EQUITY MARKET AND CORPORATE FINANCING IN BANGLADESH

M. Farid Ahmed
Abstract

The importance of security markets to economic development is being increasingly recognized. This paper attempts to examine the role of equity markets in a developing country like Bangladesh. The recent development toward privatization and that of an equity market in Bangladesh may lead to the optimism about the expeditious upgrading of the equity segment of the capital markets as a source of sufficient long-term funds necessary for the industrialization of the country. But the share of new equity to gross domestic investment is generally less than 1%. The impressive increase in various government bonds and bank deposits has taken place while their respective yield was falling. Certainly, the attitude behind such a trend can't be explained in terms of irrationality on the part of the saving public, but in terms of pronounced risk aversion. Efforts to speed up the development of the equity market, although laudable, may not lead to immediate tangible results in the face of various structural constraints. In view of such questionable effectiveness of equity market associated with various legal and structural constraints as well as the tradition of the country the development of close relations between banks and industry as a means of promoting economic development appears to be unavoidable. Development banks are an invaluable source of equity capital and long-term credit in developing countries like Bangladesh. Likewise, transformation of short-term deposits into instruments of long-term debt and ownership needs to be entrusted to a set of different institutions pending the eventual development of the capital markets. The shift in emphasis has profound policy oriented implications. But the scenario of the banking system is not encouraging in recent years in view of the large volume of non-performing loans. In order to get rid of these problems, pressures for developing the internal efficiency of these institu-
tions may straighten the efficient use of funds. Indirect financing should not be considered as hindrance to the development of capital markets, but as a necessary step prior to, and as facilitating long run growth of the latter. However, official supervision of trading and overall market development is imperative if shares and bonds are to become attractive investment vehicles. Otherwise the investors may justifiably feel too exposed to the risk of market manipulation and other abuses, and may decline to invest in equity market.

Academic discussion of equity markets in developing countries has not been extensive. Wai and Patrick (1973) is a widely referred paper on this issue who favors its development rather with caution. Drake (1980, 1977, 1985) supports the stock market development. Although Samuels (1981) and Samuels and Yacout (1981) appear to be supportive of stock market development but indicate that they are inefficient and may result in increasing inequality in income and wealth distribution. Calamanti (1983) and Parkinson (1984) emphasize the limited role of an equity market in raising new capital in a developing economy. However, it is generally agreed that an equity market under general equilibrium plays a very important role in an economy in collecting and allocating funds in an efficient manner. In order to ensure these economic activities in developed economies an equity market has or should have a significant link to the overall economy (Baumol, 1965). The equity market also reflects investors' attempt to forecast economic trends. It is evident that the equity market and economic activity move in a similar cyclical pattern (Moore, 1975). It is also recognized that the stock price index is a major component of the leading indicators of the economy (Zarnowitz and Boschan, 1975). If the major problem in the
process of development is to increase the level of savings and to channel those savings into productive investments, then the mechanism of the capital markets is a crucial intermediary element in the process of growth. It becomes a major significance to understand how the existing capital markets operate to assist the accumulation of savings and their allocation in various sectors. Then it may be possible to shape the markets in a manner to provide a more efficient mechanism for channeling increasing savings into productive investment.

However, it is not an easy task to establish an adequate and efficient capital market. Efficient operation of the capital markets is required to meet at least two basic requirements. It should support industrialization through savings mobilization, investment fund allocation and maturity transformation. Besides, it must be safe and efficient in discharging the above role. In a developing economy such conditions usually do not prevail due to prevalence of informal credit markets that tend to limit the capacity to mobilize financial savings, a low degree of ownership–management separation associated with the drawbacks of informational asymmetry and a low level of accumulated financial assets making maturity transformation more difficult. Of course, these conditions differ widely from economy to economy.

The recent development toward privatization and that of an equity market in Bangladesh for mobilizing domestic resources appears to be encouraging. This may lead someone to believe that the equity market can be relied upon for providing sufficient long-term fund necessary for industrialization of Bangladesh. Although equity market records an increasing trend both in terms of number of the companies listed in the stock exchange and their market capitalization, its performance is not up to expecta-
tion. In the following sections an attempt has been made to evaluate its role in providing corporate finance in Bangladesh.

*Industrial Scenario In Bangladesh:*

Presently, the industrial base of Bangladesh is very narrow since the economy maintains a strong agrarian economy. The industrial sector, both large and small, accounts for about 15% of the GDP and absorbs about 8% of the total labor force. However, it is generally accepted that there is need for expanding this sector.

In the wake of liberation of Bangladesh, there was hasty and wholesale nationalization, particularly of every important sector of industry, without any preparedness and consideration for its necessity. Thus 85% of capacities and 70% of fixed investment were placed in the nationalized sector (First Five Year Plan, 1973–78). It reduces the private sector share in the fixed investment of modern industrial sector which came down from 64% to only about 10% (Ahmed, 1978). In terms of the number of units, however, the private sector still remained predominant. Nearly 90% of the registered factories numbering over three thousand was in the private sector (Ahmed, 1978). They were mostly of small scale. Besides, there were a large number of small scale and cottage industrial units in private hands which were not registered. However, there was a shift of government policy emphasizing the private sector since 1975 and the industrial policy has been devised toward that end. Many industries in the public sector have been denationalized. Divestment operations under which the shares or securities of public sector enterprises are offered for a public subscription can help strengthen the process of promoting an industrial democracy. Such move in
Bangladesh is necessary to develop confidence and investment habits among small investors and relieve the pressure on public resources. In the second half of the 1980's, the divestment operation and the Holding Company Scheme began. The scheme has a direct bearing on the equity market of Bangladesh. It permits incorporation of public sector enterprises as public limited companies and floating of shares in these companies for a public subscription. This scheme allows the retention of government equity ownership at 51% with 49% of its equity made available for a public subscription. Of the 49%, 15% is kept reserved for the employees and the remaining 34% is available to the public. In order to accelerate the process of privatization the present government has taken positive measures to sell government owned 51% shares.

The essential purpose of privatization is to make the society more competitive. This helps to create more investment, more wealth and more employment in the economy. Privatization can create dynamic activities and opportunities. The role of the capital market within an economy is closely related with finding a positive and constructive role for private investment within the economy. Accordingly, both private investment and the capital market must somehow be integrated into the development program of the economy. It is important for the government to set regulations, designed to ensure competition for the newly privatized entity so that it does not become a monopoly and allow inefficiency to continue.

