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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 04/74-5

4:45 p.m., July 28, 2004

5. Bangladesh—Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Requests for Waiver of Performance Criteria, Activation of the Trade Integration Mechanism, and Augmentation of the Access Under the PRGF Arrangement in Accordance with the TIM; Poverty Reduction Strategy Paper Status Report, and Joint Staff Assessment

Documents: EBS/04/99 and Supplement 1; EBD/04/80; and EBD/04/81

Staff : Weerasinghe, APD; Boote, PDR

Length: 1 hour, 30 minutes

Executive Board Attendance

T. Kato, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A. Alazzaz (SA)
	C. Gust (CO), Temporary
	C. Harzer (GR), Temporary
	G. Francis (AU), Temporary
	M. Robert (FF), Temporary
	I. Alowi (ST)
	T. Ross (NO), Temporary
	M. Lundsager (UA)
	C. Crelo (BE), Temporary
	D. Ayala (AG), Temporary
	M. Daïri (MD)
	L. Rutayisire (AF)
	M. Martinez (CE), Temporary
	D. Lombardi (IT), Temporary
	C. Cobos (BR), Temporary
B. Misra (IN)	
	B. Kelmanson (UK), Temporary
	G. Shbikat (MI), Temporary
	P. Ngumbullu (AE)
	D. Nintunze (AE), Temporary
	Y. Wu (CC), Temporary
	V. Yotzov (NE), Temporary
	N. Yamasaki (JA), Temporary
	P. Inderbinen (SZ), Temporary

B. Esdar, Acting Secretary
A. Tarantino, Assistant

Also Present
IBRD: A. Botrill, Lead Economist. Asia and Pacific Department: D. Burton, Director; S. Dunaway, Deputy Director; N. Weerasinghe. External Relations Department: O. Stankova. Fiscal Affairs Department: B. Akitoby, A. Pivovarsky. Monetary and Financial Systems Department: Y. Yokobori. Policy Development and Review Department: A. Boote, N. Calika, L. Moers, L. Nielsen. Secretary's Department: P. Cirillo. Western Hemisphere Department: M. Mlachila. Senior Advisors to Executive Directors: M. Fiator (AF), R. Gauba (IN). Advisors to Executive Directors: E. Eurlings (NE), J. Kwakye (MD), J. Leichter (UA), A. Prasad (IN), M. Sidi Bouna (AF), G. Sidlauskas (NO), V. Srinivas (IN).

5. BANGLADESH—SECOND REVIEW UNDER THE THREE-YEAR ARRANGEMENT UNDER THE POVERTY REDUCTION AND GROWTH FACILITY AND REQUESTS FOR WAIVER OF PERFORMANCE CRITERIA, ACTIVATION OF THE TRADE INTEGRATION MECHANISM, AND AUGMENTATION OF THE ACCESS UNDER THE PRGF ARRANGEMENT IN ACCORDANCE WITH THE TIM; POVERTY REDUCTION STRATEGY PAPER STATUS REPORT, AND JOINT STAFF ASSESSMENT

Mr. Misra submitted the following statement:

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 the staff for a balanced report, and constructive advice.

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.

My authorities would like to reiterate their continued commitment to prudent macroeconomic management and a reform agenda consistent with the objectives of PRSP. At the same time, they believe that in assessing the progress achieved so far, and in the sequencing and pacing 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.

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

Recent Macroeconomic Developments

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. In addition, the targets for broad money and private sector credit were reduced, and the limit for bank credit to government was scaled back. The external position has improved further, and the contracting of nonconcessional debt was kept well below program limits. Also, the build-up in foreign exchange reserves has continued, although at a reduced pace, largely due to slower-than-anticipated aid disbursements and a pick up in imports. External competitiveness has also improved as the effective exchange rate depreciated.

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 3 and 1.5 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 would 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 as well as to confining interventions to countering disorderly conditions, and, with technical assistance from the Fund, they intend to remove the remaining exchange restrictions subject to Fund jurisdiction.

A number of measures have been taken to strengthen tax administration and check tax evasion. The new Large Taxpayer Unit set up last year has become fully operational and the 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 the VAT in the retail sector, and more services have been brought within the scope of the

VAT. The scope of tax holidays has been reduced: the existing tax holidays facility, it has been decided, will 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 taxpayers. 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 percent 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 FY05, in line with program objectives, through the intensification of their efforts.

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

The task of nationalized commercial bank (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 landing, prohibiting large unsyndicated loans, and the NCBs are 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.

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 staffs. Under these strategies, three NCBs will be brought to the point of divestment, in full or in part, over 2004–06. 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.

My authorities are also pursuing the arguably difficult task of building consensus and overcoming political opposition to closing state-owned enterprises (SOE). Despite political and trade union opposition, an additional five SOEs have been closed during FY2004, with around 16,000 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. In addition, no new hiring will 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).

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

Notwithstanding the formidable challenges ahead, my authorities remain committed to pursuing the poverty reduction strategy outlined in the 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.

The most formidable challenge pertains to the impact of phasing out 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 upgrades, 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 the ongoing liberalization of import regime should help in this endeavor. Tariffs have 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 has been halved. The overall impact of these measures is estimated to be revenue neutral. In addition, 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 of the TIM—created especially for such contingencies—and an augmentation of access under the current PRGF arrangement.

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 FY05. 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 the 100 largest payers will be covered by the LTU. A separate office of commissioner for enforcement is proposed to be created and penalties for noncompliance are proposed to be stiffened.

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 percent 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.

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.

My authorities have taken steps to address the safeguards issue. Bangladesh Bank'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.

Finally, my authorities would 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.

Mr. Steiner and Mr. Cobos submitted the following statement:

We would like to thank the staff for an interesting set of papers and Mr. Misra for his informative statement. We commend the authorities for their commitment to economic reform and for the success during the first year of their program with the Fund. Although political complications and economic setbacks have arisen, the government has been able to pursue a healthy macroeconomic stance and enhance reforms.

Economic performance has remained strong, with a 5.5 percent GDP growth in FY04, thanks to a recovery in industrial production and agricultural activity. The rebound of exports has been aided by the depreciation of the real exchange rate, especially fostering demand for ready-made garments (RMG) and frozen foods. This new export drive, together with strong remittances, has narrowed the current account deficit to below 0.2 percent of GDP as of June 2004.

The implications of the phasing-out of production quotas under the Multifiber Agreement are of concern, despite the duty free access to European markets. It is crucial that the authorities pursue the necessary reforms to minimize any potential loss of markets once the agreement expires. In this vein, we would like the staff's opinion as to whether diversification policies to enhance the export potential in other areas are in the agenda.

We are pleased to know that the authorities have achieved a budget deficit below what was programmed. Nevertheless, the reduction in tax revenues calls for the strengthening of tax administration and expansion of capabilities of the Large Taxpayer Unit. These reforms will be central to strengthening the fiscal stance in order to allow for needed social spending and infrastructure investments. We praise the authorities for pursuing such goals in the drafting of the FY05 budget.

Regarding monetary policy, efforts are needed by the central bank to reduce interest rate spreads. Although deposit interest rates have come down, lending rates remain too high. The BB has done an excellent work at mopping out excess liquidity brought by higher-than-expected remittances. The harmonization of the interest rate structure through an interbank and treasury securities market and steps to eliminate bank inefficiencies could be key elements to narrow the spread. This will be important to enhance competitiveness of Bangladeshi companies in the post-MFA era. Likewise, we urge the authorities to continue their determination to push forward the privatization of the NCB and accelerate the restructuring of SOE's, mainly in the energy sector.

We support the completion of the second review under the PRGF arrangement, the request for waivers, and the request for an augmentation of access, and wish the authorities success in their endeavors.

Mr. Alazzaz submitted the following statement:

The Bangladesh economy continues to perform well. Growth is robust and inflation remains contained. The economic program is on track and, as Mr. Misra notes, in his helpful statement, that corrective actions have been taken relating to the missed structural performance criteria. In view of these developments and the authorities' commitment to the PRGF-supported program, I support the completion of the review, the augmentation of access, and the granting of the requested waiver.

In the fiscal area, the authorities are to be commended for over-achieving the budgetary target, reducing the public debt ratio, and increasing social- and poverty-related spending. The medium-term fiscal strategy is also reassuring. In particular, I welcome the planned increase in revenues. The focus is rightly on broadening the tax base, improving tax administration, and creating a revenue structure that emphasizes private sector growth. However, in view of the importance of reaching the revenue target, it is essential to monitor the situation closely and stand ready to take further measures if needed.

On the expenditure side, the emphasis on improving quality bodes well for growth and poverty reduction. In this regard, the budgeted rise in spending on health, education, and infrastructure in 2004/05 budget is a welcome start. I am also encouraged by the progress made in strengthening expenditure management.

Turning to monetary and exchange rate policies, I welcome the authorities' stance to contain inflationary pressures without undermining growth. Achieving this objective should be facilitated by the ongoing efforts to enhance the functioning of interbank and treasury securities markets. In this connection, I endorse the authorities' request for Fund technical assistance. I also agree that the current exchange rate system continues to serve Bangladesh well. In this regard, the authorities' commitment to limit intervention to smoothing short-term fluctuations and the plan to remove the remaining exchange rate restrictions subject to Fund jurisdiction are reassuring.

On financial sector policies, advancing the reform of the nationalized commercial banks (NCBs) is a priority. In this regard, I am encouraged by the recent measures to address the slippages that have occurred in strengthening management of the NCBs and move forward with the restructuring of Sonali Bank. It is essential, however, to maintain the momentum of reform and to continue to strengthen banking supervision and reduce nonperforming loans.

Turning to the external sector, I welcome the improvement in the current account position. The substantial rise in exports is especially encouraging. However, the expiration of the Multifiber Agreement by the end of this year could pose risks to Bangladesh exports. This underscores the importance of enhancing competitiveness and diversifying the export base further. In this regard, the streamlining of trade taxes is a welcome step.

Enhancing productivity and competitiveness will also depend on improving the performance of state-owned enterprises (SOEs) and enhancing their governance. Progress in these areas will also strengthen private sector confidence and encourage investments. In this regard, the gradual approach to closing nonviable SOEs is reasonable. A faster pace in that area could unravel the whole reform process in view of political and trade union opposition to such closures.

Finally, I welcome the progress made toward finalization of the full PRSP by the end of this year. In this regard, I encourage the authorities to address the issues raised in the Joint Staff Assessment.

With these remarks, I wish the authorities further success.

Mr. Daïri and Mr. Kwakye submitted the following statement:

Bangladesh's performance under the PRGF-supported program has been satisfactory. Macroeconomic policies have been prudent and moderate progress has been made in the structural areas. Economic growth has been reinvigorated by strong agricultural and industrial production, inflation is under control, and exports growth and remittances have been buoyant. Maintaining a strong momentum of adjustment and reforms is critical for meeting the challenges posed by the phasing-out of Multifiber Agreement (MFA) quotas. In this regard, the authorities will need to muster enough political will and build public support for their policies. We agree with the thrust of the staff's appraisal and policy recommendations and support the proposed decisions.

Balancing fiscal sustainability with growth and poverty-reduction objectives is a challenge. Revenue mobilization should be a major part of this effort, given Bangladesh's rather low revenue-to-GDP ratio. While noting initiatives to this end, further elaborated in Mr. Misra's helpful statement, the impact over the medium term appears modest. The staff's indication on how Bangladesh compares with its peers in revenue effort and what additional measures would be needed to bridge the gap will be appreciated. We support Fund technical assistance in this area. Efforts to strengthen and reprioritize expenditure are well placed. Further progress is, however, called for in fiscal transparency, including in addressing the shortcomings identified by the ROSC. A medium-term expenditure framework will enhance budget preparation and execution.

