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AGENDA**

EBS/87/7
Correction 1

CONFIDENTIAL

February 5, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Bangladesh - Staff Report for the 1986 Article IV Consultation,
Second Review Under the Stand-By Arrangement, and Request for
Arrangements Under the Structural Adjustment Facility

The following corrections have been made in EBS/87/7 (1/15/87):

Page 15, para. 4, penultimate line: for "TK 17.2 billion"
read "TK 18 billion"

Page 16, line 1: for "TK 3.5 billion...TK 9.2 billion"
read "TK 3 billion...TK 7.3 billion"

line 2: for "18.2 percent" read "17 percent"

Page 16a, Chart 4: Revised

Corrected pages are attached.

Att: (3)

During the 1985/86 season, the Government instructed the Bangladesh Jute Corporation (BJC) to maintain a floor price for growers (Tk 200 per maund). The BJC purchased about 2.4 million bales and its stocks at the end of that year stood at 1.9 million bales, consisting mostly of low quality jute not suitable for export. The entire operation put a considerable financial burden on the BJC and, consequently, its outstanding bank borrowing at end-1985/86 amounted to Tk 3.4 billion, compared with Tk 0.6 billion in the previous year. For 1986/87, the Government has discontinued its price support policy, and although insufficient storage facilities and financial difficulties have forced the BJC to scale down its procurement program, actual purchases so far have exceeded the annual target by a wide margin because private sector jute traders have remained inactive.

The jute mills sustained heavy losses in both 1984/85 and 1985/86. The losses of the government-owned Bangladesh Jute Mills Corporation amounted to Tk 1.43 billion in 1984/85 and Tk 1.58 billion in 1985/86. Virtually all of the 1985/86 losses were financed by interest-free medium-term loans; the Government will assume the cost of this interest subsidy. The 1984/85 losses were caused by the sharp rise in the price of raw jute and the substantial decline in the export volume of jute goods. The sharp decline in export prices and a further decline in the export volume account for the 1985/86 losses. In that year, the financial difficulties of the jute mill sector were compounded by heavy carrying charges associated with the large accumulation of stocks and by the minimum procurement price established by the BJC.

The authorities indicated that their major policy objective is to reduce the price and supply instability in the jute sector. To this end, the World Bank undertook a comprehensive study of jute sector issues. This study, which was completed in June 1986, is currently under review by the authorities. The study recommends timely dissemination of information to growers, traders, and mills; improved and enlarged private storage facilities; a limited buffer stock operation by the Government; and rationalization of the operations of government-owned mills. The mission encouraged the authorities to complete the review and take appropriate action. In particular, the need to rationalize the existing capacity, to grant operational autonomy to the jute mills, and to encourage them to operate on a commercial basis was stressed. The staff team also emphasized that subsidies extended to the jute sector should be viewed as temporary measures, while the structural weaknesses of the sector are addressed.

3. Financial sector issues

a. Loan recovery

Agricultural and industrial overdue loans have grown rapidly in recent years. Overdues in agriculture increased from Tk 4.6 billion in 1982/83 to Tk 18 billion in 1985/86. Over the same period, overdues on industrial loans extended by the two development finance institutions

(DFIs) rose from Tk 3 billion to Tk 7.3 billion. In total, these nonperforming loans accounted for 17 percent of total domestic bank credit outstanding on June 30, 1986. The rapid increase in overdue loans has been caused by expansionary credit policies and low loan recovery. Credit, particularly to the agricultural sector, expanded rapidly during the first half of the decade in line with the Government's policy to stimulate the growth of priority sectors. The sharp increase in lending was facilitated by the liberal refinancing policies of Bangladesh Bank and the availability of external loans. However, beginning in 1985/86, Bangladesh Bank refinancing of agricultural credit was linked to loan recovery and aid donors began to withhold new commitments from the two DFIs. These actions led to a sharp decline in loan disbursements by the financial institutions. ^{1/}

The rapid rise in disbursements was accompanied by a steady decline in collection rates. In 1985/86, loan recovery rates deteriorated sharply to only 27 percent for agricultural loans and 8 percent for industrial loans held by the two DFIs. The loan recovery problem was exacerbated by poorly staffed financial institutions and managerial and accounting practices that have, in effect, masked the implications of nonperforming loans and thus delayed necessary action to restore credit discipline and rehabilitate affected banks. Financial institutions, prompted by the Government emphasis on lending to priority sectors and on meeting lending targets, extended credit without proper consideration of commercial criteria. The outstanding stock of overdue loans was also inflated as a result of capitalization by banks of interest and penalties ^{2/} and their reluctance to write off loans and absorb losses. In the agricultural sector, loan recovery was adversely affected by the inability of the understaffed rural bank branches to collect on a vast number of small loans, owing mainly to lack of support from local authorities and inadequate enforcement of legal procedures. Moreover, severe floods in 1985, together with the collapse of jute prices, reduced the capacity of farmers to service their debts, thereby causing the rate of loan recovery to drop sharply (Chart 4). The rapid growth of overdue industrial loans partly reflected the impact of the successive devaluations of the taka on loans denominated in foreign currencies and uncertainties regarding exchange rate guarantee arrangements, as well as the failure to clearly define the financial obligations to be assumed by the new owners of recently denationalized enterprises. Consequently, loans to several denationalized firms have been disputed, which also encouraged many willful defaulters not to service their debt. Furthermore, the inadequate legal framework has hampered loan recovery and encouraged willful defaulting.

