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EBS/87/227

CONFIDENTIAL

October 28, 1987

To: Members of the Executive Board

From: The Secretary

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

Attached for consideration by the Executive Directors is a paper on Bangladesh's request for the second annual arrangement under the structural adjustment facility, which, together with the policy framework paper (EBD/87/276, 10/27/87), will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 26.

Mr. Al-Eyd (ext. 7335) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

BANGLADESH

Request for the Second Annual Arrangement Under the Structural Adjustment Facility

Prepared by the Asian and the Exchange and Trade Relations Departments

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

Approved by P.R. Narvekar and H.B. Junz

October 28, 1987

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I. Introduction

In the attached letter dated October 28, 1987, the Government of Bangladesh requests the second annual arrangement under the structural adjustment facility (SAF) in an amount equivalent to SDR 86.25 million, or 30 percent of quota, in support of a medium-term adjustment program for the three-year period ending June 1989. 1/ The Memorandum of Economic and Financial Policies, which describes the program that the Government intends to implement, is annexed to the letter. A detailed description of the economic policies and objectives of the Government's medium-term program for the period 1987/88-1989/90 is set forth in the updated policy framework paper (PFP), which has been prepared in collaboration with the staffs of the Fund and the World Bank (EBD/87/276; 10/27/87). It is expected that the updated PFP will be considered by the Bank's Executive Directors, at a meeting of the Committee of the Whole, on November 17, 1987. This PFP updates and extends the original PFP (contained in EBS/87/7; 1/15/87), which covered the period 1986/87-1988/89.

On February 6, 1987, the Executive Board approved Bangladesh's request for a three-year arrangement under the SAF and for the first annual arrangement thereunder (EBS/87/7, 1/15/87). The loan under the first annual arrangement, in an amount equivalent to SDR 57.5 million (20 percent of quota) was disbursed shortly thereafter. 2/ The first annual SAF program, covering the period July 1986-June 1987, overlapped with the final 12 months of a 19-month stand-by arrangement, in an amount equivalent to SDR 180 million or 62.6 percent of quota, approved by the Executive Board on December 2, 1985 (EBS/85/251, 11/12/85). Bangladesh observed all performance criteria established under the

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1/ Negotiations were held in Dhaka during May 11-25 and August 26-September 9, 1987 and were concluded in Washington during the Annual Meetings. The staff representatives met with Mr. M. Syeduzzaman, Minister of Finance; Mr. G. Kibria, Finance Secretary; Mr. A.G. Choudhury, Governor, Bangladesh Bank; and other senior government officials. The staff representatives were Mr. Al-Eyd (Head), Ms. Milne, Messrs. Banerjee, Miranda (all ASD), Shome (FAD), Felman (ETR), and Mrs. Atienza (TRE) and Ms. Job (ASD). Mr. Westin of the World Bank participated in one of the missions. The staff team was assisted by Mr. Ghesquiere, the Fund's Resident Representative in Bangladesh and Mr. Hughart of the World Bank Resident Mission in Dhaka. Both visits to Dhaka overlapped with a Bank-Fund financial sector mission, in which Mr. Lindgren (CBD) participated.

2/ At that time, the Board also approved Bangladesh's request for a purchase under the compensatory financing facility in an amount equivalent to SDR 88.9 million in respect of an export shortfall during the year ended September 30, 1986 (EBS/87/8, 1/16/87).

stand-by arrangement (Table 1) and the full amount was purchased (Table 2). 1/

The second arrangement is being requested prior to the termination of the first arrangement. The lengthy review of the original PFP by the Bangladesh authorities resulted in a seven month divergence between the program year--which corresponds to the fiscal year--and the coverage of the first annual arrangement. By advancing the second arrangement, this divergence will be narrowed to about four months. The staff recommends the early approval of the second annual arrangement so that there is a better coincidence between the SAF arrangement and the policymaking cycle in Bangladesh.

The second annual arrangement under the SAF is included in Attachment I, and the letter of transmittal from Bangladesh's Minister of Finance and the Memorandum of Economic and Financial Policies of the Government of Bangladesh are included in Attachment II. Bangladesh's relations with the Fund and the World Bank are described in Attachments III and IV, respectively, and social and demographic indicators are contained in Attachment V.

II. Background

In an effort to deal with mounting macroeconomic imbalances, the Bangladesh authorities adopted a stabilization program covering the two-year period 1985/86-1986/87, which was supported by a stand-by arrangement from the Fund. During the first year of the program, economic performance improved significantly. Real GDP growth reached 4.4 percent, inflation moderated, and the external current account deficit narrowed, despite a sharp fall in the terms of trade. The overall balance of payments swung into surplus, and by the end of the year, gross reserves increased to the equivalent of 2.4 months of merchandise imports, compared with only 1.8 months at end-1984/85. This progress reflected the implementation of strong adjustment measures, including a sharp reduction in the rate of broad money expansion and the adoption of a flexible exchange rate policy. The latter was crucial in stimulating rapid growth in nontraditional exports and workers' remittances.

1/ At end-September 1986, Bangladesh Bank transferred to the central government all of its estimated profits of Tk 350 million for the first quarter of 1986/87; in the past, profits were calculated at the end of the fiscal year and transferred in the first quarter of the following year. In the absence of the transfer, the September 30 ceiling on net credit to Government, which was a performance criterion under the stand-by arrangement then in effect, would have been exceeded by a small margin (0.8 percent). After reviewing the matter, Management has found that the transfer of estimated profits did not constitute a form of "net bank credit to the Government" for purposes of the performance criterion under the stand-by arrangement.