Monetary operations will be facilitated by plans to deepen the interbank and treasury securities markets. Providing preferential National Savings Certificate interest rates to pensioners and widows would, however, be cumbersome to implement and could be subject to abuse. It would, therefore, be advisable to find an alternative social safety net. The exchange rate regime has been prudently tailored to building reserves and safeguarding the economy's competitiveness, and the strong growth in exports and remittances indicate that it had served the economy well. Maintaining exchange rate flexibility will help absorb the impact of the lifting of MFA quotas. However, the authorities should not rely on depreciation alone to promote exports, but should also pay attention to reinforcing non-price factors geared at fostering economic efficiency and productivity. The plan to phase-out remaining exchange restrictions subject to Fund jurisdiction is a step in the right direction.

Further momentum is needed in the reform of the nationalized commercial banks (NCBs), including by addressing weaknesses identified by the 2002 special audits. While recognizing the unique role of the Sonali Bank, it is important to ensure that it operates efficiently and does not burden the budget or pose risk to the financial system. The authorities' alternative restructuring strategy, elaborated by Mr. Misra, to contain the bank's problems in the near term, while placing it on a path of eventual divestment, appears appropriate. The central bank's vulnerabilities identified by the 2002 safeguards assessment need to be addressed.

Reinforcement of structural reforms will facilitate adjustment to the post-MFA era. In this connection, building consensus and providing appropriate safety nets will help to overcome resistance to reform. The adjustment of energy prices has led to a welcome reduction in the financial losses of the petroleum sector and should facilitate a gradual phasing-in of import parity prices. The privatization or restructuring of SOEs should be accelerated in order to enhance efficiency and reduce fiscal costs and cross arrears. Mr. Misra points out that, in this regard, considerable political opposition will have to be overcome. We commend efforts to further liberalize the trade regime. Governance-improving initiatives, including in budgetary transparency, public procurement, and anti-corruption will help improve the investment climate and spur growth.

As rightly recognized by Mr. Misra, the phasing-out of MFA quotas is the "most formidable challenge," as well as a key risk to the Fund-supported program; it is reassuring to learn that the authorities are contemplating measures to mitigate its impact. It is also encouraging to note that Bangladesh will remain competitive in the EU and Canadian markets where it will continue to enjoy duty free access. Given, however, that it will face stiff competition and lose market share in the United States, experience financing gaps, and require funding to upgrade infrastructure, we support the authorities' request for augmentation of access under the PRGF arrangement.

While it is reassuring to note that Bangladesh's debt remains sustainable over the medium term, achieving higher rates of growth would be helpful in sustaining the favorable debt dynamics and ensuring a faster improvement in social indicators. In this connection, we appreciate the staff's views on how Bangladesh's potential sources of growth could be fully harnessed. Also, given the adverse impact of excessive agricultural volatility on growth and rural incomes, information on how the World Bank is assisting to stabilize agricultural production is welcome.

The authorities have made commendable progress toward preparation of their full PRSP. The broad participatory process will enhance consensus building and ownership and, thereby, the prospects for acceptability and effectiveness of the strategy. The four underlying pillars are appropriate for achieving sustained high growth and poverty reduction and improving prospects for reaching the Millennium Development Goals. The staff's helpful suggestions to improve the final draft merit attention. The PRSP should adequately anticipate the risks associated with MFA phase-out and potential erosion of political support, and plan appropriate mitigating responses.

Finally, we extend our sympathy to the Bangladesh people and government following the catastrophic floods. We would appreciate Mr. Misra's or staff's early assessment of the human toll and material damage. We urge management to follow the situation closely and to consider how the Fund could assist in these difficult circumstances.

Mr. Martí and Mr. Martínez submitted the following statement:

Growth in Bangladesh has continued to be strong, based on prudent macroeconomic policies. The outlook for the coming years is also positive, driven by the external sector and robust private and public consumption. The authorities' commitment with the implementation of reforms is essential to consolidate these gains and to continue improving the economy's competitiveness with a view to achieving a long-lasting reduction in poverty. In this sense, Mr. Misra's helpful statement is reassuring. We concur with the staff's view that the key risks to the IMF-supported program derive from the Multifiber Agreement quota phase-out and the structural areas.

We see, with satisfaction, that all the targets in the program for end-December were met and all quantitative performance criteria for end-March were achieved. On the structural field, and notwithstanding some advances, we note with some concern that only one of the six structural performance criteria and benchmark established for the second review has been observed. The staff's assessment on whether this low level of accomplishment could be due to excessively optimistic assumptions for the deadlines would be welcome.

We commend the authorities for their prudent fiscal policy. Despite some slippages on the implementation of the tax administrative reforms, the budget deficit for FY04 will eventually be below program. Fiscal policy over the medium term is appropriately focused on broadening the tax base, improving tax administration and fighting tax evasion, while maintaining a pro-growth and pro-poor spending.

The achievement of the targeted fiscal deficit for FY05 heavily depends on the implementation of wide-ranging budgetary measures. We would like to ask the staff whether it considers realistic and feasible the fiscal goals for 2005, bearing in mind the delays in observing structural conditionality and the increasing political pressure against reforms.

On the structural front we note the delays on the implementation of nationalized commercial bank (NCB) and state-owned enterprise (SOE) reforms. This situation is not new in Bangladesh where opposition to reform is very strong and appears to be heightening. We encourage the authorities to build consensus to support their ambitious policy agenda.

We welcome the progress in the implementation of the Memoranda of Understanding for the four NCBs. Process of strengthening bank management and bank-by-bank resolution seem to be now under way. On SOEs, stalling of the reforms in the manufacturing sector and financial performance of the energy sector are cause of serious concern.

We share the staff's analysis on the impact of the Multifiber Agreement quota phase-out. The abolition of the quotas could adversely affect the Bangladeshi balance of payment due to its heavy dependence of ready-made garment (RMG) exports. Increased competitiveness is needed to maintain the current market share of the Bangladeshi exports of RMG. Structural reforms are crucial to achieve this more durable solution.

Based on the authority's reaffirmed commitment to macroeconomic prudence and steadfast efforts in structural reforms, we support the staff proposal and wish the authorities all success in the implementation of the PRGF arrangement.

Mr. Alowi and Mr. Segara submitted the following statement:

Bangladesh's economic performance since the last review has been broadly on track. The economic recovery has continued, with stronger GDP growth, a lower budget deficit, and stronger external position. At the same time, the official reserves have continued to increase. Moreover, all quantitative targets and performance criteria for end-March 2004 were observed. We commend the authorities for all of these achievements.

Despite all these positive developments, the economy faces formidable challenges. While the projected real GDP growth of 5.5 percent for FY04 seems achievable, the risks on the external front for FY05 and beyond remain considerable, owing mainly to the phasing-out of the MFA quotas and complex socio-political situation. As highlighted in Box 1 of the staff's well written report, the total impact on output and jobs could be significant. To mitigate such risks, the Fund-supported program will be geared toward creating a friendly investment climate by continuing structural reforms with more concerted effort so as to put the economy on a sustainable and higher growth path, which is critical for reducing poverty. While this approach seems appropriate, such reforms will take time to bring result. Hence, we agree that additional financial assistance will be warranted to mitigate the adverse impact on the economy.

With continued support from the international community and the authorities' strong commitment to the program, we believe that Bangladesh will be able to sustain its healthy economic growth and achieve the objectives of PRSP. In this regard, we are pleased to note the authorities' reaffirmation of their commitment to prudent macroeconomic management and reform agenda, as highlighted by Mr. Misra in his insightful statement. As we concur with the thrust of the staff's assessment, we support the completion of this review, granting of the requested waivers, and endorsing the activation of the TIM, including the augmentation of the access under the PRGF arrangement.

On the fiscal front, we are pleased to note that the overall budget deficit for FY04 would be contained to 3.8 percent of GDP, well below the program target. Nevertheless, we note that such an achievement was not due mainly to higher revenue collections but rather because of much lower-than-targeted Annual Development Program (ADP) spending. Tax revenue collections by the NBR are projected to be even lower than programmed. In this regard, we agree with the staff that further technical assistance is critical to strengthen the implementation capacity of the NBR. In view of the importance of the development spending and in line with the objectives of the MDGs, we would like to encourage the authorities to address the weaknesses in the areas of ADP and to strengthen project selection and approval procedures for the ADP.

Looking forward, we welcome the downward revision of the overall deficit to 4.3 percent of GDP for FY05. We would like to underscore that the ability to do so will largely depend on the effectiveness of tax administration measures, including the full functioning of the LTU, which needs more concrete steps to cover the VAT and withholding taxes. In this connection, we agree that particular attention should be given to ensuring continued effectiveness of measures already in place. The authorities' move to reduce and rationalize trade taxes is a welcome direction.

With regard to monetary policy, we commend the Bangladesh Bank for its efforts in maintaining a prudent policy stance, in particular, for maintaining modest inflation and stabilizing the exchange rates. At the same time, foreign reserves steadily increase, reaching a more comfortable level. We are pleased to note that Bangladesh Bank remains vigilant. While the staff has reservations regarding the creation of a special window of above market interest rates NSCs for limited access by pensioners, we view that the measures is appropriate provided adequate safeguards is put in place. The authorities need to ensure that registration requirement, proof of identity, and limited amount of transaction is strictly implemented to minimize the scope for abuse. In the longer term, the authorities may need to design a better safety net program with less scope for abuse and less distortive effect to the economy.

Turning to the other structural reforms, we recognize that progress in SOE reform has stalled due to rising political resistance. Given the difficulties in closing or privatizing the manufacturing SOEs, downsizing of the loss-making SOEs with freezes on hiring and with no recourse to the budget or borrowing is considered appropriate. In the energy sector, the authorities have adopted politically difficult measures, namely upward adjustments of oil prices by using the pricing formula agreed with the World Bank. While these price adjustments fall short of a full pass-through of changes in import parity prices, we understand that such a case should be handled with care given the social and political implications. Adoption of such measures has to be well considered in order to maintain public support for the government overall reform efforts. Regarding governance, we are pleased to note that an independent Anti-Corruption Commission (IACC) will soon become functional as it would enhance credibility. But, the most important is the effectiveness of the commission.

With these remarks, we wish the Bangladeshi authorities continued success in their endeavors.

Ms. Lundsager and Mr. Leichter submitted the following statement:

Bangladesh's macroeconomic performance has been relatively strong with growth and inflation near the program targets, but policy implementation leading up to this PRGF arrangement was mixed and we are disappointed in the number of waivers requested. Delays in meeting several PCs and benchmarks highlight the need to strengthen political consensus on reform and address capacity constraints. Fiscal, banking, and especially governance issues need to be addressed without delay. We welcome the first use of the Trade Integration Mechanism (TIM) which, combined with policy adjustment, should help smooth out possible adverse effects of the MFA quota phase-out. We welcome the series of participatory consultations on the PRSP that the authorities have initiated both at the national and regional levels and encourage them to complete the process over the coming months.