The last industrial policy was declared by government in July 1991. The main objectives of the policy are:

1. Develop the industrial sector in order to increase its contribution to the GDP, income, resources and employment.
2. Expand industries by putting more emphasis on development of the
3. Encourage domestic and foreign investment in overall industrial development.
4. Develop export-oriented, export-linkage and efficient import substitute industries.
5. Encourage specially the development of small and cottage industries.
6. Encourage development of labor intensive industries through acquisition and improvement of appropriate technology.
7. Encourage development of agro-based and agro-supportive industries.
8. Stimulate development of industries based on indigenous raw materials and technology.
9. Confine the role of the government particularly in establishing strategic industries and to improve efficiency of public sector.
10. Create possible opportunities for revitalizing and rehabilitating sick industries.

Although this policy does not reflect much qualitative change over its predecessor but reiterates strong commitment for further deregulation, privatization, trade policy reform and export promotion as well as government’s strong desire for industrial development through its supportive role. Proper implementation of these policies may gradually broaden the industrial base of the country, but it is possible that the policies may have to face difficulties in its implementation process due to various uncertainties associated with a developing economy.

The proportional contribution of agriculture, industry and services to GDP as calculated for the past years was as follows:
Table 1

<table>
<thead>
<tr>
<th></th>
<th>1973-75</th>
<th>1977-80</th>
<th>1985-88</th>
<th>1990-93</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>58.3%</td>
<td>52.2%</td>
<td>40.0%</td>
<td>33.7%</td>
</tr>
<tr>
<td>Industry</td>
<td>11.4</td>
<td>14.5</td>
<td>14.4</td>
<td>15.3</td>
</tr>
<tr>
<td>Services</td>
<td>30.4</td>
<td>33.4</td>
<td>45.6</td>
<td>51.0</td>
</tr>
</tbody>
</table>

Source: Estimated from various issues of Economic Trends, Bangladesh Bank.

During the 70’s, 80’s, and early 90’s the contribution to GDP from the agricultural sector decreased noticeably while the contribution of the industrial sector increased only by smaller increments. The remaining contribution came from the service sector with an increasing trend (Table 1).

Bangladesh public sector is not large. Overall 86.8% of the total GDP is in the hands of private sector, the remaining 13.2% being the public sector contribution to GDP (Haque, 1990). On a global scale, public enterprises account for around 10% of GDP, and in developing countries they typically produce between 10 and 20% (Killick and Commander, 1988 and Berg, 1985). In Malaysia, India and Sri Lanka, Government accounts for one third of GDP; public expenditure in Thailand, Pakistan and Indonesia is one quarter of GDP (Kholi, 1987 and Tabni, 1987). Problems of measurement and the reliability of statistics do exist, and there is certainly no reason to believe in the existence of an optimal level of involvement by the government in GDP. Nevertheless, a number of studies do point to a negative correlation between Government contribution to GDP and economic growth (Naya, 1988).

The industrial scene of Bangladesh is dominated by a relatively small
number of large enterprises which coexist with large number of small units. About 65% of the public limited companies registered with the Registrar of Joint Stock Companies have a paid up capital below Tk. 5 million and about 21% have paid up capital over Tk. 10 million (Khan et al, 1995). A relatively extensive industrial foundation is a necessary condition (although not a sufficient one) to an increased supply of shares, ceteris paribus. If we look at the comparative picture of listed stocks of the Asian emerging markets we find that the total market capitalization of Dhaka Stock Exchange (DSE) was $454 million (which increased to $1.04 billion in 1994) compared to $98 billion in India, $11.6 billion in Pakistan, $139 billion in South Korea and $220 billion in Malaysia (Table- 2). Besides, the average size of the companies was the smallest among the emerging markets listed

Table- 2
Major Indicators of Some Emerging Markets, 1993
(Amount in Million US Dollars)

<table>
<thead>
<tr>
<th></th>
<th>Bangladesh</th>
<th>India</th>
<th>Pakistan</th>
<th>Sri Lanka</th>
<th>Thailand</th>
<th>Phillippines</th>
<th>South Korea</th>
<th>Malaysia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Listed Securities</td>
<td>153</td>
<td>6800</td>
<td>653</td>
<td>200</td>
<td>347</td>
<td>180</td>
<td>693</td>
<td>410</td>
</tr>
<tr>
<td>Market Capitalization</td>
<td>454</td>
<td>97976</td>
<td>11602</td>
<td>2498</td>
<td>130510</td>
<td>40327</td>
<td>139420</td>
<td>220328</td>
</tr>
<tr>
<td>Value of Securities Transacted</td>
<td>15</td>
<td>21879</td>
<td>1844</td>
<td>385</td>
<td>86934</td>
<td>6785</td>
<td>211710</td>
<td>153661</td>
</tr>
<tr>
<td>Average Size of Company</td>
<td>3</td>
<td>14</td>
<td>18</td>
<td>12</td>
<td>376</td>
<td>224</td>
<td>201</td>
<td>537</td>
</tr>
<tr>
<td>Price-Earnings Ratio</td>
<td>10.6*</td>
<td>39.7</td>
<td>27.6</td>
<td>27.8</td>
<td>27.5</td>
<td>38.8</td>
<td>25.1</td>
<td>43.5</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>6.6*</td>
<td>1.0</td>
<td>1.5</td>
<td>1.6</td>
<td>1.5</td>
<td>0.3</td>
<td>0.6</td>
<td>1.0</td>
</tr>
</tbody>
</table>

by International Finance Corporation (IFC). The market appears to be less liquid than others if it is considered in terms of the share of annual transaction volume to market capitalization. Accordingly, the supply of equities is restricted by the paucity of large private concerns in various industries. Unless the existing industrial structure of the country undergoes a transformation, the desirable flow of equities will not be forthcoming. This is a weakness which, by its very nature, can't be remedied in the short run. The enlargement of the industrial base and the size distribution thereof can come about only with the gradual development of the country (Maniatis, 1971). Until the transformation process is successful, other things being equal, the necessary flow of equities to sustain an efficient capital market can't be expected.

