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Office Memorandum

CONFIDENTIAL

TO : The Managing Director
The Deputy Managing Director

DATE: October 31, 1979

FROM : Bruce J. Smith

SUBJECT : Bangladesh--1979 Article IV Consultation Discussions

A staff team, including also Messrs. Huh, Thakur, Sisson and In-Su Kim and Miss Windsor, visited Dacca during October 12-26 to hold the 1979 Article IV consultation discussions with Bangladesh and to review progress in implementing the program under the stand-by arrangement approved in July; Mr. Deshmukh was also present during part of the period.

Recent developments

Severe drought and escalating import costs have had an adverse impact on economic performance. Foodgrain production fell in 1978/79 (fiscal year ended June 30) and is likely to show only a small increase in 1979/80. As a result, real growth, which fell by half to 4 per cent in 1978/79, is unlikely to show much recovery in the current year. Emergency imports of foodgrain, which will reach about 2.7 million tons in 1979/80, have disrupted the flow of other external trade and clogged the internal distribution network, but have successfully prevented widespread food shortages during the current lean season. Incomes in drought-hit rural areas have also been reduced by the poor quality of the jute crop, but large carryover stocks from last year will limit the impact on export earnings. Industrial performance has improved as a result of expanded imports and more liberal investment policies over the last couple of years, but continuing electricity shortages are affecting some major industries, including jute goods and textiles.

The authorities are particularly concerned by inflation, which is currently 17 per cent per annum and tending to rise. The drought has resulted in sharply higher food prices, and rising import prices and adjustments to controlled prices are contributing factors. We emphasized that excessive increases in liquidity, averaging 26 per cent per annum in the September quarter, are a principal cause of inflation, and that a phased reduction in the growth in liquidity as envisaged in the stand-by program is essential if inflation is to be reduced. The continued rapid liquidity increase can be attributed largely to stronger than expected balance of payments performance. An overall surplus of $112 million was recorded in 1978/79, and the monetary contraction from external transactions which had been projected for the current year is yet to eventuate.

It now appears that because of bouyant prices export earnings in 1979/80 will increase by about 20 per cent, considerably more than earlier estimated, while remittances for workers abroad will also be higher. On the basis of improved foreign exchange receipts, the mission advised the authorities to expand the allocation of exchange for imports in 1979/80 by about 10 per cent; the official import program so far allowed for virtually no growth in non-oil imports. We estimate that the enlarged import program, which the authorities seem likely to adopt, can be financed while keeping the overall deficit near the earlier estimate of $130 million (excluding net financing from the Fund of about $90 million) and maintaining international reserves at a relatively comfortable level. Gross reserves currently amount to a record $443 million, or over two months' merchandise imports. In July this year, the arrangement whereby the taka was pegged to the pound sterling was abandoned, and the taka is now pegged to a currency basket, comprising mainly the U.S. dollar and pound sterling (with small weights also for the deutsche mark and Japanese yen), within margins of 2.5 per cent. The pound sterling continues to be the intervention currency, and one adjustment from Tk 33 = pound stg. 1 (the rate set as a prior condition for the stand-by arrangement) to the current rate of Tk 34.7 = pound stg. 1 has been made to offset the impact of the strength of the pound on the effective exchange rate.

Performance under the stand-by arrangement

All the performance criteria, including the September 1979 ceilings on credit to the public sector and total domestic credit, have been observed. In line with their undertakings, the authorities have continued their program of adjusting officially controlled public sector prices. Prices for water, sugar, and electricity have been increased since the program was agreed, and a further considerable increase in prices for petroleum products is expected to be introduced shortly. The authorities reiterated their intention of raising further the ration price for rice in about January 1980. An increase of up to Tk 20 per maund (17 per cent) was possible, which would result in a significant reduction in the unit rice subsidy over the program period. The authorities indicated that it was possible that the January 1980 credit ceilings may prove too tight, particularly in view of the need to provide a substantial volume of credit to support disastrously low raw jute prices. We agreed that a review of the ceilings could be undertaken at about the end of the year, but indicated that the outcome of the review would depend, in part, on progress over coming months in reducing the rate of liquidity growth toward the program's objective of 15 per cent per annum by May 1980.

Compensatory Financing Facility

The possibility of a purchase under the CFF was discussed with the authorities at the Annual Meeting. The mission collected necessary data upon which a preliminary assessment of the possible drawing can be made by the staff, after which the authorities will decide whether or not to pursue the matter further. On present indications no more than a small export shortfall appears likely.

Extended Fund Facility

The authorities now appear more definite in their desire to enter into an EFF program in 1980/81, the first year of the new Five-Year Plan. However, preparation of the Plan has been delayed, mainly because agreement on the basic Plan objectives has yet to be reached. President Zia appears committed to ambitious performance targets--including the doubling of foodgrain production--which the planners and other administrators do not believe are realistic or even desirable However, the authorities expect that these issues will be resolved soon, and that a draft of the Plan will be completed by early February 1980 It was tentatively agreed that a mission visit Dacca toward the end of February for exploratory discussions, with negotiations for the EFF to be conducted in July 1980.

cc Mr Tun Thin (on return)
Mr. Watson
ETR
FAD
LEG
TRE
ASD Senior Staff
Division A

Mr. Hinh

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: September 25, 1979

FROM : Albert A. Mattera aam

SUBJECT : Bangladesh--1979 Article IV Consultation--Briefing Paper

Attached for your approval is the Briefing Paper for the 1979 Article IV Consultation mission to Bangladesh. It has been cleared by Mrs. Lachman (LEG) and Messrs. Beveridge (FAD) and Cutler (TRE).

Attachment

c.c. LEG
FAD
TRE
Mr. Ware

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

BANGLADESH

Briefing Paper--1979 Article IV Consultation

Prepared by the Asian Department and the
Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal, and
Treasurer's Department)

Approved by Tun Thin and Donald K Palmer

September 25, 1979

I Introduction

A staff team consisting of Messrs. Smith (ASD, Head), Huh (ETR), Thakur (ASD), Sisson (FAD), In-Su Kim (ASD) and a secretary will visit Dacca during October 12-26 to hold the 1979 Article IV consultation discussions with Bangladesh The team will also review the implementation of the program supporting the stand-by arrangement which was approved on July 30, 1979 Mr. Deshmukh has been consulted on the mission

II. Recent Economic Developments

The growth in real GDP slowed to about 4 per cent in 1978/79 (fiscal year ended June), about half the rate of growth recorded in the previous year (Table 1). The slowdown reflected a drop of 2 per cent in foodgrain production (following a gain of 11 per cent in 1977/78), resulting from localized floods and severe drought. However, wheat and jute production increased considerably. The industrial sector maintained a pace of expansion of about 8 per cent in 1978/79 Public and private investment were buoyant, in part reflecting less restrictive policies concerning private industry introduced over the past several years

Table 1 Bangladesh Selected Economic Indicators, 1975/76-1979/80

	1975/76	1976/77	1977/78	1978/79	1979/80 1/
		(Per cent changes)			
Real GDP	10	2	8	4	7 2/
Foodgrain output	14	-8	11	-2	11 2/
Raw jute output	12	10	13	20	-23
Industrial production	9	6	7	8	.
Consumer prices	-7	1	15	10	8 2/
Total liquidity	15	24	21	24	15 2/
Domestic credit	23	11	26	21	20 2/
		(In millions of U S dollars)			
Exports (f o b)	320	461	502	582	650
Imports (c i f)	-1,319	-835	-1,424	-1,572	-2,260
Current account	-935	-322	-841	-906	-1,505
Overall balance	-128	132	-17	123	-66
Gross international reserves (end-period)	215	301	269	372	
In months of imports of the following year	(3 1)	(2 5)	(2 1)	(1 9)	

Sources Data provided by the Bangladesh authorities and staff estimates

1/ Projections
2/ Official targets

The budget outturn improved in 1978/79 Revenues are estimated to have increased by 21 per cent Sales taxes and nontax revenues each increased considerably, the former partly as a result of measures introduced in the 1978/79 budget Total expenditures are estimated to have risen by 22 per cent. Current expenditures increased by no more than 9 per cent, while development outlays increased by a third, largely reflecting increased utilization of foreign aid A shortfall in domestic foodgrain procurement resulted in a substantial increase in the cash surplus on food account. The budget deficit increased by 14 per cent Foreign loans and grants are estimated to cover 96 per cent of the deficit, and after taking account of previously unanticipated borrowing from domestic nonbank sources, a small overall surplus on transactions with the banking system was recorded, compared with sizable net borrowing in 1977/78.

The rate of growth in liquidity increased to 24 per cent in 1978/79 from 21 per cent in the previous year Domestic credit increased by 21 per cent, somewhat less than in 1977/78, but the impact of external transactions, which was contractionary in 1977/78, accounted for about a third of the liquidity expansion in 1978/79. Credit to public enterprises and the private sector increased by 31 per cent, there was a large increase in jute credit, especially in the first half of the year, and agricultural financing also increased considerably. Inflation tended to moderate during most of 1978/79, aided by relatively stable foodgrain prices. However, as a result of the tightening food supply position, food prices jumped sharply toward the end of the year The average inflation rate in 1978/79 fell by about a third to 10 per cent

The balance of payments recorded an overall surplus of some $123 mil- in 1978/79 following a small deficit in the preceding year Exports rose by about 16 per cent, mainly because of strong foreign demand for both raw jute and jute goods, although power shortages and industrial disputes led to a reduction in the volume of exports of jute goods Nonjute exports rose by 7 per cent The growth in imports slowed to 10 per cent in 1978/79 following a large increase in the previous year Foodgrain imports were lower and despite a substantial increase in the petroleum import bill, general imports rose only moderately. While the more liberal import policy introduced in the previous year was maintained, disbursements of commodity aid were less than expected and utilization of cash import licenses was delayed. In total, disbursement of external assistance increased by one quarter to about $1 billion in 1978/79 At end-June 1979, gross international reserves were $372 million, equivalent to about two months of 1979/80 imports.

During 1978/79, the taka was depreciated on six occasions against the pound sterling, to which it is pegged, a further adjustment to a rate of Tk 34 7 per pound sterling was made in August 1979, bringing the cumulative depreciation since mid-1978 to 19 per cent. The decline in the effective exchange rate over the same period was 5 per cent. No new exchange restrictions or multiple currency practices have been introduced since the last mission

III Topics for Discussion

1 Exchange rate

The six depreciations against the pound in 1978/79 represent the phased implementation of a policy to adjust the exchange rate by 15 per cent to

Tk 33 per pound sterling. Such an adjustment was considered necessary to offset the effects of inflation which re-emerged in mid-1976, and was estimated to be sufficient to eliminate the perennial operating losses of the jute industry The adjustment was set as a prior condition in negotiations for the current stand-by arrangement.

While a rate of Tk 33 per pound sterling would probably continue to be adequate to assure the profitability of the jute industry, where prices are set in pounds, the appreciation of the pound against the U S dollar and some other currencies over recent months threatened to undermine the other aims of exchange rate policy--to strengthen nonjute exports and establish reasonable costs for imports, the bulk of which are priced in dollars. In order to counter this the authorities adjusted the exchange rate by a further 5 per cent in August In making this last change, the authorities used a currency basket to calculate developments in the effective exchange rate, and the size of the change was such that it about offset the increase in the effective exchange rate which occurred since the previous rate adjustment.

The authorities should be encouraged to continue to follow these more flexible and rational exchange rate policies For the future, further strengthening of the pound sterling ~~above its~~ August level should again be offset by depreciation against the pound, but weakening of the pound sterling should not be offset by appreciation of the taka against the pound in order to obtain a depreciation of the taka against the dollar and in effective rate terms It would also be useful to discuss the future role envisaged by the authorities for the currency basket they have developed, and their attitude toward the continuation of the peg arrangement with the pound sterling

2 Balance of payments

The balance of payments outlook for 1979/80, based on projections made in March, is for a shift from surplus to moderate deficit because of a deterioration in the terms of trade and increased foodgrain imports While the present external position is relatively favorable, the authorities have shown concern that increased oil and foodgrain import costs will result in a larger than projected deterioration in 1979/80

It appears unlikely that export earnings in 1979/80 will fall short of the March estimate While the drought has sharply reduced raw jute output, the authorities do not expect there will be a constraint on export supplies as holdover stocks are large. Jute export prices continue to be relatively buoyant and an expected downturn has yet to materialize There is greater uncertainty concerning imports The current projection is for an increase of 44 per cent, with foodgrain imports more than doubling and substantial increases in imports of petroleum and fertilizer Beginning in 1978/79 there was a slowdown in imports under the official program, which appears to be continuing in 1979/80. The slowdown is evidenced mainly by an increase in import licenses issued for which letters of credit have not been opened. Investigation is needed to determine the relative importance of the factors which have inhibited the flow of imports Means are essential to ensure that the import program is implemented efficiently and that full advantage is taken of the scope which exists for further effective import liberalization.

3 Domestic financial policies

The budgetary position is inherently weak Domestic resource mobilization is inadequate and consumer and producer subsidies make a large call on available resources. As a result, the budget's contribution to investment is relatively small, despite substantial foreign financing The overall deficit is large, equivalent to some 8 per cent of GDP, and in some years heavy recourse to the banking system has been necessary Against this background, developments over the past year have been favorable. Developments in 1978/79 show progress in improving tax administration and restraining public consumption while stepping up public investment, and borrowing from the banking system was avoided In addition, in the context of the 1979 stand-by arrangement with the Fund, important progress was initiated to improve the underlying public finance position fertilizer and foodgrain ration prices were increased to contain large budget subsidies and prices for several other public sector goods and services have been raised

A careful assessment is needed of the newly-introduced budget for 1979/80. On the revenue side, new measures are expected to yield a mere 4 per cent of the projected revenue increase, and other progress, including the implementation of the recommendations of the Taxation Inquiry Commission, appears limited. Achievement of the projected 20 per cent increase in revenues is heavily dependent on a 30 per cent increase in customs duties which may be optimistic in view of the ~~lag in imports~~. On the expenditure side, current expenditures are projected to decline in real terms While this is partly a result of the elimination of losses by the jute industry, the feasibility and desirability of a decline in real current expenditures in two successive years requires investigation

Increases in total liquidity in excess of 20 per cent for the past three years resulted in double-digit price increases in 1977/78 and 1978/79 It appears that the adverse psychological impact of the tightening food supply position, and the faster liquidity expansion last year, are yet to be fully reflected in prices. Taking account also of the impact of recent increases in certain controlled prices, inflationary pressures may prove to be persistent in the current year. The financial program for 1979/80 agreed in the context of the 1979 stand-by arrangement envisages a deceleration in liquidity to 15 per cent in order to reduce inflation to 8 per cent

Credit policies of the Bangladesh Bank have been liberal over the past two years, and the Bangladesh Bank's lending to banks increased sharply in both 1977/78 and 1978/79. In order to restrain the growth in liquidity, credit policies were tightened in December 1978, but it does not appear that these measures had an appreciable effect in slowing the growth of credit, partly because larger than normal jute stocks prevented the seasonal contraction of jute credit in the first half of 1979.

Interest rates are relatively low and have been virtually unchanged for three years. Most rates are currently negative in real terms. The authorities have indicated that they are considering raising interest rates, a move which should be encouraged in order to alleviate the existing disincentives for financial savings and the efficient allocation of credit.

4. Agriculture, industry and investment

The severe drought in 1978/79 resulted in a shortfall in rice production of about 1 million tons. The largest impact was on the main aman (summer) crop, and despite efforts to intensify production during the boro (winter) season, persistent drought brought further losses. Shortages of diesel fuel adversely affected the operation of irrigation tubewells in 1978/79, aggravating the impact of drought Although the drought has now broken, its effects will spill over in 1979/80 The deepwater aman rice crop suffered from late planting, and the transplanted aman crop will be reduced as a result of late sowing of aus (spring) rice and jute in double-cropping areas As a result, it is probable that foodgrain production will again fall short of the official target in 1979/80, and that aggregate economic growth will be lower than the official target of 7 per cent.

In order to facilitate the growth in food production needed over the medium term, a large expansion in irrigation capacity is required Progress in this direction has been slow to date, although public investment in this field has been stepped up recently On the other hand, recent pricing policy changes appear well-tuned to provide necessary financial incentives for agricultural expansion. Official procurement prices for the forthcoming aman rice crop have been raised by 20 per cent and the minimum price for jute has been increased by 15 per cent However, while free market rice prices have risen sharply, raw jute prices have been stable or declining because of abundant stocks As a result, the jute/rice price ratio has deteriorated to a point where relative prices now clearly favor rice This shift in relative prices was one factor accounting for the decline in jute acreage in 1979 and, based on the present price ratio, a further shift from jute to rice is in prospect next year. Measures are needed to achieve a stable jute/rice price relationship at a level which encourages adequate and stable jute production

The most pressing immediate problem facing the authorities is to assure food supplies, especially in rural areas hard hit by drought It is reported that the drought has already resulted in considerable suffering and malnutrition in certain areas, and that landlessness is increasing President Ziaur is himself overseeing the food supply operation, which is preempting scarce administrative resources and infrastructure facilities Total foodgrain imports in 1979/80 are expected to increase by more than 50 per cent to 2 million tons, commercial foodgrain imports in 1979 and early 1980 are estimated to total nearly 1 million tons at a cost equivalent to about a quarter of annual exports. While distribution prices were raised in May 1979--by 20 per cent for rice and 12.5 per cent for wheat--the increases are well below those in the open market The authorities also plan to increase the share of wheat and reduce that of rice under the ration when the supply position allows. This change is welcome because the distribution price is high relative to cost for wheat in comparison with rice

A fundamental aim of policies is to raise investment which is only some 12 per cent of GDP. Considerable increases in the size of the capital budget over the past two years reflect efforts to increase public investment, especially in agriculture With public sector business enterprises accounting for over half of the industrial sector, efforts are needed to increase their ability to generate investment resources internally. At the present time, low and controlled product prices prevent many public enterprises from even maintaining their capital stock. Further price increases, in addition to those recently introduced, are needed for public sector prices, while for the future, a more flexible pricing policy is desirable Measures have been taken over the past several years to relax restrictions on private investment, and the Government is now encouraging the return to private ownership of many public enterprises outside the jute, sugar and textile sectors

These policies represent important steps in the right direction, and there is evidence of increased interest in Bangladesh on the part of foreign investors.