Fiscal

Implementation of policies to increase revenue 0.5 percent of GDP per year over the next two fiscal years is key to supporting much needed infrastructure and social spending and to keeping debt on a sustainable path. Therefore, we are disappointed that the Central Intelligence Cell (CIC) of the Large Taxpayer Unit (LTU) was not made fully operational on time, and that its coverage is far below target. We encourage the authorities to bring VAT under this umbrella. The authorities could request technical assistance in this area from donors and the World Bank and should continue to implement recommendations of the ROSC.

Monetary

We agree with the staff that the authorities have done well to contain inflation. We are however concerned that the authorities resorted to central bank financing to cover a gap created by delayed World Bank disbursements. Although they have committed to repay the central bank once they receive this disbursement, continued reliance on such funding undermines the monetary program and the independence of the central bank, especially given uncertainty over the timing of aid flows. We commend the authorities on their commitment to the floating exchange rate regime and encourage them to remove remaining exchange restrictions. Exchange rate flexibility will facilitate adjustment to future external shocks, including the lifting of MFA quotas. Development of the interbank and treasury bill markets is also important as it will improve the effectiveness of monetary policy and could help lay the foundation for developing markets for other financial instruments.

Financial Sector

Strengthening the financial sector is critical for Bangladesh's long-term economic development and poverty alleviation. In that context, the delays in strengthening bank management at the nationalized commercial banks and adopting resolution strategies are particularly disappointing. We urge the authorities to undertake concerted efforts to minimize the cost to taxpayers and to accelerate restructuring as much as possible. With respect to Sonali, the largest of the banks, we urge the authorities to consider ways to serve the rural population in a more cost-effective manner and reconsider the potential for divesting functions that can be performed more efficiently by the private sector.

Structural Reforms

We are concerned that closure or privatization of manufacturing SOEs has been halted. Momentum needs to be found to prepare these SOEs for full closure in FY07 as committed under the World Bank's Enterprise Growth and Bank Modernization Project. Developing and implementing reforms will also be key to addressing infrastructure bottlenecks in the energy sector, improving domestic energy pricing, and turning around the financial performance of energy sector SOEs.

We agree with the staff that faster progress on governance issues is needed. We are encouraged to find out from Mr. Misra that progress is being made on an action plan for the Anti-Corruption Commission and look forward to a rapid implementation of the plan. We look forward to publication of the full outside audit of the central bank ahead of the next review, as called for under our safeguards policies.

Trade Integration Mechanism (TIM)

We commend the staff on the implementation of the first TIM augmentation case. We reiterate the staff's view that attention to the adjustment policy mix, including exchange rate flexibility, tariff reform, and broader trade reforms, will be instrumental to mitigate the impact of the quota removal, enhance investment, and stimulate growth in other export sectors. Investment in infrastructure will also help support export growth in the longer term. Since World Bank assistance on trade policy adjustment is a key component of the TIM, it would have been useful if the paper further discussed Bank/Fund collaboration on this issue.

We thank the staff for the detailed analysis laid out in Table 7. The staff's post-MFA policy adjustment scenario forecasts the initial impact on the balance of payments of the removal of MFA quotas and includes the effects of policy and NIR adjustment. We would like to have seen an additional line in Table 7 calculating the projected MFA-sector exports net of MFA-sector imports, so that future TIM-related requests can be more clearly linked to TIM-related deviations, rather than predicated on movements in services, the capital account or reserves, unless these can be explicitly linked to the impact of MFA removal.

Mr. Wang and Ms. Wu submitted the following statement:

Key Points

· We support proposed completion of the review and the augmentation of access under the PRGF arrangement, in accordance with the TIM.

· With daunting challenges ahead in the post-MFA era, the authorities' commitment and full engagement with various initiatives is crucial.

· Although revenue performance is set to improve, additional measures will be needed to compensate for losses stemming from the MFA quota phase-out. Pro-poor expenditure will need to be safeguarded.

· Structural reforms in the SOE, energy, and banking sectors should be expedited.

We thank the staff for the well-balanced papers and Mr. Misra for his helpful statement.

Despite some structural performance slippages, program implementation has been broadly on track. In view of the authorities' early corrective actions and their commitment to the remaining reform agenda, we support the proposed completion of the second review. With the challenges facing the authorities after the phase-out of the Multifiber Agreement (MFA), we agree with the suggested augmentation of access under the PRGF arrangement, in accordance with the Trade Integration Mechanism (TIM).

With the support of strong demand, recent economic development has been robust. Inflation, though exceeding the program target, stemmed mainly from external factors. The build-up of foreign exchange reserves has continued and external competitiveness has improved.

Notwithstanding these favorable circumstances, daunting challenges remain, besides alleviating poverty and introducing structural reforms, the phase-out of the MFA quotas will have a substantial impact on the Bangladeshi economy, given its heavy dependence on ready-made garment (RMG) exports. The staff provides supporting analysis on this issue in Box 1 of the report. We are encouraged to note the establishment of an inter-ministerial committee to define a post-MFA action program. Meanwhile we are reassured from Mr. Misra's statement that the authorities have prepared a number of policy initiatives, including improving productivity, enhancing competitiveness, and reducing business costs. Since these measures will take time to produce results, we urge the authorities to implement them as early as possible to mitigate any adverse impact. In addition, the investment climate needs to be further improved. In this regard, we welcome the authorities' Anti-Corruption Act to address governance issues. We also urge them to expedite their structural reforms to this end.

We note the authorities' tax administration measures to improve revenue and, recognizing that progress will take time, we encourage them to seek additional revenue-boosting measures, such as broadening the tax-base, to compensate for lost revenue as a result of the damage to shares in the RMG export market. As for expenditures, we welcome the restrained actions to bring the fiscal deficit back on track. However, we urge that care be given to safeguard pro-poor expenditure.

Structural reforms need to be accelerated. While we understand fully how hard it is to proceed with SOE reforms in socially difficult circumstances, there is no doubt that the authorities' efforts in this regard should be commended, although the pace has been slow. On banking sector reform, despite some early slippages, the Memoranda of Understandings (MOUs) have been performing satisfactorily and progress has been made. Due to the central role Bank Sonali plays for the government, we deem the alternative restructuring strategy to be appropriate.

Progress has also been made in aligning prices in some energy products with international prices. However, as the authorities recognize, the financial performance of energy sector SOEs remains a concern. It is astonishing that the stock of arrears of a single company—Dhaka Electricity Supply Authority—has risen to 2 percent of GDP. To prevent further losses, we urge that the restructuring plan for this company be implemented without any delay.

With these remarks, we wish the authorities well in their reform endeavors.

Mr. Usman submitted the following statement:

We commend the Bangladeshi authorities for the strong economic performance achieved in the implementation of their PRGF-supported program. Economic growth accelerated as projected, fiscal deficit narrowed better than expected, while inflation was maintained at low levels. Monetary policy remained prudent and external competitiveness strengthened, thereby resulting in the observance of all quantitative targets and performance criteria. Looking ahead, however, the Bangladesh economy is still faced with numerous challenges and risks, as underscored by the need to diversify exports and promote private sector development in order to put the economy on a higher and sustained growth path, as well as reduce poverty.

We are assured by the authorities' commitment to fully implement their reform agenda, as highlighted by Mr. Misra in his helpful statement, as well as to complete the process of preparing the PRSP, to address the underlying challenges, and to increase domestic consensus and support for reform. In this connection, the government's priorities during the second year under the PRGF arrangement rightly include fiscal and monetary consolidation to maintain macroeconomic stability. Also, the authorities' steadfast structural reform efforts—to multiply the sources of growth and mitigate the forthcoming expiration of the Multifiber Agreement (MFA) impact—are steps in the right direction.

Given the satisfactory performance achieved and these efforts, we are in broad agreement with the staff assessment and support the approval of the proposed decisions.

On fiscal policy, we are encouraged by the authorities' strategy to focus both on boosting revenue performance and improving the quality of public expenditure. In this regard, we welcome their efforts to strengthen tax administration, including further steps towards the extension of the Large Taxpayer Unit (LTU) to cover VAT and withholding taxes. On the expenditure side, we commend the continued efforts to reorient public expenditure to favor pro-growth and pro-poor spending, in line with the attainment of MDGs.

On monetary and exchanges rate policies, we commend the authorities for the implementation of a cautious monetary policy, to support growth and control inflation. We encourage them to continue to improve monetary operations through measures aimed at better functioning of the interbank and treasury securities markets. Their commitment to maintain the floating exchange rate regime, consistent with the objective of strong external competitiveness, is also commendable.

We welcome the authorities' structural reform agenda, which includes the reform of state-owned enterprises (SOEs) and the trade sector covering reduction in the level and dispersion of customs and supplementary duties, as well as the elimination of quantitative restrictions, in order to further improve economic competitiveness.

With regard to SOEs reforms, we encourage the authorities to include reform of main enterprises in the manufacturing and energy sectors, and to continue to build consensus for the support of these reforms. We welcome steps being taken by the government to tackle the issue of governance, including to make new procurement guidelines operational and to adopt the Anti-Corruption Commission Act. We believe that the implementation of the governance measures combined with other structural reforms will help to strengthen the private sector environment and attract foreign direct investment.

We wish the authorities continued success in their endeavors.

Mr. Ondo Mañe submitted the following statement:

We thank the staff for a well-written set of papers and Mr. Misra for his informative statement.

Economic growth in Bangladesh has been steady over the past year, driven mainly by the recovery of the ready-made garments (RMG) sector. RMG exports to European markets rebounded following the depreciation of the Bangladeshi currency against the euro. The current account deficit has narrowed and inflation has remained manageable. On the structural front, however, the pace of economic reforms has been slow and slippages did occur. The structural performance criteria and the benchmarks in tax administration and nationalized commercial bank (NCB) reform, were not observed. But based on the authorities' efforts to address these slippages—remedial actions have already been taken—and their willingness to move forward with the structural reform process, we support the granting of a waiver for the non-observance of performance criteria.

Bangladesh is currently facing a key external challenge with the lifting of quotas under the Multifiber Agreement (MFA), at the beginning of 2005. The authorities have reaffirmed their commitment to macroeconomic prudence and steadfast efforts in structural and trade reforms. But as the staff points out, significant uncertainties remain. Given the socio-economic importance of the garments sector in the economy, and to assist the authorities in better coping with the impact of the MFA phase-out, in terms of pricing pressure, trade balance deterioration, and additional financing gap, we support the authorities' request for an activation of the Trade Integration Mechanism (TIM). Bangladesh should be able to continue its debt service to the Fund without difficulty given the country's low level of debt and prudent external debt management.

Fiscal Policy

We support the authorities' cautious medium term fiscal strategy centered on improving revenue performance and reorienting expenditure to better support economic growth and the MDGs. As such, we commend the Bangladeshi authorities for containing the fiscal budget deficit below program and for increasing transfers to enhance social safety nets and school teachers' compensation. However, tax revenue collection is expected to be lower than programmed. To further increase fiscal revenue, we urge the authorities to speed up the implementation of tax administrative reforms, notably the broadening of the revenue base.

Monetary and Exchange Rate Policies

We believe that the authorities' cautious monetary policy, supportive of the private sector and designed to contain inflation, is appropriate. But to strengthen monetary operations, we encourage them to improve the interbank market and secondary market for treasury securities, and to address the rigidities that have led to disparities in the structure of interest rates. The monetary authorities should also put in place banking sector reforms to reduce the wide spreads between lending and deposit rates resulting from the high level of nonperforming loans.

The authorities' objective to build-up reserves is welcome given the forthcoming lifting of the MFA, and their renewed commitment to a floating exchange rate regime and decision to limit their interventions in the foreign exchange market to building-up reserves, is commendable.