**Performance of Bangladesh Equity Market.**

An equity market can be relied upon to a considerable extent to meet the needs of corporate finance has been widely held in Bangladesh in recent years. Optimism in the practicability of such an expeditious upgrading of the equity segment of capital markets derives mainly from the persistent accumulation of bank deposits and heavily oversubscribing rate of corporate securities in the past few years. However, before going to detailed analysis, we need to see the saving and investment behavior in Bangladesh.

Within a general framework, the importance of stock market stems from its perceived classical role of allocating funds to the most productive sectors of the economy. Thus, it is imperative that a stock market has or should have important links to the overall economy in which it works (Ando and Modigliani, 1963). According to the life cycle theory of Ando and
Modigliani households project their resources or wealth over their expected lifetime and decide consumption flows that best suit their preferences. Part of the household wealth is held in the form of stocks. This indicates an increase in stock prices and the resulting corporate gains result in higher wealth, which in turn results in additional consumption expenditure (see Bhatia, 1972). In Bangladesh, households are the largest group of shareholders although stock as a percentage of overall household wealth has always been small in the portfolio composition of stock investors (Ahmed et al, 1993), not to speak of the general public. Naturally, the impact of stock price changes on household consumption should be insignificant. Another factor that might lead to this outcome is the pattern of distribution of stockholders in Bangladesh across wealth classes. The distributions of stockholding in Bangladesh are skewed in the direction of the relatively wealthy (Ahmed et al, 1993), who, it is argued, are less sensitive to the increases in stock prices when undertaking consumption decision, because of lower marginal propensities to consume (Arena, 1965). Recognizing the highly skewed ownership structure of Bangladesh companies as a fundamental issue, of late, government had adopted several policies intended to broaden the base of share ownership which are as follows:

1. The government has withdrawn all restrictions on foreign investment permitting them to invest directly in primary and secondary market.
2. The restriction on sale of shares on a premium has also been withdrawn.
3. No permission is needed to issue Right or Bonus shares.
4. Some fiscal measures have been aimed at primarily curbing tax evasion and encouraging savings and investment. These are briefly:
   a) All capital gains on disposal of securities have been tax exempt.
b) Dividend income has been tax free upto Tk. 30,000.00, withholding taxes of 15% will apply for dividends remitted overseas to countries without double tax treaties.
c) Corporate tax rates have been lowered from 45% to 40% for publicly listed industrial companies while unlisted companies are taxed at 45% down from 50%.

Recent increasing trend in stock prices has attracted more investment in stocks. In fact, there is no lack of potential savers willing to invest in industrial equity offerings by well established and large concerns. The prevailing narrow base of a stock market, as we have mentioned earlier, may be attributed to the deficient supply of securities. Nevertheless, equity offerings could be considerably increased if the more easily available bank loans at less cost could be discontinued and thereby compelling the large corporations to resort to the capital market (Khan et al, 1995). However, it may be observed from the analysis that optimism about investment in more advanced form of assets, such as industrial equities, is not warranted. It is not only the supply of equities which is at fault but also the demand for equities to hold. An array of decisive factors that impedes the development of an equity market — both demand and supply side — in Bangladesh may conveniently be listed as follows:

i) absence of broad industrial base;

ii) diffident attitude of the saving public toward more advanced form of assets;

iii) unwillingness of family controlled undertakings to expand their equity capital;

iv) prevailing market structure that partly conditions investment and supply of securities;
vi) pursuing a financial policy of a high debt-equity ratio by firms, a tendency encouraged by easy access to bank loans.

These impediments tell upon the development of Bangladesh equity

Table- 3
Growth Pattern of Listed Companies From 1976 to 1994

<table>
<thead>
<tr>
<th>Year</th>
<th>No. Of Listed Securities</th>
<th>Paid Up Capital</th>
<th>Market Capitalization</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Total Taka (in mil.)</td>
<td>% increase</td>
</tr>
<tr>
<td>1976</td>
<td>9</td>
<td>137.5</td>
<td>—</td>
</tr>
<tr>
<td>77</td>
<td>11</td>
<td>230.5</td>
<td>67.61</td>
</tr>
<tr>
<td>78</td>
<td>14</td>
<td>281.3</td>
<td>22.05</td>
</tr>
<tr>
<td>79</td>
<td>18</td>
<td>365.0</td>
<td>29.77</td>
</tr>
<tr>
<td>80</td>
<td>23</td>
<td>405.8</td>
<td>11.17</td>
</tr>
<tr>
<td>81</td>
<td>26</td>
<td>528.1</td>
<td>30.12</td>
</tr>
<tr>
<td>82</td>
<td>29</td>
<td>726.5</td>
<td>37.38</td>
</tr>
<tr>
<td>83</td>
<td>44</td>
<td>1001.5</td>
<td>38.04</td>
</tr>
<tr>
<td>84</td>
<td>58</td>
<td>1546.6</td>
<td>54.42</td>
</tr>
<tr>
<td>85</td>
<td>72</td>
<td>2059.7</td>
<td>33.18</td>
</tr>
<tr>
<td>86</td>
<td>82</td>
<td>2653.0</td>
<td>28.81</td>
</tr>
<tr>
<td>87</td>
<td>92</td>
<td>3149.6</td>
<td>18.72</td>
</tr>
<tr>
<td>88</td>
<td>111</td>
<td>3663.7</td>
<td>16.32</td>
</tr>
<tr>
<td>89</td>
<td>116</td>
<td>4539.2</td>
<td>23.90</td>
</tr>
<tr>
<td>90</td>
<td>134</td>
<td>5361.1</td>
<td>18.11</td>
</tr>
<tr>
<td>91</td>
<td>138</td>
<td>5586.6</td>
<td>4.21</td>
</tr>
<tr>
<td>92</td>
<td>149</td>
<td>6020.3</td>
<td>7.76</td>
</tr>
<tr>
<td>93</td>
<td>153</td>
<td>8201.7</td>
<td>36.23</td>
</tr>
<tr>
<td>94</td>
<td>156</td>
<td>9268.0</td>
<td>13.00</td>
</tr>
</tbody>
</table>

Source: DSE Fact Book, 1994 and DSE Monthly Reviews (various issues)
market. Dhaka Stock Exchange (DSE), the only bourse of Bangladesh, was reactivated in 1976 with 9 companies after having been originally established in 1954. Immediately after liberation of the country the market was closed for the period from 1971 to 1975 due to socialistic economic policy pursued by the then government. With the change of government policy, DSE was reactivated in 1976, Investment Corporation of Bangladesh (ICB) and Controller of Capital Issues (CCI) were set up for market development. The number of securities listed on the DSE had risen from 9 in 1976 to 156 in 1994 with accumulative value of Tk.9268.0 million at issue prices. The growth of paid up capital was somewhat slow in 1990–1991. During this period the growth rate of market capitalization is also seen as negative (Table-3). This indicates the bearish market condition. During the period from 1984 to 1987 the growth rate of market capitalization was unexpectedly high peacked at 121.11% increase in 1987 indicating a bullish condition.