IV. 1979 Stand-By Arrangement

A one-year stand-by arrangement in the upper credit tranches for SDR 85 million (56 per cent of quota) was approved by the Fund on July 30, 1979 The performance criteria are (a) a phased ceiling on total credit and a phased subceiling on credit to the public sector, (b) limits on the contracting of new debt of maturities of 1 to 5 years and 1 to 15 years, and (c) the standard clauses relating to multiple currency practices, bilateral payments agreements and import and exchange restrictions The first of the phased credit ceilings occurs on September 30, 1979, based on the most recent available data, there is no indication that the credit ceilings will be exceeded

In the letter of intent the authorities agreed that progress in implementing the program would be discussed with a Fund mission during the middle period of the stand-by arrangement. In addition to a general review of policies and developments, there are two areas where further policy action is needed. The increase in the ration price for rice introduced in May was less than the increase in the rice procurement price which will be offered for the forthcoming aman crop. A further increase in the ration price, of more than Tk 6 per maund (5 per cent), is needed to meet the objective of reducing the unit rice subsidy. Also, additional increases in the prices for goods and services provided by the public sector were envisioned in the program, but in some cases, e g sugar, electricity, gas and water, these could not be finalized at the time of discussions In both cases, the authorities indicated their agreement to making further price adjustments during the course of the program period While some of the public sector price adjustments have already been introduced, e g , electricity and water, it is timely to discuss with the authorities their plans concerning the magnitude and timing of the adjustment to the rice ration price and other adjustments to public sector prices

The authorities have expressed interest in an extended arrangement which would coincide with the introduction of a new Five-Year Plan in mid-1980. While the authorities may wish to discuss in a preliminary way some aspects of such an arrangement, preparation of the Plan outline has not yet reached a stage which would allow substantive discussions to commence.

Fund Relations with Bangladesh

Quota	SDR 152 million
Use of Fund resources	Bangladesh has made frequent use of the Fund's resources Stand-by arrangements were approved in June 1974 and in July 1975, the full amounts available were drawn. Purchases were made under the Compensatory Financing Facility in December 1972 and in August 1976, and purchases were also made under the 1974 and 1975 Oil Facilities
Current arrangement	A stand-by arrangement for one year in an amount of SDR 85 million was approved on July 30, 1979 SDR 29 million was purchased in August 1979
Trust Fund	A Trust Fund loan was approved in June 1977 and Bangladesh received disbursements on the loan totaling SDR 51.8 million In respect of the second period, Bangladesh received an interim disbursement of SDR 29 6 million in ~~August 1979.~~
Fund holdings of taka	The Fund's holdings of Bangladesh taka amounted to 210 3 per cent of quota on August 31, 1979, excluding outstanding purchases under the oil facilities (42 4 per cent of quota) and the compensatory financing facility (25 7 per cent of quota) they stood at 142 2 per cent of quota.

SDR position

Bangladesh received its first allocation of SDR 15 8 million on January 1, 1979 Its holdings of special drawing rights amounted to SDR 36 7 million on August 31, 1979.

Exchange rate

The official exchange rate of the taka was fixed at Tk 18.968 per pound sterling from February 1, 1972 On May 17, 1975, it was changed to Tk 30 per pound sterling. Since then, the taka-pound sterling rate has been periodically changed The last change became effective from August 13, 1979 when the middle rate of spot buying and selling was changed to Tk 34 7 per pound sterling from the rate of Tk 33 per pound sterling established on May 28, 1979

Last Article XIV consultation

Article XIV consultation discussions were held during February 28-March 14, 1978 The Staff Report (SM/78/119, 4/28/78) was considered by the Executive Board on June 14, 1979.

Fund technical assistance

Since June 1972, the Fund has maintained a resident representative in Dacca, and since September 1975, also a deputy resident representative.

ETR.

Office Memorandum

CONFIDENTIAL

TO : The Managing Director
The Deputy Managing Director

DATE: April 4, 1979

FROM : Tun Thin

SUBJECT : Bangladesh--Stand-By Negotiations, March 13-24, 1979

Blue File

1. Mission members: Messrs. Tun Thin (ASD), Smith (ASD), Huh (ETR), Thakur (ASD) and Ballali (FAD), and Miss Lee (ASD, secretary). Messrs. Siber and Yadav (resident staff) assisted the mission.

2. Bangladesh representatives: The principal negotiators were Finance Secretary Khair and Bangladesh Bank Governor Nurul Islam. Discussions were also held with Finance Minister Professor Huda.

3. Political situation: The Parliamentary elections held in February resulted in a landslide victory for President Ziaur Rahman's party, which won over two thirds of the 300 seats contested. The announcement of the Cabinet has been delayed by the recent death of prospective Prime Minister Mashiur Rahman and important policy actions have been delayed somewhat as a result. It now appears that Professor Huda will retain the Finance portfolio.

4. Economic situation: Economic growth has been satisfactory during the past two years. Growth reached 7.8 per cent in 1977/78 (fiscal year July-June) but will be somewhat lower--about 5 per cent--in 1978/79, mainly because adverse weather has reduced the main rice harvest. Growth in the industrial sector has picked up--10 per cent in 1977/78 and 8 per cent in the current year reflecting the buoyancy of agricultural incomes and more liberal imports of raw materials and capital goods. The jute goods industries, however, have suffered a setback as a result of power shortages and labor disputes in 1978/79. Mainly because of a large increase in imports, the balance of payments reverted from a sizable surplus to a deficit in 1977/78, and despite an acceleration in export earnings due to high prices, a further small deficit is in prospect in 1978/79. The main difficulty has been inflation which has intensified since mid-1976. Increases in liquidity at rates in excess of 20 per cent, resulting mainly from increases in domestic credit, have been the principal cause of price pressures. Inflation reached an average of 15 per cent in 1977/78 and is expected to be about 12 per cent in 1978/79.

5. Problem areas: The underlying budgetary position is weak, although it has improved somewhat in 1978/79. Revenues have been buoyant because of more efficient tax administration, and current expenditures have been tightly controlled. As a result, it is likely that the authorities' objective of avoiding recourse to the banking system to finance the deficit will be achieved in 1978/79; unplanned bank financing of the budget amounted to Tk 1 billion in 1977/78, accounting for about a quarter of the growth in liquidity. Despite the good performance in the current year, the budget is excessively reliant on foreign assistance, producer and consumer subsidies make a heavy and growing claim on available resources, and some public corporations

are financially weak. During 1978/79, the subsidy on fertilizer is estimated to absorb about 60 per cent of development expenditure on agriculture and 10 per cent of the development budget; subsidies on the distribution of domestically procured foodgrains will account for about 7 per cent of current expenditure; and budget subsidies to cover the losses of the jute mills will absorb a further 6 per cent of current expenditure.

One factor contributing to the favorable budgetary position in 1978/79 has been the considerable shortfall in official foodgrain procurement, partly the result of the less favorable harvest, but also due to relatively low official procurement prices. Besides the distinctive effects of low procurement prices on production, the shortfall in procurement may have to be offset by imports, at considerable cost to the already weakening balance of payments.

6. Stand-by negotiations: The authorities continue to express keen interest in an Extended Fund Facility program. It is expected that discussions will begin in May 1980 when details of the Second Five-Year Plan have been finalized. The current discussions were framed to meet the immediate need for stabilization and to initiate steps to overcome the underlying structural problems.

The mission negotiated, ad referendum, a one-year stand-by arrangement. During the discussions we emphasized the crucial importance of an exchange rate change and measures to mobilize domestic resources to promote high rates of investment.

As a prior condition, the exchange rate is to be adjusted, probably in two steps to be completed in May or before early June, from the present rate of Tk 31.125 per pound sterling to Tk 33 per pound sterling. It is expected that at this rate the losses of the jute mills would be eliminated. The budget would benefit additionally from some increases in tax collections and the counterpart of foreign commodity assistance.

You will recall that during the Annual Meeting the Finance Minister had indicated to you the broad direction of their domestic policies. Subsequently, they established a number of working groups to examine available options. Most of the recommendations of these groups have now been finalized, and some have already been submitted for cabinet approval. Decisions by the new Cabinet are expected in May or early June.

The main elements of the policy package are:

(1) Fertilizer prices are to be increased by about 20-25 per cent, resulting in about an equivalent reduction in the prospective fertilizer subsidy. The extent of the adjustment has been left to be decided during the visit of IBRD Vice President Hopper, who arrived to negotiate a fertilizer loan following the mission's departure.

(2) Procurement prices for paddy and rice are to be increased by about 10 per cent to a level which the authorities believe will provide incentives to increase production.

(3) The distribution price for rice is to be increased by 15 per cent or more, and that for wheat by a somewhat smaller amount, so as to encourage a shift in consumption from rice to wheat, which is in more plentiful supply. This increase will more than offset the increase in the cost of domestic procurement and in addition will generate increased revenues from the sales of imported foodgrains.

(4) The prices of a number of goods and services provided by the public sector are to be increased by varying amounts, with the aim of improving the financial position of public sector enterprises and utilities. Complete details of the items to be included are not yet finalized, but they are likely to include post and telegraph charges, gas and electricity tariffs, and sugar, gasoline, textile and pharmaceutical prices.

The performance criteria are:

(1) Phased credit ceilings, including a subceiling on credit to Government and the public sector, allow for an increase in total credit of 19 per cent and a target increase in liquidity of 15 per cent during the stand-by period. The credit ceilings aim to achieve a reduction in inflation to 8 per cent while allowing for economic expansion of 6 per cent.

(2) Ceilings on foreign borrowing allowing for up to $35 million in borrowings of between 1 and 5 years to meet emergencies, with an overall ceiling of $60 million for borrowings between 1 and 15 years.

(3) Commitments regarding multiple currency practices and exchange restrictions, bilateral payments agreements with Fund members, and import restrictions for balance of payments purposes.

7. <u>Balance of payments outlook</u>: The balance of payments position is projected to deteriorate considerably in 1979/80, mainly because of a worsening in the terms of trade. An overall deficit of about $80 million (SDR 62 million) has been forecast. Export prices are expected to decline somewhat as jute prices recede from current abnormally high levels. While the value of imports is expected to rise by 17 per cent, increased prices will reduce the scope for continued import liberalization. In particular, the oil import bill is estimated to rise by over $50 million, accounting for nearly 20 per cent of the estimated increase in imports.

8. <u>Financing needs</u>: International reserves are forecast to be about SDR 230 million at the end of 1978/79, equivalent to less than two months of the projected level of imports in 1979/80. The authorities consider this to be a minimum level. Repurchases due to the Fund in 1979/80 total SDR 96 million, which, after scheduling amounts due on a three-year basis, could be reduced to about SDR 75 million. (The attached Annex describes Bangladesh's Fund position during the period of the proposed stand-by.) Total financing needs during 1979/80 are thus about SDR 137 million, of which about SDR 50 million may be provided through a Trust Fund loan and SDR allocation, leaving a gap of some SDR 87 million.

I believe that the program outlined above is a strong one and fully deserving of adequate Fund support. The availability of additional financing would be of considerable benefit to the Bangladesh economy in maintaining the recent momentum toward import liberalization. Another relevant factor is the coincidence of repurchases under the oil facility and a further sizable increase in the cost of oil imports in 1979/80. These together are estimated to involve a burden of about SDR 65 million on the balance of payments in the coming year. In view of these considerations, I recommend that the amount of support under the proposed stand-by should be SDR 85 million, i.e., equivalent to about two-and-one-quarter tranches, and sufficient to maintain official reserves at their present low level.

Attachment

c.c. ETR
FAD
LEG
TRE
Mr. Ware
ASD Senior Staff
West Asia Division

Bangladesh: Fund Holdings of Taka During the Proposed Stand-By Period

(In millions of SDRs)

	Purchases	Repurchases Regular	Repurchases Total	Regular Tranches	Total (Including Oil and CFF)
February 28, 1979	--	--	--	210.7 (138.6)	325.6 (214.2)
May 31, 1979	--	12.3	17.1	198.4 (130.5)	308.5 (203.0)
May 31, 1980	85.0	36.8 1/	75.0 2/	246.6 (162.2)	318.5 (209.5)

1/ Includes SDR 10.8 million of the SDR 21.5 million due in July 1979 in respect of the stand-by purchase of July 1976, on the assumption of scheduling in four equal installments.
2/ Assumes scheduling in four equal installments of SDR 20 million due in August 1979 in respect of CFF purchase of August 1976.

Note: Figures in brackets are in per cent of quota of SDR 152 million.

Office Memorandum

Mr. Palmer

TO : The Managing Director
The Deputy Managing Director

DATE: March 8, 1979

FROM : Tun Thin and Donald K. Palmer

SUBJECT : Bangladesh: Briefing Paper - 1979 Stand-by Arrangement

Attached for your approval is the briefing paper for the forthcoming stand-by discussions with Bangladesh. The paper incorporates comments from Messrs. Cutler (TRE), Radford (FAD) and Guardia (LEG).

We draw to your attention the second full sentence on page 10 which proposes a depreciation of the taka as a prior condition for the stand-by arrangement.

Attachment

cc: FAD
LEG
TRE
Mr. Ware

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

BANGLADESH

Briefing Paper--1979 Stand-By Arrangement

Prepared by the Asian Department and the Exchange and Trade Relations Department

(In consultation with the Fiscal, Legal and Treasurer's Departments)

Approved by Tun Thin and Donald K. Palmer

March 8, 1979

A staff team consisting of Messrs. Bruce Smith (ASD, Head), Huh (ETR), Thakur (ASD), Ballali (FAD) and Miss Lee (ASD, secretary) will visit Dacca during March 13-25 to negotiate, ad referendum, a stand-by arrangement in the third credit tranche. Mr. Tun Thin will join the mission during March 18-22.

1. Background

Bangladesh has been granted two stand-by arrangements since it became a member of the Fund in August 1972 and has also made extensive use of Fund resources under the oil and compensatory financing facilities. With the balance of payments reverting to deficit in 1977/78 and with substantial repurchases to the Fund coming due, the foreign exchange reserve position is coming under pressure. Over recent months, the authorities have been exploring the possibility of obtaining access to Fund resources. During the Bangladesh Aid Group Meeting held in January 1979, one option discussed between the staff and the authorities was an extended arrangement--and the staff outlined in broad terms the general form such an arrangement would take and the key actions which would be expected of the authorities. The authorities were favorably disposed toward the possibility of requesting an extended arrangement but indicated that the framework for the new

Five-Year Plan to go into effect in July 1980 was as yet incomplete. They thought it preferable to envisage an extended arrangement coinciding with the introduction of the Plan and supporting its objectives during its first three years. In the meantime, in view of the need for balance of payments support, they wished to request a stand-by arrangement to cover the intervening year.

It is in this setting that discussions will take place. The program the staff will discuss will be consistent with the policies of the Fund for purchases in the upper credit tranches. At the same time, it will be framed to address some of the underlying structural problems facing Bangladesh, so that in the event that the authorities proceed to request an extended arrangement in 1980, the policy aims will be clarified and the first steps taken toward achieving them.

2. Recent developments

Economic growth increased to 8 per cent in 1977/78 (fiscal year ended June), well above the average of 6 per cent over recent years. The main source of growth was an 11 per cent increase in foodgrain output following the poor harvest of the previous year. Output of jute also rose from low levels in the previous two years. Value added in manufacturing rose by 10 per cent, reflecting a recovery in the jute goods, cotton textiles, cement and sugar industries. The improved industrial performance was sustained by increased imports of raw materials and capital goods which allowed higher rates of capacity utilization and higher investment. Indications are that growth will slow to 4-5 per cent in 1978/79. Agricultural production is expected to increase at a slower rate, mainly because adverse weather reduced the main aman rice crop, limiting the growth in foodgrain output to about 3 per cent, despite sharp increases in use of modern inputs including fertilizers. However, jute production is expected to show a further considerable increase. Private investment demand has been reviving, especially in the manufacturing sector and public sector development outlay is expected to rise sharply. Nevertheless, investment continues to be low (12-13 per cent of GDP) and its share financed by foreign aid has risen rapidly in the last two years.

Government revenues rose by 27 per cent in 1977/78 as a result of renewed inflation and increased economic activity and total expenditures by 40 per cent. Current expenditures rose twice as fast as budgeted and the surplus on government foodgrain trading was less than expected. Thus, although the increase in capital expenditure was only slightly larger than budgeted, unplanned financing from the banking system amounted to Tk 1 billion, equivalent to 5 per cent of the stock of liquidity at the beginning of the year. As a result of the large budget deficit, and rapid increases in bank credit to public enterprises and the private sector, accommodated by liberal rediscounting policies, total liquidity expanded by 22 per cent in 1977/78, about the same as in the previous year. Inflation, as measured by the Dacca cost of living index, increased somewhat to 12 per cent during 1977/78.

Financial policies have continued to be lax during the current year. In the 1978/79 budget, revenues were estimated to rise moderately and current expenditures were virtually unchanged, allowing a 16 per cent increase in development expenditures to be financed without recourse to the banking system. However, revised estimates suggest that largely because of higher than budgeted expenditures, a budgetary gap of about Tk 1 billion is likely, a large part of which will have to be financed by the banking system. Because of this and continuing strong growth in credit to the private sector, the growth in liquidity has increased further--reaching 24 per cent in the year to January 1979. Inflation has tended to increase, and was 16 per cent in the year to October 1978. The authorities' targets for liquidity growth (11 per cent) and inflation (5 per cent) are most unlikely to be achieved.

