

INDUSTRIAL DIVERSIFICATION IN BANGLADESH: OPPORTUNITIES AND CHALLENGES

FINANCIAL INNOVATIONS LAB® REPORT



December 2014



MILKEN INSTITUTE



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Financial Innovations Labs® bring together researchers, policymakers, and business, financial, and professional practitioners to create market-based solutions to business and public-policy challenges. Using real and simulated case studies, participants consider and design alternative capital structures and then apply appropriate financial technologies to them.

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Introduction

Like other emerging and developing countries, Bangladesh has leveraged its abundant and low-cost labor to spur economic growth and attract domestic and foreign investment. Over the past decade, the country has positioned itself to take control of a large segment of global trade—in particular, the ready-made garment (RMG) market, where it is second only to China in global export to European and U.S. buyers.

However, like its predecessors in the emerging markets, Bangladesh faces challenges to economic growth. It must continue its efforts to strengthen and modernize the economy through diversification of industry sectors; and it must develop a highly skilled workforce—its human capital—to keep pace with that diversification. Training and education will transform an unskilled and semi-skilled workforce into one that is able to support emerging sectors, such as information technology, pharmaceuticals, and shipbuilding.

To address these issues, the Milken Institute, in partnership with the Bangladesh Enterprise Institute, convened a two-day Financial Innovations Lab®, “Industrial Diversification in Bangladesh: Opportunities and Challenges.” The Lab took place August 12–13, at the Singapore Management University, and brought together representatives of government, investors, and leaders in finance and economic development to analyze best practices and provide recommendations for building on the country’s current capital and labor strengths.

Lab participants from Singapore discussed lessons learned in their country as it transitioned from a labor-intensive economy to one increasingly based on capital and high-skill industries. Based on this example and other countries that have made similar transitions, the participants created a series of recommendations to help form a framework for advancement. The recommendations focus on solutions that are practical and applicable to Bangladesh, and include:

- Improve market-oriented policies and incentives.
- Develop a cohesive marketing and investment promotion strategy.
- Develop a highly skilled workforce.

Over the past few decades, we've been able to translate our strengths into economic growth. In the next decades, we need to promote Bangladesh as a country of high productivity to maintain our competitive advantage.