Structural Reforms

We support the authorities' prudent approach to the restructuring and privatization of state-owned enterprises (SOEs), and we agree that due consideration should be given to socio-political factors in the sequencing and timing of sensitive measures and the pace of reforms. Nevertheless, we encourage the authorities to downsize loss-making SOEs, with a freeze on hiring and a non recourse to budget and bank borrowing. We also believe that the authorities should step up the reform of the energy sector SOEs to address the infrastructure bottlenecks to growth and improve financial performance.

Given the difficult financial condition of the nationalized commercial banks (NCBs), we commend the authorities for the steps taken to move ahead with their restructuring, notably through the reduction of nonperforming loans and the strengthening of bank management, and we agree with the strategy of bringing in sequence, the divestment of the three mentioned NCBs over a three year period (2004-06). With regard to the largest NCB's divestment prospects, however, we support the authorities' cautious approach and the need to start by gaining experience with NCB restructuring, before proceeding with its privatization, given the central role that this NCB plays in the economy, particularly in the rural sector.

PRSP and JSA

As noted by staff, progress in finalizing the full PRSP has been satisfactory, but we would like to encourage the authorities to consider a more comprehensive approach to tackle economic governance and to strengthen efforts in public expenditure management. Notwithstanding the actions already taken by the authorities to strengthen governance and implement an anti-corruption strategy, faster progress on governance issues will be needed to improve the investment climate.

Finally, on technical assistance, the authorities will need the support of the IMF and the World Bank to provide continued technical assistance to be able to move faster with the implementation of structural reforms and to assist them with the phasing-out of the MFA. We call on the IMF and the World Bank to provide the technical assistance that has been identified by staff and requested by the authorities.

With these remarks we wish the authorities every success in their endeavors.

Mr. Misra informed the Board of the damage to date (394 lives lost and extensive damage to infrastructure) of recent flooding that had inundated more than two-thirds of Bangladesh, including parts of Dahka. The government was engaged in rescue and relief operations, which was being monitored by the prime minister. The authorities were sanguine that the international community, IFIs, and other agencies would respond to their eventual request for international assistance for post flood rehabilitation and reconstruction work. The Islamic Development Bank had already assured their support, and the ADB would be assisting the authorities to make an assessment of damage. The authorities were grateful for the expressions of support from countries and organizations.

The staff representative from the Asia and Pacific Department (Mr. Weerasinghe), in response to questions posed by Directors, made the following statement:

> Regarding the question on the exigencies of the structural PCs and benchmarks, the six PCs and benchmarks for the second review were focused in just two crucial structural reform areas: tax and NCB reforms. The benchmarks were designed to guide and monitor progress in these areas. The poor record of meeting the structural PCs and benchmarks on original deadlines had been due to capacity constraints and, in some cases, needing additional time to build political consensus.
>
> The original timetable, to set in motion the key steps to accomplish the structural agenda, is broadly reasonable. It is a timetable without stop-and-go elements, and it was established on extensive consultation with the authorities and World Bank. However, the capacity constraints had not been previously tested in the program context. The expanded audit program to cover one thousand large taxpayers, for example, may have been too optimistic, given the technical capacity constraints. Some delays also occurred despite technical assistance on various fronts, but the staff has exercised flexibility in the program reviews.
>
> Without the original timetable and the extensive technical assistance, it would hardly have been possible to achieve the structural agenda on which progress has been made under the current program. Hence, although the deadlines agreed between the authorities and the staff were ambitious—underscoring the need for substantive progress in these two crucial areas of structural reform—they were not overly optimistic in the staff's opinion.
>
> On how Bangladesh compares to its peers in revenue generation, additional measures that might be taken to increase performance, and whether the fiscal goal for 2005 is feasible, the program includes a revenue target of an annual increase of 0.5 percent of GDP. The target is in line with the medium-term fiscal strategy, as well as supportive of pro-growth spending and the achievement of the Millennium Development Goals, at the same time as preserving fiscal sustainability.

The tax to GDP ratio in Bangladesh is 10.3 percent, below most of its peers Pakistan (12.8 percent), Cambodia (8.4 percent), Sri Lanka (14.6 percent), and Vietnam (15.2 percent). In addition, the revenue effort called for in the program (0.5 percent of GDP) compares with that of its peers, which were under Fund-supported programs (Pakistan, 0.3 percent in FY02; Cambodia, 0.5 percent for FY02, Vietnam, 1.3 percent in FY01; and Sri Lanka, 0.4 percent in FY02). While, on a comparative basis, Bangladesh's revenue target is realistic, the achievement of the target is contingent upon a demonstration of strong political will to enforce tax administration measures and improved capacity in the NBR.

On tax administration, particular attention should be given to insuring continued effectiveness of measures already in place. In addition, concrete steps are needed to expand the LTU to cover the VAT and withholding tax. On tax policies, the authorities have taken steps in the FY2005 budget to reduce and rationalize trade taxes. In addition, the value-added tax net has been expanded to cover most services and additional taxpayers.

Hence, on balance, although the program revenue target for Bangladesh is ambitious, it is also realistic and feasible.

Regarding the possible need for additional revenue measures, the programmed revenue effort is based on improved and strengthened tax administration efforts and a broadening of the tax base. There is potential in Bangladesh for much better tax collection, and the current revenue target is achievable based on measures already in the program, provided they are implemented with determination. No consideration has been given to raising revenue through tax rate increases, as this would not be optimal in Bangladesh's case. The problem is more one of needing better tax collection.

On the extent of Bank-Fund collaboration on trade policy, Bank-Fund collaboration in Bangladesh has been strong and covered a number of areas, including NCB reforms, revenue administration, and state enterprise reforms, as well as trade policy reform. Bank lending, including DSC-II, has been closely coordinated with the Fund PRGF arrangement. Trade reform has been included as an enhanced and strengthened key trigger under DSC-II, which was approved by the World Bank Board yesterday. In close coordination with the World Bank, trade tariff reform is also a strengthened policy area under the second year of the PRGF-supported program.

Related to the application of the TIM, one Director suggested that Table 7 of the staff report could include a projection of RMG sector exports net of RMG-related imports, which would be useful in the event of future TIM-related requests: the TIM-related deviations are more clearly identified with this information. This is a good suggestion which we will adopt by issuing a correction to the table. For your immediate information, RMG exports have been about 40 percent import content in Bangladesh.

On the export diversification policies being pursued by the authorities, the authorities are fully aware of the need to diversify the export base to reduce Bangladesh's vulnerability to external shocks. Rather than picking winners, the policy thrust, which was discussed with the Fund staff and the World Bank staff, has been to level the playing field and increase the flexibility of the economy, including through floating the exchange rate, introducing trade reforms (e.g. reducing anti-export bias), and liberalizing the FDI regime (e.g. reducing structural and policy-induced impediments, reducing the cost of doing business, and improving infrastructure over the short to medium term). So far the most promising emerging export products outside textiles has been in light engineering, pharmaceuticals, and food processing.

On whether it is a concern that the authorities accessed central bank financing to cover the gap created by delayed World Bank disbursements, there are three main factors to take into consideration: (i) the bridge financing amounted to taka 16 billion, equivalent to the amount of the delayed World Bank loan disbursement; (ii) the delay was temporary and short term; and (iii) the DSC-II was approved yesterday by the World Bank. By opting for bridge financing, the authorities avoided having to go to the banking system and risk a hike in interest rates. Moreover, the Fund-supported program envisaged only partial additional government borrowing from the central bank. Preliminary data indicates that the central bank has provided about taka 6 of the 16 billion, which is expected to be fully reversed once the World Bank DSC-II loan is shortly disbursed.

On the question of Bangladesh's potential sources of growth, the economy continues to be mainly services- and agriculture-based (52 and 22 percent of total GDP respectively). The industrial sector, despite significant growth, accounts for a relatively small share of the overall economy, as compared to many other countries in the region. In addition, the industrial sector is concentrated in RMG and chemical production, and are at the relatively low end of the market.

The key to fully realizing potential sources of growth in Bangladesh is to improve the investment climate through measures to address governance issues, as well as bottlenecks. The PRGF-supported program and the World Bank DSC-II are designed to help the authorities achieve better growth prospects through macroeconomic stability and structural reforms to enhance economic efficiency and improve economic governance.

On how the World Bank is working to help stabilize agricultural production to minimize the impact of agricultural volatility on growth and rural income, agricultural output in Bangladesh is vulnerable to natural disasters—the current flood being one such example—and, to a lesser degree, to reliance on crop agriculture (i.e. rice). Measures to reduce the volatility of rural incomes include diversifying agricultural production to other crops and livestock.

The World Bank has been working with the government to liberalize and privatize the input factor markets for the agricultural sector. In addition, the IDA has financed two rural road projects and together with other donors, the Bank is helping the government extend electricity to rural areas. The Bank has also supported micro credit to rural poor. The first IDA-financed micro finance projects reached 2.1 million people, 90 percent of which were women. The Bank is now supporting a second project.

The Bank is also working with the government to improve water management, control flooding, and reduce the vulnerability of the rural poor to disaster.

Mr. Daïri asked, given that flooding was a significant source of agricultural volatility, how crop diversification would be helpful to establishing stability.

The staff representative from the Asia Pacific Department (Mr. Weerasinghe) responded that diversifying crops would not address volatility stemming from flooding, but the effort was directed more to the problem of over-reliance on a limited variety of crops. A question that has been directed to the World Bank, as well as other donors, in the wake of recent flooding, was what could be done to develop an ex ante strategy to help mitigate the vulnerability related to repeat flooding.

Mr. Francis made the following statement:

We welcome the fact that Bangladesh is making progress under the PRGF arrangement. The indicators suggest the macro-economy is performing soundly, with the budget deficit coming in at 3.8 percent of GDP, well below the program target. While inflation has been higher than forecast, this appears to be largely the result of external factors, and is not a concern at this point. The authorities, however, will need to remain vigilant against possible second-round effects that could drive inflation higher, particularly as financial sector reforms proceed, which should allow reduced interest rate spreads and greater credit growth.

The recent macroeconomic performance can be attributed in part to favorable external conditions, but also macroeconomic policies, in particular, the effort to bring spending more in line with revenue. This performance serves as a reminder to the authorities and to other countries that there are no development shortcuts that avoid the need for a consistent policy framework. Like Mr. Daïri and Mr. Alowi, we think, that looking ahead, solid progress in boosting revenue will be required to balance development needs and fiscal sustainability.

Like Mr. Alazzaz, Mr. Alowi, and other Directors, we welcome that progress is being made towards preparing the full PRSP. We are encouraged by the fact that the interim PRSP, and the full PRSP, when completed, will become the government's only development strategy document. We have had concerns throughout the PRSP process that, being a hoop to jump through, it can create tension between the objectives of meeting Bretton Woods institution requirements and the need for country ownership, as well as the need to be properly integrated with national budgetary processes. On the latter point, we assume that as the General Economic Division is coordinating its work with the National Steering Committee under the supervision of the Minister of Finance, the PRS is fully integrated with Bangladesh's budgetary processes.

As noted by Mr. Martí and Ms. Lundsager, it is also concerning to us that progress on structural reform has been mixed and that opposition to reform is rising. With the macro-economy performing reasonably well, now is a good time to be pushing ahead with reforms. Failure to do so risks the need for more unpleasant adjustments under more difficult circumstances in the future. Indeed, the implications of the expiry of the Multifiber Agreement, as outlined in Box 1 should serve as a reminder that major reforms across a broad front are needed soon.