For getting a better understanding of the equity market performance we should examine its relative contribution in resource mobilization in Bangladesh. The extent to which the equity market has been successful in mobilizing additional resources can be directly analyzed with reference to the share of corporate security issues to funds mobilized by the other investment opportunities available in Bangladesh like the banking system, postal savings and other government savings schemes. Table-4 presents the share of corporate securities. As can be seen, the proportion of funds raised via the stock market are small relative to banking system as well as govern-

1) Government saving schemes include Bangladesh Savings Certificates, Defense Saving Certificates, Bonus Savings Certificates, 8-year Bangladesh Savings Certificates, Wage Earners Development Bond and Savings Tickets which usually provide 10 to 18% interest.
Table- 4
Funds Mobilized by Banking System, Government Saving Schemes and Stock Market in Bangladesh

(Taka in million)

<table>
<thead>
<tr>
<th>Year</th>
<th>Corporate Securities</th>
<th>Bank Deposits (Time Deposits)</th>
<th>Postal Savings</th>
<th>National Savings</th>
<th>Total of Col. 3 to 5</th>
<th>Ratio (Col.2 As % of col.6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975-76</td>
<td>137.5</td>
<td>5147.0</td>
<td>430.0</td>
<td>567.0</td>
<td>6144.0</td>
<td>2.24</td>
</tr>
<tr>
<td>76-77</td>
<td>230.5</td>
<td>7670.0</td>
<td>447.0</td>
<td>713.0</td>
<td>8830.0</td>
<td>2.61</td>
</tr>
<tr>
<td>77-78</td>
<td>281.3</td>
<td>9169.0</td>
<td>468.0</td>
<td>826.0</td>
<td>10463.0</td>
<td>2.69</td>
</tr>
<tr>
<td>78-79</td>
<td>365.0</td>
<td>12352.0</td>
<td>493.0</td>
<td>1023.0</td>
<td>13878.0</td>
<td>2.63</td>
</tr>
<tr>
<td>79-80</td>
<td>405.8</td>
<td>15131.0</td>
<td>533.0</td>
<td>1196.0</td>
<td>16860.0</td>
<td>2.41</td>
</tr>
<tr>
<td>80-81</td>
<td>528.1</td>
<td>21497.0</td>
<td>583.0</td>
<td>1482.0</td>
<td>23562.0</td>
<td>2.24</td>
</tr>
<tr>
<td>81-82</td>
<td>726.5</td>
<td>25366.0</td>
<td>591.0</td>
<td>1783.0</td>
<td>27740.0</td>
<td>2.62</td>
</tr>
<tr>
<td>82-83</td>
<td>1001.5</td>
<td>32639.0</td>
<td>688.0</td>
<td>2187.0</td>
<td>35514.0</td>
<td>2.82</td>
</tr>
<tr>
<td>83-84</td>
<td>1586.6</td>
<td>48359.0</td>
<td>810.0</td>
<td>2646.0</td>
<td>51815.0</td>
<td>2.98</td>
</tr>
<tr>
<td>84-85</td>
<td>2059.7</td>
<td>63024.0</td>
<td>949.0</td>
<td>3040.0</td>
<td>67013.0</td>
<td>3.07</td>
</tr>
<tr>
<td>85-86</td>
<td>2653.0</td>
<td>74102.0</td>
<td>1075.0</td>
<td>3694.0</td>
<td>74871.0</td>
<td>3.57</td>
</tr>
<tr>
<td>86-87</td>
<td>3149.6</td>
<td>90903.0</td>
<td>1195.0</td>
<td>4458.0</td>
<td>96556.0</td>
<td>3.26</td>
</tr>
<tr>
<td>87-88</td>
<td>3663.7</td>
<td>113603.0</td>
<td>1551.0</td>
<td>6045.0</td>
<td>121200.0</td>
<td>3.02</td>
</tr>
<tr>
<td>88-89</td>
<td>4539.2</td>
<td>136174.0</td>
<td>2062.0</td>
<td>7662.0</td>
<td>145898.0</td>
<td>3.11</td>
</tr>
<tr>
<td>89-90</td>
<td>5361.1</td>
<td>159289.0</td>
<td>2697.0</td>
<td>9803.0</td>
<td>171789.0</td>
<td>3.12</td>
</tr>
<tr>
<td>90-91</td>
<td>5586.6</td>
<td>178807.0</td>
<td>2977.0</td>
<td>19033.0</td>
<td>200817.0</td>
<td>2.78</td>
</tr>
<tr>
<td>91-92</td>
<td>6020.3</td>
<td>202686.0</td>
<td>2983.0</td>
<td>27186.0</td>
<td>232855.0</td>
<td>2.58</td>
</tr>
<tr>
<td>92-93</td>
<td>8201.7</td>
<td>224730.0</td>
<td>—</td>
<td>—</td>
<td>—</td>
<td>—</td>
</tr>
</tbody>
</table>

ment saving schemes. The increasing popularity of the equity market since 1982–83 arose due to different tax incentives offered and the denationalization policy adopted by government. Indeed, the corporate bond market came into being as a new investment vehicle since 1987. However, the market is yet to be broad based, only seven bonds issued at the end of 1994. The attractiveness of bank deposits was magnified due to high interest rates until 1991. Government saving schemes were specially attractive due to high interest rate and tax exemption of income from this source. But from 1991 interest rates have been reduced significantly.