The balance of payments deteriorated sharply in 1977/78 when an overall deficit of $46 million was recorded, compared with a sizable surplus in the previous year. The current balance deteriorated sharply--exports increased by 8 per cent, but imports jumped by two thirds. The inflow of official transfers and capital increased, due to higher disbursements of food, commodity and project aid. A small overall deficit is in prospect for 1978/79. Exports are expected to increase by 19 per cent, largely because of higher prices for jute and jute goods. Imports are estimated to increase by 25 per cent, with large increases in aid imports; sharply higher inflows of official transfers and capital are estimated. At end-December 1978, gross international reserves were $310 million, equivalent to slightly over two months of estimated 1978/79 merchandise imports.

3. <u>The stand-by</u>

With the possibility that Bangladesh may later request an extended arrangement to begin in 1980, the mission will negotiate a one-year stand-by arrangement for SDR 38 million, or 25 per cent of quota. During the stand-by period, which is expected to cover June 1979-May 1980, Bangladesh has repurchase commitments totaling SDR 95.8 million. Of this amount, SDR 41.5 million is due on a three-year basis and the authorities are likely to request that these amounts be scheduled; repurchases during the stand-by period would then be reduced to about SDR 75 million. Were the stand-by arrangement fully drawn, and the repurchases reduced in this way, Bangladesh would make net repayments to the Fund of SDR 37 million during the stand-by period. The Fund's holdings of taka, excluding drawings under the oil and the compensatory financing facility, which are estimated to amount to 131 per cent of quota at the end of May 1979, would remain unchanged at the end of the stand-by period Bangladesh is eligible for Trust Fund assistance, and its access during the Second Period is presently estimated to be in the neighborhood of SDR 50 million The stand-by program would form the basis upon which Bangladesh would receive access to Trust Fund assistance during the Second Period

The main objectives of the stand-by program will be to reduce the rate of inflation, to strengthen the financial position of the public sector, and to establish the conditions necessary for a sustained improvement in the external position It is unlikely that the problem of inflation could be solved during the stand-by period without causing excessive disruption to economic activity, and for this reason the program will seek to achieve a reduction in inflation to about 8 per cent This would represent considerable progress in combating inflation, but should not inhibit the attainment of the growth target of 5 1/2 per cent of real GDP set by the authorities for 1979/80

The mission will formulate a financial program for the period June 1, 1979 to May 31, 1980 consistent with these growth and price objectives The rate of expansion of total liquidity is estimated to exceed 21 per cent in 1978/79 Changes in the income velocity of liquidity in Bangladesh are strongly influenced by the size of the harvest, the marketed surplus of foodgrains, and price expectations, particularly those regarding the price of foodgrains Income velocity has stabilized in the last two years, after a sharp fall during 1975/76 and 1976/77, which mostly reflected a fall in prices Good harvests and ample supplies of foodgrains have kept the increases in rice and other food prices well below those for nonfood items over the past year Food security has dominated price expectations so that large increases in the overall price level do not seem to have had the adverse impact on the public's demand for liquidity which might otherwise have been expected If the rice harvest in the coming fiscal year is average or better, favorable price expectations may be reinforced and some decline in the income velocity may be expected The staff therefore believes at this stage that the program should allow for a rate of increase in total liquidity during the stand-by period of about 15 per cent

The financial program will include, as a performance criterion, a ceiling on domestic credit expansion consistent with the projected growth in total liquidity and the expected balance of payments outturn A sub-ceiling will be established with respect to the banking system's net claims on the Government plus gross claims on the rest of the public sector, also as a performance criterion This subceiling will be established on the understanding that the Government will avoid recourse to the banking system to finance the budget, apart from any seasonal needs There exists a pronounced seasonality in the demand for credit by both the public and the private sectors The financial requirement of the public sector reaches its peak during the first quarter of the calendar year when the bulk of foodgrain and raw jute procurement takes place The demand for credit by the private sector also reaches its peak during this period and decelerates after March The over-all credit ceiling and the subceiling will be established for end-September 1979, end-February 1980, and the end of the program period Taking account of seasonal needs, the level of credit may be permitted to exceed the ceiling for the end of the program period during the peak period of credit demand

The rates of interest on time and savings deposits have been generally unchanged since April 1976, although rates for some categories of savings deposits were reduced in 1977, their range currently is 4-10 per cent, depending on maturities Given the significant increase in inflation in the last two years, there is a case for some increase in interest rates to maintain attractiveness of time and savings deposits, and a corresponding increase in loan rates The mission will impress on the authorities the importance of a realistic and flexible interest rate policy, especially in view of the need to mobilize domestic resources to finance the forthcoming Plan

A major aim of the fiscal program will be to reverse the expansionary fiscal stance of the past two years through an elimination of the budget deficit financed by bank borrowings The subceiling on credit to the public sector will allow some increase in credit to public sector enterprises To achieve the budgetary improvement, revenue would have to be increased mainly through a broadening of the tax base, although some increase in revenue may be possible from further improvements in tax administration In this connection, the mission will urge the authorities to implement the revenue-yielding measures recommended by the Taxation Inquiry Commission, which include widening the scope of tax deductions at the source of income, cutting tax arrears by reducing the time limit between tax liability and payment from four to two years, and extending the scope of excise taxes to cover additional products Even with increased revenue, growth in expenditure at the rate of the past two years (averaging 30 per cent) cannot be sustained if reliance of the budget on bank finance is to be eliminated Undertakings by the authorities for expenditure restraint in 1979/80 will therefore be necessary This could best be achieved through a phased reduction in subsidies and restraint in salary and wage increases

There are severe underlying problems in public finance The budget is excessively reliant on foreign finance and domestic resource mobilization is inadequate Available resources are committed heavily to provide consumer and producer subsidies, and despite a large overall deficit the level of taka resources remaining for investment and to supplement foreign development assistance is deficient The staff believes that the recent progress in agricultural output has created an opportunity, not only for increasing taxation of the farm sector, but for reducing the subsidies on various agricultural inputs In particular, fertilizer subsidies should be reduced by increasing considerably fertilizer prices which currently cover only about half of their cost Higher fertilizer prices would require some increase in rice procurement prices to maintain producer incentives There is also scope for a gradual reduction of food subsidies by increasing ration prices, and reducing access to the ration system to only the lowest income groups The food distribution system also should be adapted to help stabilize market prices for both producers and consumers In addition, measures are needed to gradually eliminate subsidies to public sector corporations, including in particular the jute mills These measures include appropriate pricing policies and exchange rate action

Staff projections suggest a further overall balance of payments deficit is in prospect in 1979/80 However, in their submission to the recent Aid Group Meeting, the authorities projected a small overall surplus The authorities are projecting that in 1979/80 exports will increase by 14 per cent and imports by 9 per cent External aid disbursements are projected to amount to $1,195 million, an increase of $100 million from the estimated level in 1978/79 At this point the staff considers these projections to be optimistic The mission will review external prospects and the assumptions underlying the authorities' projections In particular, the level of imports needed for the planned rate of economic growth to be achieved, the availability of external assistance for disbursement in 1979/80, and the level of exports that can realistically be achieved in light of expected external market conditions and domestic production developments will be examined By the end of June 1979, gross official international reserves are projected to decline to $250 million, equivalent to less than two months of estimated 1978/79 imports The authorities have in the past considered a level of reserves equivalent to at least two months of imports to be a minimum to meet the unpredictable needs for imports of foodgrain On this basis, it appears unlikely that they will allow external reserves to fall significantly during 1979/80

External debt data are inadequate Service payments in 1978/79 are estimated to be up to $125 million and are projected to be $106 million in 1979/80 In view of the deterioration in the external debt profile since 1977/78, a quantitative limit will be established on the contracting of external debts of maturity between 1 and 15 years as a performance criterion The ceiling will limit new debts to an amount consistent with Bangladesh's continuing ability to service the debt while not increasing the debt service burden, borrowing in short maturities (less than 5 years) will be strictly limited

In May 1975 the exchange rate of the taka was devalued by 37 per cent to Tk 30 per pound sterling Between May 1975 and mid-1978, the Bangladesh authorities adjusted the exchange rate periodically, involving in many instances small appreciations of the taka in terms of the pound sterling The staff has urged the Bangladesh authorities to pursue a more realistic exchange rate policy and has indicated that an adjustment of the exchange rate to Tk 33 per pound sterling is necessary, especially to eliminate losses in the jute industry Since mid-1978 the exchange rate of the taka has been gradually depreciated, and on January 15, 1979, it was set at the current rate of Tk 31 125 per pound sterling The staff will reiterate its position that the exchange rate of the taka should be adjusted to Tk 33 per pound sterling before the stand-by program is presented for approval by the Executive Board Beyond this, the mission will encourage the authorities to pursue exchange rate policy in a more flexible manner in the future with the aim of ensuring the profitability of the jute sector, of promoting the expansion of exports, particularly of nontraditional items, and of assisting in the mobilization of budgetary resources

The authorities are at present considering alternatives to the present exchange regime under which the taka is pegged to the pound sterling, including a basket-pegging arrangement The mission will, if requested, discuss the issue with the authorities and point out the implications of alternative basket arrangements

At present, Bangladesh maintains two multiple currency practices resulting from the operation of the Wage Earners' Scheme and the Export Performance License Scheme The program will include a commitment that the Government will not impose new or intensify existing multiple currency practices and exchange restrictions, and will not conclude any new bilateral payments agreements with Fund members during the period of the stand-by arrangement

In recent years, a number of improvements have been introduced in import programing and procedures In particular, beginning July 1978, the import program has been formulated on an annual basis rather than every six months as in the past. The staff considers this to be a significant improvement, and will encourage the authorities to continue this policy in 1979/80. The program will contain a provision that the Government will continue to simplify import procedures and liberalize imports as the balance of payments position permits, and that it does not intend to impose new or intensify existing restrictions on imports for balance of payments reasons.

Drawings under the stand-by arrangement will be phased in accordance with the schedule of phased credit ceilings. The mission will propose that SDR 14 million be available immediately after the stand-by arrangement is approved and SDR 12 million each after the September 1979 and the February 1980 performance criteria are observed.

A substantial part of the proposed program will depend critically on measures introduced in the government budget for 1979/80 which will not be completed or approved until after the stand-by arrangement comes into force. It is not clear how far the authorities will be in a position at this stage to outline in detail the specific policy measures they will undertake in certain important areas to give force to the intentions contained in the program. With this in view, the staff will request that a mid-term review of the implementation of the program be conducted. However, it is not proposed that the right to draw under the stand-by arrangement be made contingent upon understandings reached during the review.

Fund Relations with Bangladesh

Quota:	SDR 152 million.
Use of Fund resources:	Bangladesh has made frequent use of the Fund's resources. A stand-by arrangement for SDR 31.25 million was approved in June 1974; the full amount was drawn. A second stand-by arrangement for SDR 62.5 million was approved in July 1975; the full amount available was drawn. Under the Compensatory Financing Facility, Bangladesh purchased the equivalent of SDR 62.5 million in December 1972 and of SDR 20 million in August 1976. It purchased an amount of SDR 51.5 million and SDR 40.5 million, respectively, under the 1974 and 1975 Oil Facilities.
Trust Fund:	SDR 51.8 million for the first period.
Fund holdings of taka:	The Fund's holdings of Bangladesh taka amounted to 214.2 per cent of quota on February 28, 1979; excluding the amounts purchased under the oil facilities and compensatory financing facility, they stood at 138.6 per cent of quota.
SDR position:	Bangladesh received its first SDR allocation of SDR 15.8 million on January 1, 1979. Its holdings of special drawing rights amounted to SDR 13.1 million on February 28, 1979.
Distribution of profits:	US$5.6 million.
Gold distribution:	80,741 fine ounces.

Exchange rate:	The official exchange rate of the taka was fixed at Tk 18.968 per pound sterling from February 1, 1972. From May 17, 1975, it was changed to Tk 30 per pound sterling. Since then, the taka/pound sterling rate has been periodically changed. The last change became effective from January 15, 1979 when the middle rate of spot buying and selling was changed to Tk 31.125 per pound sterling from the rate of Tk 30.525 per pound sterling established on October 23, 1978.
Last Article XIV consultation:	Article XIV consultation discussions were held during February 28-March 14, 1978. The Staff Report (SM/78/119, 4/28/78) was considered by the Executive Board on June 14, 1978.
Fund technical assistance:	Since June 1972, the Fund has maintained a resident representative in Dacca, and since September 1975, also a deputy resident representative.

1978

Office Memorandum

TO : The Acting Managing Director

DATE: March 21, 1978

FROM : P. Chabrier P.C.

SUBJECT : 48-Hour Report - Bangladesh: Article XIV Consultation

File

The mission, consisting also of Messrs. Evers (ASD), Huh (ETR), Ballali (FAD) and Miss Pugh (secretary, ASD), and ably assisted by Messrs. Siber and Gollé, resident staff in Bangladesh, held consultation discussions in Dacca during February 28-March 14, 1978.

The political situation is, at best, uneasy. Presidential elections which were to be held this spring have been postponed by President Ziaur Rahman and there is evidence of growing opposition to his rule. The Awami League, party of former Sheik Mujib has registered important successes in local elections. President Ziaur has the support of major elements of the army, but he lacks charismatic appeal and his attempt to form a new party has, by and large, failed.

Economic performance in 1977/78 (fiscal year ending June) has been mixed. The food situation has greatly improved as a result of good rice crops and large foodgrain imports. Because of a somewhat easier supply situation unused industrial capacity has been reduced. While improvements have been registered in several policy areas (price support policies for rice, implementation of the development program), excessive monetary expansion (on average 25 per cent throughout 1977) and continuing supply shortages in some sectors have resulted in mounting pressures on prices which, by January 1978, were 20 per cent higher than a year earlier. The main factors of the rapid monetary expansion are a sharp deterioration in the 1977/78 budget position and easy credit policies. Even though credit policies have recently been tightened, total credit expansion in the year to March 1978 will be 26 per cent, i.e., 5 per cent above the limit for that month included in the current Trust Fund program. On the external side, the balance of payments is expected to revert from a surplus of $132 million in 1976/77 to a deficit of over $100 million in 1977/78 as a result of higher import payments. Exports will grow by 6 per cent only as low production of jute has not permitted to take full advantage of the high prices prevailing on world markets and non-traditional exports are hampered by lack of profitability. By end-February gross official reserves had fallen to SDR 195 million, or 2.1 months of 1977/78 imports, a level considered as a minimum by the authorities.

While part of the deterioration in the budget position in 1977/78 can be ascribed to a shortfall in commodity aid and to a more active official foodgrain policy, its magnitude is cause for concern. This is so because development expenditures under the forthcoming two-year plan starting mid-1978 are estimated to increase substantially and at the same time, the official policies for greater foodgrain sufficiency will result, if successful, in higher outlays for domestic procurement and a loss of counterpart funds as foodgrain imports under aid decline. Unless more resources are urgently mobilized in the public sector, it is unlikely that both the development program can be financed and a satisfactory budget performance can be maintained. Until now, there has been little effort made to increase resource mobilization, apart from improvement in tax administration The most promising areas for raising public savings are through reductions of the massive food and fertilizer subsidies, more realistic pricing policies of nationalized industries and public utilities, a reduction of the scope of the public foodgrain distribution system and tight controls on the growth of all expenditures

A particular area of concern is the export sector At present most exports are made at losses and the growth momentum of nontraditional exports made by the private sector has been lost The policy of the authorities to revalue the taka over the last 18 months has been a main cause of the poor export performance The losses of jute mills continue to grow, amounting to Tk 550 million in 1977/78 or 15 per cent of their exports and are now largely financed through a budget subsidy The double imperative of maintaining attractive producer prices and competitive export prices is likely to lead to further large losses of jute mills A devaluation of the taka is now a matter of urgency in view of the need to encourage exports, price imports at more realistic levels, and generate more domestic resources for the Government Calculations made by the mission indicate that an initial devaluation of the taka from Tk 28 7 to Tk 33 per £1 would be appropriate

In view of the weakening external position, the authorities have requested negotiations on a third credit tranche stand-by The mission indicated that such negotiations would take place only after firm commitments on a devaluation of the taka to no less than Tk 33 per £1 and on the adoption of measures to improve domestic resource mobilization had been provided The next budget would be the appropriate time for introducing policies along these lines The intentions of the authorities could be communicated in early June in Paris on the occasion of the aid group meeting for Bangladesh If the envisaged measures are then judged satisfactory by the staff, a firm date for the negotiations could be set on that occasion

cc The Managing Director (on return)
Mr Palmer
Mr Beveridge
Mr Evans
Mr Miller/Mr Wittich
Mr Ware

March 9, 1978

Final Statement

1. Economic performance in the present financial year has shown encouraging trends. Economic growth, which is now estimated at 8 per cent is broadly based and output of all important crops has increased. This good agricultural performance and higher levels of imports have resulted in improvements in capacity utilization rates in industry. There have also been aspects of policies for which the authorities should be congratulated. This is in particular the case of the efficient use of official reserves, for food import at a crucial time to prevent severe inflation, food policies in general and constitution of larger operational stocks of foodgrains in particular, relatively liberal import policies and progress in implementing the Annual Development Program

2. There are, however, three areas where performance has not been satisfactory. Inflationary pressures have been mounting. By January 1978 the consumer price index was 20 per cent higher than a year earlier. In addition to continued shortages and distribution problems in several sectors, there is no doubt that a major factor has been excessive monetary expansion Indeed, throughout 1977, liquidity has expanded at an average annual rate of over 20 per cent and the credit program under the Trust Fund is unlikely to be met. Secondly, the budget performance has weakened markedly. Although part of the deterioration is due to additional foodgrain purchases and to a shortfall in commodity aid, the magnitude of the turnaround in the budget is a cause for concern. After a surplus of Tk 200 million in 1976/77 the Government is estimated to resort to bank credit in an amount of Tk 1.2 billion in 1977/78, i e., 8.5 per cent

of the stock of liquidity Thirdly, the balance of payments will revert from a surplus of $132 million in 1976/77 to a deficit of $104 million this year mainly because of large increases in non aid import payments Exports of the jute sector have benefited from sharp price increases in the international markets, but the low stocks at the beginning of the season and the modest production levels of recent years have prevented Bangladesh from taking full advantage of this development. Indeed, the volume of raw jute and jute goods exports is expected to decline from 850,000 tons last year to 800,000 tons this year. In addition, the buoyancy of non-traditional exports has subsided, the main reason being inadequate profitability of these products which are largely made by the private sector.

