very active role in credit allocation through preferential lending to priority sectors at subsidized interest rates. This has resulted in inefficient resource allocation and wide-spread loan delinquency. Instead of serving as engines of development, the financial institutions in Bangladesh themselves have become sick.

In order to overcome some of the major lapses and shortcomings of the nationalized commercial banking and to provide better banking service, a decision of far reaching importance was taken by the Government in 1980 to allow private sector commercial banking to develop in the country side by side with the nationalized sector. The first phase private banks started emerging from early 1982.

Again the alarming backdrop of the bad debt situation in the nationalized commercial banks (NCBs) and the general malaise in the sector the Government appointed in 1986 a National Commission on Money, Banking and Credit which recommended a comprehensive reform of the financial sector. The World Bank supported the Government's financial reforms program with a Financial Sector[12] Adjustment Credit (FSAC), which is currently under implementation. The principal objectives of the FSAC are to: strengthen the financial sector institutions, re-establish stability and confidence in the sector, and create a competitive climate which ensures efficient saving mobilization and resource allocation[13].

Though, ever since the launching of the Reform Programme many measures have been taken up affecting monetary policies and development of financial sectors, time is not yet ripe to say anything conclusive about their success. However, some of the measures have begun to show positive results. If all these reforms take roots, the financial sector of Bangladesh will be established on a much sounder footing than what it is at present.

If there is a single ingredient to ensure the healthy development of the financial sector it is the functioning of an appropriate legal and regulatory framework, that is the establishment of an appropriate "macro-financial enabling environment". In this regard there is a need to revisit the existing Banking Order and the Bank Companies Act, 1991[14] and the existing Bangladesh Bank's (BB's) Prudential regulations. There is also an urgent need to address the issue of developing bankruptcy laws not only for the banks but for firms, since the latter are known to contribute to the problems of the financial sector.

A major shortcoming of the financial system of Bangladesh is the underdeveloped state of the capital market. There is, for instance, no trade in government securities, even inter-bank borrowings are limited, to domestic currency borrowing; and the maturity of whatever government securities are available are relatively short-term, the longest for 91 days. All this does not help the already acute shortage of term funds for investment.

The perception of modern economic development is becoming more and more complex. Even in advanced economies or newly emerging economies, not only the national governments but also the multilateral financial agencies and donor countries are becoming increasingly involved in the formulation of national economic policies. This scenario is universal although it is more evident in least developed countries like Bangladesh than in others.

Corruption, politicisation of the administration, large-scale extortion by influential persons together with a breakdown of law and order and the political differences among the politicians led to disturbances in Bangladesh economy. These had already brought a squeeze on activities in the banking sector and the whole financial system has slowed down.

It is true that the overall situation in banking system at present is not what is necessary for embarking on a high growth development strategy. The weakness of the banking system has arisen not only because of previous non-market based mandated interest rate policy but also irregularities in evaluation of viability of various projects, failure to pay and recover the loans by the borrower and banker respectively (default culture), grant of loan because of influence of various sorts, abuse of position by some directors, non-providing for bad loans etc. and banker's role is also influenced by the various factors as stated above.

Banking and financial system provides services that are essential in a modern economy and an efficient financial system is essential for long-term development. Bangladesh is now moving towards a full market system in which growth and development are to be assisted by an efficient banking policy and system which can ensure an adequate mobilisation and efficient allocation of financial resources. The banking system, therefore, may pretty well help advance the cause of various social movements in a country like Bangladesh.

In developed economies with strong banking habits of people, banking sector literally can and, in fact, do account for every unit money that goes to the transform economies. It is, therefore, quite appropriate when people say that the stronger the banking institutions and their traditions, the quicker is the pace of development. It is in this context that this research paper will seek to examine the economic development of the country through analyzing the trends in investment and savings. Because people save their money in the banks and the banks invest these in productive sectors. The bankers act according to Government policies and guidelines given by Bangladesh Bank. So these changing policies and guidelines influence the bankers to perform their role in economic development. Much attention has been focused on direct and indirect links between the commercial banking sector and economic growth as well as low the banker's behaviours are influenced by the changing situation which have positive or negative impact on development of Bangladesh.

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# CHAPTER - III

## HISTORICAL BACKGROUND

## III.I THE BRITISH INDIAN ERA (1793-1947)

Commercial banking and central bank existing at the apex of the banking system attracted legislative recognition only in the '30s of this century in this subcontinent. When the Companies Act of 1913 was enacted it contained no special provisions for banking companies as such[1]. There was no central bank in existence at that time either, the legislative enactments over a long period of time since 1935 which culminated in the Bank Companies Act, 1991 is made up of "shreds and patches", an expression aptly used to describe the developments[2]. It was only in 1935 that the Reserve Bank of India was established by the Reserve Bank of India Act, 1934. It preceded a Royal Commission on Indian Currency and Finance which recommended in 1926 that currency and credit of the country could be put on a firm foundation if a central bank was established but all attempts in implementing the recommendation were unsuccessful and ultimately, the Banking Enquiry Committee, 1931 made a forceful recommendation for the establishment of a central bank to meet the need urgency of the then banking and financial conditions with a view to mobilizing the banking and currency reserves and for making increased credit available for trade, industry and agriculture and to mitigate the fluctuating and high cost or obtaining credit. This led to the establishment of a central bank of India.

Attention was being devoted to regulatory legislation in the field of commercial banking and it was for the first time special provisions relating to banking companies were introduced by the Indian Companies (Amendment) Act, 1936 by inserting a few regulatory provisions (S.277F to S.277N) but did not contain any special provision with regard to the winding up of banking companies[3].

After the Second World War a number of undesirable banking practices had developed to such an extent that they were clearly detrimental to the interest of the depositors and called for regulatory legislative measures. The practice that had grown was that banks engaged themselves in gaining control of non-banking companies by interlocking of shares and thus the banking companies manipulated the monies of their depositors at their disposal. This was an unhealthy and undesirable practice and was surely to the great detriment of the interests of the depositors. A few laws were enacted with the object to ensure protection of depositors' interests in respect of their monies. Another law was enacted in 1946 before partition which intended to restrict indiscriminate opening of branches.

## III.II THE PAKISTAN ERA (1947-71)

With the creation of Pakistan in 1947, the inherited structure of banking sector remained more or less intact. The banking institutions including the State Bank of Pakistan were jointly owned both by the public and private sectors, accountability and transparency of their conduct of business were ensured by law.

The policies pursued by the then private sector banks were urban oriented, with the lone exceptions of the then National Bank of Pakistan, which had some operational bias for the rural economy.

The first 'wind of change' in commercial banking, however, came with the establishment of United Bank Limited, an aggressive and somewhat non-conformist commercial bank under the leadership of Mr.Agha Hossain Abedi, who later had shot into international fame for his stewardship of BCCI.

In 1948, a law was passed to check the evil of indiscriminate advances and loans which had been persisting. It was not until 1962 that a law entirely devoted to banking was enacted. This was the Bank Companies Ordinance, 1962[4].

## III.III THE BANGLADESH ERA (1971-JUNE, 1996)

Immediately after independence of Bangladesh in 1971, the country had a shattered infrastructure. The war of independence left marks of extensive damages in all sectors–mills, factories, industries stopped production, bridges, culverts blown off, market places looted or burnt bringing the commerce and trade to stand still. The banks were also not spared of the ravages of the war of independence–branches were looted or damaged, records destroyed. The head offices of most of the banks were located outside Bangladesh. A large number of senior Bankers and technical hands left Bangladesh.

In this back drop, the banks were regrouped, renamed and nationalized. The banks were thoroughly reorganized, correspondent relationship re-established with the International Banking World to promote international trade. In fact, Banks started afresh, responding well to the challenges of a newly born nation. It was indeed a difficult task, but the banking sector started its operation in full vigour within a very short span of time.

As a matter of policy, therefore, the role of the banking sector, in the reconstruction and rehabilitation of the economy ravaged by the war of liberation was felt to be of great importance. The normal banking in the traditional sense had to be continued. At the same time, in order to initiate and sustain a process of economic regeneration and growth, the banking system was required to mobilise funds and nurse entrepreneurs and enterprises in various sectors of the economy.

Simultaneously with the nationalization of the banking and financial sectors the Government, in pursuance of its policy of Socialism, nationalized all other major sectors of economy excepting agriculture, small and cottage industries, international trade and private property. Additionally, hundreds and thousands of properties of all kinds, businesses and industries belonging to Pakistanis located throughout the country had vested in the Government overnight by the operation of law. Here again, there were no preparation or physical facilities created prior to the enactment of The Bangladesh Banks (Nationalisation) Order, 1972[5] and The Bangladesh (Taking over of Control and Management of Industrial and Commercial Concerns), Order 1972[6] to take over the physical control of these assets. In a nutshell, the Government assumed immeasurable burden of responsibilities for which neither the logistics nor the management personnel nor even clear cut policy formulations were in place. On the financial sector, the Government did not have any money of its own to start with. The Bangladesh Bank which was created overnight as the Central Bank of the country did not have facilities or any clear vision as to how the challenges were to be overcome. The only sector which was, more or less, left in one piece was the commercial banking sector on which fell the total responsibility to keep the wheels of the Government moving with whatever financial resources it had. The question of rules, regulations, norms even legal considerations were subordinated or thrown overboard to the fulfilment immediate objective, which was to overcome crisis after crisis. This was how the banking sector came under the total dictates and control of the Government, a tradition excepting for little changes here and there, has remained intact even to day.

The collapse of the centrally planned economy of the Soviet block and the simultaneous rise of Japanese free market economy, have turned attention of policy planners to prescribe economic growth based on market forces with little or no interference of the Governments. The spectacular economic development of some of the South-East Asian countries have demonstrated how these are to be achieved. The present economic policy of Bangladesh draws heavily on the experience of market economy practised by these countries.

After the post nationalization phenomenon, the growth of private sector was encouraged to emerge as a trend-setter. To cater to this phenomenon the obvious necessity was to establish private financial institutions. This was an important development because the existing public sector commercial banking was found to be too much involved to provide banking facilities to the publicly owned enterprises. Therefore, a separate banking window was needed to be established to cater to the needs of the newly emerging private sector entrepreneurs.

With the opening of private sector banks in early 1980s the monopoly of nationalized sector in the field of banking came to an end. This signalled at least potentially a fundamental shift from a highly protected state banking oligopoly to a kind of competitive financial market.

Since inception until the early 1980s the financial system in Bangladesh was controlled and directed by the Government and Central Bank regulations. These covered the interest rates on deposits, lending rates on various types of credit, direction of credit to public sector enterprises and priority sectors, setting of credit ceilings, control on expansion of bank branches, control of the management and operations of bank and financial institutions etc.. These bureaucratic control of the financial institutions resulted in corrupt financial practices, emergence of default culture in the banking sector and mis-utilization of scarce resources and many other evils that have haunted our financial sector for years. It was only in June 1994, that major break-through was attempted to bring about changes in the financial sector policies when the "Commission on Money, Banking and Credit" was established. The Commission in its report set the policy for reform of the financial system and strategy for financial sector development which led to the establishment of the Rural Finance Project (RFP)[7]. From the experience of the Rural Finance Project, it was felt that total reform of financial system was a necessity for over all economic development of the country. Based on this feeling, the Government decided to take steps to restructure the financial sector and launched the Financial Sector Reforms Program (FSRP) with the following objectives[8] :

(a) Movement towards a more market oriented financial system with indirect monetary instruments used to achieve Government objectives and explicit financing of any subsidies made through the financial system.

(b) Improved supervision of the various elements of the financial system to protect the public and insure sound management of all financial institutions.

(c) To improve the financial performance of the Government owned banks and the financial discipline of the banking system.

To implement this program the Government has initiated a broad program of actions aimed at[9] :

(a) Legislation covering the scheduled banks, the central bank, loan recovery, and tax administration related to financial institutions,

(b) A new interest rate policy to increase the flexibility of the commercial banks in achieving viability,

(c) A new system of loan classification to insure banks cover the costs of potential loan losses,

(d) Transparency of subsidies for financing priority sectors,

(e) Maintenance of capital adequacy and assessment of the loan portfolios, and

(f) Recapitalization of nationalized commercial banks to achieve financial viability.

Other important banking policies measures include improving and strengthening supervision of bank, creation of Credit Information Bureau in Bangladesh Bank for identifying and monitoring defaults in various financial institutions, enacting new Bank Companies Act and establishment of *Artha Rin Adalat*[10].

Recent reforms have laid the groundwork, and the Banking Commission Report (issued June 1986) provides an important framework for more fundamental change. Bangladesh is now in a good position to begin to move in right direction.

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# CHAPTER - IV

## FORCES OF CHANGE IN BANKING POLICY: ITS EFFECT ON BANKER'S BEHAVIOUR AS WELL AS ON ECONOMIC GROWTH OF BANGLADESH

## IV.I NATIONALIZATION

The commercial banks were wholly owned and managed by the private sector during the Pakistan period. These private sector commercial banks played a vital role in creating 22 wealthiest families by exploiting the then East Pakistan (now Bangladesh) from her due share of financial resources for development. In this context, subsequently raised the political demand for nationalization of banking and financial institutions.

All the twelve banks functioning in Bangladesh on the date of liberation were nationalized and six banks were established under President's Order No. 26 of 1972--The Bangladesh Banks (Nationalisation) Order on the 26th March, 1972[1]. The newly incorporated banks are : Sonali Bank, Agrani Bank, Janata Bank, Rupali Bank, Pubali Bank and Uttara Bank.

This meant a total metamorphosis which came suddenly and without preparation. Although form the legal point of view, the change-over presented no serious difficulty but when it came to the question of transforming the banking activities conceptually and from practical points of view, form private sector to public sector orientation, then serious multi-dimensional problems become glaringly evident. First and foremost was the non availability of sufficient number resource personnel politically committed and trained in the public sector banking.