—Dr. Gowher Rizvi,
Advisor to the Prime Minister
of Bangladesh

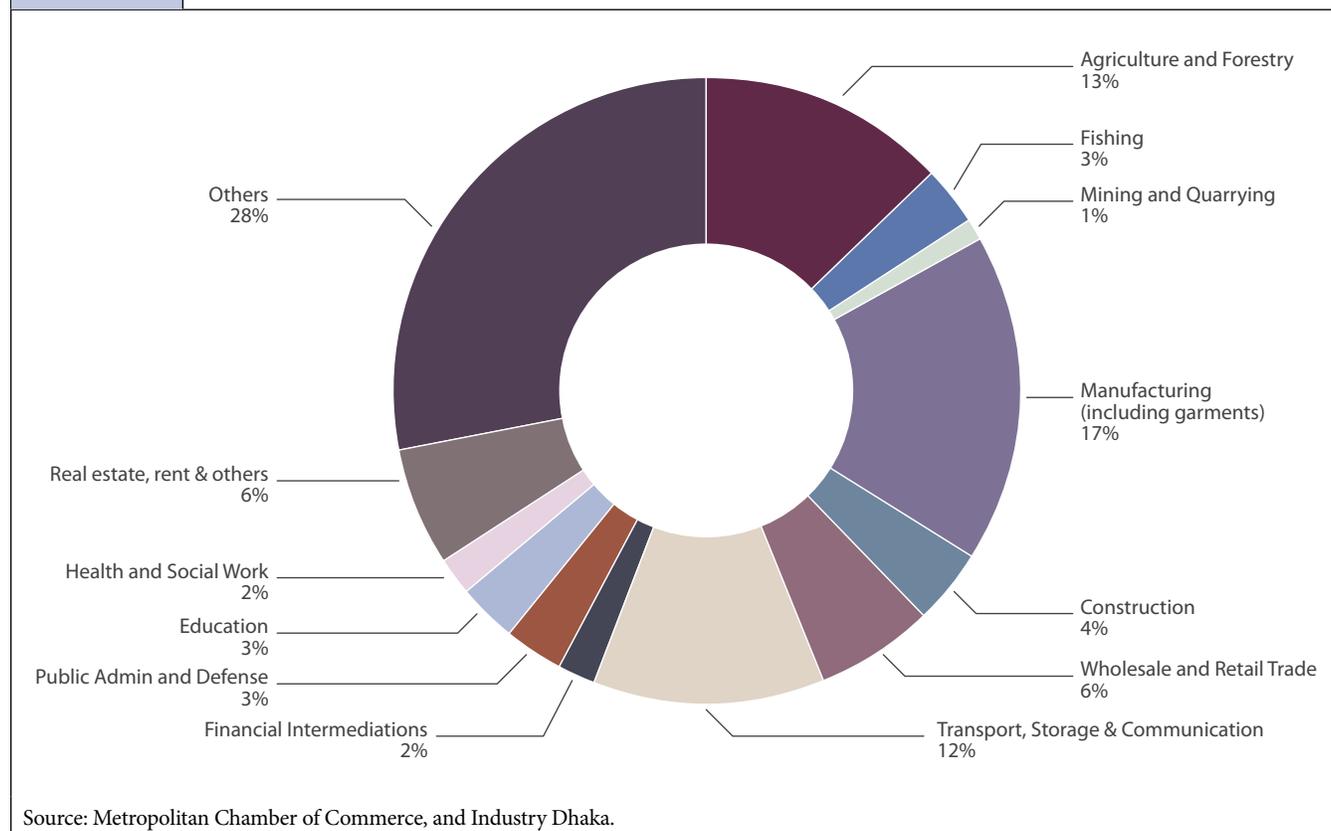
Issues and Perspectives

With more than 160 million inhabitants, Bangladesh is the world's eighth most populous country. It is also one of the world's most densely populated countries. Despite numerous and daunting challenges—including poverty, overcrowding, climate change, political instability, weak institutional capacity, and the 2008–2009 financial crisis and recession—Bangladesh has achieved substantial human and social development advances in the past decade. Among these are universal primary education, increased food production, better health care, and some success tackling the problem of overpopulation. Over the past two decades, the Bangladesh economy has grown at an average of 6 percent; in 2013, the GDP in Bangladesh was US\$324.6 billion, and in 2014 growth is predicted to be 6.4 percent, a slight increase due to higher public investment and stronger exports.

Similar to other emerging and developing countries, Bangladesh has successfully attracted increased foreign and domestic investment, providing short-term and medium-term growth. The economy is still largely dependent on the textiles and ready-made garment (RMG) sector which has now become the biggest earner of foreign currency. Bangladesh is also building up other competitive industries, such as shipbuilding, life sciences, and technology. As the birthplace of microfinance, the country also has a robust social enterprise sector that is expected to grow.

FIGURE
1

Bangladesh's GDP by industry



The garment industry has been a key driver of the Bangladeshi economy. It provides nearly 4 million direct jobs and, in 2012, contributed 13 percent of the country's GDP, with annual revenues of US\$19 billion.¹ It also represents nearly 80 percent of the country's export market.² Within the global garment market (including RMG and all other forms of clothing), the country ranks fifth, behind China, India, Germany, and Italy, as top exporter.³ Bangladesh has key advantages in this market, including a large low-cost labor pool, vast internal manufacturing capacity, strong supply chain networks, and favorable trade agreements. It also has far more factories (5,000) than do Indonesia (2,450) and Vietnam (2,000).⁴

Bangladesh's emerging industries hold the potential to expand economic growth even further. Information technology has seen increased demand, both domestically and via export opportunities. The industry generates an estimated US\$250 million in annual revenues and employs roughly 30,000 people.⁵ Currently, the majority of IT in Bangladesh targets software development and maintenance, but as the industry expands along with the talented pool of new entrepreneurs, the country should be able to tap into its higher-value sectors.