3. The complexity of the development task is reflected in the fact that in the seventies so far, average growth in production has not been commensurate with the annual rise of 2.8 per cent in population Foodgrain production has risen by 1.5 per cent per year and reliance on imports has increased In 1977/78, jute production, which provides for about 80 per cent of total exports, is still 28 per cent below its 1969/70 level while industrial production has only recently reached its 1969/70 level. In other words, the efforts and development programs of the last few years have not resulted in any major gains in real per capita output While at the present stage of development a high priority to improvements in infrastructural and social investments is necessary in order to establish the foundations of sustained progress over the long run, economic growth crucially depends on the size of the investment effort in

directly productive assets, on improvement in efficiency, and on the provision of adequate incentives to producers, in particular, through maintenance of attractive prices. While such growth policies frequently involve timely, and sometimes politically difficult, adjustments, failure to take corrective action is self defeating in the end.

4. The two most promising areas for raising output are rice and jute. Given the present low yields, an annual increase in foodgrain production of 500,000 tons is feasible while recent trends indicate that foreign markets can absorb the equivalent of a production of 7 or 8 million bales of jute a year in Bangladesh. Achievement of higher production levels would not only reduce some of the more important constraints on development in Bangladesh, namely food and foreign exchange shortages, but the higher agricultural incomes would increase demand for the products of the industrial sector and, in turn, generate employment. In 1977/78, we note that more adequate inputs and extension services have been provided and a more aggressive foodgrains procurement policy as well as other measures have provided a greater degree of price support. The positive production response this year suggests that Bangladesh farmers, like those all over the world, are more willing to adopt new techniques and raise output if they can count on sufficiently remunerative prices. Such policies must be continued with vigor. With increasing foodgrain output, the maintenance of adequate support prices will necessitate increased domestic procurement while imports of foodgrains under aid will be reduced. As the cost of domestic procurement will be relatively higher than the

cash outlays associated with aid imports, the burden on the budget of the present official distribution system will increase. In the case of jute, the maintenance of incentive prices to growers in relation to those for rice, and the expected strong competition from polypropylene in view of the substantial productive over capacity both in the United States and in Europe may mean that there will be little scope to reduce the present financial assistance of the Treasury to the jute mills in the absence of corrective measures. The financial consequences of the production promotion policies for rice and jute may be substantial over the medium term.

5. The Planning Commission officials have given us the broad outlines of the Annual Development Program under the Second Plan. We feel in general that the financing gap implied in the projections is understated and that, in the absence of a substantial effort in domestic savings mobilization it will become increasingly difficult to maintain an acceptable budget balance even with further improvement in the revenue collection of existing taxes and the possibility of increased commodity aid and/or donor financing of the domestic cost of projects. In the absence of additional measures to reduce the financial gap in the budget, either the present inflationary pressures will continue or credit to industries and the private sector will have to be squeezed to such an extent that investment and production will be discouraged. Under both assumptions, the results of your development efforts will be limited.

6. Given the large share of the population that is absolutely poor, the possibility of raising additional revenue in Bangladesh is more limited than in many other developing countries. There are,

however, promising areas for additional resource mobilization. Constant control has to be exercised on the growth of current expenditures. With regard to the development program it seems that a careful review of the expenditures should be made in order to prune some of the less essential outlays. We would, however, like to discuss in greater detail some areas where we feel action can be taken, namely increased taxes, reduction in agricultural input subsidies, reduction in the scope of the ration system and improved operations of public enterprises and utilities.

a. A greater tax effort is feasible and desirable. The Tax Enquiry Commission has identified areas for improved tax administration and we encourage early adoption of its recommendations, particularly speedier payments of tax arrears. With regard to income tax, an increase in the number of taxpayers and a reduction of exemptions is needed. Also, with the substantial increases in agricultural incomes in 1977/78, there remains little justification for maintaining the light tax burden on this sector which provides about 60 per cent of GNP. Tax revenue from agriculture income can be raised substantially. Because of administrative reasons the full revenue potential of income taxation will only develop over time, and, therefore, the next budget should include some of these measures.

b. A reappraisal of the input subsidies on fertilizer, pesticides and irrigation facilities is needed. Fertilizer prices (in relation to paddy prices) are among the lowest in Asia, but these subsidies are becoming a substantial drain on the budget--exceeding Tk 1 billion in 1977/78, i.e., 9 per cent of the annual development program and half of the expenditures devoted to agriculture and rural development. We feel that given the recent increase in agricultural income and the official intention to support agricultural prices, a progressive decrease in subsidies is needed.

c. A reduction in the scope of the present official distribution system of foodgrains would not only reduce budget outlays but also ease the administrative burden on the Government and add flexibility to overall food management policy. In view of the need to gear the system toward more aid to the poor we recommend that this reduction could take the form of a major cut in the number of the better off recipients coupled with a raising of ration prices. If need be, government employees could be compensated by a salary adjustment and some measures taken to compensate the most destitute. A straight reduction in the amount of the ration alone would directly affect the most deserving recipients Some measures along these lines, although yet insufficient, have already been taken in 1977/78 We are aware that an appropriate curtailment in official foodgrain distribution will not be an easy measure but if adequate incentive prices to farmers are to be maintained with rising domestic production, it is doubtful that adjustments in the ration system can be delayed for much longer

d. Public sector corporations account for about 60 per cent of industrial output, and, with public utilities, constitute an important potential for additional public savings Many of the corporations are now running losses and, for the sector as a whole, the return on equity after taxes is only 1 per cent. As depreciation allowances are made on the basis of historical, rather than replacement cost, it is likely that most public enterprises are decapitalizing their assets, which is borne out by the fact that the annual development budget includes replacement and maintenance expenditures for this sector. There are also indications that part of the transfers from the development budget to the industries are in part used as working capital while the increase in the contribution of public corporations to the Treasury in 1977/78 may represent a de facto transfer from the development budget to the revenue budget and not an improvement in the operational efficiency of the enterprises. The underlying causes of the performance are well known: restrictive regulations, insufficient autonomy, rigid price policy, lax financial controls, and in some cases, management deficiencies. For these industries and utilities adoption of more realistic costing and pricing policies and of efficiency measures is a matter of urgency. We are pleased to have been informed during our discussions that steps along these lines would be taken.

7. Recently the issue of the exchange rate of the taka has received increased attention among officials, particularly the results of the May 1975 adjustment. The principal objectives of that adjustment were increased volumes of exports, higher returns to domestic producers, a better financial balance in the public sector and, with Fund support, a liberalization of imports which, because of restrictions, commanded substantial scarcity premia. While export prices of jute and jute goods were lowered to those of polypropylene and substantial stocks of jute and jute goods were exported, following the rate measure, the farmer's price for jute was kept unchanged and jute production remained far below export potential. Similarly, while the additional financial resources generated

by the exchange rate adjustment permitted to increase the development budget substantially, insufficient domestic procurement and excessive distribution of the ration system in 1975/76 led to a fall in foodgrain prices to below incentive levels This importantly contributed to the fall in foodgrain production in 1976/77, and the subsequent need to import foodgrains commercially. Monetary policies and the liberalization of imports had, however, positive effects on prices and output in some sectors. The lesson to be drawn is that any move on the exchange rate should not be considered in isolation and should be accompanied by appropriate domestic policies.

The mission feels that at present a devaluation of the taka is needed for three reasons. First it will help generate the additional domestic resources--through reduction of export subsidies and higher tax and counterpart revenues--needed to finance the enlarged development program in a non-inflationary way Second, it will encourage nontraditional exports and broaden the export base, thus minimizing the impact of frequent fluctuations of foreign exchange earnings from export receipts from the traditional products, jute, jute goods and tea. Finally, it will help the financial position of the jute mills and other losing public sector export industries. The progressive introduction of the Wage Earners' Scheme, of the jute subsidy, and of the export performance license is an indication that the official rate is out of line

At this stage, a few observations should be made on the mission's recommendation for a taka devaluation Export promotion policies now concentrate mostly on marketing, tax rebates and interest subsidies While these measures are necessary, they are not sufficient to achieve maximum results since at present most exports are no longer profitable In the case of jute, the losses of the jute mills have again increased this year, despite some reduction in conversion wastage and substantially higher export prices. The major factor is the sharp rise in domestic raw jute prices. However, maximum production and exports of raw jute and jute goods will depend on continued remunerative prices to the farmers and export quotations aimed at long-term competitiveness with polypropylene products If these objectives are to be maintained, subsidization is likely to continue in the absence of a devaluation, even if efficiency is improved With regard to the impact on the cost of living, we believe it will not be excessive if the devaluation measure is accompanied by appropriate anti-inflationary policies, including monetary and import liberalization policies.

The needed exchange rate adjustment should be made through a devaluation of the official rate rather than further manipulations of the exchange system or adjustments in subsidy payments. Within the context of an overall financial program certain duties and sales taxes on imported essentials could be reduced.

8. Some of the measures indicated above have a faster resource mobilization impact than others The new taxes on the agricultural sector and the improvements in operational efficiency of public enterprises may take some time to reach their full potential yield. The positive impact on the budget of an exchange rate adjustment is immediate as would be such measures as a curtailment of agricultural input subsidies and of nonessential expenditures, as well as increases in the prices of some public enterprises and

utilities. In view of the weakening of the budget position in 1977/78 and your real growth objectives, the mission feels that prompt action on the rate of the taka is needed in addition to other tax and expenditure measures The extent of the adjustment would depend, among other things, on the Government's success to generate other resources within a relatively short time, on the desired profitability of nontraditional exports and on the need to establish more favorable conditions for profitability in the jute sector. However, there should be little doubt about the aim of restoring full profitability to the jute sector within a relatively short time.

9. The mission and our resident staff in Dacca feel that the occasion of the next budget will be particularly opportune for introducing a package of measures along the lines described above. Any delay in taking such adjustment policies will increase the severity of the measures. We are well aware that active resource mobilization may be as difficult for the Government as it is desirable for the fostering of long-term growth. But, if the resources so mobilized are used to maintain appropriate incentive prices to producers and to help in achieving better domestic and external balance, they will prove to be the most profitable investment Bangladesh can make at this stage of its development.

IMF Mission

Dacca

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INTERNATIONAL MONETARY FUND

BANGLADESH

Briefing Paper - 1978 Article XIV Consultation

Prepared by the Asian Department and
the Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs, Legal,
and Treasurer's Departments)

Approved by W John R. Woodley and Donald K Palmer

February 16, 1978

A mission consisting of Messrs Chabrier (ASD, head), Evers (ASD), Huh (ETR), Ballali (FAD), and Miss Pugh (ASD, secretary) will visit Dacca during February 28-March 14, 1978 for Article XIV consultation discussions. Mr. Rasaputram, Alternate Executive Director will, attend some of the meetings

I. Economic Background

Since mid-1975, when a stabilization program supported by a stand-by arrangement was introduced, economic performance has been characterized by rapidly changing trends Economic growth, which depends crucially on crops, was 8 per cent in real terms in 1975/76 (fiscal year ending in June), 2-3 per cent in 1976/77, a growth rate of 7 per cent is envisaged in 1977/78. Between mid-1975 and end-1976 the cost of living index fell by 8 per cent, with food prices declining by 20 per cent, while the balance of payments improved Poor rice crops in 1976/77 and declines in foodgrain imports under aid led to a depletion of stocks and a rapid increase in rice prices on the free market in the first half of 1977 While the increase was not unwelcome as an incentive to producers, there were fears that if it continued unchecked a severe inflationary situation might ensue. The authorities supplemented foodgrain aid shipments with about 400,000 tons purchased abroad with their own foreign reserves. This prompt action made possible the rebuilding of stocks and resulted in a generally declining trend in rice prices on the free market after June, especially after it became known that the aman rice crop harvested in November-December 1977 was a record one. However, the cost of living index continued to rise rapidly, and by end-1977 it was 17 per cent higher than at end-1976. The main reasons for the rise were rapid monetary expansion and continued supply shortages of some products, in particular textiles and some food items.

The balance of payments has weakened markedly since mid-1977. Exports have been hampered by inadequate domestic production in the case of the jute sector--the 1977 crop was 1 million tons below the estimates--and low profitability or even losses in the case of nontraditional products. Export receipts are forecast to be only 6 per cent higher in 1977/78 than in 1976/77, despite substantial increases in export prices of jute products. Imports have recovered rapidly from the low levels of 1976/77 and are expected to be 60 per cent higher in 1977/78 than in the previous year The main reasons are higher foodgrain imports and an enlargement of the semi-annual import programs. Despite substantially larger inflows of external assistance, the balance of payments will be in deficit by $90 million in 1977/78, following a surplus of $130 million in 1976/77 By December 1977, gross official reserves had fallen to SDR 182 million, equivalent to about two months of 1977/78 imports

In 1977/78, official foodgrain policies have been more satisfactory, although the scope of the ration system has not been reduced The Government has supplied larger levels of inputs to rice farmers, reacted promptly to food shortages through commercial imports and, more recently, has been stepping up rice procurement and reducing official ration offtakes in order to maintain free market rice prices at incentive levels In other areas, however, policies have been largely inadequate. The annual rate of liquidity expansion (about 25 per cent throughout the second half of 1977) has been much greater than is consistent with price stability. The monetary expansion reflects a 50 per cent growth of credit to the private sector in 1977 and a pronounced increase in the budget deficit (after foreign aid), in part due to large official purchases of foodgrains, but also to increased outlays for law and order and larger subsidies for rice distribution and jute exports. In the exchange field, the authorities have kept the taka pegged to the pound sterling. In spite of small devaluations against sterling since mid-1977 the taka has effectively appreciated against the U.S. dollar in which most export prices are quoted This appreciation has placed further strains on the already weak financial position of jute companies, particularly since domestic raw jute prices have increased by 35 per cent in 1977. The authorities have recently introduced substantial increases in the export price quotations of jute goods, a measure which could induce a shift by foreign buyers toward synthetics. More recently, the policy has been to maintain a fixed dollar/taka exchange rate which, in view of the changes in the dollar-sterling rate, has resulted in broken cross rates

II. Tasks of the Mission

Elections are now planned for the spring of 1978 and the political situation is at present dominated by intense activity and much uncertainty. The policy measures taken recently--modest adjustment of the ration price of rice, introduction of easy credit policies, large budget deficit, appreciation of the exchange rate--suggest that the Government is unlikely to adopt effective policies before the elections

Food dominates the economic conditions of Bangladesh, and in the 1970s foodgrain production has not kept pace with population growth. Foodgrain imports have averaged close to 1 5 million tons a year, i e., 15 per cent of domestic output The levels of domestic investment and its composition have been inadequate to make possible a significant growth in real per capita income on a sustained basis About 75 per cent of public development expenditures are foreign-financed, and as greater self-sufficiency in food and other commodities is achieved, the reduction in counterpart funds generated from the sale of foreign aid will have to be compensated by a greater domestic revenue effort. On the external front, the current account deficit has been increasing, and the heavy concentration of exports on one product (jute) has rendered export receipts and the capacity to import highly vulnerable to changes in jute output and world demand for jute The staff will review the present and prospective developments and concentrate its recommendations on the following policy areas.

1 Production and distribution policies

While considerable yield increases can be achieved in rice and jute output, official pricing and production policies have generally not provided the necessary encouragement for increased production Except in recent months, the authorities have not used official procurement and distribution policies efficiently to stabilize prices As a result, free market prices of rice and jute have fluctuated widely, which has been detrimental to production plans Besides, the official procurement prices have been set at unattractive levels.

The staff will stress that the adoption of effective price support mechanisms and the provision of adequate amounts of inputs (fertilizer, improved seeds, etc.) and credit are necessary In view of the possibilities for substitution between jute growing and rice cultivation, appropriate relationships should also be maintained between official paddy and jute procurement prices.

The official foodgrain ration system covers one fourth of the population. Ration prices are generally much lower than official procurement prices or prices in the open market, except when supplies are abundant, as in 1976. At present, the ration system gives priority to the urban areas, particularly to groups that are relatively well off, while the rural poor have little access to subsidized ration supplies The staff will recommend that in the future subsidized foodgrains be channeled primarily to vulnerable groups unable to buy in the market, that higher income earners be excluded from the system, and that the volume of government distribution, both through the ration system and the open market be determined with a view to stabilizing prices at levels that maintain appropriate price incentives to farmers.

2. Domestic resource mobilization

The annual development expenditures in the budget have consistently fallen short of budget estimates, largely because of deficient project identification and preparation and, at times, lack of domestic financial resources A positive development is the recent decision to concentrate in the next two years on consolidating and exploiting existing investments in the public sector rather than creating new capacities

The envisaged maintenance of high levels of public development expenditures necessitates the prompt adoption of measures to increase domestic financial resources, particularly in view of the recent deterioration in the budget position. Over the medium term, achievement of self-sufficiency in food will result in a loss to the budget of counterpart funds generated by the sales of food aid Besides, donors have indicated that larger proportions of their aid in the future will be in the form of project to be complemented by local resources. The possibilities for raising substantial additional resources are constrained by the large share (70 per cent) of the population that is absolutely poor. However, there are areas where policy measures can be taken. Continuous efforts are needed to control the growth of nondevelopment public expenditures and improve tax administration. The recent and prospective increases in agricultural output and incomes provide an opportunity for taxing that sector--which is at present largely untaxed--and for reviewing the appropriateness of the present subsidization of many agricultural inputs Substantial scope exists for increasing land revenue. Even though direct taxation of agricultural incomes raises problems of administration, efforts should be made to increase the effectiveness of existing taxes by, for instance, devising better ways of assessing income and by gradually reducing exemptions. In the short run, the largest potential for increasing revenue is through adoption of more ~~realistic~~ cost and pricing policies for nationalized industries and utilities, as well as of measures to improve their efficiency The staff will stress that officially administered prices should be allowed to reflect more adequately the supply and demand conditions in order to perform their proper allocative function In the case of foodgrain prices, an increase in ration prices could be coupled with a salary action, while the needs of the vulnerable groups could be met through special programs. The staff will also encourage the mobilization of domestic savings by the banking system through maintenance of attractive interest rates and rapid proliferation of bank branches in the countryside.