Bangladesh cannot continue to support loss-making, inefficient, state-owned enterprises. In general, we continue to be supportive of the staff's efforts to think creatively on how to assist the authorities to make the case for reform.

The authorities can also help themselves by demonstrating to the public that they are serious about undertaking reforms that are in the national interest rather than in their own personal interests. In this context, it is disappointing to note that strategies to tackle Bangladesh's serious corruption and governance problems are lagging. It is likely to prove easier to overcome vested interests to reform if all sectors of society are seen to be pulling their weight.

Bangladesh is undertaking important and ambitious trade liberalization. The reduction and rationalization of trade taxes should improve competitiveness and assist the export sector to respond to the challenges posed by the phasing-out of the Multifiber Agreement. Understandably, the authorities are concerned about transitional balance of payments issues and have requested assistance in accordance with the Trade Integration Mechanism. We welcome the fact that the Fund showed initiative through creation of the Trade Integration Mechanism, and like Ms. Lundsager, Mr. Wang, and other Directors, support augmentation of access in accordance with the TIM.

I found the staff papers to be very helpful, containing a balanced discussion of achievements to date, the slippages in the program, as well as the risks.

With these remarks, we support completion of the review and wish the authorities every success.

Mr. Ross made the following statement:

First of all, I would like to thank the staff for the informative set of papers. In particular, I agree with the clear and concise analysis on the potential impact of the removal of MFA quotas that support the authorities' request for the activation of the Fund's Trade Integration Mechanism. I also thank Mr. Misra for his candid statement.

Bangladesh's macroeconomic and export performance has been better than expected during the first year of the PRGF arrangement and all quantitative targets have been met. However, the slowdown on the structural front is regrettable. Indeed, reinforced policies are needed to achieve the projected medium-term growth rates and to mitigate the risks of the forthcoming changes in the foreign trade regime to their external position. As I agree with the general thrust of the staff report, I will confine myself to three remarks in the issues that we deem critical for the next year of the Fund-supported program.

First, I agree with the staff and other Directors that a flexible exchange rate should be maintained. This is particularly important in the context of the changes in the quota regime under the MFA. Interventions on the foreign exchange market should be confined to building foreign reserves to meet the program targets.

Second, structural fiscal reforms should be stepped up, including widening the VAT base, reducing the trade taxes, improving tax administration, and achieving an appropriate balance between current and capital expenditures. These measures are instrumental for revenue mobilization and for the increased efficiency of public spending and pro-poor social policies.

Third, like Mr. Francis and many other chairs, we urge the authorities to reverse slippages in reforming nationalized banks and public sector enterprises. This is critical if the expected increase of potential growth is to materialize. We note that the Joint Staff Assessment is critical on the government's efforts at communicating these difficult measures to the general public. Against this backdrop, we urge the authorities to show the necessary political leadership and will in pushing the vital structural reforms forward. It is encouraging that some progress has been made recently, as indicated in the supplement to the main report.

In addition, on one very particular issue, we join the staff in emphasizing that the special window for limited access to National Savings Certificates needs to be carefully designed and, indeed, may not be the optimal form of social safety net. The experience from some countries in our own constituency shows that these mechanisms may be subject to abuse.

In conclusion, while full observance of all prior actions would have been preferable, we support the proposed decision as the authorities have done their part in the management contract for Agrani.

We wish the authorities all the best in their endeavors.
Mr. Crelo made the following statement:

First of all, let me join Messrs. Daïri and Kwakye in extending my sympathy to the Bangladeshi authorities for the tragic floods that have submerged two-thirds of the country underwater. I thank the staffs of the Fund and World Bank for a well-written set of papers and Mr. Misra for his insightful statement.

I am gratified to see that prudent macroeconomic policies have made possible sustained growth along with contained inflation. Nevertheless, poverty remains pervasive and the Multifiber Agreement (MFA) quota phase-out at the end of this year represents a daunting challenge for Bangladesh.

In light of the recent remedial actions taken by the authorities, I can support the waiver of the structural performance criteria and the completion of the second review under the current program. Against the background of the staff's updated analysis, which points to an additional financing gap due to the MFA quota phase-out, I also support the activation of the Trade Integration Mechanism (TIM) and the related augmentation of access under the current PRGF arrangement. I share the thrust of the staff's appraisal and therefore focus on a few points for emphasis.

On the fiscal side, strengthening tax administration and stepping up efforts in tax policy will be pivotal in meeting the goal of bolstering revenues. The commitment of the authorities to keep the fiscal deficit contained while better prioritizing expenditure is most welcome. I would strongly advise the authorities to implement the recommendations of the ROSC in order to improve fiscal transparency, establish a medium-term expenditure framework, and strengthen public expenditure management.

In light of the challenges that Bangladesh faces, it will be essential to improve the economy's competitiveness, to reduce anti-export bias, and improve the business environment. For the latter, it would be crucial to strengthen the infrastructure, fight endemic corruption, and improve lending conditions.

Turning to financial policies, I welcome the steps taken by the authorities to strengthen bank management and the newly agreed bank-by-bank resolution strategy. The next step will be to guarantee its full implementation. Addressing the safeguard issues is commendable, and I look forward to the publication of the full audit relating to the central bank.

The slow pace of reforming the SOEs is quite worrisome. While acknowledging that the sensitive political and social character of reforms has to be taken into account, I believe that, in view of its comfortable position in parliament, the government should press ahead with the necessary reforms. Garnering broad support by informing the population of the benefits of such reforms as well as the designing of adequate safety-nets would undoubtedly facilitate the process.

Finally, on the PRSP, I encourage the authorities to finalize a full PRSP by the end of the year. While I commend the authorities for submitting the process to broad consultation, I urge them to focus on the issues addressed in the Joint Staff assessment (JSA) on the I-PRSP and that have not yet been tackled. I was quite disturbed to read that parliament had not endorsed the strategy yet. Could the staff inform us of the underlying reasons, especially given the dominance of the government in parliament? How does the staff assess the downside risk of such reluctance to discuss the strategy?

With these remarks, I wish the authorities every success in the challenges ahead. Sustained technical assistance in the requested fields should also contribute to their efforts.

Ms. Gust made the following statement:

In spite of economic performance remaining broadly on course, we are disappointed that progress on meeting structural performance criteria has slipped. Information provided before the meeting that the authorities have met all the prior actions, save for one, is welcome, and we take some comfort from Mr. Misra's statement, in which the authorities reassure the international community of their unwavering commitment to reforms. Given the phase-out of MFA quotas at the end of this year, dogged determination in implementing the structural reform agenda will be required to place the economy in a position to offset some of the impact of loss of preferences. The activation of the TIM will provide some assistance in this regard, but the amount provided assumes that an additional adjustment effort will be undertaken by the authorities.

Since I am broadly in agreement with the staff's assessment and support the proposed decisions, I will only focus on a few areas for emphasis.

First, fiscal policy remains an important near-term issue. In particular, expanding the Large Taxpayers Unit to cover the VAT and withholding tax will need to take place over the next few months as part of the strategy to increase revenue efforts to the level envisaged in the FY05 budget. Expanding the number of audits of large taxpayers and making the Central Intelligence Cell fully operational will also be important to increase revenues.

We look forward to the provision of technical assistance by DFID and the World Bank, as indicated in the report, to strengthen capacity at the NBR. Like Mr. Alazzaz, we agree that it is essential to monitor the revenue target closely and the authorities should stand ready to implement compensatory measures, if necessary. On the expenditure side, capacity constraints also play a role, as Annual Development Plan spending has been hampered. The poor quality of outcomes in both the health and education sectors remains a concern and, as such, we urge the authorities to undertake more participatory consultations with the private sector, and NGO community to develop new partnerships with them for the delivery of basic health and education services.

The second major area the authorities need to address is the phase-out of the MFA quotas. The authorities' plans to use the floating exchange rate regime as the first line of defense against the potential impact of lifting MFA quotas seem reasonable, but a flexible exchange rate on its own will be insufficient. Efforts to reduce and streamline tariffs are welcome and we agree with the staff that the reform effort for state-owned enterprises in the manufacturing and energy sector will need to be stepped up. Related to these efforts is the need to improve the business climate and for the authorities to show determination in tackling long-standing governance issues. We agree with the staff that early adoption of an action plan to make the independent Anti-Corruption Commission functional and effective would help to enhance credibility. Including time-bound reforms for reducing corruption and improving law and order in the PRSP would also help to increase credibility. It seems clear that without reducing corruption and improving governance, many of the country's poverty reduction goals that are dependent on 7 percent annual GDP growth targets will remain elusive.

Third, the thorny issue of reforming the nationalized commercial banks is progressing, albeit slowly. Dealing with nonperforming loans in the banking sector and reforming the nationalized commercial banks is another important factor to improve the business climate in the country. Given the high rate of nonperforming loans to politically connected persons, faster and deeper progress on this front is an important component of governance reform.

Fourth, it is encouraging that twelve inter-ministerial thematic groups were appointed by the NSC in an attempt to bring ownership of the PRSP across the whole government. However, the information in the status report appears to indicate that parliament has not had much further direct involvement in the finalizing process of the PRSP since the I-PRSP was distributed to each member of parliament. We encourage the authorities to include opposition parliamentarians not only in the discussions on and preparation of the full PRSP, but the authorities' entire reform agenda to make them both truly country-owned.

To conclude, we welcome the authorities' plans to publish the staff report and related documents and wish them every success in their efforts as they persevere with their ambitious reform agenda.

Mr. Shbikat made the following statement:

First I would like to thank the staff for a well-written set of reports and Mr. Misra for his helpful statement. Economic performance of Bangladesh under the PRGF arrangement continued to be favorable. GDP growth has been robust, inflation remained moderate, and the external sector gained strength, supported by strong exports, particularly of ready-made garments. The authorities are to be commended for achieving these positive results, which for the most part reflect the benefits of their pursuit of sound macroeconomic policies and structural reforms.

The challenge going forward is to build on this progress and sustain high growth to allow faster and lasting poverty reduction. This will be more difficult in the period following the quota lifting under the Multifiber Agreement (MFA), which will have adverse impact on the textile and garments sector, and potential ramifications for the economy at large. Coping with this challenge requires, in addition to maintaining prudent macroeconomic policies, the expedition of a well-sequenced reform agenda, aimed at addressing remaining structural weaknesses and promoting a business environment more conducive to private investment. Continued support from the international community, both financial and technical assistance, will also be essential, including through the Fund's Trade Integration Mechanism, to mitigate the effects of the quota phase-out. In light of this and the country's satisfactory record under the Fund-supported program, and their commitment to persevere with reforms as conveyed by Mr. Misra, we support the completion of the review and the request for waivers. We agree with the thrust of the staff appraisal, and will limit our comments to a few key issues in the fiscal, monetary, and structural reform areas.

In the fiscal area, we are encouraged by the fiscal overperformance in 2004, and the continued focus on boosting the revenue performance in the 2005 budget. Every effort should be made to ensure achievement of the revenue target, which we believe should be considered a minimum given the country's low revenue to GDP ratio and the substantial infrastructure and pro-poor spending needs. To this end, it will be important to further improve tax administration, including strengthening the implementation capacity of the National Board of Revenue and expanding the Large Taxpayer Unit to cover VAT and withholding taxes. On the expenditure side, like the staff, we stress the importance of improving the quality of spending and strengthening public expenditure, including by better project selection and execution under the Annual Development Program.