The production of leather goods has increased over the past few years, with companies like JC Penny, Marks & Spencer, and Walmart sourcing products from Bangladesh. Diversified jute products also represent a growing industry and could provide investment opportunities for domestic and foreign investors since Bangladesh is the second-largest producer of jute in the world behind India. The pharmaceutical industry has also grown over the past few years, with a 24 percent increase in revenue from 2010 to 2011.

However, to diversify and grow these industries and others that will enhance the country's economic sustainability, Bangladesh must consider a number of market and regulatory issues that could derail its advancement. The numbers in table 1 illustrate some of them: Bangladesh has one of the lowest gross national incomes per capita and is ranked toward the bottom of the World Bank's Ease of Doing Business ranking, which measures such factors as dealing with construction permits, protecting investors, getting electricity, registering property, and enforcing contracts. Without addressing these kinds of challenges, as well, Bangladesh is at risk of losing global competitiveness in its current industries and stifling investment in new sectors.

TABLE 1		<i>Asian economic rankings</i>		
	GNI per capita 2013. US\$ (Atlas)	Exports (G&S) % GDP	WCR Rank Out of 148	Doing Biz WB Rank Out of 189
Bangladesh	900	23	110	130
Pakistan	1,380	13	133	110
India	1,570	25	60	134
Sri Lanka	2,920	22	65	85
Indonesia	3,580	24	38	120
Malaysia	10,400	82	24	6
Thailand	5,370	74	37	18
Philippines	3,270	28	59	108
Singapore	54,040	191	2	1

Source: Singapore Optimal Development Advisers LLP.

MAJOR BARRIERS TO INDUSTRIAL DIVERSIFICATION

Lab participants discussed the constraints facing businesses and investors; table 2 lists the key constraints they addressed.

TABLE 2		<i>Major barriers to growth</i>
Lack of power sources and other infrastructure		
Political instability		
Regulatory uncertainty, a lack of transparency, weak institutional capacity		
Insufficient access to capital for businesses		
Insufficient skilled labor		

In order to attract increased foreign direct investment (FDI), the government will have to build greater strength in infrastructure, transparency, political stability, regulatory certainty, and technical skills-based training.

Lack of Power and Infrastructure

According to a 2013 World Bank report, if Bangladesh wants to bring its power grids, roads, and water supplies up to standard and serve its growing population, it must spend US\$7.4 billion to US\$10 billion a year until 2020.⁶

Regulatory uncertainty and a lack of transparency

A common theme of concern among Bangladeshis and the international community is the uncertainty of the country's political environment. The constitution provides for most of the essential elements of good governance, but the government has yet to develop fully the policies, institutions, capacities, and practices of stable governance.⁷ It has been working with foundations, NGOs, multilateral organizations, and development finance institutions to improve the effectiveness and transparency of Parliament and increase the participation of civil society in the legislative process and the making of public policy.⁸

According to the World Bank report, the government loses more than \$500 million to corruption and inefficiency, and nearly \$1 billion to poor management.⁹ In order to increase transparency and change the institutional culture, the Right to Information Act (RTI) was passed in 2009.¹⁰ The government has teamed up with the World Bank to develop a program for supporting agencies to strengthen their compliance with the RTI Act and strengthen the rules and regulations on proactive disclosure. To increase the level of comfort for investors, the government must enact policies and procedures that stress accountability, transparency, efficiency, and rule of law.¹¹

Insufficient access to capital for business

The Board of Investment was established in 1989, and operates through the Office of the Prime Minister, to encourage domestic and foreign investment in private sector and promote the country's competitiveness. But the BOI is not adequately empowered and therefore has had trouble attracting significant foreign private capital, apart from into certain industries. The government is working to strengthen the capacity of businesses and map growth, risks, and the regulatory landscape.¹² Additionally, the country is working to improve overall incentives, including financing tools and favorable tax policies, to attract new capital.

Insufficient skilled labor

Bangladesh is transitioning from a predominantly agrarian economy to an industrial and service economy.¹³ In order to attract the multinational corporations of the future, it must build a robust, educated labor force; at present, there is an abundance of labor, but for the most part it is unskilled or semi-skilled. The manufacturing sectors, especially in the garment industry, have made efforts to improve worker training, but much more can be done to formalize education programs to train a workforce that can access higher-value production companies.