The ratio of new equity issues to gross domestic investment with some activity ratios are contained in Table-5. Drake (1980) has sug-

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1985–86</td>
<td>466230</td>
<td>58850</td>
<td>593.4</td>
<td>34.3</td>
<td>0.007%</td>
<td>1.0%</td>
</tr>
<tr>
<td>86–87</td>
<td>539200</td>
<td>69490</td>
<td>496.6</td>
<td>152.4</td>
<td>0.028</td>
<td>0.7</td>
</tr>
<tr>
<td>87–88</td>
<td>597140</td>
<td>74310</td>
<td>514.0</td>
<td>120.8</td>
<td>0.020</td>
<td>0.7</td>
</tr>
<tr>
<td>88–89</td>
<td>659600</td>
<td>85190</td>
<td>875.6</td>
<td>154.3</td>
<td>0.023</td>
<td>1.0</td>
</tr>
<tr>
<td>89–90</td>
<td>737570</td>
<td>94430</td>
<td>821.9</td>
<td>187.7</td>
<td>0.025</td>
<td>0.9</td>
</tr>
<tr>
<td>90–91</td>
<td>834390</td>
<td>95960</td>
<td>225.4</td>
<td>100.4</td>
<td>0.012</td>
<td>0.2</td>
</tr>
<tr>
<td>91–92</td>
<td>906500</td>
<td>109850</td>
<td>433.8</td>
<td>261.0</td>
<td>0.028</td>
<td>0.4</td>
</tr>
<tr>
<td>92–93</td>
<td>968800</td>
<td>128370</td>
<td>2181.4</td>
<td>403.6</td>
<td>0.042</td>
<td>1.7</td>
</tr>
</tbody>
</table>

gested that the ratio of new issues to gross capital formation can provide a measure of the level of financial development, while Kitchen (1993) has suggested the use of various activity ratios as indicators of financial development. In Bangladesh, the share of new equity issues to gross domestic investment is generally less than 1%. It increased substantially in 1992–93. Besides, turnover of listed securities showed an increasing trend when it is expressed as a percent of GDP. This may, perhaps, be due to various incentives for encouraging equity investment and financial market liberalization policy declared by government together with lowering down the interest rates on bank deposits as well as on government saving schemes. The new issues abruptly declined in 1990–91, perhaps, because of the political instability and market hesitancy about the government policy due to expected change of government ensuing at that time.

Similar results can be obtained if the ratio of new equity to national savings is considered as Table–6 presents. In general, then, it may be concluded that the equity market has not been able to provide a strong alternative to the banking system and various government saving schemes for the mobilization of funds for the period under consideration in spite of adopting various policy measures and tax incentives favoring the development of equity market. The contribution of the market to financial development (as proxied by the ratio of new issues to gross investment) for the same period has not been significant. Speculative elements along with the investors’ expectations bring fluctuations in the stock market. These contributed to a stock market ‘boom’ in 1987–88. The stock market started experiencing a sluggish and declining trend since the latter part of 1988. This declining condition could be attributed to shaky investors’ confidence due to poor performance of the companies. Added to this, the overpricing of stock in 1987–88
(Seok & Park, 1992) later started falling back to its 'rational' level. It is noteworthy that new issues have been substantially oversubscribed since 1984. It reflects the investors' interest in equity investment. Nevertheless, high level of oversubscription could be partly explained by the rate of capital gain due to rising trends in stock price and issue of stock at face value.

Much of the market constraints is associated with the overall development of the country and hence investment in equities is likely to continue to be some highly risky affairs for a great many potential investors with pronounced risk aversion attitudes. The impressive increase in various government bonds and bank deposits has taken place while their respective yield was falling. In fact, the rate of interest was 14 to 18% in 1990, had

<table>
<thead>
<tr>
<th>Year</th>
<th>Ratio of Saving to GDP (As percent)</th>
<th>Ratio of New Equity to National Saving (as percent)</th>
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<tr>
<td>1985–86</td>
<td>3.22</td>
<td>3.96</td>
</tr>
<tr>
<td>86–87</td>
<td>3.52</td>
<td>2.62</td>
</tr>
<tr>
<td>87–88</td>
<td>2.97</td>
<td>2.30</td>
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<tr>
<td>88–89</td>
<td>2.70</td>
<td>5.30</td>
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<td>89–90</td>
<td>2.73</td>
<td>4.09</td>
</tr>
<tr>
<td>90–91</td>
<td>4.13</td>
<td>0.65</td>
</tr>
<tr>
<td>91–92</td>
<td>5.84</td>
<td>0.82</td>
</tr>
<tr>
<td>92–93</td>
<td>6.90</td>
<td>3.26</td>
</tr>
</tbody>
</table>

already dropped to 6 to 12% in 1995. Certainly, the attitude behind such a trend can’t be explained in terms of irrationality on the part of the saving public, but rather in terms of pronounced risk aversion. In the presence of forceful structural and other impediments, measures aiming at increasing the relative contribution of equities will most likely be of insignificant use. On the other hand, devices that purport to force industrial undertakings to resort to the new issue market are of questionable effectiveness, in view of the relative difficulties to institute and implement them. In such situations equity market appears to be difficult to develop and the transformation of short-term deposits into instruments of long-term debt and ownership must be entrusted to a set of different institutions pending the eventual development of the capital markets. This shift in emphasis has profound policy oriented implications.

Performance of Financial Institutions

In developing economies state plays a pioneering role, a promotional role and also a stimulating role for promoting private sector enterprises. Accordingly institutions are established with specific purpose to pioneer industries, to subscribe shares and debentures, to guarantee and grant long-term loans, to underwrite issues or to help in filling the ‘gap’ in some other way may be called special financial institutions or Development Finance Institutions (DFIs). French Credit Mobilier established in 1852 may be said to be the pioneer in the field. The Industrial Bank of Japan was established in 1902 and many more institutions were established after the First World War. Shortage of funds in the capital market, technical knowledge and inadequate facilities for industries and investors indicate the
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great need of such institutions in Bangladesh. Thus Bangladesh has pursued a "supply-leading" finance strategy as is seen in other developing economies (Patrick, 1966) to widen the industrial base through establishing DFIs like Bangladesh Shilpa Bank (BSB) and Bangladesh Shilpa Rin Sangstha (BSRS). The banking system underwent structural changes with the creation of 6 nationalized commercial banks (NCBs) through nationalization of all commercial banks in 1972. Before nationalization there were 12 commercial banks in the private sector and 2 DFIs—one for industrial finance and the other for agricultural finance—in the public sector. However, with the change of government policy toward privatization 2 commercial banks were denationalized in 1984. Currently, there are 3 NCBs and 12 private commercial banks (including 2 denationalized banks) and 4 government owned DFIs—2 for industrial finance (BSB and BSRS) and 2 for agricultural finance (Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank) (Bangladesh Bank, 1993). Besides, 7 foreign commercial banks operate in Bangladesh financial markets.

