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SANEM

Thinking Aloud

Editor's Desk

The theme of the 2nd issue of Volume 2 of Thinking Aloud is "Investment". The first article on "Bangladesh needs a new investment regime" identifies four investment regimes in Bangladesh which are linked to different economic and political environments of Bangladesh. Emphasizing more on the latest investment regime, the article highlights that during this regime, there have been gradual declines in the private investment as well as trade-GDP ratio, which are matters of grave concern and are also reflections of sluggishness in the economic reform process in the country. The article calls for a new investment regime in Bangladesh leading to extensive policy and institutional reforms. The second article on "Why are some countries able to invest more than others?", using cross-country panel econometrics, illustrates the major factors affecting cross-country and over time differences in investment-GDP ratios. The analysis in that article points to the importance of macroeconomic policy support in the form of raising the domestic savings and lowering the cost of borrowing, economic reforms leading to greater openness, investment in human capital, as well as reduction in the cost of doing business through a variety of institutional reforms for the upswing in the investment-GDP ratio. Mr. Syed Nasim Manzur's interview has been published on 3rd page where he talks about the current investment scenario of Bangladesh and what measures should be taken to augment the current investment environment of the country.

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Editor:
Selim Raihan

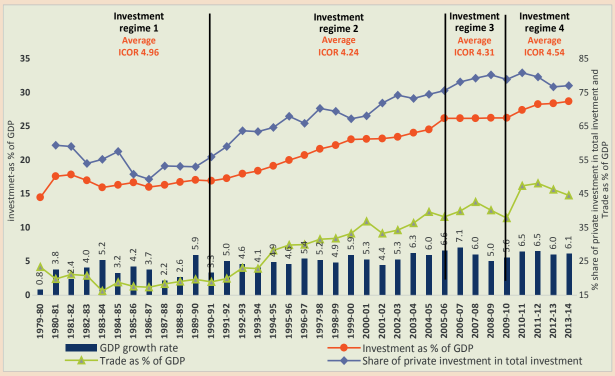
Associate Editors:
Raisa Tamanna Khan
Ahmed Tanmay Tahsin Ratul
Israt Jahan

Bangladesh needs a new investment regime

Selim Raihan

Looking at the trend in the investment-GDP ratio since 1979-80, we can suggest four different investment regimes in Bangladesh. The first regime (1979-80 to 1989-90) is characterized by low level of investment-GDP ratio with an annual average of 16.5%. This regime generated large fluctuations in GDP growth rates and the annual average GDP growth rate was only 3.5%. The second regime (1990-91 to 2004-05) saw a steady rise in investment-GDP ratio with an annual average of 21%. This regime yielded an annual average GDP growth rate of 5%. The third regime (2005-06 to 2008-09) experienced a higher but virtually flat investment-GDP ratio of 26.2% and a resultant rise in annual average GDP growth rate to 6.2%. Finally, the fourth regime is the current one (2009-10 to 2013-14) with a rise in annual average investment-GDP ratio to 28.2%, with 6.3% annual average GDP growth rate.

These four investment regimes can be tagged with different economic and political environments in Bangladesh. One economic indicator is the degree of openness. During the first regime, the economy was highly protected as is manifested by very low level of trade-GDP ratio. However, since the second regime, through different economic reform measures, the economy became more and more trade-oriented, as the trade-GDP ratio experienced a steady rise over the years since then. The third regime, however experienced a rise in the trade-GDP ratio at the beginning and then a fall. The striking feature of the fourth regime is that, the recent years are experiencing a gradual fall in the trade-GDP ratio, which is a matter of big concern. This is also linked to sluggishness in economic reforms in recent years.



On the political front, the sluggish and low level of investment during the first regime was accompanied by a military dictatorship. The second regime of the steady rise in investment was under the regime of 'parliamentary democracies' with high prevalence of 'contested politics'. The third regime of stagnant investment was associated with a 'military backed' caretaker government with complete absence of 'contested politics'. And finally, the fourth regime has been a regime of 'parliamentary democracies' with a low level of 'contested politics'.