These issues require both innovative financial and policy solutions. Best practices in industrial diversification were discussed during the Lab as a basis to form policy recommendations relevant to Bangladesh.

BEST PRACTICES FROM ABROAD

When Singapore gained independence in 1965, it was already poised for economic growth. It was a central Asian hub, with solid infrastructure and a strong history of governance and administration, inherited from the British. Yet the small island nation faced various issues as it tried to build a strategy for industrial diversification and expansion. Limited by size and without many natural resources on which to base an economy, the country needed to develop a national plan to attract both domestic and foreign investment to support its growth.

In the early years, the government made an effort to create a national strategic plan for its various potential industries. It also created a menu of financial and regulatory incentives to attract private capital into the region. Initially it had a preference for local industries and investment, although after the first few years, the government turned its attention to foreign direct investment. The government also worked to enforce transparency within the public sector to ensure accountability. This enabled an institutional culture that was performance-oriented and able to attract top-tier workers. As seen in table 3, the government then began to target specific industries.

TABLE 3		<i>Singapore's initial strategy</i>	
Development Stage	Development Goal (s)	Target Investor (s)	Explanatory Note
1) 1965 - 1968	Policy review and policy formulation	Singapore bankers and traders	Malaysian Import Substitution projects
2) 1968 - 1973	Random job creation	U.S. MNCs (GE, HP) and U.S. semiconductor firms	Pre-1973 oil price crisis
3) 1974 - 1984	Precision engineering companies	U.S. MNCs (GE, HP) and U.S. semiconductor firms	Foundation for machine tool industry
4) 1985 - 1995	De-industrialisation	U.S. MNCs (FedEx, UPS, Asian campus of top universities)	As recommended by Lee Hsien Loong's Economic Committee

Source: Chan Chin Bock.

In the decades following independence, Singapore shifted to an export-driven strategy focused on multinational corporations. It created more incentives to bring in new businesses when it dropped local investment requirements for new development and offered a very favorable 17 percent corporate tax rate. It began to privatize its major infrastructure, including power and telecommunications. It also undertook an aggressive marketing campaign to attract such firms in high-value industries, such as engineering, biotech, industrial biotech, pharmaceuticals, and aerospace, as illustrated in table 4. This strategy required a conscious effort to develop and maintain a large pool of highly skilled workers, which meant building a national program for skills training.

TABLE
4*Singapore's Later-Stage Strategy*

Development Stage	Development Goal (s)	Target Investor (s)	Explanatory Note
5) 1990 - 2000	Process industry focus	Sumitomo Chemical, Dupont, BASF, Bayer	Capital-intensive emphasis
6) 2000 - 2010	Big pharma	Top 30 global pharma firms – especially those with strong pipeline of new drugs	Compete with Puerto Rico and Ireland
7) 2010 - 2020	Biomedical products and services	Baxter, Abbott, P&G	Provides basis for medical R&D
8) 2010 - 2020	Aircraft parts and services, Logistics, data centers	Rolls-Royce, Prat & Whitney, GE, IBM, NTT Communications	Lead up to Seletar Aerospace Park, data analytics firms

Source: Chan Chin Bock.

Singapore is not the only case of economic advancement predicated on industrial diversification. China and South Korea, among others, provide sound lessons on the benefits of planning an active industrial policy. Indeed, in just 50 years, South Korea went from being one of the poorest countries in the world, with a GDP per capita of roughly \$1,500 in 1960, to a high-income OECD member country with a per capita GDP of \$25,976 in 2013.

This development was purposeful. In 1961, following the war, South Korea's military government established the Economic Planning Board, which produced a series of five-year plans for economic development from 1967 to 1981. These plans offered firms a number of incentives, such as tax benefits and low-interest bank loans, to increase and diversify exports. Further, the government reduced or eliminated all taxes and import restrictions placed on intermediary goods used in export production.