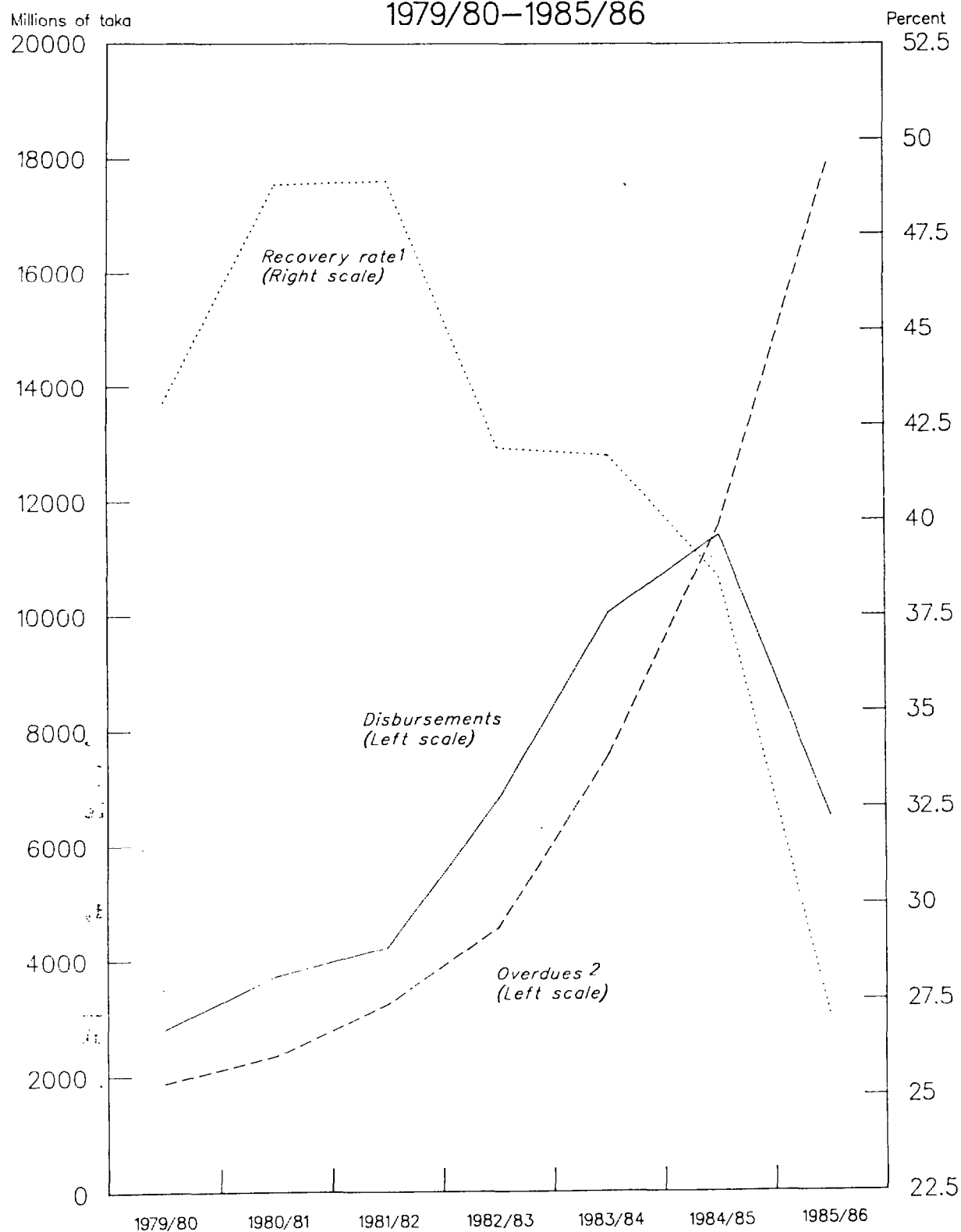
^{1/} Most loans were channeled through Bangladesh Krishi Bank (agriculture), Bangladesh Shilpa Bank and Bangladesh Shilpa Rin Sangstha (industry) and four nationalized commercial banks which extended agricultural as well as industrial credit.

^{2/} For example, in the case of Bangladesh Krishi Bank, accrued interest and penalties accounted for 29 percent of total overdue crop loans outstanding at June 30, 1986.

CHART 4

BANGLADESH

AGRICULTURAL LOAN DISBURSEMENTS AND RECOVERY,
1979/80-1985/86



Sources: Data provided by the Bangladesh authorities and the World Bank.
1In percent of overdues at beginning of period, and principal and interest falling due during the period.
2At end of period.