One very important aspect of these investment regimes is the trend in the private sector participation in the economic growth process. If we look at the trend in the share of private investment in total investment, the first regime was characterized by a low and declining share of private investment. However, during the second regime, large contribution to the rise in investment came from the rise in private investment and its share in total investment. During the third investment regime, the share increased in the initial years and then fell in the later years. However, under the fourth regime, with the fact that the investment-GDP ratio has become somehow stagnant in the recent years, the share of private investment in total investment has fallen with the rise in the share of public investment, which is essentially unsustainable.

One very striking feature is that, in the recent two investment regimes the productivity of investment has fallen. One way of measuring the productivity of investment is the Incremental Capital-Output Ratio (ICOR), which is the ratio of 'investment as % of GDP' to 'GDP growth rate'. The higher the ICOR, the lower the productivity of investment. During the first regime, the annual average ICOR was as high as close to 5. However, during the second regime it came down to 4.24. The third regime saw a rise to 4.31. But, alarmingly, the fourth investment regime has an average ICOR of 4.54. This suggests that in recent years, there have been noticeable rises in the inefficiencies in the economic institutions and resultant falls in the returns to investment. This is clearly manifested by the fact that though during the third and fourth investment regimes, the annual average GDP growth rates have been little over 6%, the investment-GDP ratio in the fourth regime was 2 percentage points higher than that of the third regime, indicating that the economy is now needing more resources to generate the same level of GDP growth rate! This also points to the alarming fact that mere rise in investment-GDP ratio would not ensure higher GDP growth rate in the future!

There is no denying the fact that economic diversification is very important for economic growth process to be sustainable. It is important to mention that as against the first investment regime, the second investment regime was able to generate some essential diversifications of the economy through significant expansion of some non-agricultural sectors. One such example is the growth of the export-oriented readymade garment sector. However, in the later investment regimes, there has not been much progress in further diversification of the economy in general and the export basket in particular. There remain large policy induced and supply side constraints inhibiting further diversification of the economy.

All these suggest that there is a need for a new investment regime in Bangladesh. This new investment regime calls for some substantial policy and institutional reforms aiming at considerable rise in private investment and its efficiency. What needed are: (i) a new paradigm of macro, trade and investment policies aiming at economic diversification, (ii) reducing the cost of borrowing through financial sector institutional reforms, (iii) reform of the economic institutions tuned to further growth acceleration and growth maintenance, (iv) stability in the political institutions and presence of higher degree of 'contested politics', (v) efficient public investment in social and physical infrastructures facilitating further private investment, (vi) attracting large FDIs, with emphasis on regional cooperation in South Asia, and (vii) improving the overall governance of the macroeconomic policy environment.

Dr. Selim Raihan is Executive Director of SANEM.
Email: selim.raihan@gmail.com

Why are some countries able to invest more than others?

Selim Raihan and Mahtab Uddin

Why are some countries able to invest more than others? Some simple scatter-plot illustrations are presented in Figures 1-4. Figure 1 shows that investment is negatively related to the lending interest rate, as higher level of lending interest rate means higher level of cost of borrowing. The World Bank's doing business survey provides cross-country information on a number of indicators related to business environment. One of these indicators is the cost of starting a business in US$. Figure 2 suggests that the higher the cost of starting a business the lower is the investment-GDP ratio at the cross-country context. Penn World Table version 8.1 provides data on human capital per capita. Figure 3 indicates that the countries with higher human capital per capita tend to have higher investment-GDP ratio. Finally, as literatures on institutions and economic growth have emphasized a lot on the importance of quality of institutions, one indicator of the quality of institution is the control of corruption. Figure 4 suggests that the higher the level of control of corruption, the higher is the investment-GDP ratio.

