

BUFF/ED/04/132

July 26, 2004

**Statement by Mr. Misra on Bangladesh
Executive Board Meeting
July 28, 2004**

1. At the outset, I would like to thank the international community, on behalf of my authorities, for their valuable support which has greatly facilitated the implementation of an ambitious reform strategy, aimed at higher sustainable growth and faster poverty reduction. We would also like to express our appreciation to staff for a balanced report, and constructive advice.
2. While there have admittedly been some slippages, program performance and macroeconomic management have remained broadly on track, despite formidable challenges. All end-March 2004 quantitative performance criteria were met and corrective actions have been taken relating to the missed structural performance criteria. A number of substantive measures have been implemented as prior actions for the Second Review. The Central Intelligence Cell (CIC) is now fully functioning, and bank-by bank resolution strategies have been adopted.
3. My authorities would like to reiterate their continued commitment to prudent macroeconomic management and reform agenda, consistent with the objectives of PRSP. At the same time, they believe that in assessing the progress achieved so far and in sequencing and pace of further reform measures, due understanding of and consideration for the complex socio-political factors needs to be shown. They are sanguine that in view of their performance, and their continued commitment, the support of the international community, including the Fund, will continue to be available.
4. Such support has become particularly important in view of the likely adverse impact of the impending complete phase-out of textiles quotas. Let me hasten to add that my authorities have not only been fully cognizant of the implications of the expiry of the WTO Agreement on Textiles and Clothing, but have also remained fully engaged in addressing the potential shocks through a number of policy initiatives. In fact, despite post-MFA concerns, fresh investments have taken place in the sector and Ready Made Garment (RMG) exports have recovered faster than expected. Bangladesh also expects to retain some of the competitive edge due to duty free access to EU markets. However, many of the policy initiatives will take time to fructify. Infrastructural improvements, like up-gradation of ports facilities, and measures aimed at increased efficiency are time- consuming. In the meantime, there is now greater clarity- in the light of recent studies and latest data- regarding the dimensions of the impact on the economy, in particular on the balance of payments position. My authorities feel that additional financial assistance will be required to mitigate this impact and therefore request activation of the Trade Integration Mechanism and an augmentation of access under the PRGF arrangement by ten percent of quota.

5. I look forward to the support of my colleagues to the proposed decisions.

Recent macroeconomic developments

6. Helped by both domestic and external demand, the momentum of a robust real GDP growth in 2003 has been maintained. Indeed, growth has been stronger this year. Higher imported food prices caused inflation to rise in late 2003, resulting in the program target being exceeded, but it has since been moderated. Consistent with our prudent and cautious monetary stance, Bangladesh Bank tightened monetary policy even though the rise in inflation was caused mainly by external factors. Targets for broad money and private sector credit were reduced and the limit for bank credit to government was scaled back. External position has improved further. Contracting of non-concessional debt was kept well below program limits. The build up in foreign exchange reserves has continued, though at a reduced pace largely due to slower than anticipated aid disbursements and pickup in imports. External competitiveness has also improved as the effective exchange rate depreciated.

7. There has been progress in moving towards a lower interest rate environment, with interest rates on treasury securities and National Savings Certificates (NSCs) declining by three and one and a half percent respectively. Consistent with the objective of attaining a low interest rate environment, another cut has now been effected in the rates on NSCs, and the reductions have been extended to postal savings accounts. A special window of above-market interest rate NSCs for limited access by pensioners has been created as a form of social safety net. My authorities will like to assure that adequate safeguards in terms of registration requirements and proof of identity, and limits on transaction amount will be put in place to minimize the scope for abuse. The system of primary dealers for government securities has been introduced, steps have been taken to strengthen the functioning of the inter-bank market, and with MFD technical assistance further steps are on the anvil to help improve intermediation and reduce interest rate spreads. My authorities remain committed to a floating exchange rate regime, confining interventions to countering disorderly conditions and, with technical assistance from the Fund, intend to remove the remaining exchange restrictions subject to Fund jurisdiction.