Next was the absence of models or guidelines spelling out precisely how the transformations were to take place or, for that matter, any clear-cut policy formulations enunciated by the Government in this regard. In the absence of specific guidelines, banking activities had to be carried on the basis of ad-hoc decisions of the Government either as a matter of expediency or to overcome crises as they came along.

Ironically, it became the responsibility of the people who had their entire training, orientation and expertise in private sector banking to switch over to public sector banking. They had neither the political commitment nor any perception as to how and to what extent their work was going to be fitted in the overall political objectives of the State. The banking sector thus started its initial journey from a political confusion. This contradiction, was largely responsible for somewhat unresponsiveness of this sector to the challenges which it was supposed to accomplished.

The concept of accountability and transparency which were mandatory for the banking sector to adhere to during the pre-independence period was sacrificed with nationalization. The fact that an important institution such as banking was immune to public accountability and transparency of its conduct of business made its isolation from people complete. This subsequently gave rise to a credibility gap between the banking sector and the people from which it has yet to recover.

For the above reasons, the Government's programme of nationalization had been a total economic disaster for the country. With total unpreparedness to handle such a massive programme covering nearly all important sectors of economy on the one hand and severe scarcity of financial needs were concerned, the Government had no other alternative but to depend entirely on the financial resources on the other, the programme not only got off to a bad start but the situation continued to get worse with every passing day. In so far the financial resources of the commercial banking sector which, in effect, meant depositors' money. The responsibility of the Government to provide much needed finance to the nationalized sectors was thus thrust upon the banking sector from which position, it has not been able to wriggle out even today. The involvement and commitment were so enormous that it needed pretty well the entire resources of the sector leaving very little for other sectors particularly the emerging private sector. This was the reason why the banking sector could not play its assigned role in the overall economic development.

Another interesting aspect of the relationship between the banking sector and the Government is that as owners, the Government is supposed to make regular cash infusions in the form of equity or short term loans to enable the sector to expand its business. Experience will, however, show that not only that no cash infusion was ever made but the Government has made to take away all the profits of the banking sector right down to the last Taka year after year, sometimes well before the profits were earned. Bangladesh Bank pays only Tk. 500 crores to the Government as dividend annually for an equity of over Tk. 5 crores. The equity of Nationalized Commercial Banks had remained static at Tk. 3 crores from 1972 to 1990[2]. "What is mine is mine, what is yours is also mine" is the basis which characterises the relationship between the Government and the nationalized banking sector.

Lately, the nationalized commercial banking sector has been very much in the news because of the following reasons :

(i) A big chunk of its loans and advances are now considered to be doubtful of recovery and adequate provision for them need to be made in the accounts. However, there is not enough revenue surplus with the banks to provide for this huge amount.

(ii) In addition to this, the banks now find that they do not have enough liquidity to maintain the prescribed equity-deposit ratio which has recently been made mandatory.

This is for the first time that nationalized commercial banking sector is subjected to some mandatory regulations, according to the prescription of World Bank.

The fact that nationalized banking sector did not fully provide for bad and doubtful loans was a gross breach of normal banking regulation and discipline. On top of this, not having enough revenue surplus to make provisions indicates the extent of financial indiscipline and lapses of this vital sector. These have serious legal ramifications.

On the question of non-performing assets of nationalized commercial banks, estimates very widely. On the basis of an inspection carried out by Bangladesh Bank, excluding the outstanding due from nationalized sectors of economy, these amounted to a staggering figure of about Tk. 1500 crores as on 31st December,1990 out of which Tk. 1238.24 crores had to be provided by the Government to make up the shortfall[3]. This is only a part of picture. The total picture would be as Tk. 10,000 crores if the doubtful debts of Jute, Textiles, Agriculture, Sugar, Power and DFIs were taken into account. The bottom line picture that emerges after 25years of nationalized banking may be summarised in one sentence. Without Government guarantees, these banks are, for all practical purposes, either bankrupt or very nearly bankrupt. On the other hand the economy has degenerated into a state of stagnation with little rays of optimism. This is the present state of affairs of our banking sector vis-a-vis economy.

From the above, it is evident that the bankers were not politically committed and trained in public sector banking at the time of sudden transformation of the banking activities from private sector to public sector orientation because of the absence of models or specific guidelines enunciated by the Government in this regard. For this, they had no perception as to how and to what extent their work was going to be fitted in the overall political objectives of the State. This resulted the failure of the development programmes. Because Government had no other alternative but to depend entirely on the financial resources of the commercial banking sector. This sudden change of Government policy had no positive effect on the banker's attitude and behaviour and for this reason why the nationalized banking sector could not play its assigned role in the overall economic development.

## IV.II DENATIONALIZATION AND PRIVATIZATION

Denationalization and privatization of the banks may be a recent fad. What Ibn Khaldun said six hundred years back is still valid about the Government ownership of banks in Bangladesh today : "Commercial activity on the part of the ruler is harmful to his subjects and ruinous to tax revenue, crowds out competitors, dictates prices for materials and products which could lead to the financial ruin of many business. When the ruler's attacks on property are extensive and general affecting all means of making a livelihood, the slackening of business activity too becomes general" (Ibn Khaldun, 1981)[4].

Even according to prescriptions of Keynes, Government ownership of banks in Bangladesh is not justified. As Keynes advised : "The important thing for Government is not to do things which individuals are doing already and to do them a little better or little worse, but to do those things which at present are not done at all" (World

Bank, 1991)[5]. In the banking sector, the Government is not only crowding out public investment but also contributing to unhealthy practices and unusually high losses (World Bank, 1987)[6]. However, the privatization of state--owned banks in Bangladesh is not an easy task.

Early in 1980s the Government denationalized Pubali Bank and Uttara Bank and later in the late 1980s it denationalized the Rupali Bank, but only partially, upto 34%. The three remaining NCBs in the Government hands are Sonali Bank, Agrani Bank and Janata Bank.

Wholly owned and managed new commercial banks under private sector first started emerging from early 1982 and there are seventeenth private banks owned by Bangladeshi now in operation including two which have been denationalized. Besides, there are ten branches of foreign banks.

Financial institutions, coming gradually away from regulatory to the increasing role of the market forces, demand that bankers have to equip themselves with up to date knowledge and expertise to face the new challenges which could not be even conceived before. For example, much emphasis is laid to-day to export led industries. In the last decade, this was reflected by the spectacular growth of export oriented Garments industry. The horizon of export led economy is expanding in other sectors as well. Back to back letters of credits, setting up Export Processing Zones, sanctioning of bonded warehouses and bonding of goods for reexport are new areas which the banking institutions must concentrate. This is an area which promises excellent growth potentials for the banking sector.

Added to it, the deregulatory policy now being pursued by the Government will demand for more innovative services at much faster pace than before. The banks under private sector was expected to have to assume the role of business counsellors for their clients.

But the combined operating result of these banks, after nearly fifteen years of their establishment, falls far short of the expectations for which they were sanctioned. The main reason why private sector banking failed to assume their expected role was principally due to the fact that they wanted to operate only in the areas which were safe and which ensured quick profits. Their involvement in the totality of the economic environment and needs of the country is still very negligible. Another criticism normally heard against the banks is that their clientele is limited to their directors, business associates, friends and well-wishers. As of August 1992, their combined deposits constitute only half of the nationalized sector.

Bankers under private sector conduct their activities in the safe areas and which ensure quick profits. their clientele is limited and they also play a very limited role in rural development. In order to meet the multifold needs of the present open market economy, the behaviour of private sector bankers fail to adjust this new situation either by negative feed back or by addressing the move well in advance. Due to their behaviour the private sector banks fail to win the confidence of the people and their contribution in the economic environment is very negligible.

The above indicates that though the bankers under public sector and private sector behave in different manner but the banker's behaviour under both sectors have a negative influence in economic development of the country.

## IV.III. FINANCIAL SECTOR REFORMS PROGRAM (FSRP)

In most developing countries financial sector reforms have been embarked upon in response to either acute financial distress and simply as an initiative to free the sector from its relatively underdeveloped state. Regarding the level of financial sector development in Bangladesh even today the financial depth of the sector is amongst the lowest in developing countries. The ratio of broad money to GDP, for instance, is 28% compared to an average of around 54% for other developing countries[7].

In order to remove the constraints faced by the Bank, a set of reform programmes has been put to operation. The major objectives of the reform programmes are to[8] :

(i) Change image, improve services, make cost effective by rationalizing banking charges, appear more customer-friendly, install more confidence in the branch Managers when it comes to lending money, adequately improve the capability in appraising the loan cases and their end use ;

(ii) Remove gradually the distortions in the interest rate structure with a view to improving the allocation of resources and income ;

(iii) Improve debt recovery process ; and,

(iv) Remove inadequacies of the existing legal framework involving default loan collections.

The strategy to achieve these objectives comprises three major elements. The first and most important element is to gradually dismantle the old system of restrictions which have put a significant yoke on the development of the sector, particularly in the banking industry. Accordingly, the reforms include the gradual liberalization of interest rates, elimination of directed credit to priority sectors, and rationalization of subsidized refinancing schemes. At the same time steps are envisaged to foster the longer term development of money and interbank markets, by developing initially primary monetary instruments like central bank paper. The heart of the reform program, however, includes measures to re-establish the integrity of the NCBs by strengthening their capital base, improving loan recovery, and installing improved management and accounting practices. The third area of reform is to improve the capacity of the Central Bank to regulate and supervise the banking system. In this regard the Financial Sector Adjustment Credit (FSAC) included provisions for establishing a major training program, a credit information unit and review of regulatory practices. A major technical assistance program with USAID assistance is underway in the foregoing areas.

In broad terms, there are four components to such a reform package :

(a) Providing an incentive system to the lending institutions;
(b) Institutional reforms to strengthen the lending institutions and the Central Bank;
(c) Making subsidies explicit; and,
(d) Changing the methods of monetary management.

**(a) Providing Incentives:** First, the lending institutions must be given an incentive to lend efficiently and to mobilize deposits. Currently, the book profitability of banks and the bonuses provided to staff are determined solely on the basis of accrued interest ; given that almost no systematic provisions are made for bad debts, this is equivalent to rewarding disbursement levels. A much tougher performance based policy is required. Similarly, the current interest rate structure encourages rediscounting loans rather than raising domestic resources. Greater flexibility in setting interest rates is required to allow sufficient spreads to encourage more aggressive deposit mobilization.

(b) Building Institutions: The following complementary actions are recommended. First, appropriate management information systems are required in the NCBs and the DFIs to allow effective provisions policies and to monitor branch performance. Second, responsibility for classifying loans should be transferred to the lending institutions ; Bangladesh Bank should audit and adjust classifications rather than initiate them. Third, NCBs must be recapitalized and given increased autonomy ; longer appoints of Managing Directors are also required. Fourth, the partial privatization of the NCBs envisaged by the Government should not be seen as a source of budgetary revenue but as a means of strengthening the financial base and efficiency of the banks. Fifth, the analytical, monitoring and supervision capacity of Bangladesh Bank needs to be built up ; this will require changes in recruitment and remuneration of staff and intensive training. Finally, longer-term programs to improve the quality and motivation of staff and the internal organization of banks and their branches; a start is being made for the DFIs under UNDP-funded project.

(c) Clarifying Subsidies : In some instances — where externalities or equity concerns warrant — interest subsidies are appropriate. However, the range of interest rates could be reduced by merging programs. Exclusive reliance on low interest rediscount facilities to finance subsidies not only tends to hide their magnitude, but also discourage deposit mobilization and makes priority programs subservient to monetary policy. Other forms of direct subsidies to the banks, preferably through the budget, could be considered and should be made transparent in the banks' accounting procedures.

(d) Controlling Monetary Aggregates: Associated with the transfer of autonomy and accountability for lending decisions to the banks must be a reduced dependence on statutory credit ceilings. While banks are required to maintain cash and liquidity ratios, the Central Bank has not generally used these for monetary control. Nor have the authorities employed open-market operations for this purpose ; an exception occurred in 1984, when a Treasury Bill issue was used to mop up excess liquidity while banks now hold T-bills (particularly to meet their liquidity requirements), these bills are "on tap" and can be resold at any time at per to the Central Bank ; there is therefore no need for a secondary market. Two alternatives might to considered by the authorities in this regard. First, a secondary market in T-bills could be encouraged. Alternatively, the Central Bank could begin to issue its own securities which could then be used for open market operations ; this second alternative has been used with success by a number of developing countries.

Economic indicators in the area of money and banking show somewhat encouraging resilience of the economy of Bangladesh. The excess liquidity problem of different commercial banks of Bangladesh is being gradually solved with the gradual increase in credit demand in both public and private sector. The excess liquidity of commercial banks of Bangladesh was about 8 per cent recently, but now it has been reduced to about 5 per cent of the total deposit in the banks.

When banks cannot find the right borrowers to lend loanable money, the excess liquidity problem arises and this affects the bank as well as the economy.

Revised interest rate policy on deposit and lending is one of the reasons for the increase in credit demand.

Under the programmes for financial sector reforms, a new system of interest rate determination was established with deposit and lending rates that better reflect market forces. The main objective of the new interest policy is to introduce flexibility into the deposit rates within the limit set by BB.

As mentioned reforms in financial sectors have led to a sizeable in the credit demand. But there is no reason for complacency as increase in credit demand does not necessarily mean economic resilience or positive economic growth. Marked increase in credit demand stands in stark contrast to the harsh realities of life in Bangladesh. How the bank loans are being used has much to do with the poverty alleviation of a country. Increase in credit demand should be matched by corresponding increase in national investment and growth of GDP.

In order to make that happen, productive use of bank loans must be ensured best by an institution empowered to monitor and control credit and investment. As poverty alleviation is the prime goal of Bangladesh's economic activities, this goal must be achieved through concrete and prudent measures taken by the Government and the private sector borrowers.