The capital market of Bangladesh broadly is divided into two segments, viz., the non-security segment and the security segment. Non-security segment comprises 2 DFIs—BSB and BSRS while the securities segment comprises DSE, ICB and its co-underwriters viz., BSB, BSRS, Sonali Bank, Janata Bank, Agrani Bank, Rupali Bank, Pubali Bank, Uttara Bank and Shadaran Bima Corporation (General Insurance Corporation). BSB and BSRS provide long-term and medium-term loans to entrepreneurs while ICB and its co-underwriters provide equity finance either through direct underwriting or through bridge finance. Short-term finance is mainly provided by the commercial banks. Industries in Bangladesh rely heavily on a bank fund. These financial institutions play a dominant role in
the industrialization process of the country. Of the total industrial credit of Tk. 920 million provided for capacity creation in the year 1984–85, 86% was provided by BSB, BSRS and ICB whereas the remaining 14% was provided by NCBs. Out of this 86%, BSB provided 62% and BSRS provided 18% (Alamgir, 1985). The DFIs in Bangladesh provide loans to the enterprises at a very high debt-equity ratio. In most cases the ratio is 70:30 and may be higher depending on the location and type of industry. Accordingly companies take unusually high volume of loan compared to their equity and thereby become highly risky. This means, in case of a loss major burden is shifted to the bank. With high leverage, the entrepreneurs could recover their equity by overvaluing equity inputs (e.g., land and buildings), overinvoicing equipments and raw materials and distributing earnings (Varley, 1992). They are tempted to lose their creditworthy entity as their lack of creditworthiness does not affect their attempt to take further loan. In contrast, businesses with relatively reduced exposure to risk go for either sharing the ownership with shareholders or use internal fund for expansion purposes. The interest rates charged by the DFIs were not consistent with the risk associated with the project, nor the equity and repayment schedule were consistent with the risk (Khan et al, 1995). The soft lending policy of the government made borrowing preferable because of ease of mobilizing funds, no necessity to repay in time, risk to businessmen from failure, deductibility of interest expense for tax purposes and greater control over the company (Varley, 1992). Of course, most companies need not pay taxes at their initial years of operation due to tax holiday applicable at that time.

The specialized financial institutions, viz., ICB, BSB and BSRS provide venture capital mainly in the form of bridge finance and underwriting. They sanctioned venture capital to 749 companies from the fiscal year 1976–
77 to 1992–93. In return the borrowing companies required to make public issue of shares and debentures. However it is reported that only 71 out of 749 companies have made public issue of securities during the period from 1976 to 1994 (Khan et al, 1995). This indicates that preparing some rule is not a sufficient condition to bring the companies for public floatation. Congenial environment and mechanism need to be devised for this purpose. Some NCBs also participate in venture capital financing. In addition, private financial institutions viz., Saudi Bangladesh Agricultural and Investment Company (SABINCO) and Industrial Promotion and Development Corporation (IPDC) take part in these activities.

In the immediate future, the institutions involved in bringing supply and demand together are ICB, DSE, and recently opened Chittagong Stock Exchange (CSE). ICB functions both as a development finance company and as an underwriter. It performs the former role when it provides either bridge or debenture financing to new companies. In this capacity, it competes with the two much larger development banks—BSB and BSRS—already in the field. It also performs underwriting function. In this capacity, it renders investment banking function that is essential for securities market. ICB is primarily engaged in the provision of venture capital and hence not immediately involved in recovering payments against their investments. But still the Corporation’s dues/overdues in respect of interest on bridge loan, debenture loan and debenture principal stood at Tk.2790.2million as on June 1994 (Ministry of Finance, 1993–94).

Bangladesh commercial banks hold a relatively modest amount of investment in corporate securities. An examination of the statements of individual banks reveals very small holdings of shares. Such holdings generally amounted to less than 1% of total deposits (Robbins, 1980). The situa-
tion does not appear to be much different even today. The internal policy of the banks clearly does not favor the acquisition of securities of companies in the private sector. This attitude represents a combination of factors including a reluctance to hold long-term investments in the face of short-term obligations, the modest amount of securities available, lack of their liquidity and lack of confidence in stock markets of Bangladesh. Even granted these factors, however, this virtual abstinence is extreme. The commercial banks of Bangladesh, as in most less developed countries, are so dominant in the nation's financial structure that their role in the creation of a securities market becomes very important. There is reason to believe that banks are not performing their due role in this regard.

The main philosophy behind setting up of the financial institutions was to ensure optimum development of the industrial sector through providing financial support. There was a time when loan sanction and loan disbursement were the main criteria for evaluating the performance of these institutions. But now, the recovery of disbursed loans has become an important element of their performance evaluation. Lower recovery of loan is at present a great problem faced by the financial institutions of Bangladesh. BSB has recovered only 19% of its overdues and 37% of its current dues whereas BSRS has recovered only 8% of the overdue amount (Ministry of Industries, 1985). The overdue loan of BSB stands at Tk.3225.9 million or 36% of total loan on 30th June 1990. The overdue loan was 49% on 30th June 1989. The overdue loan of BSRS stands at Tk.4432.1 million or 51.7% of total loan on 30th June 1990. The same figure was 78.6% on 30th June 1989 (Bangladesh Bank, 1989-90). As on 31st March 1994, BSB had the total outstanding term-loans of Tk.13420.0 million of which Tk.6870.0 million was overdue. This accounted for about 51% of total outstanding
loans. Similarly, BSRS had total outstanding loans of Tk. 9275.4 million of which Tk.5305.5 million or about 51% was overdue on the same date (Ministry of Finance, 1993—94). Thus, it appears that the performance of these banks has not been satisfactory. Before independence in 1971 specialized financial institutions viz., Industrial Development Bank of Pakistan (IDBP) and Pakistan Industrial Credit and Investment Corporation (PICIC) which after independence form BSB and BSRS respectively did not experience such a situation. Apparently, inefficiency in management is at least partially attributed for such problems. These banks have been suffering from severe liquidity constraints because of their low loan recovery rate and misallocation of resources (Sobhan, 1990). Low recovery rate is related to the misappraisal of projects, errors in assumptions about market behavior, demand and supply and long time taken for project approval. Again, misappraisal and the errors in the underlying assumptions of the project were closely associated with the extraction of premiums by the relevant bank employees (Nabi, 1992). There is some evidence of concern amongst the aid donors who have made a significant financial support to sustain the lending programs of these financial institutions. But with some stringent measures taken by the present government the situation is improving although at a slow pace. The recovery target of 100 largest defaulter borrowers of NCBs and new loans of Tk.10 million and above disbursed after June 1990 was achieved. The NCBs achieved 197.23% of their collection target from their 100 largest defaulter borrowers at the end of June 1994. In case of new loans collection stood at 77.48% of target at the end of March 1994 (Ministry of Finance). Some provision of the Financial Loan Court and Bank Company Act 1991 were amended to strengthen legal provision for recovery and ensure more discipline in the financial sector. Bank Company
Act (Amended) 1993 was promulgated. The credit information Bureau set up in Bangladesh Bank has been providing necessary information promptly as required by commercial banks. All these together may result in reduction of 'default culture'.