Figure 1: Interest rate and Investment
Average for 2006-2010. Data of 125 countries (source World Bank)

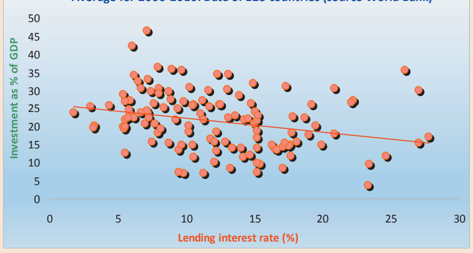


Figure 2: Cost of starting a business and Investment
Average for 2006-2010. Data of 145 countries (source World Bank)

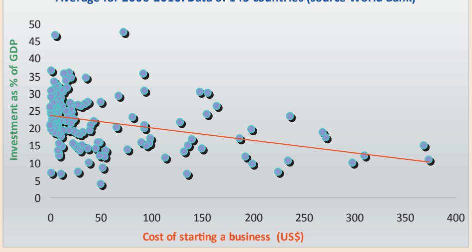


Figure 3: Human capital and Investment
Average for 2006-2010. Data of 133 countries (source PWT 8.1)

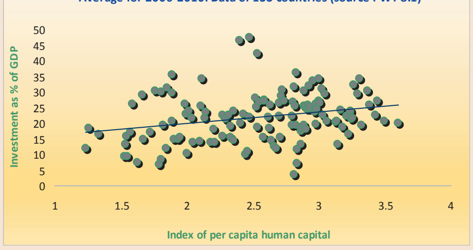
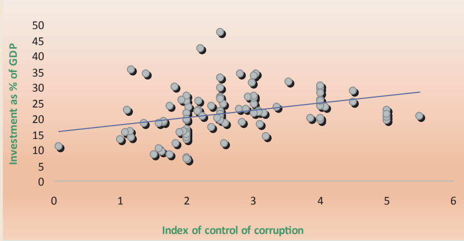


Figure 4: Control of corruption and Investment
Average for 2006-2010. Data of 103 countries (source ICRG data)



In order to do a more sophisticated analysis, we have used a cross-country panel regression for 165 countries for the period between 1960 and 2010. Our dependent variable is the investment-GDP ratio. We have used physical capital stock per capita and gross domestic savings as % of GDP as the control variables. Our first set of explanatory variables includes lending interest rate, openness (trade as % of GDP) and human capital per capita. The regression results suggest that in the long run, the countries with lower capital-stock per capita tend to have higher investment-GDP ratio, though the magnitude of the effect is very small. Furthermore, the investment-GDP ratio is positively associated with the gross domestic savings-GDP ratio. A percentage point rise in the gross domestic savings-GDP ratio would lead to the rise in the investment-GDP ratio by 0.12 percentage points. Lending interest rate indeed has a negative and significant effect on the investment-GDP ratio; however, the impact is very small, as one percentage point fall in the lending interest rate would lead to the rise in the investment-GDP ratio by only 0.003 percentage points. Openness has a positive and significant effect on the investment-GDP ratio. A percentage point rise in the trade-GDP ratio would lead to 0.03 percentage points rise in the investment-GDP ratio. Also the countries with higher human capital per capita tend to have higher-proportion of investment in GDP, as a unit rise in the human capital index would lead to the rise in the investment-GDP ratio by 2.9 percentage points.

Using region-wise interaction dummies in the panel regression, we are able to show the differences in impact of any variable on investment across regions. Here, we have made some comparisons between South Asia and East Asia. It appears that, though, as derived from the panel regression, reduction in the lending interest rate has a very low effect on investment in East Asia, in South Asia it has a much deeper favorable effect on investment. For South Asian countries 1 percentage point fall in the lending interest rate would lead to the rise in the investment-GDP ratio by 0.4 percentage points! Similarly, openness has almost four times larger positive impact on investment in South Asia than in East Asia. Human capital has larger effects on investment both in South Asia and East Asia than the global average, though the effect in East Asia is 1.5 times larger than in South Asia.