Just leaving interest rate determination to the market forces is not enough ; through reforms have to be carried out in the very structure of the institutions and their planning, co-ordination and implementation of their activities.

The macro-economic situation of Bangladesh came under severe strain in 1989-90. The rate of inflation was close to 2-digit level (9.3 per cent), the balance of payments current accounts deficit stood at 7 per cent of GDP and gross foreign exchange reserves declined to 520 million US dollars which was equivalent to only 1.7 months of import payments. For this reason, the Government of Bangladesh, as a part of its overall development programme, adopted a programme of policy and institutional reforms within the financial sector. The reform programmes include, among others, gradual elimination of the distortions in the interest rate structure with a view to improving allocation of resources, replacing direct credit controls within direct monetary policy instruments and adopting appropriate monetary tools to control inflation, establishing appropriate accounting policies including classification of loan portfolio, provisioning against loan losses and recapitalisation and strengthening the legal framework for debt recovery and updating regulations effecting banking business.

The Bangladesh Bank has an annual monetary programme with the elements of a safe limit of monetary expansion including public and private sector borrowing limit. The programme is based on the maximum attainable growth in real income and a tolerable rate of inflation. The bank monitors the credit and monetary expansion keeping in view the price situation and uses indirect monetary policy instruments to contain monetary and credit expansion within the programmed levels.

While controlling rate of inflation and maintaining adequate level of foreign exchange reserves remain the primary objective of Bangladesh Bank, the growth rate of the economy is also kept in mind at the time of formulation of monetary policy.

Under reform programme some bold steps were taken in the area of investment and banking system. However, they were not adequate to chart out a clear direction for the business and industrial community. Bureaucracy and corruption were slowing the programme.

Though some of the measures have begun to show positive results to establish financial discipline, time is not yet ripe to evaluate the reforms programmes of financial sector. However, it can be said after five years of the launching of the Reform Program that it failed to change the attitude and behaviour of the bankers till now. For this, the banker's behaviour remain the same as earlier and the investment environment has not improved. Employment position also deteriorated during last few years which indicate the negative economic growth.

## IV.IV BANKING LAW

It is pertinent to note that singling out banking companies as a special class and subject of legislation different, in many respects, from joint stock companies registered under the Companies Act 1913 was objected to on the ground of discrimination. However, these challenges were rightly met because there is a reasonable and justifiable basis for classifying banking companies separately for a special legislation as these were not comparable with other companies. The primary and principal object of all banking legislation upto the present day has been to ensure the safety of depositors' money and the protection of their interest. The banks deal with depositors' money who have no security whatso ever for their deposits with the bank except the solvency of the banking company. This solvency can be ensured only by fair and sound dealings in depositors' money. This is the crux of the entire banking legislation and its paramount object. This also distinguishes banking companies from any other joint stock company.

When the new Bank Companies Act, 1991 was enacted the Bank Companies Ordinance, 1962 was in force in Bangladesh and in Pakistan and the Indian Banking Regulation Act, 1949 in India. In Bangladesh, since 1972, banking has not attracted any noteworthy legislative attention although in Pakistan and India a number of stringent regulatory and reformist amendments were being constantly made throughout this period. If one has a close look at the legislation of 1991 the thing which comes out prominently is that the new law, which re-enacting most of the pre-existing law, has also incorporated the amendments and reforms made in Pakistani and Indian legislation by this time. So it cannot be said that our legislators did any original or new exercise, but incorporated into our law the exercises already made over the years in those two countries. However, may lacuna have this been removed and harsh and stringent measures have been enacted and the powers of inspection, supervision and control, some for the purpose of furtherance of the monetary and banking policy and some for the protection of the depositors' interests have been enacted in the new law. The extent of the power is brought into bold relief when one looks at the enabling, corrective and finally, compulsory powers exercised by the Bangladesh Bank and the Government to deal with the situation arising from the debacle of the Bank of Credit and Commerce International and ultimately, in the establishment of a bank under a scheme of reconstruction and amalgamation under Section 77 of the Act of 1991[9].

It is evident that there is no dearth or deficiency in the banking law as it is at present for promoting and sustaining a healthy banking, credit and monetary policy by the central bank or for fair and sound banking management and operation by the banks themselves.

For want of a better subject too take about, in almost all deliberations on banking, invariably the subject the change of law for the recovery of bank loans is picked up. Upto this day, the loan recovery laws have by successive amendments been made rigorous and harsh and very unilateral and one sided in their application. The laws as to recovery of loans by the DFIs have existed since 1972. They have all the powers under review, in fact three different modes, of recovering loans, one by the intervention of the court, another without such intervention by taking over the undertaking and selling it in a summary procedure of auction, and thirdly by forwarding the demand to the Certificate Officer. This demand under the law is as good as a court's decree and the Certificate Officer is only required to notify the borrower and put the property to auction if the borrower does not pay the demand. These are not alternative remedies and the Appellate Division has recently ruled that they can be applied in any combination whatever or all of them simultaneously and they are in fact being so applied. One can see the sweep of the remedy, and no legal jurisprudence would justify simultaneous application of these remedies. Having realised that such provisions may be legally and constitutionally objectionable the makers of the Constitution made these laws, along with other laws, immune from challenge as being inconsistent with any provision of the Constitution including fundamental rights. What other guided missile the law's armoury will have for enabling the DFIs to recover their loans.

As regards other banking and non-banking financial institutions, special commercial courts were set up and now a special *Artha Rin Adalat* has been established[10]. They do dispose of cases speedily and the judgement debtor, the borrower, if he wants to exercise his right of appeal to the High Court Division must deposit 50% of the decreetal dues. No discretion has been left in the courts to make any exception in circumstances where grave injustice will be caused to the judgement debtor or his right of Appeal is defeated for inability to deposit the amount.

Such courts manned by Subordinate Judges who by their training and experience have had no opportunity in the course of their judicial work of exposure to commercial works. Much of such proceeding has additionally an international and developmental dimension. Suggestions were made to the Government by Chambers of Commerce and, by the National Commission on Money, Banking and Credit, that the High Court Division of the Supreme Court should have an original jurisdiction to entertain suits in this field beyond a certain money valuation, i.e., the Commission suggested a suit exceeding Taka 1 million. The limit may be raised further because most of these cases involve monies amounting to many more million than one. The Supreme Court is independent. If it his this jurisdiction, judges may be recruited from the Bar with long standing and experience in commercial law. One or two benches may be constituted exclusively for such suits. The credit and confidence of the business community, international investors, of persons involved in international monetary and banking transactions, particularly in the field of trade and commerce, will maintained. An independent and effective judiciary plays as important a part in the developmental process as all other economic and financial components. This is a matter which is not easily understood.

In the existing legislation as to recovery there is a need for humanising it and imparting a little equity and justice. If change is needed, this is where it should be. After all, no law can be based on the assumption that banks and DFIs have without any exception acted justly, fairly and lawfully. Examples can be multiplied from the experience that many innocent borrowers are constantly being made victims of the unfavourable judicial and legal wind which is blowing everywhere, most of it being due to the mismanagement and financial anarchy and unjust enrichment had vitiated the atmosphere in this field. Referring to the innocent borrower, examples can be cited where the threat of recovery constantly had been made to hang over his head even when he found that the pledged goods lying in the bank's godown and in the bank's custody had disappeared over a period of time through pilferage and misappropriation, or when all his entreaties and requests to the bank to sell the pledged goods and adjust his liabilities with the proceeds of the sale failed because the bank, had insisted that the dues be paid first ultimately, of the goods were perislate persisted. If the offered were liable to determination for long average. Instances of the bank exercising a lien on the document called the Import Entitlement Passbook and at the same time refusing to grant further accommodation because of past defaults and not releasing this document even if the borrower has succeeded in making alternative arrangements to tide over existing financial crisis, has led to the ruination of many.

These are the realities which must be reckoned by all those who are concerned with the general question of recovery of the bank's loans. It is evident that there is no effect of the banking laws on the behaviour of the bankers. Thus, these banking laws are not contributing to the economic growth of the country.

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# CHAPTER-V

## ANALYSIS OF THOUGHT

It is clear from the previous discussions that Government has shifted its policy regarding banking sector from nationalized to denationalized and privatization. Government also started Financial Sector Reform Program (FSRP) and enacted new Banking laws. The objective of all these changes and activities is to develop the financial system. Because economic growth depends on the development of financial system. In this context, effects financial system development on economic growth is discussed below :

## V.I FINANCIAL SYSTEM DEVELOPMENT EFFORTS AND ECONOMIC GROWTH

Implicit in the development efforts of the Government is a model which exhibits the expected effects of development programmes on economic growth and poverty alleviation via their effects on a number of intermediate variables and proximate determinants of growth and equity. The ultimate aims of all development programmes are to rapidly raise the rate of economic growth and to distribute the fruits of increased economic growth among the population as evenly as possible. These objectives can be achieved through rapid increase in such proximate determinants as savings, investment and employment. However, the changes in proximate determinants require prior changes in a set of intermediate variables: structure of financial sector, outlook and attitude of the bankers and also of the people etc. The effects of development programmes proceed in a number of stage: the programmes first affect the intermediate variables, which can in turn lead to increased economic growth and reduced poverty if the changes are positive.

The McKinnon-Shaw model (1973) of financial development of a country's financial structure is a precondition for economic growth, but the two authors provide alternative theories of the transmission mechanism by which financial conditions affects savings and investment. Economic units must accumulate money prior to investment[1]. McKinnon's hypothesis emphasizes the importance of money broadly defined as the primary vehicle through which saving (investment) occurs. Complementary hypothesis implies that domestic savings shares a positive relationship with the demand for real broad money. According to Shaw (1973), economic units must not necessarily accumulate money prior to investment[2]. The financial deepening hypotheses asserts that saving and investment may occur through the accumulation of non-money assets. This hypothesis implies a negative relationship between domestic savings and demand for real broad money, suggesting a substitution from money to other non-money financial assets as the primary repository of domestic savings.

The importance of financial institutions for rapid growth is undisputed. A comprehensive study by King and Ross (1992) from across 119 developed and developing countries over the 1960-1989 period provides compelling evidence that economic growth is dramatically dependent on financial sector size, public and private sector banks, credit to enterprises and interest rates[3]. The larger the financial sector in the context of the overall economy, the greater the share of lending by depository rather than central banks, and the greater the share of credit to the efficient sector, the greater is the rate of economic growth. These factors increase growth by raising both the amount and efficiency of investment.

Hassan and Nunes (1994) also investigates the relationship between the volume of demand deposits and economic output in developing economics[4]. It is recognized that development of financial system is a prerequisite for economic growth in underdeveloped and developing nations, and have emphasized the important role assumed by the commercial banking system as an intermediary between savers and investors.

In the Bangladesh region the State has been implementing a series of development programmes since late 1960s. The development efforts of the State have been intensified since late 1770s. These efforts have rapidly affected the intermediate variables. During the last five decades or so, Bangladesh has experienced enormous changes in all spheres of activity - political social and economic. Table-1 cites few examples of such changes. Despite this, the economy remains stagnant and impoverished. During the period, the crucial macro-economic indicators such as savings, investment and growth sometimes fluctuated, but only within the narrow amplitudes, and they demonstrated a strong tendency to stabilize at a low level. This indicates that there is a sort of low level equilibrium in the economy and that the equilibrium is dynamically stable. The essence of the dynamic stability of low level equilibrium is that the economy neither develops nor crashes.

The involutional process results in the dynamic stability of a low level equilibrium in the economy. As this process continues to operate, the economy does not crash, because the increasing population is somehow absorbed, although at a lower and lower level of living, in the rural society. The economy doesn't develop either. So long as the economy has introversive tendency to absorb growing population through intensification of the existing structures, the new structures will not emerge.

The development of banking sector will increase the efficiency of the flow of funds between savings and investment. Increased efficiency will take place through a variety of mechanisms : the cost of intermediation will decrease because of increased competition to attract users and providers of funds; the cost of raising funds will decrease as the inflation rate declines; and funds will increasingly be allocated to users with better investment projects. The establishment of a market driven public and private banking system is linked to achieving higher employment, increased productivity, more efficient use of resources and more rapid economic growth in Bangladesh.

Banks, in general, perform three basic functions valued by the overall economy. One of these functions is the centralization of credit evaluation and monitoring, which produces information that cannot be easily made public by the borrower. This centralization exploits cost economies and, together with a diversified loan port-folio, lowers the price of credit. Second, banks offer transformation services that convert claims issued by borrowers into instruments that investors are willing to hold. These claims may be transformed with respect to their maturity, liquidity and credit risk. This special role of banks derives from the social welfare enhancements that can be realized when banks co-ordinate the funding of these illiquid assets with liquid liabilities. Third, banks provide access to payments system and to a clearing house for transactions. Public policies to attain safe and sound banking have traditionally been focused on methods to assure the continuous and efficient functioning of their transactions and payments mechanism. However, whether these services are rendered optimally by nationalized or private banks remains an open question.

The formal banking sector in Bangladesh includes **:**

(a) Bangladesh Bank as the central bank;
(b) Three nationalized and one Government controlled commercial banks;
(c) Seventeenth domestic private banks;
(d) Ten foreign private banks;

(e) Four Government-owned specialized banks, two of which have target the agricultural sector and the two others serve industry;

(f) One co-operative bank; and

(g) One Grameen bank.

Table-2 provides an overview of the banking institutions of Bangladesh Financial Sector.

The number of branches of the Scheduled banks are 4685, amongst these, 3617 and 1068 are branches of the nationalized banks and branches of the private sector banks respectively, The number of branches of the specialized banks are 1151 and 23 are the branches of the foreign banks. These figure is upto June, 1996. 2073 of the total branches are established in Urban areas and the rest 2612 have been established in the rural areas. The percentage of the establishment of the branches are 38% and 62% respectively in urban and rural areas.