3. Monetary policy

The rate of monetary expansion has been excessive recently. The staff will review the official credit program for the period ahead and assess whether, in the light of expected balance of payments and growth prospects, it is consistent with the achievement of a better price performance. The staff will also assess the efficacy of the present credit control instruments in enforcing credit policy.

The staff will review the experience so far with credit to agriculture, particularly with the special agricultural credit program launched in February 1977, and will discuss measures intended to improve agricultural credit recovery.

4. External policies

A main objective of economic policy should be an improvement in the balance of payments. So far, export performance has been disappointing In 1977/78, exports cover only 35 per cent of imports, a lower percentage than in previous years The present exchange rate level and exchange practices have now become an immediate issue. Most export sect~~ors, in particular~~ jute goods as well as shrimps and hides which offer the best potential for diversification, are unprofitable. The losses sustained by the jute industries have been the equivalent of 20-30 per cent of export receipts Losses of jute goods exports are being subsidized by the budget or financed through bank credit Measures are being envisaged to increase productivity and reduce costs in jute mills with the aid of IDA loans, but the impact of such steps will appear only in the medium term The staff will stress that the weak budget position and the need to encourage export growth and diversification and to maintain attractive raw jute prices at the producers' level call for a major adjustment in the exchange rate level A more depreciated rate would also permit costing imports at more realistic levels. The staff will review the present exchange system, and press for early elimination of the broken cross rate

During the last two years, semi-annual import programs have been enlarged. Actual imports, however, have fallen short of the budgeted amounts Disbursement of foreign grants and loans have also been smaller than envisaged because of inadequate import procedures and administration of aid and delays in project preparation. The staff will review import procedures and suggest ways to improve them.

External debt statistics are deficient Debt service payments have been growing in recent years and at an estimated $61 million in 1977/78, represent 13 per cent of merchandise exports The staff will recommend that if the burden of debt service is not to increase excessively over the medium term, Bangladesh should implement an aggressive policy of export promotion and careful management of new debt obligations

III <u>Use of Fund Resources</u>

The staff will review ~~the~~ performance under the Trust Fund program which was approved by the Executive Board in July 1977 As it appears now, most of policy declarations--in terms of budget balance, credit expansion, and exchange practices--have not been followed The staff will indicate that corrective measures are needed both in substance and to make future programs more credible.

In view of the deterioration in the balance of payments, the Bangladesh authorities may discuss the possibility of negotiating a third credit tranche stand-by arrangement. The staff will indicate in what areas policy adjustments would have to be taken, particularly with regard to the budget and the exchange rate, and that negotiations on a program could take place only after firm decisions by the authorities on such policy matters as the exchange rate have been made A quantified program would be discussed only at the time of such negotiations If the authorities only request negotiations on a Trust Fund program for the second period, the staff will indicate that such negotiations would have to wait until data were available for an ex post assessment of performance under the present program. Because of the fundamental importance of an exchange rate change, the authorities will be discouraged from seeking agreement on a program without this element

The staff will discuss the possible request of a repurchase schedule for SDR 8 2 million drawn under the 1975 stand-by arrangement which falls due in May 1978. Provided there is a balance of payments need, the staff will propose repurchases in not more than six equal installments.

Fund Relations with Bangladesh

Quota	SDR 125 million, of which SDR 2 million has been paid in gold. Bangladesh has consented to the proposed new quota of SDR 152 million.
Second Amendment	Bangladesh has accepted.
Use of Fund resources	Bangladesh has purchased SDR 31 25 million under a stand-by arrangement approved in June 1974 and SDR 62.5 million under a stand-by arrangement approved in July 1975. A purchase of SDR 62 5 million under the compensatory financing facility was made in December 1972. In August 1976, SDR 20 million was purchased under the compensatory financing facility, while SDR 19 06 million of an earlier purchase was reclassified as compensatory. Purchases under the oil facilities have amounted to SDR 92 million.
Fund holdings of taka:	On February 14, 1978, Fund holdings of Bangladesh currency amounted to 254 per cent of quota, excluding purchases under the compensatory and the oil facilities Fund holdings amounted to 151 per cent of quota
SDR position·	Bangladesh is a participant in the Special Drawing Account, but has received no allocation. It does, however, hold SDR 0.93 million, which were acquired to enable Bangladesh to meet charges payable to the Fund on its existing purchases.
Distribution of gold	Bangladesh has acquired 53,490 fine ounces of gold equivalent to SDR 1,872,150 from the Fund.
Trust Fund	A Trust Fund loan was approved on June 10, 1977. So far Bangladesh received disbursements on the loan totaling SDR 21 625 million.
Par value and exchange rate	Bangladesh did not establish an initial par value with the Fund From February 1, 1972, the official exchange rate of the taka was fixed at Tk 18 9677 per pound sterling and, from May 17, 1975, at Tk 30 per pound sterling On April 26, 1976, Bangladesh established a central rate with the Fund of Tk 28 10 per pound sterling. On November 3, 1976 the official exchange rate of the taka was fixed at Tk 25.45 per pound sterling and this rate has been periodically changed afterwards. The last change was on January 30, 1978 to Tk 28 725 per pound sterling. Bangladesh has established a representative rate with the Fund under Rule 0-3, this rate is determined from the middle rate of the taka against the pound sterling established by the Bangladesh Bank and the representative rate for the pound sterling

Last Article XIV consultation	The staff report on the 1976 Article XIV consultation (SM/76/99,5/17/76) was considered by the Executive Board on June 18, 1976
Fund technical assistance	Since June 1972, the Fund has maintained a resident representative in Dacca and, since September 1975, also a deputy resident representative. A CBS Advisor serves in the Bangladesh Institute of Bank Management.

February 14, 1978

TO ✓Mr Palmer
Mr Evans
Mr Beveridge
Mr Miller/Wittich

FROM P Chabrier P C

Subject <u>Bangladesh - Briefing Paper</u>

Please find attached for your comments the briefing paper for the forthcoming Article XIV consultation discussions

Your comments would be appreciated before the close of business on Thursday, February 16th (Ext 75975)

DRAFT
February 14, 1978

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INTERNATIONAL MONETARY FUND

Bangladesh

Briefing Paper - 1978 Article XIV Consultation

Prepared by the Asian Department and
the Exchange and Trade Relations Department

(In consultation with the Fiscal Affairs,
Legal, and Treasurer's Departments)

Approved by W John R Woodley and Donald K Palmer

February , 1978

A mission consisting of Messrs Chabrier (ASD, head), Evers (ASD), Huh (ETR), Ballali (FAD), and Miss Pugh (ASD, secretary) will visit Dacca during February 28-March 14, 1978 for Article XIV consultation discussions Mr Rasaputram, Alternate Executive Director will attend some of the meetings

I Economic Background

Since mid-1975, when a stabilization program supported by a stand-by was introduced, economic performance has /been/ characterized by rapidly changing trends Economic growth, which crucially depends on crops, was 8 per cent in real terms in 1975/76, 2-3 per cent in 1976/77 and a growth rate of 7 per cent is envisaged in 1977/78 Between mid-1975 and end-1976 the cost of living index fell by 8 per cent, with food prices declining by 20 per cent, and the balance of payments improved Poor rice crops in 1976/77 and declines in foodgrain imports under aid led to a depletion of stocks and a rapid increase in rice prices on the free market in the first half of 1977 While the increase was not unwelcome as an incentive to producers, there were fears that if it remained unchecked a severe inflationary situation might ensue The authorities were prompt to supplement foodgrain aid shipments with ab out 400,000 tons purchased abroad with their own foreign reserves The action made it possible to rebuild stocks and resulted in a generally declining trend in rice prices on the free market after June, especially after it became known that the aman rice crop harvested in November-December 1977 was a record one However, the cost of living index continued to rise rapidly and by end-1977, it was 17 per cent higher than at end-1976 The main reasons have been rapid monetary expansion and continued supply shortages of some products, in particular textiles and some food items

The balance of payments has weakened markedly since mid-1977 Exports have been hampered by inadequate domestic production in the case of the jute sector--the 1977 crop was 1 million tons below the estimates--and low profitability or even losses in the case of nontraditional products Export receipts are forecast to be only 6 per cent higher in 1977/78 than in 1976/77 despite substantial increases in export prices of jute products Imports have recovered rapidly from the low levels of 1976/77 and are expected to be 60 per cent higher in 1977/78 than in the previous year The main reasons are higher foodgrain imports and an enlargement of the semi-annual import programs Despite substantially larger inflows of external assistance, the balance of payments will be in deficit by $90 million in 1977/78 following a surplus of $130 million in 1976/77 By December 1977, gross official reserves had fallen to SDR 182 million, equivalent to about two months of 1977/78 imports

In 1977/78, official foodgrain policies have been more satisfactory, although the scope of the ration system has not been reduced The Government has supplied larger levels of inputs to rice farmers, reacted promptly to food shortages through commercial imports and, more recently, has been stepping up rice procurement and reducing official ration offtakes in order to maintain free market rice prices at incentive levels In other areas, however, policies have been largely inadequate The annual rate of liquidity expansion (about 25 per cent throughout the second half of 1977) has been much greater than is consistent with price stability The monetary expansion reflects a 50 per cent growth of credit to the private sector in 1977 and a pronounced increase in the budget deficit (after foreign aid) in part due to large official purchases of foodgrains, but also because of increased outlays for law and order and larger subsidies for rice distribution and jute exports In the exchange field, the authorities have kept the taka pegged to the pound sterling, and in spite of two small devaluations the taka has effectively appreciated against a basket of currencies and the U S dollar in which most export prices are quoted This appreciation has placed further strains on the already weak financial position of jute companies, particularly since domestic raw jute prices have increased by 35 per cent in 1977 The authorities have recently introduced substantial increases in the export price quotations of jute goods, a measure which could induce a shift by foreign buyers toward synthetics More recently, the policy has been to maintain the dollar/taka exchange rate at around TK 15 per U S dollar while pegging to the pound sterling, the appreciation of the pound sterling has resulted in the emergence of broken cross rates

II Tasks of the Mission

Elections are now planned for the spring of 1978 and there is at present intense political activity and uncertainty in Bangladesh The policy measures taken recently have been largely inadequate or counterproductive, e g., modest adjustment of the ration price of rice, introducing easy credit policies, large budget deficit, appreciating the exchange rate These developments indicate that the Government is unlikely to adopt effective policies before the elections

Food dominates the economic conditions of Bangladesh and in the 1970s foodgrain production has not kept pace with population growth and foodgrain imports have averaged close to 1 5 million tons a year, i e , 15 per cent of domestic output Domestic investment levels and composition have been inadequate to make possible a significant growth in per capita income on a sustained basis About 75 per cent of public development expenditures are foreign financed and achievement of greater self-sufficiency in food and other commodities will mean a loss of budget resources On the external front, the current account deficit has been increasing and the heavy concentration of exports on one product (jute) has rendered export receipts and the capacity to import highly vulnerable to changes in jute output and world demand The staff will review the present and prospective developments and concentrate its recommendations on the following policy areas

1 Production and distribution policies

While considerable increases in yields can be achieved in rice and jute output, official pricing and production policies have generally not provided the necessary encouragements for increased production Except in recent months, the authorities have not used official procurement and distribution policies efficiently to stabilize prices As a result, free market prices of rice and jute have fluctuated widely which has been detrimental to production plans Besides, the official procurement prices have been set at unattractive levels The staff will stress that the adoption of effective price support mechanisms and the provision of adequate amounts of inputs (fertilizer, improved seeds, etc) and credit are necessary In view of the possibilities for substitution between jute growing and rice cultivation, appropriate relationships should also be maintained between official paddy and jute procurement prices

The official foodgrain ration system covers one fourth of the population Ration prices are generally much lower than official procurement prices or prices in the open market, except when supplies are abundant as in 1976 At present, the ration system gives priority to the urban areas, particularly to groups that are relatively well off while the rural poor have little access to subsidized ration supplies The staff will recommend that in the future subsidized foodgrains be channeled primarily to vulnerable groups unable to buy in the market, that higher income earners be excluded from the system, and that the volume of government distribution both through the ration system and the open market be determined with a view to stabilize prices at levels maintaining appropriate price incentives to farmers

2   Domestic resource mobilization

The annual development expenditures in the budget have consistently fallen short of budget estimates, largely because of deficient project identification and preparation and, at times, lack of domestic financial resources A positive development is the recent decision to concentrate in the next two years on consolidating and exploiting existing investments in the public sector in preference to the creation of new capacities

The envisaged maintenance of high levels of public development expenditures necessitates the prompt adoption of measures to increase domestic financial resources, particularly in view of the recent deterioration in budget position Over the medium term, achievement of self-sufficiency in food will result in a loss to the budget of counterpart funds generated by the sales of food aid Besides, donors have indicated that larger amounts of external aid in the future will be in the form of project aid, to be complemented by local resources, rather than counterpart generating commodity aid The possibilities for raising substantial additional resources are constrained by the large share (70 per cent) of the population that is absolutely poor However, there are many areas where policy measures can be taken Continuous efforts are needed to control the growth of nondevelopment public expenditures and improve tax administration The recent and prospective increases in agricultural output and incomes provide an opportunity for taxing that sector--which is at present largely untaxed--and for reviewing the appropriateness of the present subsidization of many agricultural inputs Substantial scope exists for increasing land revenue Even though direct taxation of agricultural incomes raises problems of administration, efforts should be made to increase the effectiveness of existing taxes by, for instance, devising better ways of assessing income and by gradually reducing exemptions In the short run, the largest potential for increasing revenue is through adoption of more realistic cost and pricing policies for nationalized industries and utilities, as well as of measures to improve their efficiency The staff will stress that officially administered prices should be allowed to reflect more adequately the supply and demand conditions in order to perform their proper allocative function In the case of foodgrain prices, the recent increase in official ration prices of rice has been small and has not reduced the subsidy Introduction of more realistic ration prices for foodgrains and other commodities could be coupled with a salary action, while the requirement needs of the vulnerable groups could be met through special programs The staff will also encourage the mobilization of domestic savings by the banking system through maintenance of attractive interest rates and rapid spreading of bank branches in the countryside.

3 Monetary policy

The rate of monetary expansion has been excessive recently, and credit policy has been easy The staff will review the official credit program for the period ahead and assess whether, in the light of expected balance of payments and growth prospects, it is consistent with achievement of a better price performance The staff will also assess the efficacy of the present credit control instruments in enforcing credit policy

The staff will review the experience so far with credit to agriculture, particularly with the special agricultural credit program launched in February

1977, and will discuss measures intended to improve agricultural credit recovery

4 External policies

A main objective of economic policy should be an improvement in the balance of payments So far, export performance has been disappointing In 1977/78, exports cover only 35 per cent of imports, a lower percentage than in previous years The present exchange rate level and exchange practices have now become an immediate issue Most export sectors, in particular jute goods, are unprofitable and the losses of the jute industries have been the equivalent of 20-30 per cent of export receipts Losses of jute goods exports are being subsidized by the budget or financed through bank credit Measures are being envisaged with the aid of IDA loans to increase productivity and reduce costs in jute mills, but the impact of such steps will appear only in the medium term The staff will stress that the weak budget position and the need to encourage export growth and diversification and to maintain attractive raw jute producers' prices call for a major adjustment in the exchange rate level A more depreciated rate would also permit costing imports at more realistic levels The staff will review the present exchange system, and press for early elimination of the broken cross rate

During the last two years, semi-annual import programs have been enlarged Actual imports, however, have fallen short of the budgeted amounts Disbursement of foreign grants and loans have also been smaller than envisaged because of inadequate import procedures and administration of aid and delays in project preparation The staff will review import procedures and suggest ways to improve them

External debt statistics are deficient Debt service payments have been growing in recent years and at $61 million estimated in 1977/78 represent 13 per cent of merchandise exports The staff will recommend that if the burden of debt service is not to increase excessively over the medium term, Bangladesh should implement an aggressive policy of export promotion and careful management of new debt obligations

III Use of Fund Resources

The staff will review the performance under the Trust Fund program which was approved by the Executive Board in July 1977 As it appears now, most of the undertakings--in terms of budget balance, credit expansion, and exchange practices--have not been observed The staff will indicate that corrective measures are needed both in substance and to make future programs more credible

In view of the deterioration in the balance of payments, the Bangladesh authorities may discuss the possibility of negotiating a third credit tranche stand-by The staff will indicate in what areas policy adjustments would have to be taken, particularly with regards to the budget and the exchange rate, and that negotiations on a program could take place only after firm decisions by the authorities on such policy matters as the exchange rate have been made A quantified program would only be discussed at the time of such negotiations If the authorities only request negotiations on a Trust Fund program for the second period, the staff will indicate that such negotiations would have to await until data were available for an ex post assessment of performance under the present program Because of the fundamental importance of an exchange rate change, the authorities will be discouraged from seeking agreement on a program without this element

The staff will discuss the possible request of a repurchase schedule for SDR 8 2 million drawn under the 1975 stand-by which falls due in May 1978 Provided there is a balance of payments need, the staff will propose repurchases in not more than six equal installments

Fund Relations with Bangladesh

Quota: SDR 125 million, of which SDR 2 million has been paid in gold. The proposed new quota is SDR 152 million.

Use of Fund resources: Bangladesh has purchased SDR 31.25 million under a stand-by arrangement approved in June 1974 and SDR 62.5 million under a stand-by arrangement approved in July 1975. A purchase of SDR 62.5 million under the compensatory financing facility was made in December 1972. In August 1976, SDR 20 million was purchased under the compensatory financing facility, while SDR 19.06 million of an earlier purchase was reclassified as compensatory. Purchases under the oil facilities have amounted to SDR 92 million.