Existing industries, including textiles, clothing, and electrical machinery, benefited from the lifted import restrictions. Exports increased. Later, under the third five-year plan, the strategy began to emphasize production diversification, and the government expanded the country's heavy and chemical industries, and began investment in machinery, steel, shipbuilding, and electronics. This development was further aided by Japanese manufacturers who invested in production in South Korea.

The result was a dramatic change in the character of exports: from commodities and processed foods in the 1960s (75 percent of South Korea's exports in 1962) to manufactured goods (almost 90 percent of exports in 1985) and high-tech products since the 1990s. Today, heavy industry—including semiconductors, telecom equipment, automobiles, computers, steel, ships, and petrochemicals—accounts for 90 percent of all exports.

In China, the government used industrial parks in special economic zones to help stimulate industrial diversification. Special Economic Zones (SEZs) function as geographic regions, which receive preferential treatment from the government and as a result, are not subject to the same stringent regulations and laws as the rest of the country. SEZs have streamlined procedures and incentives to make countries more investor-friendly, cost-competitive, and capable of attracting foreign direct investment. SEZs are a useful tool as part of an overall economic growth strategy to allow a country to enhance industry competitiveness and attract FDI. Through SEZs, governments can develop and diversify their exports, which is of particular significance for developing countries reliant on exporting primary products.

One of the major advantages to investing in one of these zones is that firms enjoy preferential governmental policies, resource availability, modern infrastructure, and prime locations with highly skilled labor, which frequently become hubs of innovation and creativity.

After the success of China's first SEZ in Shenzhen in the 1980s, a variety of development zones across Asia have flourished, as catalysts for economic reform and foreign investment in burgeoning economies. In China, SEZs account for over 80 percent of cumulative FDI.

The China-Singapore Suzhou Industrial Park (SIP) was built in Suzhou in 1994. The Chinese and Singaporean governments developed the core district, covering an area of 80 square kilometers, jointly. From the beginning, SIP was viewed as a flagship project in economic cooperation between China and Singapore and commanded a significant amount of public attention. As a result, SIP played an important strategic role for both governments.

The success stories of South Korea and China, along with those of other high-performing Asian countries, shows that outward-looking policies that promote export diversification and market-friendly direct intervention can have positive impacts on economic growth and development.

To attract new investment, we need a mechanism through which we can set goals and create performance metrics to benchmark success. We need an action-oriented committee to review the existing government agencies to promote efficiency and effectiveness.”

—Ambassador Farooq Sobhan,
President, Bangladesh Enterprise Institute

Financial and Policy Solutions

Based on the best practices from Singapore and other countries, Lab participants reviewed financial and policy recommendations that could support Bangladesh's industrial diversification. These recommendations could address the barriers outlined above, while also addressing the conditions investors tend to look for before they make financial commitments in a given country. As seen in table 5, the group emphasized ways to attract foreign investors to help finance the diversification of the country's economy.

TABLE 5 <i>Foreign investor criteria</i>	
Social and political environment	Working language
Ease of managing the business	Exchange rate control
Supportive government	Stability of currency
Investment regulation	Banking facilities and interest rates
Import and export requirements	IP protection
Cost, supply, and quality of workforce	Possibility of a quick startup
Union and employment regulations	Land-lease rental / cost of purchase
Cost of living	Quality of life
Availability and cost of infrastructure: • roads and highways • air and container ports • availability, cost, and reliability of electricity and water supplies • telecommunications • wastewater treatment	Building-purchase / construction cost
Source: Mr. Por Kay TI.	

Based on these 18 criteria and the experiences in economic development from Singapore, participants created recommendations to address key barriers. The solutions are grouped according to the issues addressed, and include:

- improving market-oriented policies and incentives
- developing a cohesive marketing and investment promotion strategy
- developing a high-skilled workforce.

IMPROVING MARKET-ORIENTED POLICIES AND INCENTIVES

The first challenge is the lack of coordination and transparency among the various governmental agencies that are mandated to provide market incentives. Investors and industry are looking for a “one-stop shop” within the government that (1) oversees incentive policies, (2) outlines its policies in clear and undisputable language, and (3) is accountable to the broader community in terms of issuing and enforcing its policies.