Policy Issues:

The economic rationales for the reactivation of stock exchange in Bangladesh, among others, included the following:

a) mobilization of resources through non-bank intermediaries;
b) broadening of the ownership structure of corporate capital; and
c) deepening and diversification of the financial sector.

The analysis of the success or otherwise of equity markets from a macro economic perspective is not necessarily a straightforward process. A variety of different indicators and variables for judging aggregate efficiency have been suggested by a number of different authors (Wai and Patrick, 1973, Drake, 1985). However, it appears that preconditions of decisive importance may inhibit the expeditious growth of both demand for and supply of equities in Bangladesh. Indeed, in the framework of a less developed country dominated by agriculture like Bangladesh, it would be rather difficult to find an efficient equity market. Development of confidence in financial instruments and the requisite change in institutions, their framework and attitude are basically a matter of time and not only of incentives. Efforts to accelerate the development of the equity markets by policy measures do not seem very promising in a developing market condition. As is expected, not very much can be done to influence the standing, profitability and dividend policy of a firm by legislative measures. In spite of various legal
measures and tax incentives the market is still extremely volatile. The rise in the market index is too rapid which has been doubled in one year. There are some greenfield companies coming to the market at unrealistic premiums based on unrealistic profit projections. Moreover, trading is still mostly confined to blue chip stocks. For example, 76.8% of total trading was confined to the 10 most active stocks between July 1993 to June 1994 (Edward, 1995). Besides, inadequate disclosure requirements and legal framework, persistent political instability, lack of sufficient institutional structure, small number of large companies and low saving rate of 7.7% in 1993–94 (low even South Asian standards) are some of the issues that are clear indication of market weakness for playing a reliable source of long-term capital. Potentially favorable effects that legal and tax reforms—such as minimum dividend requirement, exemption of dividend income from taxes, promotion of greater company disclosure, protection of minority, imposition of penalties for misdeeds of company executives and the like—will allegedly have in stimulating the demand for equities, may well be neutralized by the existence of various problems inherent in the developing markets (Maniatis, 1971). Overall environment is very much a relevant factor to be considered while making an assessment about the operation of equity market. In the industrial countries investors will find “a home that is well defined, a legal system, i.e., well structured, a reasonably competitive situation, controls over prices and input that are not excessive and relatively open access to the international economy.” But the situation in the developing countries is not necessarily the same. One must note here that public policies in developing economies need to help promote the necessary conditions for economic growth. And the necessary elements here are savings and capital, educated people, entrepreneurs and organization, technology
and well functioning state. Without these key elements fostered and promoted, it is certainly difficult for any economic program including capital market development to attain the desired degree of success.

The slow evolution of the equity markets, however, should not hamper the industrial growth of the country. The development of the capital market and particularly that part of the equity segment, does not constitute a condition sine qua non for economic development; it is rather the outcome of the overall development process of the country and a feature of a more mature economy (Cameron et al, 1967). The potentialities of the banking system deserve greater attention and the necessary steps should be taken to enable it to play a decisive role as an agent of development. Moreover, regardless of how efficiently organized an equity market may be, it cannot ensure that the flow of available savings will be directed to the most desirable projects from the point of view of priorities for economic development. For, priorities are determined by the expected yield of the firm whose equities are marketed. Private profitability is not always a sound criterion for judging the desirability of an investment from the social point of view. Public segments of the capital market can play an important role for the developing market. Public debt management could provide a suitable transformation mechanism whereby various debt instruments can satisfy various tastes of investors ensuring safety, liquidity and yield, while private industrial entrepreneurs are permitted access to necessary funds which otherwise they might not have in a position to get. Besides, with the passage of time there is reason to believe that institutional and individual investors will have better response to the issues of private firms since they have familiarity with dealings in securities. Equities were traded in developed economies only after public confidence had been developed by
prior experience with government securities (United Nations, 1950).

It is difficult to imagine the expansion and strengthening of the securities market in a situation of political, economic and financial instability prevailing in an economy like Bangladesh. A suitable base for financial stability must exist before an active securities market can develop and this is essential in order to win the confidence of the investing public in the instruments traded on the exchanges. In the absence of these conditions it is difficult to mobilize savings and to have a properly functioning capital market (Basch and Kybal, 1975). However, stability should not be equated with simply maintaining the status quo. For long term stability the structure must be capable of anticipating and assimilating evolutionary change. The need for stability in the broadest sense cannot be overemphasized, but this does not mean resisting change; instead the priority must be to ensure that change is allowed to evolve in a reasonable and systematic way (Lloyd, 1977). Once the public loses confidence in the market, liquidity declines and the process of collapse can quickly feed on itself.