We are also interested in exploring the effects of different business environment and institutional variables on the cross-country and over time differences in investment-GDP ratios. We have used the variables from the World Bank's Doing Business Survey (for details see: www.doingbusiness.org), with a time period between 2004 and 2010 for 97 countries. Among the doing business survey indicators, three indicators appear to have statistically significant effect on the investment-GDP ratio. The cost of starting a business has a negative and significant effect on investment, and reduction in the cost of starting a business by one US$ would lead to the rise in the investment-GDP ratio by 0.004 percentage points. The time (days) for enforcing contracts also has a negative effect, as reduction in the time for enforcing contracts by one day would lead the investment-GDP ratio to rise by 0.005 percentage points. Finally, cost of enforcing contracts (% of claim) has a negative impact on investment, as one US$ reduction in such cost would lead to the rise in the investment-GDP ratio by 0.04 percentage points. Interestingly, there is not much difference between South Asia and East Asia with regard to impacts of these three variables on investment.

In the case of the institutional variables, we have considered 12 political risks variables from the International Country Risk Guide (ICRG) database (for details see: www.prsgroup.com) with a time period between 1984 and 2010 for 97 countries. These are bureaucracy quality, government stability, democratic accountability, corruption, law and order, military in politics, investment profile, internal conflict, external conflict, religious tensions, socioeconomic conditions and ethnic conflicts. The regression results suggest that all these institutional variables, except socioeconomic conditions, have positive and statistically significant effect on investment. A point rise in bureaucratic quality (in a scale of 0-4) would lead to 0.51 percentage points rise in the investment-GDP ratio. A point rise in government stability (in a scale of 0-12) would lead to 0.2 percentage points rise in the investment-GDP ratio. A point increase in democratic accountability (in a scale of 0-6) would lead to a rise in the investment-GDP ratio by 0.47 percentage points. A point improvement in the control of corruption (in a scale of 0-6) would lead to 0.44 percentage points rise in the investment-GDP ratio. A point improvement in law and order (in a scale of 0-6) would result in 0.88 percentage points rise in the investment-GDP ratio. A point improvement in military in politics (in a scale of 0-6 with higher value means lower military in politics) would steer 0.98 percentage points rise in the investment-GDP ratio. A point advancement in investment profile (in a scale of 0-12) would lead to a rise in the investment-GDP ratio by 0.14 percentage points. A point improvement in internal conflict (in a scale of 0-12) would help the investment-GDP ratio to rise by 0.4 percentage points. Similarly, a point improvement in external conflict (in a scale of 0-12) would help the investment-GDP ratio to rise by 0.54 percentage points. A point progress in religion in politics (in a scale of 0-6 with higher value means lower religion in politics) would result in the investment-GDP ratio to rise by 0.34 percentage points. Finally, a point improvement in ethnic conflicts (in a scale of 0-6) would lead to a rise in the investment-GDP ratio by 0.6 percentage points. Bureaucracy quality and investment profile appear to have three and four times respectively larger effects on investment in South Asia than in East Asia; whereas all other institutional variables tend to have larger effects on investment in East Asia than in South Asia.

The aforementioned analysis points to the importance of macroeconomic policy support in the form of raising the domestic savings and lowering the cost of borrowing, economic reforms leading to greater openness, investment in human capital, as well as reduction in the cost of doing business through a variety of institutional reforms for the upswing in the investment-GDP ratio.

Dr. Selim Raihan. Email: selim.raihan@gmail.com
Mahtab Uddin. Research Associate, SANEM:
Email: mahtab.ud@gmail.com

"...continuity and predictability of policies are needed..."

SANEM had a conversation with Mr. Syed Nasim Manzur, Managing Director of Apex Adelchi Footwear Ltd., the largest footwear exporter of Bangladesh. He is also the Director of Apex Tannery Ltd. and President of Leather Goods and Footwear Manufacturers & Exporters Association. He is the current President of Metropolitan Chamber of Commerce & Industries (MCCI). Mr. Manzur completed his B.Sc. in Economics in entrepreneurial management from Wharton School, University of Pennsylvania.