On monetary and exchange rate policy, we agree with the staff that the exchange rate should be allowed to depreciate as a first line of defense to cushion against potential pressures of the MFA quota lifting. However, the brunt of adjustment should not fall on the exchange rate only, and rigorous structural reforms will be needed to facilitate a transition to a quota-free era. Also the authorities should be mindful of the pass through of a potential large currency depreciation, and should stand ready to tighten monetary policy further to offset the impact on inflation. This highlights the need to step-up efforts to strengthen monetary operations, by developing the interbank and secondary markets and rationalizing the interest rate structure. Technical assistance form MFD in these areas would be clearly useful.

On structural reforms, weaknesses in the Nationalized Commercial Banks should be addressed in a timely manner. Restructuring the state-owned enterprises in manufacturing is also important, not only to reduce their fiscal burden, but to also promote their efficiency. Prompt actions are particularly needed to reform the energy sector to remove serious bottlenecks and address its arrears problems. Here, a timely adjustment of domestic prices of energy products and strengthening bill collection are important to render the sector financially viable. Finally, we urge the authorities to pay due attention to the social impacts of the restructuring process of these enterprises and the increase in energy prices, and to put in place programs to protect the most vulnerable segment of the population and help absorb retrenched workers.

With these comments, we wish the authorities every success.

Mr. Yotzov made the following statement:

I appreciate the authorities' efforts to maintain steady economic growth with manageable inflation and a reasonable exchange rate regime. Performance under the Fund-supported program has remained broadly on track, so I support the proposed decision. However, as many other Directors, I am concerned that five of six performance criteria and benchmarks related to tax administration and commercial bank reform were either not observed or observed with a delay. Combined with the reported slowdown in the implementation of other important structural measures, the authorities' commitment to the program could be questioned, risking support from the international community being made less generous. As I mostly agree with the staff's findings and recommendations, I will focus my intervention on four issues.

The staff and the authorities seem to be in agreement on the likely adverse impact of the impending phase-out of the Multifiber Agreement and on how it should be mitigated. Mr. Misra, in his insightful statement, points out that the authorities are fully cognizant and engaged in addressing the potential shocks through a number of policy initiatives. I see merit in most of them, though many, especially infrastructural improvements and productivity growth, are of a medium- and long-term nature and as such would hardly help to mitigate the immediate effect. Nonetheless, it is promising that on such an important issue the authorities and the staff are of the same view. I support the request for augmentation of access, although it is not clear how the authorities and the staff have come up with the requested amount. I would appreciate some clarification on this point.

I am concerned about the magnitude of the possible negative impact of the quota lifting. As the staff reports, simulations suggests that cumulative declines in exports could be between 7 and 30 percent, depending on structural assumptions. Will it be possible to devise a consistent program having given the breadth of the range?

I also find it strange that a downward exchange rate movement is touted as an appropriate policy response to the quota phase-out at the same time that the exchange rate is described as "floating." No clear indications can be found as to how inflation would be impacted by the proposed depreciation. Instead, a gradual decrease in inflation rates is part of the medium-term outlook presented by the staff. Fiscal effects of the advocated depreciation, as well as debt implications, have not been scrutinized either. In addition, what are the likely implications for pro-poor spending? I would expect deeper analysis at the time of the next review.

Next year's budget appears to rely more on a substantial increase in tax revenues and less on import duties. This is a welcome step, but also requires strengthened tax administration.

While the underlying assumptions of GDP growth and budget deficit seem reasonable, the tax revenue increase of 19 percent scheduled for 2005 will be a challenge. Decisive and timely steps will be needed. While commending the authorities for establishing, although with a delay, a Large Taxpayer Unit, I urge them to expand these offices to cover more VAT filers, as suggested by the staff.

The slowdown of structural reforms and reported stiff opposition to privatization by vested interests, together with lagging fiscal reform and uncertainties surrounding external competitiveness, are worrisome and may jeopardize successful program implementation. Stepping up the reform of the energy sector is important to address infrastructure-related impediments to growth, and close monitoring is needed with regard to nationalized commercial banks, as recent audits underscored their poor financial conditions. The authorities, but also the staff, should remain vigilant, while more analyses are needed on the sustainability of the Fund-supported program and its contingency. In this regard, additional front-loaded and prior actions measures may be contemplated.

Finally, as for fighting corruption, details on the strategy, as well as the sequencing and timing of reforms are needed to ensure that the recently established commission becomes operational and that it is independent and effective. A comprehensive national anti-corruption strategy is key to making significant progress. Ideally, the strategy will be developed through in-depth consultation with both government and non-government stakeholders, lending legitimacy to the process and increasing the likelihood of its success. The media and civil society are important institutions to support any anti-corruption strategy and should be allowed to play their important roles through greater access to information.

With these remarks, I wish the authorities every success.

Mr. Inderbinen made the following statement:

As Directors have noted, the macroeconomic outcome is favorable, and we welcome the fact that most of the quantitative targets—through June—are likely to be met. As others have remarked, however, it is disappointing that important structural measures have been delayed, in part due to the tense political environment, and that several performance criteria and benchmarks were missed. Nevertheless, we acknowledge the measures that have since been implemented and agree with the completion of the review, despite the ongoing delay of restructuring of the Agrani bank. We also agree with activation of the Trade Integration Mechanism, and are grateful to the staff for the updated analysis of the impact of the MFA phase-out, and welcome expositional improvements that the staff intend to make to the report, as mentioned by the staff representative.

We would like to recall, however, that the adverse shocks associated with the lifting of quotas is clearly permanent, and that the primary emphasis should be on structural adjustment moving forward rather than on financing. As mentioned by Messrs. Steiner and Cobos in their preliminary statement, it will indeed be crucial to rapidly implement reforms to increase competitiveness and diversify exports.

We note from the staff and from Mr. Misra's very clear statement that the authorities are committed to bring things forward in this regard and that a comprehensive post-MFA strategy is in the making. As Mr. Misra remarks, performance will take time to bear fruit, and over the longer term it will seem particularly important to promote private investment in the textiles and clothing sector, and in particular to strengthen the FDI regime. This, in turn, will depend on improvements in overall economic governance, and we share the view of the staff and others that fast implementation of reforms in this area is necessary. Against this backdrop, we urge the authorities to ensure that the anti-corruption committee is up and running soon, and that good progress is made on the action plan that is being developed with the assistance of the World Bank and other donors.

To touch briefly just on the fiscal position, we welcome the passage by parliament of the budget consistent with program targets. However, we are concerned that the 2004 revenue will come in below expectations. This underlines the importance to step up efforts to strengthen tax revenue, which is, as the staff and others have outlined, at 8.5 percent of GDP, low by any standard. A lot more progress in compliance monitoring through the CIC is thus called for, as is expanded coverage of the VAT by the Large Taxpayer Unit. It will be important for the authorities to meet the program's conditionality on this last point.

To close, like Ms. Gust, we very much welcome the authorities' intention to again publish the staff papers and we wish the country well.

Mr. Harzer made the following statement:

We broadly share the staff's assessment and recommendations and support the completion of the second review under the PRGF arrangement including the request for waiver of performance criteria as well as the activation of the Trade Integration Mechanism.

We appreciate the overall good macroeconomic performance in Bangladesh, which compares quite favourably with economic developments in other least developed countries. The achievement of such relatively strong economic performance, which to a large extent can be attributed to skilful macroeconomic management by the authorities, is even more remarkable if one takes into account the prevailing difficult political environment. At the same time, like Ms. Lundsager and Mr. Leichter, we feel that the requested waivers for program slippages in the area of structural reform can largely be seen to reflect a lack of political consensus, which clearly needs to be strengthened. Only then will necessary further structural reforms—particularly with respect to tax administration, the nationalized commercial banks, and the trade sector—unfold their full impact, thereby putting the economy on a sustainable and higher growth path as a precondition for a lasting reduction of poverty levels. This being said, we are reassured by the notion in Mr. Misra's helpful statement that the authorities, notwithstanding the difficult political environment, stand by their commitment under the program to pursue prudent macroeconomic management, and to implement their challenging reform agenda thoroughly. We would like to emphasize the following several issues.

On governance, both the overall poor business climate and the fact that Transparency International, for the third year in a row, has named Bangladesh as the world's most corrupt country, point to the urgent need to address the widespread governance problems more aggressively and swiftly. Against this background of longstanding severe governance problems, it is somewhat surprising that the IACC has yet to become fully operational and an anti-corruption strategy has yet to be developed and, more importantly, fully implemented.

On fiscal policy, the authorities' commitment to increase the revenue target of the 2005 budget is commendable, given the need to preserve fiscal sustainability, to step-up infrastructure, particularly in the energy sector, as well as to boost pro-poor spending. To this end it will be crucial to make the Central Intelligence Cell of the Large Taxpayer Unit fully operational as soon as possible.

Moreover, we urge the authorities to extend the competencies of this unit to include oversight of VAT obligations and payments.

On monetary policy, we support the staff's call for the development of an interbank and treasury securities market with a view to improving the transmission of monetary policy, as well as facilitating the financing of the budget. At the same time, we share the skepticism of the staff and other Directors regarding the envisaged introduction of a special window to NSCs for pensioners and widows. Alternative ways of extending social security benefits, which are less prone to possible abuse, should be explored. Sticking to the floating exchange rate regime, with a slight easing of the taka exchange rate possibly in the pipeline, will not only be key to cushioning the trade-related impacts from lifting the MFA quotas but will also underpin overall competitiveness of the export sector and promote its urgently needed diversification. At the same time, such possible easing should allow the continued strong flow of remittances from overseas which are still one of the economy's mainstays.

On the financial sector, we urge the authorities to make up for the regrettable delays that occurred in strengthening bank management at the nationalized commercial banks and adopting sound resolution strategies on a bank-by-bank basis.

Finally, we support the first case of activation of the new Trade Integration Mechanism, which is well-founded under the specific circumstances that Bangladesh is facing. Notwithstanding the positive role which the TIM may play in cushioning the MFA quota phase-out, like other Directors, we consider full and timely implementation of the PRGF's policy recommendations, including exchange rate flexibility, tariff reform, further opening-up of the trade sector, as well as, first and foremost, improving governance to be eventually more important to help mitigate the impacts of the quota removal.

With these remarks we wish the authorities every success in their challenging endeavors.

Mr. Robert made the following statement:

We support the second review of the PRGF arrangement and the activation of the Trade Integration Mechanism. We commend the authorities for their good macroeconomic results. Unfortunately, it has not fully translated into poverty reduction, due to the demographic inertia. That is why maintaining a high level of growth is of the highest importance. This implies a need to invigorate the process of structural reforms. In particular, the reform of the tax administration should be seen as a priority toward reducing tax evasion and giving the authorities leeway to implement other necessary reforms. The restructuring of the banking sector is also important to improve intermediation and foster growth.

The liberalization of external trade presents another challenge, as the current framework is an impediment to economic development and may favor corruption. Further, on anti-corruption efforts, we welcome the authorities' steps in this regard. Corruption should be considered the priority issue for the authorities. Does the staff have information about the independent Anti-Corruption Commission, whose members were supposed to be appointed today?

Regarding the end of the Multifiber Agreement, the authorities should stand ready to use the economic policies to cushion the shock, whose sectoral and social impacts will be significant.

With these remarks and questions, I wish the authorities every success in their future endeavors.