The Board of Investment (BOI), for example, is charged with helping facilitate access to capital for business growth. However, participants agreed that as currently structured, the BOI is limited in what it can do to promote investment. Consequently, it has not been as effective as it could be in attracting private capital, whether foreign or domestic.

Participants also agreed that the specific programs and policies could be restructured to be more effective. For example, Bangladeshi law has enabled the creation of special economic zones and provides tax incentives and other credits to investors who support businesses within them, but little has been done to use them as a means to spur investment.

To this end, Lab participants outlined three recommendations to overcome the challenges with market-oriented policies.

RECOMMENDATION 1: ADDRESS THE CHALLENGES OF THE BOARD OF INVESTMENT

The Board of Investment has been plagued with challenges in creating clear and defined policies to incentivize investment, and has struggled with implementing and enforcing these programs. To revitalize the BOI, participants suggested two possible courses of action. The first option would be to work on an overhaul of the organization by bringing back experienced expatriate talent to form a core team empowered to review and suggest changes.

The second option involves replacing the BOI with a new governing body, based on international best practices. The new agency would still be a one-stop shop for all investment policies and would bridge the bureaucratic gaps that exist when dealing with the various ministries that provide funding for business growth.

Regardless of which path is chosen, participants agreed that an improved structure would include a new board with expanded presence from the private sector. The structure, based on an adaption of the current structure, could include:

- a steering committee run by the minister for finance
- a chairman, who would be the prime minister
- membership that would include ministers for industry and commerce, among others
- other representatives from the private sector, including chambers of commerce and trade associations
- other members from different stakeholder groups for specific topics

In terms of function, participants agreed it would be useful for the entity to:

- meet every month
- review current policies and plans for industrial diversification
- develop and propose new policies
- create a monitoring and evaluation plan for each of the policies, in coordination with various ministries, to ensure compliance and implementation
- monitor progress and address specific problems of policies and investors

RECOMMENDATION 2: IMPROVE FINANCIAL INCENTIVE POLICIES

The revamped BOI or the newly empowered entity would review policies around foreign ownership rules, tax incentives, and the special economic zones, so as to streamline programs and create a framework to define metrics that increase accountability. Participants discussed a couple of the most critical policies to industrial diversification, including special economic zones (SEZs) and foreign ownership.

To make the country's special economic zones more fully operational, participants suggested the following policy modifications:

- Improve the availability of suitable land by allowing competition to boost land use productivity and logistics efficiency (e.g., better zoning and roadway and utilities development).
- Create a better framework for public-private partnerships to assist with the financing and implementation of infrastructure projects for power, roads, rails, etc.
- Clarify the legal framework for special economic zones to address investor concerns on how to best regulate the business practices within them.
- Improve financing options, as these zones have very high capital costs for companies, and potentially include different tools, such as credit enhancements for companies seeking access to commercial debt markets.

The policies around foreign ownership should also be reviewed and tailored to the needs of the business communities and best practices from abroad. Lab participants from Singapore suggested a policy based on their successful experiences with industrial diversification. For example, policies on 100 percent foreign ownership could be structured to include:

- any product not already produced in Bangladesh for domestic sale
- any product which is 100 percent for export (regardless of whether the product is already produced in country)
- establishing and operating industry training centers as a condition for approval; this should form part of the deal if there is some production in-country and some of the sales will be in the domestic market.

RECOMMENDATION 3: ADDRESS ACCOUNTABILITY

One of the critical components of the initial policy review would be to have the government announce key deliverables, timetables, and budgets to improve overall accountability.

Lab participants agreed that part of the new mandate of the BOI could include public accountability of implementation targets for major projects through the media or other channels, including social media. A public-private partnership to build a new energy generation plan, for example, would have to provide clear timelines for key milestones and deliverables from both the private-sector developer and the public-sector regulators to ensure that the project is progressing. This could be complemented by a committee of stakeholders to monitor implementation, from both public and private sectors.