The roots of Bangladesh bank (BB) date back to Reserve Bank of India out of which the State Bank of Pakistan was created in 1948. Bangladesh Bank took over central banking functions from the State Bank of Pakistan at the end of 1971. The Bangladesh Bank Order of 1972 specifies BB's central banking responsibilities and gives it substantial powers to formulate and implement monetary and supervisory policies and to advise the Government on economic policy[5]. The Bank Companies Act (1991) and Financial Institutions Act (1993) specify a wide range of prudential requirements and extend BB's powers to issuing to directions banks and financial institutions[6].

The financial health of Bangladesh bank (BB) is good without any open or hidden losses. Its lending to the Government is moderate. BB operates the country's payments system reasonably well even with a poor transport and communication infrastructure. However, Bangladesh Bank supervision is rather weak because of an inadequate number of bank auditors.

Table-3 presents the volume of deposits and advances in the banking system over the 1981-92 period. Deposits are Taka 2,600 crore and advances Taka 2,250 crore at the end of 1992. During the period of the financial sector reforms deposits have grown at rates of 10-15% per annum while advances rose first and then dropped sharply in 1992. The drop was probably caused by loan provisioning and agricultural credit write-off rather than a decline in the volume of advances. Table-4 provides the ratio of broad money to GDP. This ratio is a measure of financial deepening. The higher the ratio, the greater the level of financial deepening in the economy. This table indicates that there has been no significant increase in the financial deepening of the economy in the three year period before the reforms. The ratio was stable at 27% for the three years and then resumed its growth to 29%.

Commercial banks dominate the financial system of Bangladesh. Table-5 presents an deposits and advances by type of a bank over the 1986-1993 period. Four nationalized commercial banks dominate the banking system with 63 per cent of bank deposits and 53 per cent of advances in 1993. These banks have lost market share between 1986 and 1993, in deposits from 69% to 63% and in advances from 56% to 53%. They continue, however, to exert oligopolistic market power over the banking system. NCBs have helped to further the Government's socio-economic objectives by expanding their rural branch network and lending to agriculture, lending to small scale and cottage industries and funding state owned enterprises.

Domestic private banks, which include two denationalized banks, increased their market shares between 1986 and 1993, in deposits from 20% to 27% and in advances from 14% to 25%. These banks expanded their network by 33 branches, comprising 85% of the 39 new branches created during FY92. The domestic private bank's growth is more impressive, if data for the two denationalized banks is excluded. The denationalized banks share many of the same problems as NCBs. Domestic private banks offer higher interest rates to attract deposits and charge higher rates on loans. Their service is considered better than NCBs and they have expanded into fee-based and international services. These banks compete for a limited number of creditworthy borrowers, but not with NCBs for priority or public sector lending.

Banking sector also face problems of capital adequacy. Foreign banks lost market share in deposits from 6% in 1986 to 5% in 1993, partly because of the failure of BCCI, partly because they offer lower deposit rates. These banks cater to multinationals, international transactions and high net-worth individuals. Table-6 presents a breakdown of public and private sector loans. The Government and the public sector accounted for 23%, and the private sector 77% of deposits in FY91, about the same distribution as in the previous year. The Government and public sector increased their share of bank credit from 31% in FY91 to 39% in FY93, reducing the private sector's share commensurably. If the Government bonds issued to NCBs for recapitalization are excluded, over the medium term the share of public credit has remained more or less unchanged.

Table-2 gives the number of branches for the different types of banks. This table indicates that there are a number of large branch banks followed by the foreign and private banks which have much more limited branch networks.

The NCBs have branch networks averaging 900 branches, an extremely large number. The networks have emerged from years of management concentration on deposit mobilization and providing banking services to rural areas. The NCBs drive to expand their deposits arises from the continual need to provide fresh funds in an environment of poor loan recovery. As deposits are clearly associated with branch numbers, while advances are industry and location specific, the need to expand deposits leads directly to expanding branch networks. Urban branches are sources of deposits than rural branches so the primary objective is to increase urban branches. However, central bank policy required that the rural branch network be expanded at the same time, to provide banking services in such areas. Taken together these two factor led the NCBs to increase their branch network rapidly.

The two denationalized banks have much smaller branch networks than the NCBs. Their rural networks have been cut back since denationalization. Of the specialized banks two have large network and one a very small network. The two agricultural credit banks have more than 1,000 branches. Domestic private banks average 50 branches and foreign banks only 4. Table-7 breaks down the branch system between urban and rural branches.

This structure of the banking system is very clear. The Government banks have very large urban branch networks (300/bank); the private banks excluding the denationalized have much smaller networks (41/bank) and the denationalized banks are in between with 130/bank. Apart form the very large rural network of the NCBs, their urban networks are 7-8 times larger than that of other banks.

A large branch network is important for collection of deposits and to provide the public with general banking services. Companies and people want to maintain deposits at a convenient branch so the number and location of branches are an essential element of any strategy to mobilize deposits.. The massive branch networks reflect the explicit NCB strategy of deposit mobilization. The growth of the branch network has been an important element in the growth of deposits over the past 15 years.

The large branch network is very difficult to monitor and control. NCBs have shown to date, limited capacity to control their branch operations. The poor control of the branches is reflected in the high costs to the banks of the inter branch reconciliation balances and the high levels of bad debt. The NCBs have not effectively decentralized control of the branches so that the span of control required of the Head Office far exceeds anything that effective management can handle.

The advantage of a large branch network is based upon the proposition that deposits are collected from many small depositors and concentrated to fund the loans. One should note that by learning to participate in consortium, large loans can be managed by groups of small banks. Small banks can also mobilize funds and make these available to large city banks for lending. The connection between concentration of deposits and large loans within a single bank is not necessary.

All nationalized and denationalized banks in Bangladesh are undercapitalized even under the current standard, which is somewhat lower than the minimum recommended by the 1992 Basle Committee. The Government recapitalized the NCBs to the tune of Tk. 17.3 billion in 1992 and Tk. 14.6 billion in November 1993. The recent recapitalization has been necessary because of the laxity in recognizing losses and continued bad lending. In addition, previous recapitalization did not cover bad jute loans. While estimates of bad debts are not definitive because of weak prudential standards, they are likely to be substantial.

The high rate among NCB borrowers has occurs because of poor management, lack of little incentive to make good loans and Government directives and intervention. NCBs were required to make high-risk loans to priority sectors, new entrepreneurs, public corporations, 'sick industries and borrowers with political influence. In addition, these NCBs were obliged to endure loan forgiveness programs by the Government. Their own lending practices were not based on sound lending principles. For example, these NCBs have used imprudently high equity ratios as a basis for lending. They have also been lulled into a false sense of security because their lending has been collateralized and bad loans were masked by inadequate accounting practices.

It is nearly impossible to foreclose on collateral and liquidate it. The recent legal reforms undertaken as part of the financial sector reforms have enabled the banks to obtain decrees in their favour from the Financial Loan Courts in their cases against defaulters. However, very little collateral has actually been liquidated because of weak legal enforcement mechanisms. These problems will have to be strengthened by substantial improvements in enforcement.

The two denationalized private commercial banks inherited substantial bad loans from the nationalized period. At the time of denationalization, the quality of their loan portfolio was not fully disclosed to their former owners. Equipped with a bad loan portfolio and poor lending practices, these banks have conducted their business as if they were still NCBs. Not surprisingly, they have not come up to normal commercial banking standards under the new and tighter banking control and supervision. Their net worth is likely to be seriously eroded, specially since they have not had the recapitalization support provided to NCBs.

The domestic and foreign private banks performed better than the NCBs and the denationalized banks on operational efficiency criteria. Table-8 shows that the large private sector banks are more productive than NCBs. Deposits and loans per employee at private banks are almost twice as that of at NCBs. The private banks also mobilize almost three times more deposits and loans per branch than do the NCBs. A commercial bank's cost structure shows the most important determinant of its intermediation margins, and significant difference in margins indicate differences in efficiency.

Table-9 shows the gross intermediation margin (which includes the interest margin and fee income) of NCBs and private banks. Margins at NCBs have been consistently lower than at private banks, and furthermore, have been declining since 1989. These differences are due to their uncommercial approach to pricing loans, exacerbated by direct credit to jute and other sectors, their higher share of non-earning assets and their lower fee income. Private banks are charging higher lending rates and more fee income, so that they can afford to pay slightly higher interest rates and still earn higher gross and profit margins. However, these data do not reveal the emerging problems with the quality of loans in domestic private banks, which is likely to increase as banking supervision and capital control intensifies.

The profit-employed fund ratio of the NCBs has declined from 2% in 1984 to 1% in 1992, while the same ratio for the private banks has declined form 5.3% in 1985 to 2% in 1992. The private sector banks are the most profitable, with the Islami bank in the second, and the public sector banks in the third position. The average value of this composite productivity index over the 1984-1992 period was 0.66 for private banks, 0.57 for Islami banks and 0.23 for the public sector banks. The public sector banks are found to be more equitable than its private sector counterparts in collecting deposits and disseminating loans and advances. the NCBs did not collect deposits from small savers and disburse them to rich borrowers disproportionately like their private sector counterparts.

The privatization of two nationalized commercial banks (NCBs) in the early 1980s offers some interesting lessons in the pitfalls of implementing a policy of privatization. While the privatization of one bank (Rupali) was stalled after partial sale, the Government divested two other banks, Pubali and Uttara. The decision to divest these banks was related to the fact that their previous owners were Bangladeshi, and thus no legal entanglements were expected. The process of divestiture was, therefore, limited to negotiating only with the pervious owners. However, to make it politically acceptable, a portion of the shares was reserved for the employees, and a small part for the Government. The sale prices of Pubali and Uttara were fixed by Government on its "valuation" of net worth. Anxious not to miss a polemical window of opportunity, the Government skipped the essential task of properly evaluating asset values and restructuring finances where necessary. Even the asset valuation was reportedly unavailable to the prospective owners.

Almost a decade after privatization, the competitive position and operational efficiency of the two banks has hardly changed, no major management changes have occurred, redundant staff has not been shed, and the banks are suffering huge operating losses. In spite of the fact that both banks did not provide for classified loans, their combined loss in 1991 alone amounted to about Tk. 243 million. A large part of the ongoing problems of the privatized banks can be tracked to the history of mismanagement during the period of public sector management. Substantial advance-transferred during privatization as asset have now turned out to be non-performing; overmanning countries under threat of militant unionism; and unprofitable branches can not be closed as they serve the Government's social programs. While one bank is owed almost Tk. 240 crore by Government-owned corporations (mainly textile mills) and on account of the recent Government agricultural loan forgiveness scheme, the other carries almost Tk. 200 crore on account of the directed jute credits. Above all, the Government has not taken an even-handed approach between NCBs and these private banks in meeting its debt obligations. In one case, whereas it compensated all the NCBs for its guaranteed debt for a closed out Government consumer corporation, it refused to pay the privatized bank, which had to ultimately seek a decree from the High Court. Another important aspect which has seriously undermined commercialization of these banks is the continuing lack of autonomy of staffing issues. The privatization terms not only bound the purchasers to abide by the service and employment rules agreed to by the Government in 1982, the banks were also required to follow strictly the frequent pay raises and annual bonuses awarded to public enterprises. In short, the basic ingredients for successful privatization - a healthy cash flow and managerial autonomy - were missing, thereby eliminating the possibility of any genuine commercialization.

At present the policy towards new financial institutions in Bangladesh is a case by case approach. there is no strategic policy with respect to the vision of how the financial system would develop. At present Bangladesh has a branch banking system, i.e. a few banks each with a large member of branches in contrast with unit banking system comprising a large number of banks each with a few branches.

Large branch network have the following advantages and disadvantages. The advantage of a large branch network is based upon the proposition that deposits are collected from many small depositors and concentrated to fund the loans. A large branch network is important for collection of deposits and to provide the public with general banking services. Companies and people want to maintain deposits at a convenient branch so the number and location of branches are an essential element of any strategy to mobilize deposits. The massive branch networks reflect the explicit NCB strategy of deposit mobilization. The growth of branch network has been important element in the growth of deposits over the past 15 years.

The large branch network is very difficult to monitor and control. NCBs have shown to date, limited capacity to control their branch operations. The poor control of the branches is reflected in the high costs to the banks of the inter branch reconciliation balances and the high levels of bad debt. The NCBs have not effectively decentralized control of the branches so that the span of control required of the Head Office far exceeds anything that effective management can handle.

The management of the banking sector has two primary objectives: (a) to create competition to ensure efficiency and access to banking services; (b) to perform financial intermediation at low total cost. In the context of Bangladesh these objectives have several implications.

Competition is effective only when there is profit maximizing behaviour. This means that the financial institution has no objective other than to earn as much profit as possible. Thus, in particular reference to Bangladesh, this profit maximizing behaviour means that (a) employment levels should not be maintained except in so far as it contributes directly to bank profits; (b) salaries and other labour compensation should be managed to promote profit maximization (bonuses are incentive based etc.) (c) loans are based on the bank's assessment, not directed to achieve Government development objectives; (d) Banks do not have social objectives. If Government works to encourage loans in some sector, the Government should provide the necessary incentive through direct subsidy.

Any essential deviation from the principle of competition will lead to a loss of efficiency, reduced return to investments financed by the banks, and reduced payments to savers(depositors). All of these will reduce the rate to growth of the economy. Those who believe that there is widespread market failure can not provide convincingly a mechanism to estimate such failure and correct for it. Experience in Bangladesh and elsewhere suggests that if there are market failures the regulations of Government have generally not succeeded in correcting these. Claims to subsidize sectors to offset market failure cannot be and have not been justified analytically. There is no evidence that one can successfully replace competition by regulation. Encouragement of competition should be the objective of Government policy, not its destruction. Often it is the very private interests already in the sector that wish to restrict competition through restricting entry.