Fund holdings of taka: On February , 1978, Fund holdings of Bangladesh currency amounted to per cent of quota; excluding purchases under the compensatory and the oil facilities Fund holdings amounted to per cent of quota.

SDR position: Bangladesh is a participant in the Special Drawing Account, but has received no allocation. It does, however, hold SDR million, which were acquired to enable Bangladesh to meet charges payable to the Fund on its existing purchases.

Distribution of gold: Bangladesh has acquired fine ounces of gold equivalent to SDR 936,084 from the Fund.

Trust Fund: A Trust Fund loan was approved on June 10, 1977. So far Bangladesh received loans totaling SDR million.

Par value and exchange rate: Bangladesh did not establish an initial par value with the Fund. From February 1, 1972, the official exchange rate of the taka was fixed at Tk 18.9677 per pound sterling and, from May 17, 1975, at Tk 30 per pound sterling. On April 26, 1976, Bangladesh established a central rate with the Fund of Tk 28.10 per pound sterling. On November 3, 1976 the official exchange rate of the taka was fixed at Tk 25.45 per pound sterling and this rate has been periodically changed afterwards. The last change was on January 30, 1978 to Tk 28.725 per pound sterling. Bangladesh has established a representative rate with the Fund under Rule 0-3; this rate is determined from the middle rate of the taka against the pound sterling established by the Bangladesh Bank and the representative rate for the pound sterling.

Last Article XIV consultation: The staff report on the 1976 Article XIV consultation (SM/76/99, 5/17/76) was considered by the Executive Board on June 18, 1976.

Fund technical assistance: Since June 1972, the Fund has maintained a resident representative in Dacca and, since September 1975, also a deputy resident representative. A CBS Advisor serves in the Bangladesh Institute of Bank Management.

Office Memorandum

EIR.

cc: Mr. Stone

TO : The Managing Director
The Deputy Managing Director

DATE: September 19, 1977

FROM : A. Premchand

SUBJECT : Bangladesh: Technical Assistance

Following a request by the Bangladesh authorities for a follow-up visit regarding the implementation of my report on the Government Financial Management System, I visited Dacca from August 30-September 9, 1977 and held discussions with the Finance Secretary, Comptroller and Auditor General, and Additional Secretary, Ministry of Finance. After a leave of four days, I returned to headquarters on September 16, 1977.

2. The above-referred report was first submitted to the authorities in early February 1977. Although some progress was made in the processing of the recommendations, and in the initiation of action on some relatively small procedural matters, major issues, particularly, the strengthening of the Budget Division, restructuring of the budget, a gradual strengthening of the financial management competence in the spending agencies, and the reform of accounting procedures could not be taken up by them, owing to the rush of budget preparation work during February-June. They conveyed, however, their desire to have more detailed discussions with us after July, i.e., after the completion of the budget for 1977/78. It was in pursuance of this request that this follow-up visit was undertaken.

3. During the visit, regular working sessions were held with the Additional Secretary, Finance, who is in charge of the implementation of the report. The authorities have shown a keen interest in the implementation of the report. As, however, many of the recommendations involve structural and institutional changes, they can be implemented only in a phased way. The discussions therefore concentrated on the recognition of the linkages among the recommendations and the need for supplementary action in some areas. Discussions were also held with the Comptroller and Auditor General regarding the improvements in accounting. While he is functionally responsible for the design and day-to-day maintenance of accounts, the overall leadership in these matters is being assumed by the Finance Ministry.

4. Although formal action has not yet been taken, it is now expected that a separate Unit, responsible for improving the financial management, will be set up under the direct leadership of an Additional Secretary in the Finance Ministry. This Unit is expected to process the recommendations in close consultation with the Ministry of Planning, which is concerned with the development budget, the spending agencies, and the Comptroller and Auditor General. The Unit is also likely to be responsible for the preparation of detailed blueprints for the implementation of the report. As an integral part of this overall effort in modernizing the century-old system, which has become less satisfactory in meeting the current tasks, emphasis is also laid on the education and training programs. These programs aim at promoting a greater awareness of the deficiencies of the existing system, the need and content of reform, orientation to future tasks, and more important, transfer of technical skills to the lower and middle levels of administration.

5 The Finance Secretary expressed a desire to have the continued cooperation of the Fund so as to help them in the above tasks No formal requests were, however, made for technical assistance as these aspects are required to be processed with the President of the Republic, who is also in charge of the Finance Ministry The Finance Secretary intends to continue these discussions during the Annual Meetings

6 The authorities wanted me to convey their grateful appreciation to you for the technical assistance provided thus far, and hoped that this will continue in the future, too

cc Director, Fiscal Affairs Department
Deputy Director, Fiscal Affairs Department
Asian Department
Exchange and Trade Relations Department
IMF Institute
Legal Department
Research Department

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: March 28, 1977

FROM : P. Chabrier P.C.

SUBJECT : Bangladesh -- 48-Hour Report, Trust Fund Program

With Mr. Evers, I visited Dacca during March 11-18, 1977 to negotiate a program permitting access by Bangladesh to the Trust Fund. We were assisted by Messrs. Siber and Handy, respectively Fund resident representative and deputy representative in Dacca who enjoy the confidence of the authorities.

The political situation is calm, and General Ziaur Rahman appears firmly in power. Parliamentary elections planned for February 1977 have been delayed indefinitely in the face of growing political agitation; most Bangladesh and foreign observers agree that this delay and the firm grip on the situation by General Ziaur is providing the country with the needed political stability which had been lacking since independence. The Farakka dam issue has become highly emotional, and relations with India continue to be poor.

Since mid-1975, economic developments have, on the whole, been satisfactory. Prices remained stable in 1976, reflecting good crops, a more liberal import policy, and the impact of the 1975 stabilization program supported by a second credit tranche stand-by from the Fund. The balance of payments, which had been in deficit by just over SDR 100 million in the 12 months to March 1976, showed a surplus of SDR 65 million in the following 12 months; the surplus was a result of a recovery in exports, reduced import freight payments owing largely to substantially lower food imports, and the termination of repayments of short-term food credits contracted during the 1974 food crisis. The 27 per cent increase in exports was the result of larger export volumes of jute and jute goods, high prices fetched by some products (tea, leather), and the promising start of some new exports such as fish and shrimp. By February 1977, gross official foreign exchange reserves amounted to SDR 240 million, their highest level since independence, representing about three months of imports. Net official reserves, however, were negative to the extent of SDR 15 million, with most of the liabilities (SDR 237 million) owed to the Fund.

Following substantial deficits in the two previous years, the 1976/77 budget (fiscal year ending June) is likely to be in balance (after foreign aid). This performance, however, results from developments that cannot be considered entirely satisfactory. Tax receipts and official sales of foodgrain will be lower than initially budgeted, and there will be substantial shortfalls in development expenditures--due to inadequate project preparation and implementation--and in official domestic procurement of foodgrain. During 1976, the credit policy was substantially relaxed, particularly with regard to private sector activities. Credit to the private sector rose by 40 per cent in the 12 months to March 1977, and total liquidity, by 20 per cent. A negative aspect of policies in 1976 has been the authorities' failure to capitalize on the prevailing stable economic situation by undertaking the basic measures or reforms which, over the medium term, would have led to a more export-oriented growth and permitted the generation of the higher levels of public savings necessary to finance the development effort The exchange policy continued to be rigid, improvements in the efficiency of some export sector (jute goods) are long overdue, and progress on taxation reform has been slow

In the period immediately ahead, economic developments appear less favorable than in 1976 In view of the shortfall in official domestic procurement of foodgrain in 1976 and delays imposed by donor countries in their foodgrain shipments, foodgrain stocks in March 1977 have fallen to uncomfortable levels, at a time when foodgrain prices on the free market are starting to rise again Unless additional imports can be quickly mobilized, a difficult food situation may materialize in the coming months, which might again result in rapid inflation There was, at the time of our visit, disagreement between the authorities and donors as to the seriousness of the food situation and to the amount of food imports necessary for the period ahead So far, requests for higher imports from major donors have not met with much success On the external side, exports of jute products will rise only little in the period ahead, because crops have not come up to expectations This development, higher cash imports, and substantially larger freight payments for food imports are likely to result in a balance of payments deficit of about SDR 35 million in the 12 months to March 1978

The two most important commitments under the program for the next 12 months are avoidance of government borrowing from the banking system, even though a further increase in development expenditures and an adjustment of public sector salaries are likely, and a further liberalization of imports The 1977/78 budget is now in the early drafting stage, and it was not possible for the authorities to indicate the revenue measures they intend to take Credit policy will continue to encourage private sector activities The authorities have also indicated that the present exchange rate policy is to maintain the rate of Tk 15 5 per U S dollar, a rate which involves substantial losses for major exports (jute goods, paper) There is little likelihood, however, that this policy will be revised in the next few months

Some major changes are to take place within the civil service in coming months, particularly involving the Secretary for Finance who will serve as Alternate on the Executive Board of the World Bank Accordingly, the authorities indicated their preference for holding the next Article XIV consultation after the Fund's Annual Meeting, rather than in July 1977

The authorities expressed substantial satisfaction at the technical assistance recently provided by the Fiscal Affairs Department The report written by Mr Premchand which deals with government financial management is now being actively studied The authorities would welcome a further visit by Mr. Premchand during July-August 1977, as well as further assistance from the Fund when some of the recommendations of the report are being implemented

cc Mr Palmer
Mr Evans
Mr Beveridge
Mr Miller
Mr Green

Mr Palmer

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

DATE: March 2, 1977

FROM: Tun Thin and Donald K Palmer

SUBJECT: Bangladesh Briefing Paper - Trust Fund Mission

Attached is for your approval the Briefing Paper on the Trust Fund Program for Bangladesh The paper has been cleared with Messrs Palmer (ETR), Evans (LEG), Beveridge (FAD), and Miller (TRE)

Attachment

cc Mr Green

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

BANGLADESH

Briefing Paper--Trust Fund Program

Prepared by the Asian Department and the
Exchange and Trade Relations Department

(In consultation with the Fiscal, Legal, and Treasurer's Departments

Approved by Tun Thin and Donald K Palmer

March 2, 1977

A mission consisting of Messrs Chabrier and Evers (both ASD) will visit Dacca from March 11-19, 1977 in order to negotiate *ad referendum*, a program which will permit Bangladesh to qualify for a Trust Fund loan During the First Period, the estimated access is US$26 1 million (SDR 22 6 million) The interim loan disbursement in July 1977 will take into account SDR 6 6 million that would have been available to Bangladesh had it qualified for Trust Fund assistance in January 1977

Economic background

An easier supply situation for many imported essentials and two successive years of good rice crops continued to exert a favorable influence on domestic prices in 1976 The balance of payments moved from a deficit of SDR 109 million in 1975/76 to a surplus of SDR 48 million during the first half of 1976/77 (July-June year), mainly because of the ~~completion by~~ mid-1976 of repayments of short-term food credits, depressed levels of imports- reflecting lower food-grain arrivals, and the existence of large inventories--and a recovery of exports in response to higher world demand and more competitive prices of jute vis-à-vis artificial fibers In December 1976, gross foreign exchange reserves stood at SDR 241 million, i e , three months of projected 1976/77 merchandise imports

Recourse to the banking system by the Government has been avoided so far in 1976/77 because domestic foodgrain procurement has been low and development expenditures have been running at about 50 per cent of initial budget allocations In 1976, domestic credit rose by 13 per cent, largely reflecting a 40 per cent increase in credit to the private sector During the year, total liquidity rose by 26 per cent compared with an increase of 3 per cent in 1975

Need

The staff team will review the balance of payments situation and satisfy itself that there is a need for use of Trust Fund resources Preliminary indications are that, despite the recent improvements, the balance of payments is expected to show a deficit for the period of the Trust Fund program (April 1977-March 1978) in the order of SDR 50 million largely as a result of an increased trade deficit and higher debt servicing Exports of jute and jute goods may temporarily decline from their presently high level as a result of some supply difficulties until November 1977 when the 1977 crop comes to the market Imports, on the other hand, are expected to increase as administrative bottlenecks in the aid and development programs are progressively removed Allocations for imports financed from Bangladesh's own resources have also recently been raised The staff will press for a further liberalization of the exchange system and an increase in the allocation for cash imports in the next semi-annual import program in June

Trust Fund program

The staff will emphasize that more realistic pricing policies should be implemented if Bangladesh is to achieve its stated objectives of food self-sufficiency over the medium term and faster growth of exports In the years to come, the domestic contribution to the development effort will have to be substantially enlarged Not only are the investment needs substantial, but a reduction in counterpart funds is anticipated because foodgrain aid imports will decline as Bangladesh reaches self-sufficiency and because of indications that the composition of foreign assistance will shift toward project aid rather than commodity aid The staff will consequently stress the need for a sustained increase in the tax effort, for restraint, and better control, on nondevelopment budget expenditures, and for more realistic costing and pricing policies in the case of public enterprises There is also a need for greater mobilization of private savings, in particular through flexible interest rate policy The program will include a ceiling on total domestic credit expansion and a sub-ceiling on credit to the public sector The program should include a moderate recourse by the Government to the banking system

At present, the main export sectors are incurring large financial losses The program should specify measures designed to tackle existing inefficiencies in export industries and encourage the growth and diversification of exports, it should include the undertaking that exchange rate policy will be kept under review for this purpose The program should also specify that foreign debts of less than five-year maturity should be avoided, except in emergency situations, while debts of less than 15-year maturity should be limited to a minimum If the statistical base allows, specific ceilings should be placed on such types of maturities The program will also contain the normal clauses on the exchange and trade system The mission will inquire about the authorities' preparedness to do away with the existing multiple currency practice arising from the sale of balances in foreign currency accounts for travel purposes

Fund Relations with Bangladesh

Quota

SDR 125 million, of which SDR 2 million has been paid in gold The proposed new quota is SDR 152 million

Use of Fund resources

Bangladesh has purchased SDR 31 25 million under a stand-by arrangement approved in June 1974 and SDR 62 5 million under a stand-by arrangement approved in July 1975 A purchase of SDR 62 5 million under the compensatory financing facility was made in December 1972 In August 1976, SDR 20 million was purchased under the compensatory financing facility, while SDR 19 06 million of an earlier purchase was reclassified as compensatory Purchases under the oil facilities have amounted to SDR 92 million During the period May 1973-June 1974, Bangladesh made purchases in the gold tranche for a total amount of SDR 1 7 million

Fund holdings of taka

On February 17, 1977, Fund holdings of Bangladesh currency amounted to 289 per cent of quota, excluding purchases under the compensatory and the oil facilities Fund holdings amounted to 159 per cent of quota

SDR position

Bangladesh is a participant in the Special Drawing Account, but has received no allocation It does, however, hold SDR 16 6 million, which were acquired to enable Bangladesh to meet charges payable to the Fund on its existing purchases

Restitution of gold

Bangladesh has received gold equivalent to SDR 936,084 from the Fund

Par value and exchange rate

Bangladesh did not establish an initial par value with the Fund From February 1, 1972, the official exchange rate of the taka was fixed at Tk 18 9677 per pound sterling and, from May 17, 1975, at Tk 30 per pound sterling On April 26, 1976, Bangladesh established a central rate with the Fund of Tk 28 10 per pound sterling On November 3, 1976 the official exchange rate of the taka was fixed at Tk 25 45 per pound sterling On January 18, 1977 the official exchange rate was changed to Tk 26 70 per pound sterling Bangladesh has established a representative rate with the Fund under Rule O-3, this rate is determined from the middle rate of the taka against the pound sterling established by the Bangladesh Bank and the representative rate for the pound sterling

Last Article XIV consultation

The staff report on the 1976 Article XIV consultation (SM/76/99, 5/17/76) was considered by the Executive Board on June 18, 1976

Fund technical assistance

Since June 1972, the Fund has maintained a resident representative in Dacca and, since September 1975, also a deputy resident representative Up to September 1974 the Central Banking Service has provided a statistical advisor to the Governor of the Bangladesh Bank and a tax advisor was assigned to the National Board of Revenue for several months during 1974. The Central Banking Service has recently posted an advisor to the Institute for Bank Development.

1976

Mr Sturc

Office Memorandum

TO : The Acting Managing Director

DATE: September 1, 1976

FROM : Tun Thin and D.K. Palmer

SUBJECT : Bangladesh -- Stand-By Negotiations

RECEIVED SEP 2 1976 EXCHANGE & TRADE RELATIONS DEPARTMENT

The stand-by mission which visited Dacca in the period August 5-14, 1976 to negotiate, ad referendum, a stand-by program for 1976/77 in the third credit tranche indicated on its return that the program, as proposed by the Bangladesh authorities, was weak on several counts. Mainly because of the failure to raise adequate resources from the agricultural sector, the budget continues to rely heavily on foreign assistance, particularly food assistance. In the 1976/77 budget, the authorities have assumed official domestic sales of foodgrains at 1.8 million tons, but current indications are that such sales will not exceed 1.4 million tons. Also, the financial position of the jute mills sector is expected to substantially worsen during the year of the stand-by program because of rising costs and the expectation that the present low prices on world markets will continue. These factors raise serious doubts as to whether the budget commitment of avoidance of recourse by the Government to the banking system during the program period can be met; there is a risk that the credit ceiling would be exceeded by January, in the absence of additional fiscal measures. Largely because elections are scheduled in early 1976, the Bangladesh authorities were not in a position to indicate that the corrective action would be adopted if it appeared that the budget balance was not going to be achieved. They also indicated that they were not ready to devalue the taka in the foreseeable future in response to the situation in the jute goods sector, among other factors. Before leaving Dacca, the mission pointed out the weaknesses of the program to the authorities and indicated that they would report this to management.