8. A number of measures have been taken to strengthen tax administration and check tax evasion. The new Large Tax Payer Unit set up last year has become fully operational and auditing of 80 selected cases has been completed. Capacity is simultaneously being strengthened to bring more cases under the purview of audit. Nationwide inspections have been launched to collect VAT in the retail sector, and more services have been brought within the scope of VAT. The scope of tax holidays has been reduced, the existing tax holidays facility has been decided to be closed at end-June 2005 and will be replaced by a more rational investment incentive system. After initial delays, the organization chart, budget and staffing for CIC have now been approved and it has begun identification of potential evaders and monitoring of large tax payers. A new information base has been set up to detect large taxpayers. The bonded warehousing system has been revamped broadly as envisaged though the bank guarantee requirements for imports for domestic consumption have been stayed by the High Court. While revenue performance has improved, with National Board of Revenue (NBR) revenue recording a 10.2 % growth, the full impact of these measures will

become manifest only over time. Consequently, revenue performance was somewhat weaker than targeted but the authorities remain committed to increase the GDP to revenue ratio in FY 05 in line with program objectives, through intensification of their efforts.

9. Despite weaker than targeted revenue performance, fiscal deficit remained on track, thanks to timely expenditure restraint measures. However, care has been taken to safeguard priority sector expenditure. While capacity constraints and initial delays associated with operationalization of new procurement guidelines slowed the pace of Annual Development Program (ADP) implementation, spending was reduced mostly in lower priority areas.

Structural Reforms

10. The task of Nationalized Commercial Banks (NCB) reforms has turned out to be more time consuming than envisaged, and there have been some slippages. Notwithstanding these delays, the performance of the NCBs has improved under MOUs with the Bangladesh Bank. These MOUs have been performing satisfactorily, restricting net lending, prohibiting large unsyndicated loans, and the NCBs obliged to expedite loan recoveries. The MOUs have now been extended to end-2004 and have been strengthened to include explicit targets for cash recoveries from the largest defaulters, and targets on reductions of operating expenses.

11. After the initial slippages, considerable progress has now been made in NCB reforms. A sales advisor for Rupali has been appointed and has started work, and contract for management support for Sonali has been signed and the new management team is expected to be in place next month. The contract for new management team for Agrani is also expected to be signed in August.. Bank by bank resolution strategies have been finalized and adopted by the government, in consultation with the Bank and the Fund staff. Under these strategies, three NCBs will be brought to the point of divestment, in full or in part, over 2004-2006. In so far as Sonali is concerned, my authorities believe that, given its central role in the provision of treasury functions and essential banking services for the rural sector, an early divestment is not advisable. Therefore, a restructuring strategy to improve its management is being implemented through a strengthened MOU. Through these measures, it is proposed to contain Sonali's commercial lending operations, step up NPL recoveries, and reconstitute its Board of Directors in order to put this bank on a commercial footing and on a path to partial divestment over the medium-term.

12. My authorities are also pursuing the arguably difficult task of building consensus and overcoming political opposition to closure of state owned enterprises (SOE). Despite political and trade union opposition, an additional five SOEs have been closed during FY 2004, with around 16000 workers retrenched. While efforts will continue to be made for full closure, the loss-making SOEs are, in the meantime, proposed to be significantly downsized. It has been decided not to grant them any budgetary support, or new bank credit, for capital spending. No new hiring will also be allowed. These measures will eventually pave the way for full closure as committed under the World Bank's Enterprise Growth and Bank Modernization Project (EGBMP).

13. Progress has also been made in aligning the petroleum products with international prices, in line with the automatic pricing formula agreed with the World Bank. The authorities realize that the financial performance of the energy sector SOEs remains an area of concern. An energy regulatory commission is proposed to be created to reform the energy sector and a reform plan defined with World Bank assistance to address serious infrastructure problems. The Government has adopted a restructuring plan for Dhaka Electricity Supply Authority (DESA), which involves operational restructuring to institute accountability, reduce system losses and improve bill collection.