A second aspect of competition is to create access to the banking system for all persons with good projects. Access is restricted by a number of behaviours (a) government banks where access to funds is regulated by special programs, official objectives, or traditional regulations; (b) banks controlled by an industrial–trading group where lending is largely made available to or through members of the group. Such banks may not provide access to funds for outsiders. Good projects presented by outsiders may be joined by group interests or in some cases taken over.

This suggests that it is a myth that Government intervention can select good investments or that Government enterprises work efficiently. In Asia there has always been concern that banks will fund largely the financial interest of the owners or the business grouping to which the owners belong. The nature of business and investment has tended to emphasize family ownership and management; the separation of management and ownership that characterizes European, Japanese, and North American industry is far less widespread in South Asia and Bangladesh in particular.

Rationed financial access is characteristic of much of Asia. The transition to a world of separation of ownership and management, with owners solely concerned with the return on their investment is probably decades away. One has to expect strong group and family interests to be manifest by private banks. To insure more equality of access to capital, south Asian Governments have in the past nationalized their banks and encouraged the development of directed leading. The alternative approach to achieving increased competition and greater access to capital is to allow easier entry into the financial sector. Their is little that can be done to limit group concentration through their ownership of a bank; but it is feasible to have a large number of groups. As competition increases banks become more efficient and the group orientation can survive only if the group can generate good projects. One hundred group are better than ten.

In Bangladesh efforts are made through the Bank Companies Act 1991 and amendments there to, to achieve broad based ownership and to limit the lending to Directors[7]. The concept of broad based ownership is promoted by limiting the voting power and ownership of any person to 5% of the shares. This concept is actually difficult to make effective and the private banks, with few exception, do not really reflect broad based ownership. Instead banks come under control of a group. Such control may be majority ownership or it may be the confidence of other share holders in management permits such management to operate the bank. Broad based ownership which does not permit bank management to operate with an effective strategy is not likely to prove beneficial. The willingness of person to invest in banks on the basis of the after tax rate of return is limited, since the dividends are not particularly high. Broad based ownership will in banking be a hard path to follow. It may be more effective to increase the number of banks but allow greater ownership share in a bank.

Achievement of efficient financial intermediation requires three simultaneous conditions: (a) recognition as par to costs of bad debts and adequate return to capital by the banks; (b) profit maximizing behaviour by financial institutions; and (c) effective supervision by the central bank to insure that the banks perform within the prescribed law.

## V.II A FRAGILE BANKING SECTOR

Financial system of Bangladesh is still underdeveloped : it has a fragile banking sector, an inadequate regulatory framework, and a nascent capital market. Inefficiencies in Bangladesh's financial system are hampering development, and the fragile financial health of the commercial banks precludes them from playing an important role in mobilizing savings and allocating them to efficient investment projects. Recognizing the need to modernize this important sector, the GOB has embarked on a Financial Sector Reform Program (FSRP) which includes: interest rate liberalization; the introduction of new monetary instruments; the discontinuation of directed credit and stringent bad debt and interest accrual accounting regulations; and, the establishment of financial loan courts and a Credit Information Bureau. While gradual progress is being made in implementing the FSRP, the financial sector is still in transition. The effects of the reforms are yet to be fully felt, and new challenges are emerging requiring rapid corrective actions.

The commercial banking sector forms the mainstream of the financial system and is dominated by four nationalized and Government controlled commercial banks (3 are 100% government owned, and one with 80% government ownership). The commercial banking industry is segmented by ownership patterns and business activity. These banks dominate the banking system. They have 4,685 branches (63% of the system's branch network), hold 60% of deposits and are owed more than 50% of all outstanding loans[8]. The NCBs are inefficient and their actions are often not based on commercial consideration; political interference is considerable. They have been shielded, to a large extent, from market competition, thereby severely eroding their efficiency. Widespread defaults on bank loans constitute a major endemic problem facing the banking system. To restore their health, GOB injected Tk. 17.29 billion of fresh capital in the NCBs in 1989. However, due to lack of parallel reforms in the real sectors of the economy and insufficient restructuring of existing banking operations, the NCBs needed additional capital of about Tk. 3.2 billion within less than two years of this capital injection. There will be a continuing need for further such infusions unless systemic reforms are undertaken. The 11 private domestic banks (PDBs) are a mixed bag of efficient commercially oriented banks and two relatively large de-nationalized banks (Pubali and Uttara), which operate almost like NCBs. The third group of commercial banks comprises the six foreign banks which concentrate their business on external trade, commodity financing , and donor transactions. In addition to the commercial banks, the banking sector also includes three 100% government owned specialized banks.

The banking system in Bangladesh is not competitive, and lack of competition has resulted in a loss of efficiency. The NCBs have been, to a large extent, shielded from market forces which is an important factor impeding their efficiency. Nationalized commercial bankers have little feel for risk management and do not consider themselves wholly accountable for the quality of their assets. The key issues shackling the development of the banking sector are: capital inadequacy, a high level of non-performing loans due to weak managerial and operational practices, and poorly performing NCBs.

(i) Capital Inadequacy: Many banks in Bangladesh have an inadequate capital base. Under the Bank Companies Act (BCA), 1991, capital adequacy is defined as having a paid up capital and reserves of not less than 6% of total current and time liabilities. Thus defined, the capital base of most commercial banks of Bangladesh, particularly the NCBs, is inadequate. To restore the health of the NCBs, the GOB decided to inject fresh capital in these banks as part of the FSRP. The domestic and foreign private banks also need additional capital to meet the required capital adequacy standards, though large inter-bank differences exist.

(ii) Non-Performing Loans: The new loan classification procedure introduced by Bangladesh Bank (BB) in 1990 has unmasked the extent and gravity of the loan default problem. The pervasive nature of the loan default situation is currently one of the most serious threats to the stability and growth of Bangladesh's financial sector. Loan portfolios of almost every NCB, and the two de-nationalized banks, are seriously infected by the poor lending practices of the past. The magnitude of the problem can be gauged by the fact that as of June 30, 1991 around 25% of loan portfolios of banks was classified as non-performing. This does not, however, include the massive non-performing jute debts nor the substantial unclassified agricultural loans[9].

There are at least five reasons behind the loan default problem. These are: (i) the past practice of directed lending for "priority sectors"; (ii) an inadequate legal framework for loan recovery and contract enforcement assured borrowers that in case of default their personal assets would not be expropriated ; (iii) frequent loan forgiveness or waiver packages which eroded credit discipline ; (iv) lending indiscriminately to immature and inexperienced entrepreneurs many of whom preferred to gain immediate benefits by diverting credit funds, instead of reaping long-term benefits from an established industry ; and, (v) formula lending with fixed debt equity ratios (80:20) which greatly reduced the entrepreneurs' personal stake in the enterprise.

The poor quality of the banks' loan portfolios is one of the main causes of low bank profitability and capital inadequacy. Moreover, the high loan default rate results in the following costs: (i) the banks' risk-averse behaviour and resultant high collateral requirements 'crowd out' the dynamic and labour-intensive small scale enterprises; (ii) the high levels of non-performing assets prevent circulation of credit to other economic activities, and block the exit of resources from uneconomic firms; (iii) the high level of non-performing loans, by providing capital at zero cost, has benefited the borrowers most of whom come from the wealthier segment of society, and penalized — through reduced deposit rates — the 18 million depositors (over 90% of whom are small depositors); and (iv) very high real rates of lending (10-12%) which may be inhibiting private investment.

The GOB is aware of the loan default problem and has taken some actions to address it. Four initiatives have been taken in this area. First, the GOB has empowered DFIs to foreclose on the assets of defaulting enterprises without court process. However, this measure has proved to be ineffective since potential bidders are prevented by debtors from even inspecting the properties. To date there is not a single known case of a real asset being realized by a Bangladeshi bank. Second, it published a list of the largest defaulters and excluded them from further credit. In hindsight this action seems to have also proved less effective as it pre-empted a middle course which could have ensured partial recovery of credit against the threat of "eventually going public". The third action was the enactment of the *Artha Rin Adalat Aine,* 1991 (Financial Loans Courts Act, 1991), to expedite loan recovery suits. This measure has had some positive effects, and around 18,000 decrees have been passed involving Tk 254 crores. In addition, a large number of borrowers have reportedly settled out of court under threat of the Loan Courts issuing decrees promptly. However, the loan appeals process remains problematic, delaying ultimate implementation of decrees by several years. Fourth, the GOB has targeted the largest defaulters to net-it large amounts and economize on recovery efforts. The fact that banks are now focusing on a loan recovery strategy augurs well ; however, actual loan recoveries have been less than anticipated.

(iii) Low Profitability: As stated earlier, the high proportion of bad debt is one of the causes for the low bank profitability. In 1991, the NCBs made Tk 361 crore of losses. It was 0.19% of their average assets. A review of a sample of four domestic private banks indicate that their profits were 1.2% of average assets. The low bank profitability can be treated mainly to the low rate of interest collected, 8.5% for the NCBs and 9.9% for the PDBs, which reflects the magnitude of the bad portfolio problem. On average, the PDBs paid a higher rate of depositors (8.1% of average assets) than the NCBs (7.2%). Operating costs were around 2.5% of average assets for both groups of banks, with overstaffing at the NCBs being offset by lower salaries. However, since the PDBs provide a higher quality service, they were able to cover most of their operating costs by fees and commissions. The PDBs' non-interest income was around 2% of average assets as compared to 0.7% for the NCBs[10].

The FSRP reforms introduced by the GOB are helping to improve the NCBs' profitability by enabling them to earn a better margin. Thus, their losses fell from Tk 1,512 crore in 1989 to Tk 545 crore in 1990 and Tk 361 crore in 1991. This was mainly due to an increase in interest received which rose from 7.3% of average assets in 1989 to 8.5% in 1991. Average interest paid to depositors has remained virtually unchanged. It was 7% of average assets in 1989 and 7.2% in 1991[11]. Other cost items have also remained more or less constant relative to average assets. The improvements in profitability have been mainly achieved by keeping lending rates high which could be hurting private-sector investment. Profitability needs to be improved through a more profound reform of the NCBs which would enable reduction of the real lending rates while increasing the return on bank assets.

(iv) An Inadequate Regulatory Framework: The distressed state of the commercial banks is also an indication of regulatory and institutional weaknesses. The liberalization of the financial market requires an efficient regulatory environment, which can ensure the safety, soundness, and efficiency of the entire financial sector, particularly the banking system. The GOB recognizes the key weaknesses of bank regulations and has taken action under the FSRP to improve them while undertaking a program of technical assistance to strengthen Bangladesh Bank (BB).

The GOB has recently improved the financial sector regulatory framework by amending the Bank Companies Act (BCA), 1991, Bangladesh Bank Order, 1972, and Financial Loan Courts Act, 1991. The major changes were in the BCA, including ; more stringent capital adequacy standards; further restricting exposure limits in case of advances to loan defaulters and bank directors ; and limiting lending to a single borrower to 15% of the banks capital for unsecured borrowings and 25% of capital for fully secured borrowings.

## V.III TRENDS IN INVESTMENT AND SAVINGS

Investment and growth have stagnated since 1985. Historically, the investment rate in Bangladesh has been very low, averaging around 12% of GDP. This is the lowest domestic investment rate among South Asian countries. In 1990, the domestic investment rate was 18% in Nepal, 23% in India, 19% in Pakistan and 22% of Sri Lanka. A comparison with low and lower-middle income countries in East Asia yields even more striking results. In 1990, the domestic investment rate was 39% in China, 36% in Indonesia, 37% in Thailand and 34% in Malaysia. Out of 37 low income economies for which investment data was available in 1990, only 6 had investment rates lower than that of Bangladesh : Zaire, Sierra Leone, Haiti and the Central African Republic had an investment rate of 11%; Chad had an investment rate of 10%; and Niger had an investment rate of 9%[12].

Table-10 shows that private investment in Bangladesh has been flat since 1985, fluctuating between 5.5% of GDP and 6.5% with no clear trend, while public investment seems to be on a declining trend falling from 7.4% of GDP in FY85 to 4.7% in FY92. Private investment was particularly low in FY92, 5.6% of GDP as compared to 5.8% in FY91 and 6.4% in FY90, reflecting the combined effect of the April 1991 cyclone and the political transition. Direct foreign investment also declined significantly in FY92. In FY91, the Board of Investment (BOI) registered 35 foreign or joint venture projects for a total investment of Tk 3.7 billion. This declined in FY92 to 24 projects for a total investment of Tk 1.0 billion.

Table-11 shows the pattern of production trends and the slowdown of economic activities in the past years are reflected in the evolution of key macroeconomics indicators. The data suggest a persistent decline in resource availability over the last decade, with slight improvements only in the past two years. The impact of the declining resource availability has been felt largely in investment rather than consumption.

During FY91 and the early part of FY92, weak demand for industrial goods (including construction), denial of new credit to defaulters as part of a much needed effort to restore credit discipline and the political uncertainties during the early part of FY91 seem to have contributed to the decline in private investment and the consequent sluggishness in economic activity.

The low level and the declining trend in the investment ratios are also related to the sluggish domestic savings during the eighties. Gross domestic savings as a percentage of GDP performed erratically in the early eighties, although they generally declined towards the end of the eighties. National savings, (which includes the important resources obtained from remittances of Bangladeshi workers abroad) was more stable during the eighties. Foreign savings (equals the current account balance), which is the principal source for financing public investment declined consistently from 10% of GDP in FY81 to about 4.3% in FY91. A disaggregation of recent trends in national savings (Table- 11) indicates that public savings remain stuck at a low level and were sometimes negative.

The apparent stagnation of credit during FY92 to the private sector partly reflects the impact of the write-off of agricultural loans. After adjusting the data to take account of this, growth in private credit was 11.3% in nominal terms, or 4.8% in real terms. That is, the growth rate of credit to the private sector has slowed down considerably during the 1990s, but the published data on credit to the public sector includes bonds issued to recapitalize the nationalized commercial banks (NCBs). After adjusting for this factor, actual credit to the public sector shows a 0.9% decline during FY92, with credit to the central government falling by 13.3%, which is consistent with fiscal developments. Credit to other public entities grew by 5.3% in nominal terms, implying that it stagnated in real terms.

