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Editorial Notes

The financing of economic development warrants two basic issues: first, how best to provide external finance for the industrial sector, and second, how to monitor the behavior and performance of corporate borrowers under an effective system of corporate governance. Internally generated funds are essential for sustainable growth but inadequate especially when firms and economies are rapidly growing. A fundamental choice then is between a stock-market-based system (Anglo-American model) and a bank-based system (Japanese-German model) of external finance. Of course, the choice of the system is crucial in evolving a financial system and developing appropriate incentives and institutions. The securities market might have an edge over the banking sector in that, securities provide relatively liquid means of sharing risks and its holder can liquidate the holdings at any time.

Like many other countries, Bangladesh pursued the strategy to develop its industrial sector through banks and development financial institutions in the seventies and early eighties. The major thrust for adopting such a strategy was the absence of alternative conduits for financing the industrial sector. As a part of this strategy, two development financial institutions (DFIs) were established to provide entrepreneurs with the access to long-term industrial loans for which commercial banks have a limited role. The critical issue on the state of industrial term finance in the banking sector is the fact that high classified loans and default cost, and non-optimum portfolio mix make banks unsustainable and the banking sector vulnerable. Moreover, as the credit market in Bangladesh is characterized by imperfect and asymmetric information and an oligopolistic banking structure, a well-functioning securities market is essential for the success of the financial liberalization programs pursued by the monetary authorities. An active and vibrant securities market, which offers positive real returns on a variety of financial instruments, provides an alternative investment opportunity selecting the best portfolio through diversification of risk according to investors' preferences. Poor corporate governance, lack of discipline, and inadequate disclosure and transparency are fundamental problems afflicting the financial sector and capital market in particular in Bangladesh.

Effects of the 1996-crash have been multi-dimensional — from shaking investor confidence to narrowing the size of markets, from positive to negative attitude of the entrepreneurs. But the fact remains that the role of capital market has increased greatly when the size of public sector is being reduced and the consensus policy of open market economy is being pursued. In such economic environment, capital market cannot be undermined. In addition, arguments for a sound and developed capital market becomes stronger to restore financial discipline, reduce default cost and improve allocative efficiency and sustainability of the financial institutions in the financial markets.

Stock market in Bangladesh is characterized by a *high information asymmetry, shallow depth and thin market trading having small market capitalization ratio and low level of liquidity*. This situation is traceable to the low level of investor confidence associated with poor market governance, moderate level of institutional investment, lack of variety of trading instruments, and lack of financial analysts and fund managers who furnish superior information revelation. This market tends to be shallow without fully developed systems of regulation, institutional framework, international accounting and auditing standard and so forth. Lack of liquidity and variety of trading instruments is and continued to be an important deterrent for diversification of portfolio. Role of institutional investors and financial intermediaries like merchant banks,

commercial banks, insurance companies except ICB, has been remarkably insignificant in revitalizing the securities market.

Following the 1996-crash, much improvement has taken place in regulatory framework and supervisory structure. SEC has become more organized than before. The lack of financial independence of regulator constrains its ability to attract qualified professionals to carry out its tasks. DSE and CSE are more structured than before. Management has been separated from ownership in DSE and CSE. Brokers and dealers are treated separately. Still a large number of member firms of the exchanges devoid of skilled personnel and suffer from small capitalization, weak governance structure, and in-efficient operations. Moreover, potential conflict of interest does exist from non-separation of ownership and membership in the exchanges. Weak governance is mainly responsible for abnormal practices in the financial markets, such as insider lending, insider trading, accounting and auditing wrongdoing, etc. It impedes market development and constrains growth and potential investor participation. Consequently, issues in the development of capital market are required to be addressed. These issues include, among many, weak enforcement, poor corporate governance, slow development of the market infrastructure, moderate level of institutional investment, lack of financial analysts and fund managers providing superior information, and low level of capacity of major market players.

The general observation is that governance structures are deficient, and market regulator has ineffective enforcement and weak implementation capacity. The regulatory framework is to be strengthened and made adequate for the prevention of unbridled speculations, market-rigging and insider trading so that erosion in public confidence can be contained. The DSE and CSE are empowered and strengthened by updating its rules and regulations to facilitate surveillance and enforce compliance of rules, and to ensure close monitoring, transparency and accountability of the trading of the exchanges.

Issues, such as divestment of government equity holdings in SOEs and MNCs, trading of treasury bills, bonds and government securities, relating to broaden the base of securities market need to be focused. This will improve the supply of securities in the market and deepen the securities market, diffuse ownership and bring in market discipline.

On the other hand, listed companies lack transparency, corporate governance and rules are perceived to favor majority shareholders to the detriment of minority shareholders. In majority cases, entrepreneurs of the public-limited companies in many cases continue to behave like private owners. Sometimes, accounts are cooked to manipulate earnings and hence financial statements do not provide a reliable basis for informed decision making, as they still do not fully comply with international accounting standards (IAS) and are not audited according to international standards on auditing (ISA). Accounting Board should be created to regulate accounting profession and to ensure such standards are followed and disclosure norms are complied with.

Under SEC regulations, commercial banks are allowed to be merchant bankers, underwriters and managers of mutual funds giving rise potential conflicts of interests unless appropriate checks and balances are not in place and supervision remains relatively weak. Level playing conditions are necessary to ensure fair and effective market competition.

Mahmood Osman Imam

Editor