The development of contractual institutions in private sector like mutual funds which presupposes a relatively developed capital market is not likely to come about shortly in Bangladesh. Even if such institutions grow, it is highly uncertain whether they would be able to acquire industrial equities in requisite quantities. Indeed, at the present stage of development of the country the role of financing economic development largely lies on the banking system—commercial, investment and development banks. Traditionally, corporate sector depends on equity market to a smaller extent. It would then appear that a reorientation of the functions of the banking system in Bangladesh is far more promising and practicable than a swift change in the pattern of asset choice of mass savers. It is even conceivable
that the banking institutions, operating within a circumscribed framework to prevent financial vicissitudes, may display initiative and enterprise reminiscent of the Credit Mobilier (Cameron, 1953) and the German "Universal" banks (Gerschenkron, 1962). However, heavy reliance on banks for long-term funds may sometimes lead to an extensive increase in money supply or even dispose some of the securities on the face of tight monetary policy. This may cut off the flow of long-term funds unexpectedly resulting demoralizing effect on the capital market (Williams, 1966). Of course, it is not difficult to contain such undesirable developments through suitable measures to be worked out in advance.

In spite of the importance of banking system for corporate financing in the initial stages of development, necessary measures must be directed to remove the discrepancies and odds in the capital markets so that demand for and supply of equities are matched. Accordingly, it is desirable that government should proceed with positive steps to have an integrated program where the different segments of the financial market will be given due consideration in an orderly fashion.

For working of efficient operation of the capital markets government policy can influence the overall economic framework, which determines the basic efficiency of the capital market, through such policies as:

a) Expansion of participation and ownership base in the industrial sector; its attitude toward monopolies and restrictive practices;
b) Policies relating to overall credit control including the level of interest rates;
c) Taxation policies allowing special incentives and disincentives which can influence the investment, reinvestment and industrialization of the country;
d) Encouragement for the development of an institutional structure that will influence industrialization and financing including securities companies, investment banking and enhancing the efficiency of the existing specialized financial institutions and commercial banks working in the field.

Apart from the various aspects of the general economic framework, there is also the obvious need to establish appropriate regulations and standards covering such issues as the rules of conduct of stockbrokers, accounting and auditing standards and so on. Accounting and auditing standard is particularly important since "almost without exception in countries where there is poor financial reporting there exists substantial tax evasion..... it is perfectly natural that a wealthy industrialist sees no reason to forego voluntarily the financial advantages of avoiding accurate financial reporting" (Gill). Some of the information defects which exist in Bangladesh resulting inefficient operation of the market include:

1. The amount of information contained in company accounts.
2. The extent to which information published in accounts is out of date by the time it is publicly available.
3. The existence of a number of unscrupulous companies which use their accounts in order to conceal fundamental facts about the financial position of the company.
4. The existence of a structure of extensive public analysis and criticism of such information as is published.
5. The existence of both high standards and effective machinery to enforce those standards and a strong, independent financial press for ensuring the accountability necessary to keep and improve these standards.
It is likely that the asymmetry in information among investors is caused by poor communications and uneven disclosure by companies. This may result in a lack of confidence in the market by investors. Insider trading, even when it is nothing more than a quick reaction to slowly spreading information which is possible in the absence of an efficient information network, may induce others to shun the market. Drake (1980) has pointed out the need for official regulation and supervision to ensure full disclosure and wide dissemination of information in order to prevent market rigging, and to protect shareholders.

Brokers and jobbers should be honest. There are also reports about violations of rules and regulations by the exchange members in Bangladesh. This creates distrust among the investing public about stock markets. In the past in the U.K. the stock exchange council has been the main focus of control over the activities of its members and it has the power to reprimand, suspend or expel any member who (Briston, 1976):

a) violates any of the rules or regulations of the exchange,
b) fails to comply with any of the decisions of the council,
c) is guilty of dishonorable or disgraceful conduct,
d) acts in a manner detrimental to the securities exchange and unbecoming the character of a member.
e) conducts himself in an improper or disorderly manner or wilfully obstructs the business of the exchange.

Securities and Exchange Commission (SEC) of Bangladesh who is responsible for overseeing the market needs to give attention to these issues so that proper transparency is ensured and code of conduct of the exchange members is defined and adhered to. However, SEC should take care in applying such rules. Wai and Patrick (1973) warn of the “danger of
regulatory overkill.....which may inhibit capital market development.” Alternatively, it may drive it underground, as happened in Kuwait. There the well-regulated official market, with only about 40 quoted securities did not provide sufficient opportunities for the financial community. This led to the development of the unofficial market (Souqal Manakh), where shares of new companies and of other companies in the Gulf, were traded. Again, about 40 companies’ shares were traded, but payments with post-dated cheques creating a forward market in shares and the bubble burst in September 1982. Accordingly, it is advisable for the authorities responsible for stock market regulation to follow a path in between undersupervision and over-supervision. Investors should have confidence but not feel overprotected.

Conclusion:

Divergent opinions about the contribution and development of equity market prevail among the academics and practitioners. It appears to be pertinent to note that the appropriate policy for a country will depend on its socio-economic structural condition prevails there. In view of the present stage of market development associated with various legal and structural constraints as well as tradition of the country there is reason to believe that the development of close relations between banks and industry as a means of promoting economic development appears to be unavoidable. Increased savings by all classes of investing public, and the utilization of those savings for productive investment, requires the existence of an appropriate network of savings and credit institutions, in particular an efficient banking system. One of the most important developments is the existence of specialized development banks which are usually supported by government as well as
International Financing Agencies. Development banks are an invaluable source of equity capital and long-term credit in developing countries like Bangladesh. Likewise, surplus funds of the commercial banks can also be made available for industrial financing through efficient maturity transformation. Pressures for developing the internal efficiency of these institutions may straighten the efficient use of funds. It should be remembered that efforts to speed up the development of the equity market, although laudable, may not lead to immediate tangible results in the face of various structural problems of Bangladesh market. Despite the desirability of direct financing, it seems more desirable to give emphasis on indirect financing through financial intermediaries until a later stage of development of the country. Accordingly, indirect financing should not be considered as hindrance to the development of capital markets, but as a necessary step prior to, and as facilitating long run growth of the latter. For promoting economic development direct and indirect financing should not be considered as mutually exclusive but complementary. It does not mean ignoring the equity segment of the financial system rather the emphasis needs to be given to other so-called secured vehicles for fund mobilization at least at the initial stages of development. Simultaneously, official supervision of trading in particular and the market development in general is imperative if shares and bonds are to become attractive investment vehicles. Otherwise the investors may justifiably feel too exposed to the risk of market manipulation and other abuses and may decline to invest in equity market.
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