Gross fixed investment (GDI) is estimated by the Bangladesh Bureau of Statistics (BBS) to have risen marginally from 13.8 percent of GDP in FY93 to 14.2 percent in FY94. This increase in the overall investment rate has been largely due to rise in public investment under the ADP. National savings performance improved further in FY94, while foreign savings fell to 1.6 per cent of GDP. Foreign savings represented only 11 per cent of GDI[13].

Both the investment and savings rates are likely to have fallen in FY96, with an increasing share of foreign savings compensating for a sharper fall in national savings. The total investment / GDP ratio in FY95 must have remained well below the 16.6 percent estimated for FY95 by the Bangladesh Bureau of Statistics (BBS) national accounts data. Table-12 shows that this was a reversal in the rising trend in private investment/ GDP ratio achieved in recent years and in FY95, domestic savings performance had not kept pace with investment as the domestic saving rate declined almost by a percentage point to 8.3 percent of GDP in FY95.

While the incentive structure has improved over the years as a result of macroeconomics and sectoral policy reforms, private investment in the formal sector has not yet picked up. Problems in the financial sector have also constrained access to bank credit for financing investment. These constraints continue to cause considerable delays and raise the cost of doing business in Bangladesh and hence adversely affect the competitiveness of domestic activities, which is likely to have discouraged potential local and foreign investors alike.

The performance of commercial banks were not satisfactory during 1995-96 though they institutionally expanded during this period. The positive impacts of Financial Sector Reforms Program (FSRP) was slowed down and banking sector was in liquidity crisis during 1995-96 because of capital inadequacy and indiscipline in credit management.

Total bank deposit was increased from Tk 7410 million to Tk 363909 million upto March, 1995-96. It is observable that during this period, the banks were rigid in sanctioning credit because bank deposit position was not satisfactory. After examining the trends of advances and deposits in urban and rural areas, it is seen that advances is decreasing and deposit is increasing in rural areas. It means that economic activities in rural areas were not expanded during 1995-96.

There are four explanations for the stagnation of investment. First, the political uncertainty has prompted some entrepreneurs to postpone their investment plans. Second, the slow pace of structural reforms and the apparent lack of consensus on economic policies has increased the climate of uncertainty and further discouraged new investors. Third, the appreciation of the real exchange rate vis-a-vis neighbouring countries has partly offset the GOB's export promotion efforts and has made Bangladesh less attractive to foreign investors interested in export markets. Fourth, many of the reforms are still in the early stages of implementation and hence a time lag should be expected before private investment starts responding to the new incentive structure.

The decline in public investment during the second half of the 1980s was due to financial constraints caused by soaring government consumption and stagnating revenues. Thus, the lack of local counterpart funds was the main constraint facing the implementation of the Annual Development Program (ADP). The improvement in domestic resource mobilization, due to tax reform, has removed this constraint after FY90.

Despite the financial sector reforms initiated in 1989, rigidities in the banking sector, which limit its ability to respond to changing macroeconomics conditions, persist. The decline in the demand for credit in FY92 was accompanied by an increase in bank deposits as M2 rose by 14.1%. Thus, bank liquidity improved, and the banking system as a whole is holding excess liquidity of around Tk 7 billion[14]. In a well functioning financial system this would have provided a signal to banks to lower interest rates, leading to a fall in deposits and a rise in credit. However, this has not occurred so far.

While theoretically the new interest rate regime provides considerable freedom to the banks, in practice the dominance of the NCBs in the market curbs interest rate flexibility. The oligopolistic nature of the banking industry not only permits its dominant players (NCBs) to influences the market interest rates, but the relatively high cost structure of NCBs influence high real lending rates. The smaller and relatively more efficient private-sector commercial banks generally follow the NCB rates and are able to earn some profits by confining their lending to the less risky and more profitable, trade and working capital financing.

It is still too early to assess the overall impact of the recent interest-rate liberalization on deposit mobilization and investment financing, but so far interest rate change have failed to stimulate credit demand; in fact since 1989 credit has stagnated in real terms. In June 1992, BB reduced its bank rate from 9.7% to 8.5% which prompted NCBs to marginally lower their lending rates, but with no noticeable impact on the overall level of investment credit.

The Bank rate was further reduced to 7% in February, 1993. While a substantial reduction in lending rates, through a reduction in bank spreads, could help stimulate investment demand, such a reduction in spreads is not a feasible option given the current poor state of Bangladesh's banking sector. The rapid decline in interest income from non-performing loans, and the huge provision requirements prevent the dominant NCBs from reducing lending rates without also reducing deposit rates.

The stagnation in bank credit has also been for reasons other than high lending rates. These are :

(i) some 3000 small and medium scale "sick industries" have become uncreditworthy and fresh lending has been denied to these enterprises;

(ii) lending to the generally non-viable public-sector corporations has shrunk drastically;

(iii) agricultural lending has declined to a trickle following the government's loan forgiveness scheme; and most banks are either denying new credit or linking it to at least some recovery of past debts;

(iv) working capital credit to the jute sector, which took up almost 20% of annual credit to the industrial sector has declined sharply in 1992 as NCBs are resisting government directives to lend to this traditionally loss-making industry; and

(v) the commercial banks are too preoccupied in dealing with their seriously infected loan portfolios.

The contraction in credit is reflected in high liquidity in the banking sector. Under competitive conditions this would have generated lending pressures on the banks and prompted a decline in real lending rates. However, given the deep structural problems of the banking sector's dominant players (NCBs), the setting of floors on deposit rates by Bangladesh Bank, and the recent instability in the financial sector –the closure of BCCI and one investment company as well as serious problems with another –the relatively weaker banks have maintained a high liquidity preference.

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# CHAPTER-VI

## CONCLUSION

Commercial banks are at the heart of the problem in Bangladesh's financial sector and this sector is caught in a vicious circle. Banks earn no money on huge non-performing loans to both private and public sector borrowers. Weak and unaccountable bank management does nothing to change the situation. And the government is caught up in the conflicting roles of bank owner, customer, regulator, and provider of the legal framework for debt recovery. This kind of behaviour would be impossible to sustain in a competitive, well regulated banking system.

Table-2 shows what Bangladesh has instead is a government monopoly over much of the sector. The market hold of the four large nationalized commercial banks remains secure in the government's implicit guarantee against failure. The smaller private banks have been content to pick up the profitable customers and to do insider lending in the shadow of the nationalized commercial banks. It is no wonder then that surveys of private business consistently show that credit – its limited access and high cost – is at the top of their list of impediments to faster investment and growth.

The Ministry of Finance and Bangladesh Bank have recently begun work on banking reform. This effort needs to lead to early and decisive results. The objective of financial sector reform should be to create the conditions under which banks can intermediate efficiency between savers and borrowers on a competitive, sound basis without requiring public bailouts.

A healthy financial sector is critical to economic growth, especially for economies like Bangladesh whose growth must come largely from exports and whose enterprises must therefore be internationally competitive. To serve its many functions – transferring funds from savers to investors, selecting projects that yield the highest returns, amassing capital in amounts large enough to fund investments in diversified economic activities, pricing risk across assets, monitoring performance, and enforcing contracts – the banking sector requires highly skilled and knowledgeable staff, access to comprehensive and reliable information on borrowers, and a history of competence and enforcement that encourages savers to deposit and borrowers to repay. Government plays the vital complementary role of regulator, to monitor and strengthen bank solvency and to maintain financial stability. Bangladesh still needs to put most of these elements in place if it is to move to a sounder, more efficient banking system.

The biggest barrier to financial sector reform has been government ownership of the dominant financial institutions (Table-2). The poorly managed nationalized commercial banks, without incentives to make good loans, have fallen easy prey to political and administrative interventions. The banks have made high risk loans to "priority" sectors, state enterprises, sick industries, and borrowers with political influence under the false comfort of collaterealised lending and behind a screen of inadequate disclosure requirements and tax provisioning practices.

As a group the eighteen small domestic private banks are hardly better off. They offer no serious competition to the nationalized banks. Estimates based on unaudited financial statements suggest that at the end of 1994 the private banks needed more than Tk. 13 billion just to meet current regulations on capital adequacy.

Inadequate prudential regulation and weak supervision are a recipe for banking problems. Poor prudential regulation and supervision are made all the worse by an inadequate legal framework.

Banks are not the only problem in the financial sector. Capital markets are small and do not offer a competitive alternative to bank borrowing.

During 1992-93 the government poured Tk. 3.2 billion into recapitalising the nationalized banks, and already they need more funds. Recapitalising these banks will clearly not improve portfolio performance unless: performance incentives change.

These problems will not go away on their own, and neglect will only make matters worse. The shortfall in loan loss provisions for the nationalized banks was estimated at more than Tk. 11.1 billion at the end of 1994, seriously threatening their capital base. A rough estimate suggested that by the end of 1995 the provisioning shortfall had gone up by 15 per cent, to Tk. 12.8 billion and that is based on Bangladesh Bank's provisioning standards and not the more stringent international norms.

The spread between lending rates and the bank's cost of funds would have to be well over 20 per cent a year just for the banks to break even, according to a simple bank earnings model that assumes 40 per cent of loans to be non-performing (the actual figure at the end of 1994 was closer to 45 per cent) and that equates the cost of funds to the current weighted average cost of deposits. Demand for loans would plummet at the implied high rates, severely affecting private investment and output.

For the above problems of the banking sector which is the wheel for development of a country, Bangladesh continues to trial far behind its neighbours in

South Asia and further to the East. Bangladesh is unlikely to attain the 7-8 per cent GDP growth needed for faster poverty alleviation without a substantial boost in domestic saving-investment, and tax revenue and a firmly established, internationally competitive, private sector.

The economy of Bangladesh, however, needs a jump-start. Average annual growth rate in rate in Bangladesh, since independence (1971) till today, has been less than 4 per cent, while in other low income countries the rate was nearly 5 per cent. The industrial sector grew, in average annually, at below 5 per cent rate, while in other low income economies the corresponding rate was about 7 per cent. The rate of investment fell from 11 per cent of GDP in 1970 to 10 per cent in 1991 in Bangladesh, while in other low income countries the figure rose from 21 to 27 per cent during the corresponding period. The gross domestic savings declined in Bangladesh from 7 per cent of GDP in 1970 to 3 per cent in 1991 – the rate increased from an average of 20 per cent to 27 per cent of GDP during the same period in other low income economies.

Recent performance of the economy is, however, a little better. The GDP growth rates for the fiscal years 1991-92 and 1992-93 were 4.2 per cent and 4.3 per cent respectively. During this period, although industrial sector's growth rate declined from 7.1 per cent to 6.9 per cent, the manufacturing sector's growth increased from 7.3 per cent to 7.7 per cent, and service sector's growth rose from 4.8 per cent to 5.1 per cent. During the same period, domestic savings increased from 6.2 per cent of GDP to 6.5 per cent, and investment rose from 12.1 per cent to 12.7 per cent of GDP. During these years, positive of foreign reserve position strengthened significantly, and current account deficit was lowered to manageable limits.

The nation faces the challenge to raise the rate of investment to 18 to 20 per cent from the current level of 12 to 13 per cent to attain a growth rate of 6 to 7 per cent necessary for sustainable economic development.

The fact that Bangladesh lacks a conducive investment climate is not a matter of dispute. Statements of government officials from Prime Minister to Finance Minister, as well as business leaders – clearly demonstrate severity of the problem. Despite significant liberalization in government policies, investment – both domestic and foreign – remains at alarmingly low levels. To achieve 6-7 per cent growth target, the rate of investment has to be raised to 18 per cent from the current level of 13 per cent.

Goals of achieving rapid industrialization will remain a far cry unless sizeable increases in both domestic savings and investment are ensured.

However, the overall macroeconomics pictures of current years suggests commendable results on stabilization, not on growth. Currently, the country enjoys remarkable macroeconomics stability. High levels of foreign exchange reserves and tax revenues, fading fiscal and current account imbalances and low inflation rates have succeeded in creating some of the necessary conditions for economic take-off. However, all these have so far failed to accelerate the rate of investment or economic growth. It seems increasingly clear that unless the banking sector takes the lead, such a window of opportunity, as the World Bank likes to put its, will be lost. Likewise, the hard earned macroeconomics stability may be frustrated.

A well functioning financial system that mobilizes savings and allocates it to efficient investment is a pre-requisite for the success of any development strategy. Government of Bangladesh is cognizant of this fact and has undertaken a program of financial sector reforms whose objective is to restructure the financial system on a sound basis and make it more responsive to private sector requirements. Thus Government of Bangladesh carried out an initial recapitalization of the nationalized commercial banks (NCBs), took measures to improve loan collections, liberalised interest rate policies, replaced direct credit controls with indirect monetary instruments and took steps to strengthened banking supervision. Besides, Government of Bangladesh his also decided to complete the privatization of one of the NCBs, Rupali Bank. This action is design to demonstrate that the Government is serious about restructuring the banking sector and rendering it more competitive. Effective financial sector reforms will help to boost investor confidence.

In spite of those efforts, the financial system in Bangladesh remains in a poor position and is unable to play its role in supporting a private-sector-led economic recovery. The continued dominance of the system by the NCBs, and their uncommercial attitude and highly politicized unions, hurt the banking system and restrict competetion. Despite the recapitalization of about Tk 17.3 million in 1989, the NCBs are again in need of new capital of about Tk 3.2 billion because of continued poor performance. Establishing credit discipline has proven to be very difficult. Although special loan courts have been created, inadequacies in the legal system have severely hampered the execution of court decrees and the liquidation of assets. More needs to be done to strengthen the regulatory framework and the legal system affecting banks, privatize the NCBs, and increase competition in the sector, develop the capital markets and further liberalize interest rates.