SANEM: What is the current investment scenario in Bangladesh?

NM: Although we are continuously congratulating ourselves for maintaining 6% growth rate on average for the last 10 years, this is not enough. We need to mobilize further investment, and investment-GDP ratio has to be increased by another 7% - 8%. The main driver of investment should be the private sector. Unfortunately, in recent years, the growth in private sector investment has gone negative. To compensate for this, the government has been increasing public investment by undertaking various ambitious projects under the Annual Development Programs. These kind of ventures have been successful in centrally planned economies like China and Vietnam. In China, the government is the biggest landlord, the largest business house, and has the resources for undertaking such initiatives. However, for a quasi-free market economy like Bangladesh it is very difficult to continue such a scenario for long. Thus, the present investment scenario in our country, which, as the finance minister admitted, is quite frustrating.

SANEM: What are the major obstacles to increase the private investment in Bangladesh?

NM: Investors are generally attracted to long term ventures. This is the reason why people invest more in China and India. However, in Bangladesh, the return to investment is not high enough to compensate for the risks and obstacles associated with it. For example, a study by BBS shows that less than 1.7% of all incoming remittances are spent on monetary instruments while majority is spent on purchasing land. The low risk and high return from land within a short time has created a craze among people to invest their money on land, and as a consequence, it is distracting investment. Also, the cost of doing business in Bangladesh is very high. According to the 13 indicators of Doing Business Report 2015, Bangladesh severely underperformed in the following three: (i) enforcing contracts: It takes 1442 days to enforce a contract in Bangladesh, while in Vietnam and China corresponding figures are 400 and 443 days; (ii) electricity connections: It takes 429 days to get electricity connection in Bangladesh compared to 115 days in Vietnam and 143 days in China; (iii) registering property: It takes 244 days in Bangladesh to register a property. In West Bengal it has been pulled down to 7 days only. It takes 57 days in Vietnam while in China it takes 19 days.

In addition to these, interest rate must be lowered for attracting investments in Bangladesh. For example, in China it is only 5% for export oriented investments whereas in Bangladesh it is still 13%. Cost of finance, cost of land, cost of construction materials etc. are very high in Bangladesh. We did a study on Bangladesh, Vietnam and Cambodia regarding the cost of a squared-meter of land. Near Dhaka (42 km vicinity) it is $340 while in the industrial zones of Vietnam and Cambodia; where you have water, electricity and gas connections, it is $144. Thus whoever goes there with the permission can just immediately set up a plant.

Now, how do we compensate our inefficiencies in the banking, transport and legal systems? We do so by giving unhealthy pressure on wages to keep it low. Ironically, this is counterproductive, as by depressing wages we are decreasing productivity, output and their loyalty. This is a dilemma for Bangladesh that must be addressed. Another alarming factor is our educated unemployed youth. The more GPA 5.00 are out in the market, the more educated unemployed we have. Although number of GPA

5 holders in the country has increased, their quality is not in accordance with their results. Almost in every sector, there is still a lack of technically qualified people. This mismatch can only be overcome by vocational and technical training. However, there is a stigma prevalent in our country that only the lowest category of students goes for vocational education.

SANEM: How important is political stability for private investment?

NM: Everyone adds a risk premium for uncertainties such as strikes, blockades, or other political unrests while undertaking any business initiative. The investor tries to predict about the long term continuation of such instabilities while taking investment decisions. Although right now, there is no political violence in the country, political uncertainties still persist. Hence, if someone decides to invest with a long term plan in mind, he/she has to consider these facts. Only an inclusive, responsive and participatory political practice can curtail uncertainties about political stability.

SANEM: How could FDI inflow in Bangladesh be increased?

