

EBS/87/227
Correction 1

CONFIDENTIAL

November 20, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Bangladesh - Request for Second Annual Arrangement
Under the Structural Adjustment Facility

Based on recently received information described in EBS/87/227, Sup. 1 (11/20/87), the following corrections have been made in EBS/87/227 (10/28/87):

Page 17, 2nd full para., lines 6 and 7: for "15.9 percent" read "15.8 percent"
for "14.8 percent" read "14.7 percent"

line 8: for "8.2 percent" read "7.9 percent"

Page 35, para. No. 14, line 5: for "14.8 percent" read "14.7 percent"

line 6: for "8.2 percent" read "7.9 percent."

Corrected pages are attached.

Att: (2)

real effective exchange rate will not be allowed to appreciate against its reference level. Moreover, the gap between the official and the secondary market exchange rates will be reduced further, through a depreciation of the official rate, to not more than 5 percent by end-December 1987. In the meantime, and in line with the authorities' stated objective of unifying the dual exchange markets, the scope of the SEM will be expanded. For the first time, aid imports will be transacted at the secondary rate. Virtually all of the recently approved \$190 million IDA industrial sector credit will be channeled through the SEM. In July 1987, XPB was extended to tea, but removed from wet blue leather; consequently the proportion of export receipts effectively receiving the secondary rate is likely to remain unchanged.

The authorities will continue to implement a cautious external debt policy. In particular, they intend to minimize commercial borrowing. In line with this policy, Bangladesh Bank will reduce its outstanding short-term liabilities by \$40 million during the current fiscal year. However, in the exceptional circumstances arising from the severe floods, it has proved necessary to finance about \$45 million in additional foodgrain imports with nonconcessional loans. Also in 1987/88, Bangladesh is expected to contract long-term nonconcessional loans to finance the purchase of a passenger airplane valued at \$67 million. This airplane, which will be delivered in 1988/89, will allow the national airline (BIMAN) to expand its share of the international migrant worker traffic and is expected to increase Bangladesh's foreign currency earnings on a net basis. Despite these loans, the debt service ratio is expected to fall significantly over the medium term.

2. Financial sector policies

To facilitate the achievement of macroeconomic objectives, a monetary program for 1987/88 has been elaborated and quarterly benchmarks for net domestic assets of the banking system and for net credit to the public sector have been established. Broad money expansion is projected at 16.5 percent; the growth of net domestic assets will be limited to 15.8 percent; and that of domestic credit is projected at 14.7 percent. The increase in credit to the public sector is programmed not to exceed 7.9 percent so as to provide adequate credit to the private sector.

Domestic credit is likely to have expanded rapidly in the first half of 1987/88 as additional bank credit was extended to facilitate replanting in flood-affected areas; agricultural crop and term loan payments falling due between December 1986 and December 1987 were rescheduled to ease the burden on farmers; and public sector credit increased beyond its seasonal level to finance emergency food imports and to cover the bonus granted to civil servants in August. The recovery of agricultural loans and the programmed net repayment by the

central government will slowdown the growth of credit in the second half of 1987/88.

A thorough reform of the financial system will be initiated in the current fiscal year. The focus of the reform will be: to enhance the effectiveness of monetary policy; to sustain and further strengthen credit discipline; and to re-establish the financial viability of the NCBs and DFIs. To enhance the effectiveness of monetary policy and ensure the successful implementation of the 1987/88 program, a greater role has been assigned to indirect instruments of monetary control. Bangladesh Bank has discontinued quantitative restrictions on credit. To sterilize excess bank liquidity, which amounted to Tk 8 billion at end-June 1987, Bangladesh Bank raised, in October 1987, the cash reserve requirement and the liquid assets ratio by 5 percentage points to 10 percent and 25 percent, respectively. In addition, Bangladesh Bank intends to sell to the banks treasury bills out of its own portfolio and pursue a cautious refinance policy. Monetary developments will be monitored closely and further action will be taken as required. Key interest rates will be maintained positive in real terms and the structure of borrowing and lending rates will be reviewed with a view to increasing flexibility. At present, loan rates in certain sectors are significantly lower than term deposit rates. This anomaly has particularly affected the NCBs, which are required to accept term deposits.

Agricultural crop loans will continue to be extended only to those borrowers possessing valid passbooks and industrial credit from the DFIs will be limited to those with certificates of "no objection." Agricultural loan recovery targets have been established for the second half of 1987/88, while quarterly targets through June 1988 have been set for industrial loan recovery under the terms of IDA's industrial sector credit. Legal action against willful defaulters, initiated in 1986/87, is proceeding and draft laws are being finalized that will enhance the ability of banks to collect overdue loans. The existing credit information system will be improved with a view to creating a Credit Risk Bureau in Bangladesh Bank.