Outlook

14. Notwithstanding the formidable challenges ahead, my authorities remain committed to pursuing the poverty reduction strategy outlined in PRSP. The PRSP preparation is on track to be completed by end-2004, as per target. My authorities have taken fully into consideration the feedback received on the I-PRSP, and have accordingly taken steps to strengthen the consultative process, costing of pro-poor policies and incorporating them into a medium term expenditure framework.

15. The most formidable challenge pertains to the impact of phase-out of textiles quotas. My authorities are in the process of implementing a number of measures to mitigate this impact. Reducing the cost of business by streamlining administrative procedures and licensing requirements, improving productivity through technological and infrastructural up-gradations, and enhancing competitiveness by opening up the RMG sector to foreign direct investment are the key elements of their strategy. Continued adherence to a flexible exchange rate policy and reduction in anti-export bias through ongoing liberalization of import regime should help in this endeavor. Tariff has been reduced by 3.5 percent through a significant reduction in the level and dispersion of customs and supplementary duties. There is now a three-tier duty structure in place and the number of products subject to quantitative restrictions have been halved. The overall impact of these measures is estimated to be revenue-neutral. Besides, a number of measures are being implemented to assist the RMG sector in the post-MFA era. These include a skill development program for workers and managers, retraining program for displaced workers and a capacity-building program for SMEs who are most at risk, especially in technology and marketing. It is a measure of the importance and priority being accorded to this effort that the formulation and implementation of this strategy is being overseen at the highest level in the government, through a committee headed by the Principal Secretary to the Prime Minister. However, as stated earlier, many of these initiatives will take time to fructify. Infrastructural improvements, like up-gradation of ports facilities are, in particular, time- consuming. In the meantime, there is now greater clarity- in the light of recent studies and latest data- regarding the dimensions of the impact on the economy, in particular on the balance of payments position. My authorities feel that additional financial assistance will be required to mitigate this impact and therefore they are seeking additional external assistance, including through activation TIM -created especially for such contingencies, and an augmentation of access under the current PRGF arrangement.

16. My authorities recognize that a significant improvement in the revenue performance is crucial to a sustained increase in poverty reducing expenditure, consistent with the objectives of ensuring macroeconomic stability. It is proposed to carry forward the ongoing revenue enhancement effort through strengthening of tax administration and policy reform, and an increase by 0.5 percent of GDP in revenues is being targeted for FY 05. Trade taxes are being reduced and rationalized to improve compliance. Preparations are under way to ensure that VAT and withholding income tax are brought within the purview of the expanded LTU system on target. At least 50 percent of VAT collections and 100 largest payers will be included in the LTU. A separate office of commissioner for enforcement is proposed to be created and penalties for non-compliance are proposed to be stiffened.

17. Expenditure management is being strengthened to ensure increased spending on high quality infrastructure projects, and priority social sectors. Pro-poor spending is proposed to be raised by a further 0.8 per cent of GDP. A better balance is to be created between recurrent and capital spending, with greater focus on adequate maintenance expenditure on physical infrastructure and for MDG-related social sectors.

18. As part of our efforts to improve governance, the Anti-Corruption Act has been passed by the parliament and an independent Anti-Corruption Commission will soon become functional. With the help of technical assistance from World Bank, ADB, and USAID, an action-plan is being drawn up to develop a comprehensive anti-corruption strategy. These measures, in addition to the wide-ranging reform of the tax administration, and implementation of the new public procurement guidelines are expected to have a lasting impact on the improvement of governance.

19. My authorities have taken steps to address the safeguards issue. Bangladesh Bank (BB)'s FY04 financial statement will be audited by a local auditor affiliated to an international firm in accordance with the international standards and results signed off by the affiliated international firm. The full audit opinions will be published ahead of the third review.

20. Finally, my authorities will like to reassure the international community that despite a difficult political environment, they are confident of staying the course of prudent macroeconomic management and their ambitious poverty reduction agenda. With their comfortable parliamentary majority, and an unwavering commitment to reforms, they are confident of successfully concluding the present PRGF arrangement.