Mr. Kelmanson made the following statement:

We welcome today's review discussion and agree with the proposed decisions. We have very similar views to those expressed by Mr. Francis and Ms. Gust. We also are grateful to Mr. Misra for his helpful remarks at the start of this meeting on the impact of the recent floods.

Overall performance on macroeconomic issues has been strong. Prudent fiscal policy has meant that the overall budget deficit is estimated to be come in below target levels, and as the IMF staff notes, this should result in public debt falling to 60 percent of GDP—a welcome development. However, we remain concerned that such overperformance on the fiscal side is in large part due to lower-than-budgeted spending on the Annual Development Program (ADP). Such expenditures should be protected, and we hope to avoid future underperformance in forthcoming years. In this context we would be grateful for comments from the staff on the realism of the proposed increase in budget for the ADP. We would also very much agree with others on the need to focus in future on revenue enhancement.

Progress against the quantitative performance criteria set out in the PRGF arrangement has generally been good, and the authorities clearly deserve credit for their achievements in this regard. However, as already noted by others, there have clearly been slippages in meeting a number of the structural performance criteria and benchmarks. Performance in this area has been mixed due to delays in implementation capacity and also, increasingly, to a sensitive political environment, which has led the authorities to pursue reforms in an opportunistic fashion. We concur with Mr. Robert on the need to enhance political consensus to move forward on reform.

We are concerned about the ambition and the realism of some of the future structural performance criteria. We note the staff representative's comments on the realism of the structural reform agenda as well as the timetable, but we would be grateful for any additional comments that they may have on the likelihood that the LTU will be expanded to cover the VAT by the end of September, which is the current benchmark.

We welcome the analysis on the impact of the removal of the MFA quotas. This clearly constitutes a significant external shock for Bangladesh. An adequate and timely policy response is certainly necessary and will hopefully mitigate significant elements of the shock.

A number of comments have already been raised about the depreciation of the taka, and I would be grateful for any comments the staff may have on the likely extent of depreciation. Also, we wonder whether the benefits of a strengthened investment climate and investment in infrastructure could really be realized in time to mitigate the export shock expected in FY2005 and FY2006, given the likely lags in investment.

In light of the uncertainties of the external environment, we very much welcome the augmentation of access under the Fund-supported program in line with the Trade Integration Mechanism. Like Mr. Harzer, who commented that this is the first augmentation in line with the TIM, we believe the balance of payments vulnerabilities justifies the flexible approach, which allows for the banking system to increase credit to the government to smooth out fluctuations in the timing of donor financing and donor disbursements. This flexibility in program design and implementation is particularly welcome, and we very much would hope to see similar flexibility should similar circumstances warrant that in future cases.

Finally, we very much look forward to the development of the full PRSP. We see it as an important vehicle to reinforce momentum and build ownership around Bangladesh's key development challenges. We hope that buy-in to the PRSP can also be as broad as possible, including across the entire political spectrum.

The staff representative from the Asia Pacific Department (Mr. Weerasinghe), in response to additional questions from Directors, made the following statement:

Regarding the PRSP and the parliamentary process, the full PRSP is not yet completed, so the formal process of parliamentary discussions have not yet started. Notwithstanding that point, even though the government has two-thirds majority in parliament, the opposition has been repeatedly successful in boycotting parliament—a fact which was a subject of the recent donor community meeting led by the World Bank. The donor community has, in turn, tried to play a constructive role in conveying to the opposition the nature of the policies in the PRSP. The process has been difficult, but the opposition has to be included in the dialogue, and their support for the PRS somehow garnered. Perhaps Mr. Misra could provide some further clarification, but the government had indicated that they had invited the opposition to the donor meeting to discuss the PRS, but so far the opposition has only been spending the minimum required time in parliament, and has not been forthcoming in terms of participating in discussions. The donor community's and the government's best efforts to bring the opposition into the discussion is an ongoing process that will be important in the next six months, as the PRSP is being finalized.

On the determination of the augmentation of access under the PRGF arrangement in accordance with the TIM, the 10 percent figure was arrived at by determining the sufficient reserves required to allow orderly adjustment in response to the MFA quota phase-out. As indicated in the staff report, the potential impact of the removal of quotas is quite large, but taking into account additional reforms and some drawdown in reserves, the gap diminishes.

Looking at the two scenarios, (i) with policy adjustment policies and (ii) without, as noted in Table 10, there is a gap of about $55 million in FY05 and $112 million the next year with policy adjustment. There is also an assumption that other IFIs, in particular the World Bank and ADB, will provide additional assistance. This is the rationale behind the figure: it was based on a policy scenario that included a flexible exchange rate, as well as efforts aimed at trade reform (reducing the anti-export bias) and an improvement of the investment climate. The bottlenecks at Chittagong port are also being addressed over the medium term with the donors' help.

On the Independent Anti-Corruption Commission, as the staff report notes, the selection committee and its chairman have been appointed. The committee was indeed supposed to meet this week, although I have not yet received an update on this. The three-member IACC should be selected soon, recognizing that it will be important to have the IACC functional as soon as possible, the government has made a commitment, and we expect to see something quickly on this. Just to add, the Asian Development Bank is also providing technical assistance on institution building for anti-corruption institutions.

On whether increasing the ADP is realistic, and whether the reduction that we have seen relative to program is a concern, the reduction is attributable to slower-than-projected implementation and could undermine poverty alleviation initiatives, thereby undermining progress toward achieving the MDGs. Accordingly, the authorities are making best efforts to step-up ADP spending by streamlining the decision process while introducing new procurement guidelines to enhance its quality and poverty impact.

The budget for FY05 provides for a substantial increase in ADP spending, but will require stepped-up efforts in terms of project selection and execution. In that context, the overall allocation for poverty-reducing spending has been increased by 0.8 percentage points of GDP to 7.4 percent of GDP. The government appears committed to ensuring that these funds will be spent, recognizing that it will be critical for meeting the MDGs and for the overall PRSP strategy.

On the realism of the end-September target for expanding the coverage of the LTU to include the VAT, although ambitious, the DFID has been helping—and the technical assistance will continue—the authorities to work toward this goal. Tax administration has also been enhanced in the context of the DSC-II, so the World Bank will also be providing additional support. The LTU needs as much hands on expertise as possible, with coordinated efforts from DFID as well as the World Bank. It is an area where momentum has to be maintained, and an initiative to which the Minister of Finance is very committed—he was pioneering the tax effort during the last program and takes pride in continuing the push.

We also discussed, given the government is in at the midterm of the political cycle, that there is a good window of opportunity in which to push the reform agenda forward: the government's commitment is unwavering on getting the tax reform processes going. There are, however, certain capacity constraints that need to be plugged with technical assistance. The DFID and World Bank are fully on board and will be continuing their efforts in the field.

The staff representative from the Policy Development and Review Department (Mr. Boote) added that the determination to increase access under the PRGF arrangement by 10 percent of quota in accordance with the TIM was based on the impact of the phase-out of MFA quotas (Box 1 of the staff report), along with the authorities' adjustment policies, the additional financing available from other sources (in particular, the World Bank and the ADB), and the limited availability of concessional PRGF resources. In the event that the impact on the balance of payments is significantly worse than forecast, as had been noted in paragraph 31 of the staff report, there would be potential for a further augmentation of access under the deviation feature of the TIM.

Mr. Misra made the following concluding statement:

I would like to thank my colleagues for their interest, constructive comments, and support. My authorities value the Board's advice, and the views expressed today will be conveyed to my authorities. Since the staff representative gave comprehensive responses to your questions, I will limit my clarifications to some of the more important issues that have been raised.

Several chairs have referred to the political situation, where opposition to reforms is posing a risk to the Fund-supported program. I think it needs to be clearly understood that while there are problems, it is not as though reforms have stalled. There have been delays, but as many colleagues have also acknowledged, in most areas substantive progress has been made over the last year, in particular with respect to the nationalized commercial banks, the overhaul of tax administration, and the dismantling of administered prices in favor of marketoriented user charges. There should be no misgivings about the authorities' commitment or their ability to push forward the reform agenda. I would like to quote Mr. Steiner in saying that "[a]lthough political complications have arisen, the authorities have been able to pursue a healthy macroeconomic stance and enhance reforms."

While on this point, I am afraid that too much is sometimes read into newspaper reports about protests, labor unrest, and political opposition. Firstly, the political situation needs to be viewed in the context of the political milieu of the region. Secondly, all opposition cannot be attributed to vested interests. It is natural that those likely to be affected will voice their apprehension. Bangladesh is a vibrant democracy where the authorities have to be sensitive to all sets of opinion. That is the way to ensure durable reforms. I cannot agree more than with Mr. Alazzaz, when he says that an accelerated pace of SOE closures could unravel the whole reform process. Having said this, let me clarify that the authorities are aware that a lot remains to be done.

On the impact of the phasing-out of MFA quotas, we are moving simultaneously on a number of fronts to minimize these effect. There is progress being made toward lowering interest rates, the efficiency of the banking sector is set to improve, tariffs have been rationalized and reduced, and there is commitment to maintain exchange rate flexibility. In addition, governance and anti-corruption are on the road to improvement. Significant progress has also been made towards general economic integration with the creation of a South Asian free trade area. These measures will boost investment and help diversify and enhance export potential.

My colleagues have also raised concerns with regards to governance and the independent Anti-Corruption Commission, the delay took place because my authorities wanted this to be an effective institution. The consultative process and the need to address the concerns of civil society required a certain amount of time. Under the finally legislated act, the IACC has financial independence and steps are being taken to ensure that the chairperson and members are chosen by an independent process and have impeccable credentials.

There is a selection committee of five individuals, two of whom are judges of the highest court. The meeting was held today, although I am not yet aware of what transpired. Obviously, the names of the committee will not be disclosed before they are told to the prime minister and the president. In the meantime a number of other initiatives will help improve the overall climate of governance—such as tax and tariff reforms and new procurement guidelines.

On revenues, the impact of the measures being implemented will be realized over time. We are making full use of technical assistance to continuously strengthen revenue administration.

On finalizing the PRSP, even though the government has a two-thirds majority, the opposition has boycotted the parliament. The PRSP process and document have been discussed in an extensive participatory process, but without the opposition's stamp of approval, there is a risk that it may eventually be considered a government document rather than a country strategy. The authorities, therefore, are taken great care and a little more time to pursue broad-based approval.

I thank all of you for today's decisions. My authorities greatly value the Fund's support, and they look forward to continue working together. It was a pleasure to have been the first country to receive approval for augmented access under the PRGF arrangement in accordance with the TIM.

The Acting Chair made the following summing up:

Executive Directors commended the Bangladeshi authorities for the strengthened economic performance under the first year of the PRGF-supported program. They observed that the economic recovery has continued, inflation has been kept in check, and the external sector has strengthened. Macroeconomic management has remained on course and all quantitative targets and performance criteria have been observed. On the structural front, while expressing some concern about initial policy slippages, Directors commended the authorities for continuing with their reform agenda, despite a difficult political environment.

Directors underscored that faster and lasting growth needed for poverty reduction will require determined policy implementation and deeper structural reforms to tackle governance issues and improve the investment climate, and to meet the challenge posed by the phase-out of quotas under the Multifiber Agreement at end-2004. Directors agreed that the macroeconomic stance should continue to be supportive of growth. On the structural front, Directors welcomed policy actions that have already been implemented, but stressed that stepped up reform efforts are needed, particularly with respect to tax administration, the nationalized commercial banks (NCBs), and improved governance. Enhancing investor confidence will require concerted actions to improve law and order, and develop and implement an anti-corruption strategy, including the early and effective functioning of the independent Anti-Corruption Commission (IACC). Against this background, it will be important to strengthen the political consensus on reform and address capacity constraints, including through the introduction of appropriate social safety nets.