NM: If the local investors in a country remain absent in taking business initiatives, then foreign investors will also be discouraged. For making us an attractive investment destination, we must deal with corruption at first. A recent survey by us shows that, 94% of people who want to get a permit and 99% of people who want to get a service have to pay bribe in Bangladesh. This also adds up to the cost of doing business. What is more alarming is that, even after paying the bribe many of them do not get the service at all. The three departments where corruption is most prevalent include the departments of environment, gas and electricity. Furthermore, to attract FDIs, our major focus should be on the predictability and continuity of policies, which are still very low in Bangladesh. We also need to have a proper soul searching whether we really need FDI, and if so, by how much.

SANEM: What do you think about the PPP?

NM: Many of the investors are not fully acquainted with the concept of PPP. Our government has also not called for any such projects yet. Once the laws of PPP are well prepared, the government should go for some small projects. It is necessary to set up some success stories of PPPs which could attract the investors. Any investor will not be encouraged to be the first mover in any new projects unless there are some well-established examples of success.

SANEM: What role can MCCI and other business chambers play?

NM: The trade bodies can keep a running score card of the major ongoing projects and update the policymakers based on it and also make suggestions as well; for example, updates on the progress of Dhaka – Chittagong and Dhaka - Mymensingh highway. We could also provide information to our government on the opportunities that the other competing countries like Cambodia, Vietnam or Ethiopia are offering to their investors. MCCI and other chambers can suggest potential and pragmatic target specific strategies. For example, China has come around with a 'new manufacturing policy' by which they commit to create 85 million jobs within the next 10 years. The government of Bangladesh has to come forward with such forward looking policies and chambers could provide specific suggestions. MCCI has a historical relationship with Japan and is currently working on a very high level delegation. MCCI is providing Japan with necessary information on the potential areas for investments. This will encourage the Japanese investors to come and invest in Bangladesh in collaboration with the domestic investors. Chambers should project our success stories like women empowerment, improvement in social development indicators etc. to create a positive image of Bangladesh to the outer world. The next 3 to 5 years are very crucial for us. Hence it is high time that both the private and public stakeholders take necessary initiatives to boost investment in the country for higher economic growth.

SANEM: Thank you very much for your time.

NM: You are welcome.

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SANEM celebrates 1 year of *Thinking Aloud*

SANEM team celebrated the completion of one year of its monthly newsletter *Thinking Aloud* on June 13, 2015 at SANEM office, Gulshan-2, Dhaka. The celebration took place with the presence of the well-wishers of SANEM, the ex-research associates and SANEM employees. Dr. Bazlul Haque Khondker (Chairman, SANEM and Professor, Dept. of Economics, University of Dhaka) and Dr. Selim Raihan (Executive Director, SANEM) provided special remarks during the ceremony. Among other distinguished guests, Dr. Taiabur Rahman (Professor, Department of Development Studies, University of Dhaka), Dr. Abu Eusuf (Professor, Department of Development Studies, University of Dhaka) and Dr. Sayema Haque Bidisha (Associate Professor, Dept. of Economics, University of Dhaka) adorned the celebration. The guests exchanged their thoughts about the first year journey of *Thinking Aloud* and they complimented the efforts of team SANEM for successfully publishing twelve issues on twelve different themes throughout the year. SANEM team is looking forward to present the future issues of *Thinking Aloud* on more vibrant themes related to trade facilitation, investment environments, macroeconomic issues, South Asian integration and so on.