The law governing the commercial banks provides them with some measure of autonomy, but in practice their effectiveness is circumscribed by the Ministry of Finance. Even in traditional areas of a central bank's purview, such as prescribing the statutory liquidity ratios, maintenance of cash reserves and prescribing the Bank rate, the Ministry's role is accepted and practised. This state of affairs does not allow for a formulation of an independent monetary policy and does not enhance staff morale at Bangladesh Bank.

Industrialization of the country will remain a distant dream unless the banking sector — a vital part of a market - economic system — is thoroughly overhauled and activated. The banking sector currently fails to show dynamism and vigour, in terms of its operations and conduct, to foster enterpreneurship and accelerate industrial development in the country. It is striving that the banks tend to avoid taking risks and intend to pass on the same to entrepreneurs.

Lingering incongruities, paradoxical conditions in lending and recovery rates, and inconsistent policy of the government, etc. eating into the vitals of the banking sector. Apparently the banking sector is playing with a number of proposals ranging from credit guarantee to loan without collateral. The crux of the problem is that the banks are still shying away from taking risks. Banks must have a stake in every project it finances.

Moreover, compound interest rates imposed by the banks are the real killers of industrial projects. Given capital constraints in the country, a high rate of interest may be and acceptable condition. However, interest rate structure is highly distortionary in may respects. Both high formal and informal costs of bank credits function as disincentives for many existing and potential borrowers. Calculation of interest rates on a compound basis for industrial projects seem awfully irrational, they seem to have more interest in collecting interests than the principal amount.

Fortunately, a consensus seems to be emerging — among all concerned, including major political parties — that the nation's economic development requires a dominant role of the banking sector. The Asian countries are widely dubbed to be the bastion of growth in the 21st century. Bangladesh can hardly afford to miss the boat.

Banking sector plays an important role in development. Among the major functions — the banks are responsible to increase savings and invest money in development purposes. The efficiency of banking system largely depends on the bankers and they perform their duties according to Government policies and directions.

The banks were under private sector during Pakistan regime. After liberation of Bangladesh, the political ideology was towards the nationalization and it shifted to denationalization and privatization later on. The banks enjoy different types of autonomy under Government policy of nationalization or privatization and bankers behave accordingly.

The banks are organised institutions and they operate under different laws and makes banking system much more cautious in their dealings with public as well as with other public and private organizations. Sometimes the bankers have to act under the directions of pressure groups also. Banker's efficiency also depends on modern technological facilities. All these factors influence banker's efficiency. Again, development depends on the efficiency of the banking sector because savings and investment are two major factors for economic development.

Under the present circumstances, the banking sector is not functioning well and that is why it is clear from the above analysis that savings and investment trends are decreasing and the whole banking sector is now fragile.

Finally, it can be concluded that the proposed hypotheses which were drawn at the beginning of the study has been proved justified through this research that it is policy that matters because an appropriate policy regime may bring about necessary changes in the development process including those among human beings.

# TABLES

**Table-I : Change in Selected Development Variables of Bangladesh in the Post-Liberation Period.**

| Variables | Initial number/ value | Percentage Change | Period of Change |
|---|---|---|---|
| Development expenditure (in million Taka, at current prices) | 3314.76 | 1497.13 | 1973/74-1989/90 |
| Transport and Communication | | | |
| Total road length (Kilometers) | 4048 | 1097.46 | 1972-1990 |
| No. of telephones | 8473 | 323.95 | 1972/73-1989/90 |
| Rural Electrification | | | |
| No. of villages electrified (cumculative) | 250 | 4929.20 | 1971/72-1989/90 |
| Education: | | | |
| No. of primary schools | 40313 | 13.57 | 1975/76-1989/90 |
| No. of secondary schools | 6469 | 51.83 | 175/76-1989/90 |
| No. of colleges (general) | 606 | 47.36 | 1975/76-1989/90 |
| Health and Family Planning | | | |
| No. of govt. hospitals | 130 | 367.89 | 1972-1990 |
| No. of registered doctors | 7482 | 167.39 | 1972-1990 |
| No. of hand/shallow tubewells for drinking water in rural areas | 185977 | 297.66 | 1972-1990 |
| No. of Family Planning and Family Welfare Assistants | 16852 | 51.55 | 1979/80-1989/90 |
| Banking | | | |
| No. of bank branches | 1197 | 378.78 | 1972-1990 |

Source: BBS (1980), BBS (1991).

TABLE - 2 : An Overview of the Banking Institutions of Bangladesh (upto June 1996).



| Bank's Name | Urban | Rural | Total | Govt. Share % |
|---|---|---|---|---|
| 1. Nationalized /Govt. Controlled Banks : | | | | |
| a) Commercial Banks : | | | | |
| 1. Sonali Bank | 420 | 883 | 1303 | 100 |
| 2. Janata Bank | 347 | 547 | 894 | 100 |
| 3. Agrani Bank | 315 | 588 | 903 | 100 |
| 4. Rupali Bank Ltd. | 244 | 273 | 517 | 94.5 |
| | 1326 | 2291 | 3617 | |
| b) Specialized Banks : | | | | |
| 1. Bangladesh Krishi Bank | 109 | 727 | 836 | 100 |
| 2. Bangladesh Shlpa Bank | 15 | - | 15 | 100 |
| 3. Rajshahi Krishi Unnayan Bank | 27 | 273 | 300 | 100 |
| 4. Bangladesh Shilpa Rin Sangtha | - | - | - | 100 |
| | 151 | 1000 | 1151 | |
| 2. Private Commercial Banks : | | | | |
| 1. Pubali Bank Ltd. | 193 | 161 | 354 | 5 |
| 2. Uttara Bank Ltd. | 146 | 52 | 198 | 5 |
| 3. Arab Bangladesh Bank Ltd. | 38 | 16 | 54 | 5 |
| 4. IFIC Bank Ltd. | 40 | 10 | 50 | 40 |
| 5. Islami Bank Bangladesh Ltd. | 63 | 27 | 90 | 5 |
| 6. National Bank Ltd. | 50 | 11 | 61 | 5 |
| 7. The City Bank Ltd. | 56 | 19 | 75 | 5 |
| 8. United Commercial Bank Ltd. | 58 | 19 | 77 | 5 |
| 9. Al Baraka Bank Bangladesh Ltd. | 26 | 06 | 32 | 5 |
| 10. Eastern Bank Ltd. | 14 | - | 14 | 20 |
| 11. National Credit & Commerce Bank Ltd. | 25 | - | 25 | - |
| 12. Bank of Small Industries & Commerce Bangladesh Ltd. | 18 | - | 18 | 100 |
| 13. Prime Bank Ltd. | 6 | - | 6 | - |
| 14. South East Bank Ltd. | 5 | - | 5 | - |
| 15. Dhaka Bank Ltd. | 3 | - | 3 | - |
| 16. Al Arafah Islami Bank Ltd. | 5 | - | 5 | - |
| 17. Social Investment Bank Ltd. | 1 | - | 1 | - |
| | 747 | 321 | 1068 | |
| 3. Foreign Commercial Banks : | | | | |
| 1. American Express Bank Ltd. | 2 | - | 2 | |
| 2. Bank Indosuez | 2 | - | 2 | |
| 3. ANZ Grindlege Bank PLC | 9 | - | 9 | |
| 4. Standard Chartered Bank Ltd. | 3 | - | 3 | |
| 5. Habib Bank Ltd. | 2 | - | 2 | |
| 6. State Bank of India | 1 | - | 1 | |
| 7. National Bank of Pakistan | 1 | - | 1 | |
| 8. Muslim Commercial Bank Ltd. | 1 | - | 1 | |
| 9. City Bank N.A. | 1 | - | 1 | |
| 10. Society General (The Bank) | 1 | - | 1 | |
| | 23 | - | 23 | |
| Grand Total | 2217 | 3612 | 5859 | |

Source : Bangladesh Bank

TABLE 3

Total deposits and advances (all banks)
End period

(Tk. in Crore)

| Period | Deposits (Depo) | Advances (Adv) | Growth of (Depo) | Growth of (Adv) |
|---|---|---|---|---|
| June 81 | 348.26 | 309.69 | - | - |
| June 82 | 391.41 | 411.89 | 12.39 | 33.00 |
| June 83 | 511.78 | 471.19 | 30.76 | 14.40 |
| June 84 | 737.50 | 645.66 | 44.10 | 37.03 |
| June 85 | 937.81 | 861.83 | 27.16 | 33.48 |
| June 86 | 1,113.66 | 1,047.29 | 18.75 | 21.52 |
| June 87 | 1,334.97 | 1,129.07 | 19.87 | 7.81 |
| June 88 | 1,561.60 | 1,334.28 | 16.98 | 18.18 |
| June 89 | 1,646.25 | 1,588.69 | 5.42 | 19.07 |
| June 90 | 1,910.93 | 1,903.25 | 16.08 | 19.80 |
| June 91 | 2,139.26 | 2,124.57 | 11.95 | 11.63 |
| June 92 | 2,445.33 | 2,158.58 | 14.31 | 1.60 |
| Dec. 92 | 2,600.50 | 2,248.80 | 13.12 | 8.60 |

Source : Bangladesh Bank Bulletin

TABLE 4

Gross Domostic Product (GDP) and Money Supply (M2)

(Tk. in Crore)

| Period | GDP | M2/CPI | M2/GDP(%) | GDPG |
|---|---|---|---|---|
| 1980-81 | 36,062.52 | 6,130.00 | 17.00 | |
| 1981-82 | 36,351.02 | 6,281.00 | 17.30 | 0.80 |
| 1982-83 | 37,659.66 | 7,147.00 | 19.00 | 3.60 |
| 1983-84 | 39,241.36 | 9,045.00 | 23.00 | 4.20 |
| 1984-85 | 40,693.30 | 10,534.00 | 25.90 | 3.70 |
| 1985-86 | 42,459.30 | 10,931.00 | 25.70 | 4.34 |
| 1986-87 | 44,234.70 | 12,068.00 | 27.30 | 4.18 |
| 1987-88 | 45,513.50 | 12,202.00 | 26.80 | 2.89 |
| 1988-89 | 46,660.30 | 12,576.00 | 26.90 | 2.52 |
| 1989-90 | 49,752.70 | 14,025.00 | 28.20 | 6.60 |
| 1990-91 | 51,444.20 | 14,592.00 | 28.30 | 3.40 |
| 1991-92 | 53,618.90 | 15,670.00 | 29.20 | 4.23 |

Souce : 1. Fro M2. Bangladesh Bank Bulletin. June of each period

2. Fro GDP. Bangladesh Bureau of Statistics. Base Year: 1984-85=100; and fro preceding years, data have been estimated as per the growth of GDP.

3. CPI June of each period Bangladesh Bank Bulletin barious issues.

TABLE 5

Deposits and Advances by Type of Bank (Taka billion in 1989 constant prices)

| | June-1986 | | June-1989 | | | June-1992 | | | June-1993 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Tk. billion | % Share | Tk. billion | % Share | Growth Rate | Tk. billion | % Share | Growth Rate | Tk. billion | % Share | Growth Rate |
| Deposits | | | | | | | | | | | |
| NCBs | 102.82 | 69 | 115.97 | 64 | 4.0 | 141.04 | 65 | 6.7 | 155.30 | 63 | 10.2 |
| Dom Private Banks | 29.17 | 20 | 42.66 | 24 | 14.0 | 54.96 | 25 | 8.9 | 61.74 | 27 | 21.4 |
| Foreign Bank | 9.35 | 6 | 13.69 | 8 | 15.9 | 11.27 | 5 | -7.7 | 11.6 | 5 | 2.9 |
| Specialized Banks | 7.53 | 5 | 8.59 | 4 | 3.3 | 10.91 | 5 | 6.9 | 13.77 | 5 | 26.2 |
| Advance | | | | | | | | | | | |
| NCBs | 82.12 | 56 | 85.24 | 51 | 1.2 | 103.46 | 53 | 6.6 | 116.76 | 53 | 12.8 |
| Dom Private Banks | 20.66 | 14 | 33.30 | 20 | 16.3 | 45.63 | 23 | 11.7 | 55.84 | 25 | 22.4 |
| Foreign Bank | 8.36 | 5 | 10.51 | 7 | 11.2 | 7.96 | 4 | -10.1 | 9.42 | 4 | 18.3 |
| Specialized Banks | 36.14 | 24 | 37.81 | 22 | 1.8 | 39.36 | 20 | -0.9 | 40.07 | 18 | 1.8 |

Source Bangladesh Bank, Financial Sector Reform Program.

TABLE 6

Public/Private Share of Commercial Bank Credit, FY89-93 (Percent, end of period)

| | FY89 | FY 90 | FY91 | FY92 | FY93 |
|---|---|---|---|---|---|
| Public Sector a/ | 24.3 | 23.4 | 30.8 | 31.5 | 38.8 |
| Private Sector | 75.7 | 76.6 | 69.2 | 68.5 | 61.2 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

a/ Includes bonds issued by the Government to NCBs to recapitalize them.
Sources: Financial Sector Reform Project, Bangladesh Bank, and staff estimates.