We believe that in view of the weak budget situation and the worrying financial situation of the jute inudstry, stronger commitments on policies in these two areas are needed if we are to proceed with the stand-by program. We propose to raise these issues again in the course of the Governors' Conference in Manila. In order to give the authorities more time for preparation for these discussions, we plan to cable Mr. Siber, the Fund Resident Representative in Dacca, to inform the authorities of our reservations and indicate the areas where policies should be strengthened and further commitments needed. We propose to ask Mr. Chabrier, who will be on a mission in Rangoon in late September, to join the Manila discussions.

This matter has been discussed with Mr. Beveridge who concurs.

For your approval.

cc: The Managing Director (on return)
FAD
LEG
TRE
ADM
Mr. Green

Office Memorandum

CONFIDENTIAL

E72
cc: Mr. Stowe
Mr. Mookerjee
Mr. Dahnhaus

TO : The Acting Managing Director

DATE: August 23, 1976

FROM : P. Chabrier P.C.

SUBJECT : Bangladesh -- Stand-By Negotiation

During August 5-14, 1976, a mission consisting of Messrs. Evers (ASD), Faria (FAD), Stahl (ETR), Ms. Kandel (YPP, ASD), Ms. Knauseder (Secretary, ASD) and myself negotiated, ad referendum, a third credit tranche stand-by arrangement for SDR 41 million. Mr. Siber, the Fund's Resident Representative in Dacca, participated in the discussions.

The Government of General Ziaur Rahman appears firmly in control. In early August 1976, the Government announced that general elections would be held "within seven months" and the year-old ban on political parties was revoked. As a result, a resurgence of political activities is evident and several parties have been created.

Economic achievements in 1975/76 (fiscal year ending June) have been, on the whole, gratifying. The bumper crops permitted a reduction of foodgrain imports to 1.6 million tons, the lowest level since independence. GDP rose by 11 per cent in real terms, and the combination of good crops, prudent fiscal management, and some liberalization of import policies resulted in a 10 per cent fall in prices during the year, following three years of severe inflation. The sharp increase in foodgrain production necessitated higher official procurement while sales through the ration system remained substantially below the budget estimates. As a result, the authorities' intention to avoid recourse to the banking system could not be achieved. However, the credit ceilings under the 1975/76 stand-by, as revised, were met. A disappointing development in 1975/76 was a substantial balance of payments deficit (SDR 109 million) which occurred because of depressed export receipts, and repayment of short-term credits.

The main elements of the new stand-by for 1976/77 are avoidance of any recourse by the central government to bank financing, except for seasonal needs, and a limit of Tk 2,150 million or 13 per cent placed on total credit expansion during the year. This compares with a credit expansion of Tk 3,156 million or 23 per cent in the previous 12 months. Based on this program and on estimates of further good crops, a recovery of foreign demand for jute and jute goods, and a slowdown in the growth of imports, it appears likely that the objectives of the authorities for 1976/77, namely, a growth rate of 5 per cent in real terms, price increases of 5 per cent during the year, and a balance in external payments, can be met.

A major area of uncertainty in the budget is food operations. In order to encourage production, the Government intends to increase its domestic procurement of foodgrain from previous years' levels, but there are doubts that the envisaged level of 1.8 million tons of official foodgrain sales (which consist largely of wheat) will materialize, especially if the rice crops are good, the 1975/76 levels of imports are maintained, and free market prices continue to be depressed as is presently the case. The potential adverse impact on the budget could be as high as Tk 1 billion The Minister of Finance offered assurances that in order to meet the budget balance objective, every possible step would be taken, but it was not the intention to reduce official procurement, since this would have an adverse impact on production From the discussions, it appeared to the mission that in view of the forthcoming elections no new tax measures were likely in 1976/77 and that any necessary adjustment would be on expenditures

There are two major areas of concern in the financial situation First, the dependency of the budget on external financing is substantial and rising, which emphasizes the urgent need to mobilize more domestic resources, especially from the agricultural sector While recognizing that the present coverage of the taxation of agricultural surplus is limited, the authorities stressed that the introduction of the land development tax in the 1976/77 budget was a major step, even though initial receipts are small They also felt that in the long run, farmers should be able to do without subsidies of agricultural inputs, but the need to encourage use of modern farming technology made the provision of adequate incentives necessary for the time being The second area of concern is the continuation of substantial financial deficits in public corporations, in particular jute mills Despite the devaluation of the taka in May 1975, some reduction in the work force, and greater availability of spare parts and machinery, the jute mills still report operating losses estimated at Tk 370 million in 1976/77 An action program has been devised with the assistance of the IBRD in order to improve efficiency in the sector The mission indicated that if such program took time to implement or if the measures envisaged fell short of the basic ones necessary to make the sector financially viable, then a change in the exchange rate would seem to be indicated However, the authorities are not considering such a move at present In fact, exchange rate policy now aims at keeping the rate of the taka in terms of the U S dollar stable at the present level of about Tk 15 per U S dollar Since the taka is pegged to the pound sterling, the implication is that small changes in the rate of the taka in relation to sterling will be made when the sterling/dollar rate varies by more than 5 per cent The authorities indicated that they had no intention of pegging the taka to the SDR or to a "basket" because of the administrative difficulties involved

The Bangladesh authorities were not satisfied with the results of the May 1976 aid group meeting in Paris Total aid commitment had amounted to $920 million, short of the $1,150 million requested They had asked the IBRD to convene a second aid group meeting to request additional aid, but the Bank had advised against such a move since ~~it~~ felt that donor countries would not be receptive

The mission discussed the operations of the "wage earner scheme" under which proceeds of remittances by Bangladesh nationals working abroad can serve for payments for imports of specified goods and for travel abroad by the account holder or his nominee The details of the scheme are now being reviewed by the staff in order to assess whether its operation involves a multiple currency practice The authorities are reluctant to eliminate the scheme at present, since about $40-50 million of foreign exchange is repatriated through it each year In their view, it is a useful mechanism for the financing of imports of semi-luxury goods and of raw materials and capital goods above entitlements of the import program

The authorities indicated their agreement to the repurchases in a lump sum of a series of earlier small purchases that were made in connection with the payment of charges They will communicate with the Treasurer's Department on this issue

Attachment

cc The Managing Director (on return)
ETR
FAD
LEG
TRE
Mr Green

Bangladesh Wage Earner's Scheme

Bangladesh nationals maintaining a Foreign Currency Account or otherwise effecting remittances to Bangladesh in accordance with the regulations of the Bangladesh Bank may import commodities 1/ either in their own name or through their nominees Beneficiaries of funds remitted by Bangladesh nationals abroad may import commodities 1/ in their own name

Foreign Currency Accounts may be maintained only in the name of Bangladesh nationals working abroad Balances in Foreign Currency Accounts can be used by the account holder or any Bangladesh resident, including registered firms and companies Apart from import payments, balances in Foreign Currency Accounts can be used for charges related to imports and travel abroad, by the account holder or any person authorized by him Likewise, foreign exchange received through normal banking channels from Bangladesh nationals working abroad, may be used for imports under the Wage Earner's Scheme and for foreign travel

Imports under the Wage Earner's Scheme require an Advance Import Permit In case of Foreign Currency Account holders the Advance Import Permit may be issued in their name, in the name of a Bangladesh national, in the name of a person of Bangladesh origin or in the name of a company or firm registered in Bangladesh The application for an Advance Import Permit by a Foreign Currency Account holder must specify the amount of foreign exchange required, the taka equivalent, and the exchange rate applied In the case of beneficiaries of remittances of Bangladesh nationals working abroad, the Advance Import Permit must be issued in

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1/ These commodities include those on List III, permissible items of Annexure II, spare parts, and items of Lists I and II importable by commercial importers and the TCB Commodities in List III are otherwise prohibited the name of the beneficiary within one month after the receipt of the foreign exchange Advance Import Permits do not specify the nature of the envisaged import

All Advance Import Permits are freely transferable to any other Bangladesh national, person of Bangladesh origin, or company registered in Bangladesh Advance Import Permits are required to be registered with the Bangladesh Bank Transfers of Advance Import Permits are effected by endorsement Advance Import Permits have a validity of three months

Applications for import licenses must be submitted at least 15 days before the expiration date of the Advance Import Permit Import licenses issued against Advance Import Permits are required to be registered with the Bangladesh Bank

Imports under the Wage Earner's Scheme of certain raw materials, listed in Annexure II of the import program, that are consigned to a recognized industrial unit will be exempted from payment of 75 per cent of the applicable Customs duty for up to 100 per cent of the half yearly entitlement of that unit under the regular import program The exemption applies only after the industrial unit has fully utilized his entitlement under the import program

Imports of specified items under the Wage Earner's Scheme by registered commercial importers will be exempted from payment of 50 per cent of the applicable Customs duty, provided they have fully utilized their entitlement under the import program

Although the holder of the Foreign Currency Account specifies the official exchange rate when the Advance Import Permit is issued in the name of a nominee, it is likely that, in fact, the taka proceeds against which the Advanced Import Permit is transferred to the nominee exceeds the foreign exchange value of the Permit converted at the official exchange rate The transfer of Advance Import Permits between Bangladesh residents involves a similar premium over the official exchange rate In recent months, this premium above the official exchange rate has ranged from Tk 36 to Tk 38 per pound sterling

The sale of foreign exchange in a Foreign Currency Account to a Bangladesh resident (for purposes including foreign travel) occurs against a premium above the official exchange rate which in recent months has ranged from Tk 36 to Tk 38 per pound sterling

In 1976/77 foreign exchange receipts through the Wage Earner's Scheme amounted to Tk 26 3 crores, equivalent to SDR 15 2 million Out of this, Tk 19 crores or SDR 11 million was used for financing imports

The amount of foreign exchange received under the Scheme and used for purposes of travel abroad amounted to some $20,000 in 1975/76

Banks do not intermediate between sellers and buyers of Advance Import Permits and between sellers and buyers of foreign exchange used for travel The transfer of Advance Import Permits takes place through private channels Banks maintaining Foreign Currency Accounts do the necessary accounting and issue certificates to the licensing authority stating the balance in the Foreign Currency Account when the account holder or his nominee applies for an Advance Import Permit The banks make the foreign exchange, obtained under the Wage Earner's Scheme, available to the ultimate user of the import license issued against the Advance Import Permit for effecting payments abroad and to persons entitled to use the foreign exchange under the Scheme for travel abroad

The Wage Earner's Scheme permits Bangladesh nationals also to import directly from their foreign exchange earnings commodities specified in the import program 1/ In this case no remittances to Bangladesh are involved An import permit is required (Bangladesh Gazette, paragraph 23b, dated July 5, 1976) Goods so imported can be consigned to other Bangladesh nationals Applications for import permits must be accompanied by (a) invoice, (b) Bill of Lading, (c) Treasury challan showing payment of import permit fee Commodities imported on this basis amounted to Tk 60 crores (SDR 34 6 million) in 1975/76 Thus, total imports financed through the Wage Earner's Scheme amounted to Tk 79 crores (SDR 45 6 million)equivalent to 4 3 per cent of total imports and 14 5 per cent of imports financed through Bangladesh's own resources

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1/ See Footnote 1, page 1

Office Memorandum

TO: The Managing Director
The Deputy Managing Director

DATE: July 29, 1976

FROM: Tun Thin and Donald K Palmer

SUBJECT: Bangladesh--1976 Stand-By Arrangement

Please find attached for your approval the Briefing Paper for the forthcoming stand-by mission to Bangladesh The paper has received the comments of Messrs Beveridge (FAD), Evans (LEG), and Williams (TRE)

Attachment

c c Mr David Green
" Mr Narvekar
" Beveridge
" Evans
" Williams
" Salgado

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

BANGLADESH

Briefing Paper--1976 Stand-By Arrangement

Prepared by the Asian Department and
the Exchange and Trade Relations Department

(In consultation with the Fiscal, Legal and Treasurer's
Departments)

Approved by Tun Thin and Donald K. Palmer

July 29, 1976

A staff team consisting of Messrs. Chabrier (ASD, Head of mission), Evers (ASD), Faria (FAD), Stahl (ETR), Ms. Kandel (YP), and Ms. Knauseder (secretary) will visit Dacca for about ten days starting August 5, 1976 to negotiate ad referendum a stand-by arrangement with the Bangladesh authorities.

Background

The Bangladesh economy made important gains during 1975/76 (fiscal year ended June), largely because of the adoption of comprehensive stabilization measures, good harvests and an increase in imports. GDP increased by 12 per cent in real terms and the easier supply situation, particularly of food, combined with prudent financial policies resulted in a fall in retail prices of about 10 per cent in 1975/76, as against an increase of 35 per cent in 1974/75. Largely because of sluggish demand conditions abroad, export receipts in 1975/76 were 10 per cent lower than in 1974/75. Imports rose by 22 per cent, reflecting largely import liberalization measures. The increased trade deficit, administrative delays in finalizing individual aid agreements and an unexpected reduction in the amount of outstanding import letters of credit were responsible for the turnaround in the overall balance of payments from a surplus of SDR 80 million in 1974/75 to a deficit of SDR 103 million in 1975/76 The deficit was largely financed by net use of Fund resources (under the 1975 Oil Facility and the last stand-by arrangement) totaling SDR 74 million and a fall of SDR 29 million in gross reserves At the end of June 1976, reserves were SDR 186 million, equivalent to nine weeks of estimated imports in 1975/76

During 1975/76, the stabilization measures were supported by a stand-by arrangement from the Fund in the amount of SDR 62 5 million The key elements of the financial program, which was preceded by an adjustment of the exchange rate of the taka on May 17, 1975 from Tk 18 9677 to Tk 30 per pound sterling, were avoidance of recourse by the Government to the banking system, a limit of 14 per cent on the growth of total domestic credit, and a liberalization of imports Despite an increase of nearly 30 per cent in current budget revenues as a result of better tax collection procedures, introduction of new tax measures, and increases in some public service charges, as well as a reduction of about two thirds in the annual subsidy on foodgrain consumption, the recourse to bank credit amounted to Tk 1 1 billion in 1975/76 This was almost entirely due to the increase in the deficit on food operations, the increase in domestic foodgrain production necessitated higher official procurement, while sales through the ration system were depressed in the second half of the year because of ample supplies in the free market The necessary modification of the stand-by arrangement on this account was agreed to by the Executive Board on June 18, 1976 (EBS76/240) The revised credit ceilings for end-June 1976 as well as other performance criteria were observed Total credit expanded by 23 per cent during 1975/76 but, with the substantial balance of payments deficit, the increase in total liquidity was limited to 10 per cent

Stand-by program

The Bangladesh authorities have indicated that, in view of the large use of Fund resources that they have already made (amounting to SDR 254 million or 202 5 per cent of the quota by mid-August 1976), they would limit net use of Fund resources during the stand-by period to the amount of scheduled repurchases, i e , SDR 41 million If the amount under the stand-by arrangement is fully drawn, Fund holdings of taka, excluding drawing under the oil facility and the compensatory financing facility, would increase from 160 to 191 per cent of quota during the stand-by period

On the occasion of the Bangladesh Aid Group Meeting in May 1976 in Paris, Bangladesh representatives met with the staff to discuss the broad outlines of a financial program which could provide the basis for the new stand-by arrangement The main objectives of the authorities in 1976/77 are to achieve an increase in GNP of 5 per cent in real terms, to limit the increase in prices to no more than 5 per cent, and equilibrium in the balance of payments A liquidity expansion of no more than 15 per cent would be consistent with these objectives In view of the favorable price performance, a continuation of the recent fall in the income velocity of money can reasonably be expected The stand-by arrangement should include avoidance of any net recourse by the Government to the banking system in 1976/77 (apart from seasonal needs) and a limit on total credit expansion to a maximum of Tk 2,100 million over the level of July 2, 1976 Based on end-June provisional data, the rate of credit expansion (12 per cent) during 1976/77 would be half that during 1975/76 The increase in credit to public enterprises and the private sector, taken together, would amount to 18 per cent as against 22 per cent during 1975/76 The overall credit ceiling and any agreed subceilings will be established for end-September 1976, end-January 1977, end-May 1977, and end August 1977 The policy statement of the authorities would include indications to the effect that exchange rate policy would provide maximum encouragement to export growth and diversification and would, in particular, give due consideration to the profitability of the jute sector, that there would be no intensification of restrictions on imports and current payments during the program period, and no new bilateral payments arrangements with Fund members

Given the recent substantial purchases from the Fund, the staff team will propose that one third of the total amount of the stand-by arrangement be available soon after Board approval, one third, no earlier than end-February 1977, i e , when it is known whether the January 1977 credit ceiling and other performance criteria have been observed, and the remainder, after the May 1977 performance criteria have been met

The 1976/77 budget does not provide for any recourse to deficit financing by the Government The salient features of the budget are an increase of 34 per cent in the development program and a reduction in fertilizer subsidy No major tax or other resource mobilization measures have been introduced and government revenue is expected to fall from 9 7 per cent to 9 4 per cent of GDP Some of the budget assumptions appear on the optimistic side For instance, while both domestic production and imports of foodgrains are projected at about the same level as in 1975/76, official distribution of foodgrains is projected to rise sharply to 2 million tons from an annual rate of 1 2 million tons in January-June 1976 If actual distribution falls short of this target total Treasury receipts in 1976/77 could fall below the budget estimate by as much as Tk 1 billion The staff team will emphasize that such a shortfall should not be compensated for by reducing official domestic procurement, procurement of less than 400,000 tons would adversely affect incentives to farmers and the stated objective of achieving food self-sufficiency over the medium term

Given the above uncertainties and the medium-term objective of increasing the domestic contribution to the development effort, the staff team will stress the need for a review and greater control of public expenditures which are expected to increase by a further 27 per cent in 1976/77, and for a substantial tax effort, more vigorous mobilization of savings, and continued restraint on nondevelopment expenditures In particular, the team will indicate that the recent increase in agricultural output provides an opportunity for increasing taxation of the agricultural sector and for reviewing the appropriateness of the present subsidies on agricultural inputs Given recent price trends, the present interest rates on deposits--which range from 7 per cent for three-month deposits to 10 25 per cent for three-year deposits--appear adequate However, the staff team will point to the need to maintain a flexible interest rate policy so that real interest rates remain positive, and to substantially improve the collection effort, particularly in the countryside The stand-by program would also provide (i) for prompt measures to be taken if it appears that equilibrium in the budget will not be achieved in 1976/77, and (ii) an indication of the intention of the Government to increase the tax effort over the medium term and to improve the financial position of public corporations through appropriate costing and pricing policies, and improvement in management and labor productivity