Policy advocacy strategy for reduction of NTMs in South Asia

With a request from GIZ, Kathmandu, Dr. Selim Raihan is in the process of preparing a strategy for "Policy advocacy for the trade promotion focusing on reduction of non-tariff measures in South Asia". This exercise would aim to develop a two tier – national and regional level policy advocacy strategy for the reduction of NTMs, and to promote intra-regional trade in the South Asia. The prepared strategy will serve as a blueprint/model for policy advocacy at the national and regional level and also as a reference material for organizations and institutions working for the trade promotion in the region. As part of this exercise, Dr. Selim Raihan visited New Delhi during 1 and 3 June, 2015 and consulted with a number of Indian stakeholders from the Department of Commerce (Ministry of Commerce and Industry, Government of India), Federation of Indian Chambers of Commerce and Industry (FICCI), Centre for WTO Studies of Indian Institute of Foreign Trade, Indian Council for Research on International Economic Relations (ICRIER), Research and Information System for Developing Countries (RIS), Confederation of Indian Industry (CII) and Federation of Indian Micro and Small & Medium Enterprises (FISME). Dr. Raihan also visited Colombo during 4 and 6 June to discuss with Sri Lankan stakeholders from Department of Commerce of Government of Sri Lanka, Ceylon Chamber of Commerce, Federation of Chambers of Commerce and Industry of Sri Lanka (FCCISL), National Institute of Exports, National Chamber of Commerce of Sri Lanka, and Institute of Policy Studies of Sri Lanka.

SANEM researchers' articles published in the Newspaper

In May 2015, two articles by Dr. Selim Raihan got published in the English Newspaper *The Daily Star*. On 9th May 2015, the article on "The Manufacturing Sector in Bangladesh: Is it a sustained driver of economic growth and employment creation?" got published, and on 23rd May 2015 the published one was on "From 'good-enough' jobs to 'decent' jobs". In June 2015, three articles by the researchers of SANEM got published in the same newspaper. Dr. Bazlul H. Khondker and Dr. Abu Eusuf, on 18th June 2015, wrote on "Budget 2015-2016: GDP growth and private investment"; Dr. Bazlul H. Khondker, Dr. Selim Raihan and Dr. Abu Eusuf, on 24th June 2015, wrote on "Reforming the Social Security System"; and finally, on 27th June 2015, Dr. Selim Raihan's article on "Our garment industry at a crossroad" got published.

Book Launching by PRI

Dr. Selim Raihan was a designated discussant in a book launching event organized by the Policy Research Institute (PRI) on 17 June 2015. The book is written by Dr. Rizwanul Islam, a former special adviser on employment at the International Labour Organisation. Written in Bangla, the University Press Ltd. published the book. The program was chaired by Dr. Zaidi Sattar, Chairman of PRI, and was attended by distinguished participants such as Dr. Akbar Ali Khan, Dr. Ahsan H Mansur, Dr. Rushidan Islam Rahman of BIDS, Ms. Shaheen Anam of Manusher Jonno Foundation, Mr. Kamran T Rahman, former president of Bangladesh Employers Federation, and Dr. Quazi Mesbahuddin Ahmed, former member of the Planning Commission.

SANEM Chairman visits Mongolia

Dr. Bazlul Haque Khondker (Chairman of SANEM), as a member of a team comprising of national and international experts, was on a mission in Ulaanbaatar, Mongolia during 17 and 29 June 2015, sponsored by the ADB, to work in a project under the aegis of Ministry of Population Development and Social Protection, Government of Mongolia. The purpose of this mission was to update the 2003 social protection strategy of the country. It has been argued by development partners (especially World Bank, Asian Development Bank (ADB), ILO and UN system) as well as experts that the social protection system in Mongolia is fragmented and generosity (i.e. transfers to beneficiary groups) has been low. Thus, the reform aims at rationalization of schemes, purposeful targeting using PMT data base and augmenting transfer amounts either through savings from rationalization and expansion of social insurance coverage or additional funding from state budget.

e-version: http://sanemnet.org/thinking-aloud/

SANEM is a non-profit research organization registered with the Registrar of Joint Stock Companies and Firms in Bangladesh. Launched in January 2007 in Dhaka, it is a network of economists and policy makers in South Asia with a special emphasis on economic modeling. The organization seeks to produce objective, high quality, country- and South Asian region-specific policy and thematic research. SANEM contributes in governments' policy-making by providing research supports both at individual and organizational capacities. SANEM has maintained strong research collaboration with global, regional and local think-tanks, research and development organizations, universities and individual researchers.