TABLE 7

DISTRIBUTION OF URBAN AND RURAL BRANCHES

| Type | Urban Branches (%) | Urban Branches/Bank | Rural Branches (%) |
|---|---|---|---|
| NCB's | 33 | 300 | 67 |
| Denationalized | 48 | 130 | 52 |
| Private | 100 | 41 | 0 |
| Specialized | 10 | 37 | 90 |
| Foreign | 100 | 4 | 0 |
| Total | 34 | 84 | 66 |

TABLE 8

Poor Productivity of Nationalized Commercial Banks, 1989-92 (Taka million)

| Type of Bank | Deposits per Employee | | | | Addvances per Employee | | | |
|---|---|---|---|---|---|---|---|---|
| | 1989 | 1990 | 1991 | 1992 | 1989 | 1990 | 1991 | 1992 |
| NCBs | 2.20 | 2.31 | 2.67 | 2.87 | 1.68 | 1.88 | 1.95 | 2.05 |
| PSBs | 3.94 | 4.09 | 4.51 | 4.97 | 3.25 | 3.33 | 3.80 | 3.75 |
| | Deposit per Branch | | | | Advances per Branch | | | |
| NCBs | 38.06 | 40.64 | 47.01 | 50.52 | 29.11 | 33.10 | 34.60 | 36.06 |
| PSBs | 107.35 | 106.63 | 120.44 | 133.01 | 88.51 | 86.83 | 101.35 | 100.41 |

Note : NCB=Four Nationalized Commercial Bank; PSB= Four largest Sector Banks (Arab-Bangladesh, IFIC, City Bank, And National Bank)

Source: Annual Reports of Various Banks.

# TABLE 9

## Public vs. Private: Comparative Margins at Commercial Banks

| | Aggregate NCBs | | | | Aggregate private Banks | | | |
|---|---|---|---|---|---|---|---|---|
| | 1989 | 1990 | 1991 | 1992 | 1989 | 1990 | 1991 | 1992 |
| Interest recieved | 8.84 | 5.74 | 8.62 | 7.12 | 8.97 | 10.14 | 9.88 | 9.49 |
| interest paid | 7.47 | 7.37 | 7.23 | 6.59 | 7.95 | 8.06 | 8.06 | 7.75 |
| Interest Margin | 1.37 | -1.63 | 1.39 | 0.53 | 1.02 | 2.08 | 1.82 | 1.74 |
| Other Income | 1.08 | 3.81 | 0.66 | 0.85 | 1.73 | 1.91 | 2.03 | 2.02 |
| Gross Margin | 2.45 | 2.18 | 2.05 | 1.38 | 2.74 | 3.98 | 3.86 | 3.76 |
| Operating cost | 2.44 | 2.23 | 2.14 | 2.23 | 2.47 | 2.59 | 2.65 | 2.50 |
| Staff cost | 1.75 | 1.59 | 1.53 | 1.65 | 1.16 | 1.23 | 1.23 | 1.21 |
| Other expenses | 0.61 | 0.56 | 0.53 | 0.51 | 1.00 | 1.05 | 1.10 | 1.00 |
| Depreciation | 0.08 | 0.08 | 0.08 | 0.08 | 0.32 | 0.32 | 0.31 | 0.08 |
| profit (pre-tax) Margin | 0.01 | -0.05 | -0.09 | -0.86 | 0.27 | 1.39 | 1.21 | 1.25 |
| (Taka Million) | | | | | | | | |
| Total Yr-end Assets | 160,804 | 177,485 | 200,620 | 215,644 | 22,393 | 24,810 | 29,462 | 32,746 |
| Average Assets | 141,717 | 169,145 | 189,053 | 208,132 | 20,749 | 23,601 | 27,136 | 31,104 |

Source : Bangladesh Bank and staff estimates.

Table 10 LOW INVESTMENT
(percent of GDP)

| | FY85 | FY86 | FY87 | FY88 | FY89 | FY90 | FY91 | FY92 a/ |
|---|---|---|---|---|---|---|---|---|
| Consumption | 98.4 | 97.0 | 96.8 | 97.4 | 98.0 | 98.0 | 97.0 | 96.2 |
| Investment | 12.8 | 12.3 | 12.5 | 12.0 | 12.2 | 12.1 | 10.4 | 10.3 |
| Public | 7.4 | 6.7 | 6.3 | 5.6 | 5.7 | 5.7 | 4.6 | 4.7 |
| Private | 5.4 | 6.0 | 6.2 | 6.4 | 6.5 | 6.4 | 5.8 | 5.6 |
| Domestic Savings | 1.6 | 3.0 | 3.2 | 2.6 | 2.0 | 2.0 | 3.0 | 3.8 |

a/ Preliminary estimates

Source: Bangladesh Bureau of Statistics and Bank Staff Estimates

TABLE - 11

Bangladesh - Macroeconomic Balances FY81-FY91
(as percent of GDP in current prices)

| | FY81 | FY82 | FY83 | FY84 | FY85 | FY86 | FY87 | FY88 | FY89 | FY90 | FY91 c/ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Gross Domestic Product (GDP) | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Resource Balance | 12.5 | 14.8 | 13.2 | 10.6 | 10.9 | 10.1 | 9.4 | 9.6 | 11.8 | 9.8 | 7.4 |
| Resource Availability | 112.5 | 114.8 | 113.2 | 110.6 | 110.9 | 110.1 | 109.4 | 109.6 | 111.8 | 109.8 | 107.4 |
| Consumption | 96.6 | 99.5 | 99.8 | 98.4 | 98.1 | 97.8 | 96.9 | 97.6 | 99.6 | 98.0 | 95.7 |
| Private | 89.9 | 93.4 | 94.1 | 91.6 | 90.8 | 89.6 | 89.5 | 89.5 | 90.1 | 89.2 | 86.7 |
| Public | 6.7 | 6.1 | 5.7 | 6.8 | 7.3 | 8.2 | 7.4 | 8.1 | 9.8 | 8.8 | 9.0 |
| Gross Investment (GDI) | 15.9 | 15.3 | 13.4 | 12.2 | 12.8 | 12.3 | 12.5 | 12.0 | 12.2 | 11.8 | 11.7 |
| Private | 6.5 | 6.3 | 6.1 | 5.5 | 5.4 | 6.0 | 6.3 | 5.6 | 5.7 | 5.7 | 5.6 |
| Public | 9.4 | 9.0 | 7.2 | 6.7 | 7.4 | 6.3 | 6.2 | 6.4 | 6.5 | 6.1 | 6.1 |
| MEMO ITEMS | | | | | | | | | | | |
| Domestic Saving | 3.4 | 0.5 | 0.2 | 1.6 | 1.9 | 2.2 | 3.1 | 2.4 | 2.0 | 1.9 | 4.3 |
| National Saving | 5.9 | 3.0 | 4.4 | 5.5 | 4.4 | 5.3 | 7.0 | 6.2 | 7.1 | 5.9 | 7.4 |
| Private | .. | .. | .. | .. | 3.1 | 4.2 | 6.0 | 6.3 | 6.7 | 6.5 | 6.9 |
| Public | .. | .. | .. | .. | 1.2 | 1.2 | 1.2 | -0.4 | 0.4 | -0.6 | 0.5 |
| Foreign Saving a/ | 10.0 | 12.3 | 9.0 | 6.7 | 8.4 | 6.9 | 5.5 | 5.8 | 6.7 | 6.8 | 4.3 |
| FS:INV b/ | 62.7 | 80.1 | 67.1 | 54.8 | 65.9 | 56.6 | 43.8 | 48.3 | 54.8 | 58.3 | 36.8 |
| Aid Disbursement | 8.0 | 9.3 | 11.1 | 9.0 | 7.8 | 8.5 | 9.0 | 8.7 | 8.3 | 7.9 | 7.7 |
| Comparator Country Ratios d/ | | | | | | | | | | | |
| Low-income economies | | | | | | | | | | | |
| Consumption | 74.4 | .. | .. | .. | 76.4 | .. | 73.7 | 73.4 | 73.9 | .. | .. |
| GDI | 25.5 | .. | .. | .. | 26.9 | .. | 28.4 | 29.2 | 28.5 | .. | .. |
| Gross National Savings | 24.6 | .. | .. | .. | 22.4 | .. | 24.9 | 25.1 | 24.5 | .. | .. |
| South Asia | | | | | | | | | | | |
| Consumption | 83.4 | .. | .. | .. | 81.2 | .. | 81.9 | 81.5 | 82.2 | .. | .. |
| GDI | 22.0 | .. | .. | .. | 23.6 | .. | 21.6 | 22.5 | 21.6 | .. | .. |
| Gross National Savings | 16.2 | .. | .. | .. | 17.9 | .. | 17.1 | 17.3 | 16.5 | .. | .. |
| East Asia | | | | | | | | | | | |
| Consumption | 69.4 | .. | .. | .. | 69.0 | .. | 64.6 | 64.5 | 65.6 | .. | .. |
| GDI | 30.4 | .. | .. | .. | 32.5 | .. | 33.0 | 33.6 | 34.2 | .. | .. |
| Gross National Savings | 29.4 | .. | .. | .. | 29.2 | .. | 33.7 | 34.0 | 33.1 | .. | .. |
| Sub-Saharan Africa | | | | | | | | | | | |
| Consumption | 78.6 | .. | .. | .. | 87.2 | .. | 85.7 | 87.0 | 85.7 | .. | .. |
| GDI | 20.0 | .. | .. | .. | 12.1 | .. | 15.9 | 15.7 | 15.1 | .. | .. |
| Gross National Savings | 18.0 | .. | .. | .. | 9.4 | .. | 9.8 | 7.7 | 8.9 | .. | .. |

a/ Equals current account balance.
b/ Ratio of foreign savings to domestic investment.
c/ Preliminary estimates.
d/ Refers to calendar years 1980, 1985, 1987-89.

Source: Statistical Appendix Table 2.5; and World Bank, World Development Report 1991, p. 184.

TABLE 12



Table 1: MACROECONOMIC INDICATORS, FY80-FY95

| | FY80-84 (Average) | FY85-89 (Average) | FY90 | FY91 | FY92 | FY93 | FY94 | FY95(P) |
|---|---|---|---|---|---|---|---|---|
| | | | (In Percentages) | | | | | |
| GDP growth rate: | 3.1 | 3.4 | 6.6 | 3.4 | 4.2 | 4.5 | 4.2 | 4.4 |
| GNP Per Capita (in $) a/ | 145 | 174 | 208 | 213 | 213 | 214 | 230 | 253 |
| | | | (Percent of GDP) | | | | | |
| Savings: | | | | | | | | |
| Domestic Saving | 1.6 | 2.9 | 2.7 | 4.2 | 6.0 | 7.6 | 9.1 | 8.3 |
| National Saving | 4.4 | 5.8 | 5.8 | 7.4 | 9.7 | 11.7 | 13.8 | 13.1 |
| Investment: | | | | | | | | |
| Gross Investment | 14.3 | 12.4 | 12.8 | 11.5 | 12.1 | 14.3 | 15.4 | 16.6 |
| Public | 6.2 | 6.2 | 6.4 | 5.7 | 5.5 | 6.4 | 7.6 | 7.2 |
| Private | 8.1 | 6.2 | 6.4 | 5.8 | 6.6 | 7.9 | 7.8 | 9.4 |
| Budget: | | | | | | | | |
| Total Revenue | 8.9 | 9.0 | 9.3 | 9.6 | 10.9 | 12.0 | 12.2 | 12.1 |
| Tax Revenue | 7.2 | 7.2 | 7.8 | 7.8 | 8.8 | 9.6 | 9.3 | 9.6 |
| Total Expenditure | 18.4 | 16.6 | 17.2 | 16.8 | 16.8 | 17.8 | 18.1 | 18.9 |
| Current Expenditure b/ | 6.4 | 7.7 | 8.8 | 8.7 | 8.3 | 8.9 | 8.9 | 8.8 |
| Overall Budget Deficit c/ | -9.3 | -7.5 | -7.9 | -7.2 | -5.9 | -5.9 | -6.0 | -6.8 |
| Balance of Payments: | | | | | | | | |
| Exports d/ | 5.4 | 6.0 | 6.8 | 7.3 | 8.4 | 9.8 | 9.8 | 11.9 |
| Imports e/ | 18.3 | 15.8 | 16.9 | 15.0 | 14.8 | 16.8 | 16.3 | 20.0 |
| Current Account Balance | -9.9 | -6.7 | -7.0 | -4.2 | -2.4 | -2.6 | -1.6 | -3.5 |
| | | | (In Precentages) | | | | | |
| Debt Service Ratio f/ | 9.7 | 14.1 | 13.7 | 12.5 | 11.5 | 10.2 | 11.5 | 10.0 |
| External Debt g/ (billion US $) | - | - | 12.3 | 12.9 | 13.2 | 14.1 | 15.7 | na |
| Rate of Inflation h/ | 13.4 | 10.1 | 9.3 | 8.9 | 5.1 | 1.3 | 1.8 | 5.2 |
| Memorandum Items: | | | | | | | | |
| BB Gross Reserves: | | | | | | | | |
| (billion US $) | - | - | 0.6 | 1.0 | 1.7 | 2.2 | 2.9 | 3.1 |
| (in months of imports) | - | - | 1.9 | 3.3 | 5.8 | 6.6 | 8.2 | 6.3 |
| Exchange Rate (TK/US $) | 20.1 | 30.0 | 32.9 | 35.7 | 38.2 | 39.2 | 40.0 | 40.2 |

a/ In calculating GNP workers' remittances are included in net factor income (see Annex Table-2.4). Per capita GNP is calculated using the same year's period average exchange rate.

b/ Excludes food subsidies.

c/ Defined as the difference between expenditure/GDP and revenue/GDP ratios, further adjusted for a residual amount to reflect the difference between the fiscal accounts and estimates of total financing of the Government (see Annex Table-5.1).

d/ Exports imply merchandise exports only.

e/ Imports imply merchandise imports only.

f/ Represents the ratio of debt service to total foreign exchange earnings from export of goods and non-factor services, plus workers remittances. Debt service includes interest on public M&LT debt, amortization of public M&LT debt, total IMF transaction (net) and IMF service charges. Source: Annex Table-3.1.

g/ End December in each fiscal year. Source: Annex Table-4.1

h/ Based on Dhaka Middle Class Consumers Price Index (CPI). P: Provisional

Source: Bangladesh Bureau of Statistics (BBS); *Twenty Years of National Accounting of Bangladesh: 1971/72-1991/92*, BBS; Export Promotion Bureau; Bangladesh Bank.

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