To improve the financial position of the NCBs, it has been decided that the cost of any interest subsidies will be borne by the Government or Bangladesh Bank, as appropriate. In line with this policy, the Government has assumed in the current fiscal year the interest subsidy associated with the segregation of jute mill losses; as noted earlier, the Government and Bangladesh Bank have each assumed one third of the cost of the interest remission granted in 1986/87 under the agricultural loan recovery program. The budgetary contribution of the NCBs has been reduced, and Bangladesh Bank has decided to pay interest on the additional reserves resulting from the increase in the cash reserve requirement. The modalities of loan classification, provisioning against bad and doubtful debt, and bank recapitalization are expected to be finalized during the current fiscal year, with implementation

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ANNEX

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by selling shares to the public, several units in the steel, sugar, and chemical corporations. Significant action will also be initiated in the energy sector. We intend to restructure the Bangladesh Power Development Board (BPDB) and initiate a major reorganization of the Bangladesh Oil, Gas, and Minerals Corporation. Appropriate steps will be taken to reduce accounts receivable and system losses of the BPDB to acceptable levels.

14. During 1987/88, monetary policy will be conducted consistent with the growth, inflation, and balance of payments objectives of the program. Consequently, broad money is projected to increase by 16.5 percent, in line with that of nominal GDP, while domestic credit expansion will be held to 14.7 percent. Recourse to bank credit by the public sector is programmed to increase by not more than 7.9 percent in order to accommodate the credit needs of the private sector, especially agriculture. To facilitate replanting in flood-affected areas, the Government permitted increased access to bank credit and rescheduled some agricultural loans; crop loans will become due in the second half of the current fiscal year and repayment of the rescheduled portions of term loans will be spread over installments falling due beginning in January 1988. However, in order to sustain the improvements in credit discipline realized in 1986/87, new crop loans will be extended only to borrowers in good standing and with valid passbooks. Despite the special circumstances created by the flood, the agricultural loan recovery program will be sustained and a loan recovery target of Tk 5.5 billion has been established for end-June 1988.

15. Consistent with the goals of the financial sector reform, Bangladesh Bank has removed all quantitative ceilings on bank credit and at present relies on indirect instruments of monetary policy. The past use of quantitative ceilings, combined with liberal loan refinance policies of Bangladesh Bank, has resulted in a large liquidity overhang, complicating monetary management in the current fiscal year. Bangladesh Bank will therefore actively utilize its existing monetary instruments in order to achieve the monetary targets set in the program. To sterilize part of the excess liquidity, Bangladesh Bank has recently increased the cash reserve requirement from 5 percent to 10 percent and the statutory liquid assets requirement to 25 percent. Further, we intend to limit refinancing of loans. Bangladesh Bank will also sell treasury bills out of its own portfolio to the commercial banks, using these as an open market instrument. Furthermore, key interest rates will remain positive in real terms. We will monitor credit developments closely throughout the year and will modify further the reserve and liquid assets requirements as necessary. To develop new instruments and strengthen the operational framework for monetary intervention, Bangladesh Bank will initiate a study in early 1988, with technical assistance from the Fund.

16. The recovery program for industrial loans will continue uninterrupted, and targets have been set through June 1988. We also intend to

intensify the implementation of other elements of the action program for development finance institutions initiated in 1986/87. This program includes measures such as increasing provisions for bad debts and a strengthening of their capital base, and initiating a technical assistance program to strengthen portfolio rehabilitation, loan collection, supervision, and accounting and personnel systems.

17. Close monitoring of several key indicators should permit us to assess performance under the SAF program for 1987/88 and alert us to the need for timely remedial action in case of deviations. Attention will center on developments in net domestic assets of the banking system; net credit to the public sector from the banking system; the contracting and guaranteeing of new nonconcessional public external debt; outstanding external public debt with a maturity of less than one year; outstanding external liabilities of Bangladesh Bank with a maturity of less than one year; the overall budget deficit; total revenue of the central government; and the level of agricultural loan recovery. For these targets, quantitative benchmarks have been established (Table 1). Individual components of revenue and expenditure and financing of the deficit through the domestic banking system (Table 2) will also be watched closely. Benchmarks of policy implementation are presented in the attached Table 3.