As part of the effort to increase domestic resource mobilization, and in order to reduce price distortions, the stand-by program would include intentions to adopt a flexible policy on administered prices, including those of food While the decline in free market prices of rice during the last 12 months has led to an increase in the area under jute cultivation, the program should include undertakings by the authorities that, in view of the possibilities for substitution between jute growing and rice cultivation, appropriate relationships should be maintained between paddy procurement prices and jute procurement

A main objective of the program is an improvement in the balance of payments in 1976/77 The current upturn in the economies of industrial countries should stimulate demand for jute goods, this and the increase in competitiveness of jute goods vis-a-vis polypropylene due to the combined effect of a reduction in jute prices and the recent rise in the price of polypropylene, would point to an increase in export receipts of jute and jute goods in 1976/77 Total export earnings in 1976/77 are projected to increase by about 10 per cent and, with some acceleration in aid disbursements, it appears likely that the external accounts will be in balance in 1976/77 so that gross official reserves at end-June would be close to the level of SDR 220 million which the authorities consider appropriate in view of the vulnerability of the Bangladesh economy to natural calamities The import program for the period July-December 1976 introduces further, though modest, liberalization measures

The exchange rate of the taka is not an immediate issue, given the devaluation of May 1975, the effective depreciation since then and the good domestic price performance The two revaluations of the taka against the pound sterling in April and June 1976 (to Tk 26 70 per pound sterling) were motivated by the sharp fall of sterling on exchange markets and sought to strike a balance between mitigating a rise in import costs and maintaining adequate profitability for the export sector In terms of the U S dollar, the taka depreciated by 13 per cent between May 1975 and July 1976 This has helped improve the competitiveness of jute and jute goods on world markets However, the financial position of the jute sector is still weak and remedial action on this front should no longer be postponed The Bangladesh authorities have indicated that measures are being envisaged to increase productivity and reduce labor costs The staff team will stress that if such cost reductions (by reducing the labor force and/or other efficiency measures) do not appear feasible within a reasonable period of time, the appropriateness of the exchange rate should be reviewed Given the overriding need to increase exports, the program should state that improvement in the profitability of the jute industry and, more generally, export promotion and diversification, are the major criteria of exchange rate policy It should also state that exchange rate policy would be conducted in a flexible manner, particularly if recent price trends are reversed The staff will also review the operation of the "Wage Earners Scheme" in order to assess whether this involves a multiple currency practice and also the implications of the Scheme for the exchange rate of the taka If the Scheme involves an aspect of multiple currency practice, the staff will press for early elimination

The available foreign debt statistics on outstanding and contracted amounts are unreliable Provisional figures indicate that foreign debt outstanding and disbursed at mid-1976 is around US$1 7 billion Debt service payments have increased rapidly from US$17 2 million in 1973/74 to US$69 2 million in 1975/76, representing approximately 21 per cent of merchandise exports in the latter year If the burden of debt service is not to increase excessively over the medium term, Bangladesh should implement an aggressive export promotion policy as well as careful management of new debt obligations The latter would require obtaining foreign assistance at low interest and in long maturities The staff team will explore with the authorities the possibilities of establishing quantitative ceilings on the amount of debt, of various maturities, to be contracted during the period of the stand-by The principal difficulties would be the inadequate statistical base and possibly, administrative problems of implementation In any case, the stand-by program will specify that debts of less than five-year maturity should be avoided, except in emergency situation, while debts of less than 15-year maturity should be limited to a minimum

In 1975/76, disbursement of foreign grants was smaller than envisaged, mainly because of inadequate procedures and administration of aid and delays in project preparation The staff will review the authorities' plans to improve project preparation and aid absorption procedures

Fund Relations with Bangladesh

Quota

SDR 125 million, of which SDR 2 million has been paid in gold

Use of Fund resources

In December 1972, Bangladesh purchased the equivalent of SDR 62 5 million under the compensatory financing facility During the period May 1973-June 1974, Bangladesh purchased a total of SDR 1 7 million in the gold tranche A stand-by arrangement for SDR 31 25 million was approved in June 1974, the full amount was drawn A stand-by arrangement for SDR 62 5 million was approved in July 1975, the full amount has been drawn Bangladesh has purchased SDR 51 5 million under the 1974 Oil Facility and SDR 40 5 million under the 1975 Oil Facility Bangladesh has requested the purchase of the equivalent of SDR 20 million under the compensatory financing facility and the reclassification of SDR 19 06 million of an earlier purchase as compensatory The request will be submitted for Board consideration on July 30, 1976

Fund holdings of taka

After the purchase of SDR 20 million under the compensatory financing facility and a repurchase of SDR 8 8 million, Fund holdings of Bangladesh currency will amount to 302 per cent of quota by mid-August 1976 Excluding purchases under the compensatory and the oil facilities, Fund holdings will amount to 160 per cent of quota

SDR position

Bangladesh is a participant in the Special Drawing Account, but has ~~received no~~ allocation It does, however, hold SDR 20 4 million, which were acquired to enable Bangladesh to meet charges payable to the Fund on its existing purchases

Par value and exchange rate

Bangladesh did not establish an initial par value with the Fund From January 1, 1972, the official exchange rate of the taka had been fixed at Tk 18 9677 per pound sterling and, from May 17, 1975, at Tk 30 per pound sterling On April 26, 1976, Bangladesh established a central rate with the Fund of Tk 28 10 per pound sterling On June 7, 1976, the central rate was changed to Tk 26 70 per pound sterling Bangladesh has established a representative rate with the Fund under Rule 0-3, this rate is determined from the middle rate of the taka against the pound sterling established by the Bangladesh Bank and the representative rate for the pound sterling

Last Article XIV consultation

Article XIV consultation discussions with Bangladesh were held in Dacca March 1-12, 1976 The staff report (SM/76/99, 5/17/76), together with a request for a modification of the stand-by arrangement (EBS/76/240, 5/17/76), was considered by the Executive Board on June 18, 1976

Fund technical assistance

Since June 1972, the Fund has maintained a resident representative in Dacca and, since September 1975, also a deputy resident representative Up to September 1974 the Central Banking Service posted a statistical advisor to the Governor of the Bangladesh Bank, and a tax advisor was assigned to the National Board of Revenue for several months during 1974 The Central Banking Service will shortly post an advisor to the Institute for Bank Development

Mr. Stern

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: March 18, 1976

FROM : Subimal Mookerjee

SUBJECT : Mission to Bangladesh

MAR 18 1976

A mission visited Bangladesh to hold annual consultations and to review the stand-by program which was adopted in July 1975. In view of the uncertainties with regard to the jute and rice crops, the stand-by arrangement provided for a review of the credit ceilings for the latter part of the program period.

Since the last staff mission in mid-1975, there have been very important political changes in Bangladesh. The cabinet and the Parliament have been dissolved and the Government is run by a group of men, mostly from the military, under a civilian President who is the nominal head. The most powerful man is General Zia who is also in charge of the Ministry of Finance. I met General Zia twice and was impressed with his ability to grasp problems and make decisions. He realizes that Bangladesh will remain dependent on large-scale foreign aid for years to come and is eager to project a favorable image for his country in the outside world. One important change in the direction of economic policies appears to be a greater reliance on the private sector. The new Government has retained essentially the same civil service; the mission therefore dealt with the same group of officials as on previous occasions.

The implementation of the stabilization program has proceeded satisfactorily and all of the measures outlined therein have been taken, although with some delay in respect of a reduction in budget subsidies. The economic situation has shown a marked improvement. The weather has been kind and the output of foodgrains has risen by 17 per cent, but the stabilization policies followed by the authorities have been no less important in bringing about the favorable economic results. The continuation of restrictive credit and fiscal policies as well as substantial import liberalization has greatly increased the availability of goods, particularly industrial inputs. Total output is now projected to rise by 12 per cent, nearly double the rate assumed in the program. Prices have declined by some 8 per cent between June 1975 and January 1976.

The overall balance of payments position in 1975/76 is likely to be quite different from the program target of a near equilibrium. The latest projection is for a balance of payments deficit of SDR 170 million. There are several reasons for this. Although exports of raw jute and jute goods have risen in volume, there has been a substantial price decline in both cases and receipts will be lower. On the import side, there have been delays in aid commitments but the import target has been maintained. Moreover, taking advantage of the rise in reserves in the first half of 1975, the authorities have encouraged a substantial reduction in their indebtedness under import letters of credit.

One difficulty that the authorities will face in implementing the present credit program in the coming months is with respect to the ceiling on expansion of credit to the public sector. The main reason for this is the following. In order to stimulate production and also to maintain an adequate official stock of foodgrains, the Government has decided to raise official procurement in the domestic market at existing support prices from 200,000 to over 400,000 tons.

At the same time, the increased availability of foodgrains in private markets is expected to reduce sales through the official ration system by 200,000 tons. As a result, financing of foodgrain stocks by the Treasury is likely to exceed the budgeted amount by a very substantial amount. The authorities therefore requested an upward revision of the credit ceiling for the public sector for end-May and end-June, and a corresponding change in the overall credit ceiling. A draft letter of intent proposing these changes in the provisions of the original letter is attached.

Looking ahead, the most important policy adjustments that will be necessary relate to the fiscal sector. As food production rises, there will be less need for food aid, and hence a decline in the receipt of counterpart funds for the Government. The mission therefore made a strong plea for a substantial strengthening of the budget in two ways: a drastic reduction or, ideally, the elimination of food subsidies during 1976/77 which have so far benefitted mainly the more privileged urban dwellers, and introduction of new revenue measures, particularly taxation of the agricultural sector. The authorities, including General Zia, were responsive to these suggestions, and asked for more specific advice and an account of the experience of other countries. We offered to communicate with them on these matters.

The authorities were very keen that a new stand-by arrangement should follow the existing one as soon as possible. They suggested that preliminary discussions on the framework of a financial program for 1976/77 take place in Paris at the time of the meeting of the Aid Group for Bangladesh which is scheduled for the third week of May. For this purpose they were prepared to add the Finance Secretary and the Deputy Governor of the Bangladesh Bank to their delegation which normally consists of officials of the Ministry of Planning. If an understanding were reached on the broad outlines of a program in Paris, a staff mission could later visit Dacca to complete the discussions when the budget for 1976/77 reached an advanced stage of preparation. If you approve of this procedure with which Mr. Tun Thin agrees, we shall advise the authorities accordingly.

On other matters, the possibility exists of an export shortfall in terms of the Compensatory Financing Facility, and the mission has gathered the relevant data for closer examination. As to the repurchase of a compensatory drawing made in December 1972, the authorities agreed to a schedule of equal quarterly payments over 1976 and 1977.

Attachment

Ministry of Finance

Government of the People's Republic
of Bangladesh

Dacca, March , 1976.

Dear Mr. Witteveen:

1. On July 28, 1975, Bangladesh entered into a stand-by arrangement with the Fund for one year for the amount of SDR62.5 million. The stand-by arrangement was in support of the program that was outlined in the letter to you dated June 11, 1975 by the then Minister of Finance. The program aimed at reducing the rate of inflation from about 75 per cent in 1974 to no more than 8-10 per cent in 1975/76 and at strengthening the external payments position. To these ends, the program provided for a ceiling on total domestic credit expansion and also on the expansion of credit to the government and the rest of the public sector. An increase in development expenditures of 25 per cent in real terms was projected but it was not expected that the Government would, except for seasonal needs, resort to additional financing from the banking system in 1975/76. The balance of payments was expected to be in near equilibrium. Imports, in particular of raw materials and spare parts, were to be increased substantially in order to reduce shortages that had developed and import procedures were to be greatly simplified. Other measures included in the program related to adjustments in pricing policy following the exchange rate adjustment of May 1975, restraint on wages and salaries, reduction in the rate of subsidy on the sale of foodgrains, rationalization of the tax system and improvement in the financial performance of the public enterprises. In view of the uncertainties with regard to the jute and rice crops, the stand-by arrangement provided for a review of the credit program with the Fund during the period of the arrangement.

2. The implementation of the program has proceeded satisfactorily and all of the measures outlined in the program have been taken. The economic situation has shown a marked improvement. As a result of favorable weather and continued efforts to improve the agricultural infrastructure, the domestic output of foodgrains is expected

to rise by about 17 per cent to about 13 million tons. The continuation of tight monetary policies has contributed to a reversal of speculative stock building which, together with import liberalization, has led to an easier supply situation, particularly of imported inputs. Total gross output is now projected to rise by over 10 per cent compared with about 6 per cent projected in the program. Prices, as measured by the Dacca cost of living index, have declined by 8 per cent between June 1975 and January 1976.

3. On the external side, exports of raw jute are likely to exceed the original volume target by at least 25 per cent but shipments of jute goods may fall somewhat below our expectation, despite some recent increases in sales. Both items have experienced price declines in the international market mainly as a result of the recession in the industrial countries. On the import side, we have had to spend more of our own foreign exchange resources because of delays in aid commitments. In addition, it is expected that importers will have reduced their short-term indebtedness under import letters of credit by about SDR24 million from the high level of SDR140 million outstanding in June 1975. On account of these and other factors, the balance of payments is now projected to show a deficit of about SDR170 million in 1975/76.

4. With a view to accelerating economic activity and industrial investment, the Government has recently taken a number of measures to encourage the private sector. The ceiling on private investment has been raised from Tk30 million to Tk100 million. Industrial financing institutions have been directed to provide equity support to small-scale industries, particularly those that process agricultural products and have an export potential. The role of the private sector has also enlarged in the field of trade and distribution.

5. The credit ceilings for the period ended January 30, 1976 have been adhered to. However, in view of certain developments which were not either foreseen or fully taken into account at the time the credit program was formulated, we find it necessary to adjust the program for the remainder of the stand-by period. The following paragraphs

describe these developments and the extent of adjustment that is called for.

6. Recently, the Government has substantially decreased subsidies on official food distribution. The ration prices have been raised from Tk60 to Tk90 per maund for rice and from Tk50 to Tk70 per maund for wheat. However, due to the sharp decline of foodgrain prices in the free market, the increases were less than originally planned and the effective date of these changes had to be delayed. This will cause the expenditure on food subsidies to remain somewhat above the projected level. Moreover, in order to maintain adequate incentives for a continued high level of foodgrain production, the Government has decided to raise official procurement in the domestic market from 200,000 to over 400,000 tons. On the other hand, the increased availability of foodgrains in private markets is expected to reduce sales through the official ration system by 200,000 tons. The resulting need for financing of foodgrain stocks by the Treasury will exceed the budgeted amount by Tk690 million. On February 9, the Government also increased the ration price of edible oil from Tk8 to Tk12 per seer. The decision had been postponed from June 1975 partly as the result of a decline in the volume of distribution through the ration system. The total offtake of edible oil is now estimated at 28,000 tons, compared with the original budgeted estimate of 60,000 tons. The increased burden on the Treasury as the result of the delayed price increase and the rise in stocks is estimated at Tk200 million.

7. Since June 1975, it has become apparent that our current expenditures will exceed the original target by about Tk630 million. While tight expenditure control is expected to lead to savings of about Tk260 million on existing appropriations, a small salary increase for civil servants in the lowest grades to compensate for the higher ration prices of foodgrains and higher expenditures on transportation, the food for work program and law and order, will increase current expenditures by about Tk890 million. In order to maintain a sufficient surplus on our current budget (excluding the food account), the Government introduced on February 9, 1976 a number of measures that are expected to yield Tk140 million during this fiscal year. These include

increases in railway fares, postal rates and telephone charges, higher tariffs and/or excise duties on metals, textiles and chemicals, and an increase in the export tax on jute. The increase in economic activity and better tax collection procedures are expected to yield an additional revenue of Tk430 million. The overall Treasury deficit in 1975/76, including food operations, is now estimated at Tk 1 billion.

8. While a major part of the Government deficit in 1975/76 is on account of the increased need for funds to finance accumulation of food stocks, the Government is aware that subsidies on food continue to be a heavy burden on the budget. Moreover, with continued progress in raising domestic foodgrain production, it is likely that counterpart generation from imported foodgrains will gradually decline. It is therefore the Government's intention to keep official ration prices under continuous review. Furthermore, The Government intends to mobilize, as soon as possible, additional resources from the agricultural sector.

9. With the exception of the jute and paper industries, the financial position of the public enterprises has continued to improve and further measures to increase their efficiency are being considered. In addition, the Bangladesh Bank has continued to apply strict discipline on their access to bank financing. As the result of this, and also because of the recent policy of transferring some activities from the public to the private sector, noted above, the expansion of credit to public enterprises in 1975/76 is expected to be Tk1,011 million less than was originally estimated under the program. The credit needs of the private sector are expected to rise by Tk490 million more than was anticipated, mainly because of their increased role in the economy.

10. In accordance with the projections above, the Government proposes to limit total domestic credit to no more than Tk17,192 million during the period up to May 28, 1976 and Tk17,503 million during the period up to June 25, 1976. Within this overall ceiling the sum of net credit to the Government and gross credit to the rest of the public sector will be limited to Tk13,187 million during the period up to May 28, 1976

and to Tk13,357 during the period up to June 25, 1976.

11. The Government of Bangladesh believes that the policies described in the letter of June 11, 1975, as supplemented by the policies and measures set forth above, are adequate to achieve the objectives of the financial program but will take any further measures that may become necessary for this purpose. Bangladesh will consult with the Fund in accordance with its policies as indicated in the letter of June 11, 1975.

Sincerely yours,

(Ziaur Rahman)

r. H. Johannes Witteveen
anaging Director
nternational Monetary Fund
ashington, D.C. 20431, U.S.A.