DEVELOPING A COHESIVE MARKETING AND INVESTMENT PROMOTION STRATEGY

Despite strong efforts from the government to promote the country as a destination for foreign direct investment, a comprehensive marketing campaign is needed to help familiarize global investors with Bangladesh and change the international perceptions of the country as a less inviting destination for their capital.

RECOMMENDATION 4: ADDRESS THE LACK OF MARKETING

Bangladesh should create a government-wide effort to market the country to ensure that the appropriate image is being projected to foreign investors. Moving past the barriers and the perceived risks of reduced institutional capacity and increasing environmental challenges, a more coordinated effort to promote the country externally could increase investment flows and grow new industries.

Lab participants suggested the government work with the private sector to help develop a marketing plan. The campaign could include materials that document success stories of local businesses and entrepreneurs, as well as positive feedback from global investors and multinationals that have taken advantage of the great opportunities in Bangladesh.

Apart from the success stories, participants recommended focusing on aspects of the nation's economy that are extremely valuable assets for the country, including:

- an abundant labor supply
- large-scale manufacturing capacity
- increasingly diversified industries
- strategic location between India and China
- widespread English usage
- preferential access to consumer markets in key countries

DEVELOP A HIGHLY SKILLED WORKFORCE

Bangladesh's workforce is a strong asset. However, current industries have focused on low-skill jobs. To tap into more of the higher-value production, there needs to be a greater effort to provide education and training to the country's workforce to attract multinational corporations.

RECOMMENDATION 5: IMPROVE WORKFORCE TRAINING

The government currently runs industrial training programs and partners with different private-sector companies, especially in the garment industry. Industry-run programs enjoy partial funding from the government and to date have been the most successful in engaging the workforce. However, participants agreed, more could be done to integrate this industrial training into more mainstream education curriculum. As in Western countries, a stigma exists against vocational training versus traditional higher education; and consequently, participants suggested that the government work with the private sector to create marketing materials to improve public awareness of the opportunities for industrial training to attract more students.

One of the biggest challenges when addressing workforce training is the cost of the program. Lab participants discussed the possibilities for generating funding for these types of programs. The first thing that would need to be done is a review the rules and procedures for how funds are being allocated today (such as the government's \$500 million for such training and the Asian Development Bank's \$1.17 billion allocated toward Bangladesh for training). Once there has been a review, the government could consider drafting new levies or reallocating current funds to support new vocational training programs that would be accredited as a continuation of education within high schools that promotes industry-based labor skills. For example, if the review finds that the current allocation of funds is not adequate, then the government could develop a skills development levy of 1 percent imposed on all production workers as was done in Singapore in the early years.

The recommendations suggested during the Lab provide a strong foundation; they are the building blocks of economic development. What's important now, and what has been difficult for countries around the world, is how to make these ideas operational."

—J.Y. Pillay,
Chairman of the Council of
Presidential Advisers, Singapore

Conclusion

Bangladesh has successfully leveraged its core assets—its human capital and strategic industries—to drive its initial economic growth. From the established garment industry to new industries like IT and shipbuilding, the country has the ability to diversify its sectors and attract new types of foreign direct investment.

However, to create the ideal environment for this investment and growth, the government must address certain barriers that have limited both foreign interest and domestic expansion in industry. Based on the Lab's discussions on best practices from other countries, especially Singapore, participants agreed that attracting development capital to fund growth in new and existing sectors requires a strong organization to implement the recommendations. Current government agencies can be tasked to facilitate this effort, but it is clear that the governance around any new initiative should be structured less like a traditional public sector program and much more like a private sector business strategy, with clear goals that reinforce the bottom line and a strong mandate to influence policy and marketing.

With an efficient investment promotion strategy, all government agencies involved can work together to execute the recommendations rapidly. Developing a cohesive marketing and investment promotion strategy, with concrete policies and enforcement, will help ensure that Bangladesh can support effective industrial diversification.

Implementing the recommendations will allow the country to employ more of the tools necessary to realize its true economic potential and increase prosperity for its citizens for decades to come.

APPENDIX

Financial Innovations Lab Participants

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Aamra Companies***Khandaker Fatema Begum***Joint Secretary
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