Directors endorsed the targeted increase in the FY05 budget for infrastructure and pro-poor social spending to better support growth and the attainment of the MDGs. They stressed, however, that stepped-up spending in the context of the Annual Development Program would require improved project selection and execution, better public expenditure management with improved fiscal transparency and accountability, and timely decisions on policy conditions for project financing.

On the revenue side, Directors stressed the need for strengthened tax administration and for ensuring the continued effectiveness of measures already in place. They noted that decisive and timely steps are needed to expand the Large Taxpayers Unit, which should cover also the value-added and withholding taxes. Given the need to strengthen the implementation capacity of the National Board of Revenue, Directors encouraged the authorities to take advantage of further technical assistance.

Directors agreed that monetary policy should continue to balance the support for economic growth while containing inflation. They welcomed the introduction of market-based monetary operations through the development of the interbank and treasury securities markets, and encouraged timely action to establish a treasury bill market to meet the nonbank financing needs of the budget. They also supported the authorities' request for technical assistance in this area. Directors welcomed the interest rate adjustments on the National Savings Certificates (NSCs), but most Directors expressed concern about the special window for limited access by pensioners to NSCs at above market interest rates. Given the potential for abuse of such a system, they encouraged the authorities to consider alternative forms of social safety nets.

Directors noted that the floating exchange rate regime has worked well for Bangladesh. They encouraged the authorities to continue to confine their interventions in the exchange market to countering disorderly conditions and building international reserves to a more comfortable level. Moreover, they supported using the floating exchange rate as a first line of defense against the potential impact from the lifting of the MFA quotas, noting that a market-based depreciation of the taka will be consistent with the need to maintain external competitiveness.

Directors supported the reform agenda for the NCBs, and stressed that its implementation will require strong political will and technical assistance. They noted that the poor financial condition of the NCBs as evidenced in the special audits underscores the urgency for decisive actions, particularly with regard to Sonali Bank. They called for close monitoring to ensure adherence to the strengthened memoranda of understanding between the NCBs and the central bank. The authorities were also encouraged to build on the first steps recently implemented in strengthening bank management and persevere with the implementation of the bank-by-bank resolution strategies that have been adopted.

Directors welcomed the concerted trade reform efforts identified in the budget, particularly given the background of the MFA quota phase-out at end-2004. They were encouraged by the prospects for enhanced competitiveness and reduced anti-export bias through such trade reform. While the tariff reforms are estimated to be revenue neutral, Directors urged the authorities to protect revenue through the rigorous implementation of the additional revenue measures in the FY05 budget. In addition, the authorities should move quickly in further defining and implementing their post-MFA action program, together with decisive efforts to improve the business climate.

Directors noted that stepping up the reform of the energy sector will be important to address infrastructure bottlenecks to growth and improve the financial performance in this sector. They encouraged the authorities to work closely with the World Bank and the ADB to define a framework for turning around the financial and operational performance of the energy sector SOEs, particularly the Dhaka Electricity Supply Authorities (DESA). In this connection, they welcomed the recent decision of the government to adopt an operational restructuring plan for DESA supported by the ADB. They urged the authorities to keep domestic energy prices under close review and to make any needed adjustments in a timely manner. Directors stressed the need to regain the momentum for reform of state-owned manufacturing enterprises as soon as practicable.

Directors welcomed the progress that has been made toward finalization of the full PRSP by end-2004, but they noted that much work is still ahead. They endorsed the staff assessment in the joint staff assessment of the PRSP preparation status report, particularly the need for a more comprehensive approach to tackle governance issues, including law and order, and for a strengthened effort in public expenditure management.

Directors noted that risks to program implementation have heightened in a difficult political environment, but were reassured by the continued strong commitment of the government to the overall reform process. In particular, they pointed out that risks remain considerable, especially in the structural areas deriving from resistance of vested interests and weak administrative capacity, in addition to the external risk from the phasing-out of the MFA quotas. To mitigate these risks, Directors encouraged the authorities to be vigilant on policies, while noting the importance for close monitoring and continued technical assistance.

To assist Bangladesh to better cope with the MFA quota phase-out, and encouraged by the authorities' commitment to strengthening the reforms under the PRGF arrangement, Directors agreed an augmentation of access under the PRGF arrangement, in accordance with the Trade Integration Mechanism.

The Executive Board took the following decisions:

Poverty Reduction Strategy Paper Status Report

The Fund has reviewed the Preparation Status Report of the Poverty Reduction Strategy Paper (PRSP) (EBD/04/80, 7/14/04) submitted by Bangladesh and determines that it provides a sound basis for continued access to Fund concessional financial assistance. (EBS/04/99, 7/14/04)

Decision No. 13306-(04/74), adopted
July 28, 2004

Poverty Reduction and Growth Facility—Three-Year Arrangement—Review, Waiver of Performance Criteria, Activation of Trade Integration Mechanism, and Augmentation of Arrangement

1. The government of Bangladesh has consulted with the Fund in accordance with paragraph 2(I)(c) of the three-year arrangement for Bangladesh under the Poverty Reduction and Growth Facility (PRGF) (EBS/03/76, Supplement 2, 06/23/03) and paragraph 26 of the Memorandum of Economic and Financial Policies attached to the letter dated December 18, 2003 from the Minister of Finance and Planning of Bangladesh in order to review program implementation and to request waivers of performance criteria, activation of the TIM, and augmentation of the amount of the arrangement.

2. The letter dated July 8, 2004 from the Minister of Finance and Planning of Bangladesh (the "Letter"), together with its Memorandum of Economic and Financial Policies (the "Memorandum") and Addendum to the Technical Memorandum of Understanding (the "Addendum TMU") shall be attached to the three-year PRGF arrangement for Bangladesh (the "arrangement"), and the letters dated June 4 and December 18, 2003 from the Minister of Finance and Planning of Bangladesh, together with their attachments, shall be read as supplemented and modified by the Letter and its Memorandum and Addendum TMU.

3. Accordingly,

a. paragraphs 1(a) and 1(b) of the arrangement shall be revised by replacing "SDR 347 million" with "SDR 400.33 million", and "SDR 247.5" with "SDR 283.06", respectively.

b. paragraph 1(c) shall be revised by replacing "During the first year of the arrangement" with "During the period of this arrangement", and deleting the word "and" at the end of paragraph 1(c)(i).

c. paragraphs 1(c)(iv) and 1(c)(v) shall be added to read as follows:

"(iv) the fourth disbursement in an amount equivalent to SDR 67.28 million, will be available on or after December 15, 2004 at the request of Bangladesh and subject to paragraph 2 below; and

(v) the fifth disbursement in an amount equivalent to SDR 67.28 million, will be available on or after June 15, 2005 at the request of Bangladesh and subject to paragraph 2 below."

d. paragraph 1(d) shall be amended to read as follows:

"(d) Further conditions for disbursements during the second year of the arrangement and the phasing of, and conditions for disbursements during the third year of this arrangement, shall be determined in the context of the third and fourth reviews contemplated in paragraph 2.I.B(c) of this arrangement, respectively."

e. paragraph 2.I shall be amended to read instead "2.I.A." and a new paragraph 2.I.B shall be added to read as follows:

"I.B. the fourth and fifth disbursements specified in paragraphs 1(c)(iv) and 1(c)(v), respectively:

(a) If the Managing Director of the Trustee finds that, with respect to the fourth disbursement, the data as of September 30, 2004, and with respect to the fifth disbursement, the data as of end-March 2005, indicate that:

(i) the ceiling on net domestic assets of the Bangladesh Bank; or

(ii) the ceiling on net domestic financing of the central government; or

(iii) the ceiling on net bank borrowing of the central government; or

(iv) the floor on cumulative increase of net international reserves of Bangladesh Bank; or

(v) the limit on the new nonconcessional external debt with maturities over five years contracted or guaranteed by the central government with respect to the fourth disbursement, as specified in Table 2 of the Memorandum, in the Addendum TMU, and in the TMU attached to the letter dated June 4, 2003 from the Minister of Finance and Planning of Bangladesh, and with respect to the fifth disbursement, as should be specified at the time of the third review referred to in paragraph 2.I.B(c) of this arrangement, was not observed; or

(b) if the Managing Director of the Trustee finds that:

(i) with respect to the fourth disbursement, Bangladesh has not carried out:

a. by September 30, 2004, its intentions with respect to expanding the LTU system to cover withholding income tax and VAT, with a minimum coverage for VAT of 50 percent and at least 100 largest VAT filers, as specified in paragraph 18 and Table 3 of the Memorandum; or

b. by November 30, 2004, its intentions with respect to agreeing on action plans with the management of Sonali, Janata, and Agrani covering the period to June 2006, to operationalize the resolution strategies for each bank, as specified in the Memorandum and as further specified in the Addendum TMU;

(c) until the Trustee has determined, with respect to the fourth disbursement, that the third review, and with respect to the fifth disbursement, that the fourth review of Bangladesh's program referred to in paragraph 34 of the Memorandum, has been completed."

f. paragraph 2.II (a) shall be amended to read as follows:

"(a) if, at any time during this arrangement the government of Bangladesh

(i) accumulates any new external payment arrears; or

(ii) exceeds the limit on the external debt contracted or guaranteed by the central government with maturities shorter than or equal to one year; or

(iii) exceeds the limit on the new nonconcessional external debt with maturities over one year but less than five years contracted or guaranteed by the central government as specified in the TMU attached to the letter dated June 4, 2003 from the Minister of Finance and Planning of Bangladesh and as further specified in Table 2 of the Memorandum; or"

g. a paragraph 2.III shall be added to read as follows:

"III. If at any time during the period of this arrangement Bangladesh requests augmentation of the amount of the arrangement in accordance with paragraph 3 of Decision No. 13229-(04/33), a review shall take place to consider such a request."

4. The Fund notes the intention of Bangladesh to request augmentation of the amount of this arrangement should the balance of payments difficulties of Bangladesh identified in paragraph 1 of Decision No. 13229-(04/33) on the Trade Integration Mechanism, be larger than anticipated. The Fund will be prepared to consider such an augmentation in an amount not to exceed 10 percent of Bangladesh's quota, in accordance with paragraph 3 of Decision No. 13229-(04/33).

5. The Fund decides that:

(a) the second review contemplated in paragraph 2.I.A(c) of the arrangement is completed; and

(b) Bangladesh may request the third disbursement referred to in paragraph 1(c)(iii) of the arrangement, notwithstanding the nonobservance of: (i) the end-December 2003 structural performance criterion on making fully operational a CIU to monitor compliance of 1,000 large taxpayers, and (ii) the end-April 2004 structural performance criterion on adopting resolution strategies for the four NCBs, specified in paragraphs 2.I.A(b)(2)(i) and 2.I.A(b)(2)(ii) of the arrangement, respectively, on the condition that the information provided by Bangladesh on the performance under these criteria and on the implementation of the measures specified as prior actions in Table 4 to the Memorandum, is accurate. (EBS/04/99, 7/14/04)

Decision No. 13307-(04/74), adopted
July 28, 2004

APPROVAL: November 16, 2004

SHAILENDRA J. ANJARIA
Secretary