Table 1. Bangladesh: Fund Position During Period of the SAF Arrangement, 1986-89

	Outstanding June 30, 1986	July 1986 June 1987	Projected July 1987- June 1988	Projected July 1988- June 1989
		(In millions of SDRs)		
Transactions under tranche policies (net)		21.7	-70.1	-36.0
Purchases 1/		96.0	--	--
Repurchases		-74.3	-70.1	--36.0
Transactions under special facilities (net) 2/		49.1	-6.5	-27.5
Purchases		88.9	--	--
Repurchases		-39.8	-6.5	-27.5
Structural Adjustment Facility loans		57.5	86.3	38.8
Total Fund credit outstanding (end of period)		513.8	523.6	498.9
Under tranche policies		306.1	236.0	200.0
Under special facilities		150.2	143.8	116.3
Under Structural Adjustment Facility		57.5	143.8	182.6
		(In percent of quota; end of period)		
Total Fund credit outstanding	134.1	178.7	182.1	173.5
Under tranche policies	98.9	106.5	82.0	69.6
Under special facilities	35.2	52.2	50.0	40.4
Under Structural Adjustment Facility	--	20.0	50.0	63.5
Memorandum item:				
Trust Fund loans outstanding				
In millions of SDRs	75.6	51.2	28.3	11.3
As percent of quota	26.3	17.8	9.8	3.9

Source: International Monetary Fund.

1/ All under the Fund's ordinary resources.
2/ Compensatory financing facility.

Table 2. Bangladesh: Quantitative Performance Criteria and Quantitative Benchmarks, Actual Outturn Under the Stand-by Arrangement and SAF Through End-June 1987, and the Benchmarks Under 1987/88 Program

	End-September 1986		End-December 1986		End-March 1987		End-June 1987		End-June 1988
	Program	Actual	Program	Actual	Program	Actual	Program	Actual	Program
					(In millions of taka)				
Credit ceilings 1/ 2/									
Net domestic assets	124,600	121,810	131,700	130,850	133,300	126,765	139,400	139,215	160,822
Net credit to the Government	22,200	22,028	22,400	20,549	21,600	19,414	22,600	24,637	...
Net credit to the public sector	...	...	...	...	...	...	...	...	73,793
					(In millions of U.S. dollars)				
External debt ceilings									
External public debt 1/ 3/									
One to twelve years	100	--	100	--	100	55	100	52	60
Of which:									
One to five years	(80)	(--)	(80)	(--)	(80)	(--)	(80)	(--)	(45)
Less than one-year maturity 1/ 4/	...	31	...	22	36	30	36	22	15
Outstanding external liabilities of Bangladesh Bank of less than one-year maturity	80	78	80	78	80	78	80	78	40
					(In percent)				
Ratio of the overall deficit in central government 5/ 6/ operations to GDP							7.2	8.2	7.9
Ratio of central government total revenue to GDP 5/ 6/							9.5	9.1	9.1
					(n billions of taka)				
Recovery on agricultural loans 5/	...	...	3.4	3.4	5.6 7/	8.8	8.6	11.1	5.5

Source: Data provided by the Bangladesh authorities.
1/ Quantitative performance criteria under the stand-by arrangement and SAF benchmarks through March 1987; SAF benchmarks only thereafter.
2/ At constant exchange rates prevailing at end-June 1985.
3/ Contracting or guaranteeing of new nonconcessional external public debt.
4/ Outstanding level.
5/ SAF benchmark only.
6/ Applies to the fiscal year ending-June 30.
7/ Applies to February 1987.

Although the policies implemented under the stand-by arrangement were instrumental in reducing macroeconomic imbalances, severe structural weaknesses persisted: the underlying structure of the balance of payments remained weak, with a few traditional exports still accounting for the bulk of export earnings; domestic savings continued to be extremely low and the tax system was highly inelastic and excessively dependent on import-related taxes; and industrial expansion was constrained by an underdeveloped infrastructure, inefficient public enterprises, restrictions in the trade and payments system, and a weak financial system.

To address these structural problems, the authorities initiated, in 1986/87, a wide-ranging program of structural adjustment, to be supported by a three-year arrangement under the SAF. As set out in the original PFP, the adjustment strategy focused on industrial and trade liberalization, domestic resource mobilization, and financial sector reform. In the trade and industrial area, impediments to private investments were to be removed, while the import system was to be liberalized and the exchange markets gradually unified. Efforts to increase domestic resource mobilization were to include a major tax reform--to raise the ratio of government revenue to GDP--together with measures to improve the profitability of public enterprises. Financial sector reforms were aimed at restoring credit discipline, strengthening financial institutions, and enhancing the effectiveness of monetary policy. In order to provide a stable financial environment in which to implement these reforms, the authorities would maintain cautious financial policies and continue to pursue a flexible exchange rate policy. In particular, it was envisaged that the budget deficit would be stabilized at 7 percent of GDP and government recourse to domestic bank borrowing would be minimized.

With these structural and financial policies, it was expected that the average annual real GDP growth rate would increase from less than 4 percent realized during 1980/81-1984/85 to 5 percent during the 1986/87-1988/89 period, while the rate of inflation would decline from 10 percent to 7 percent. The average external current account deficit would narrow from about 9 percent of GDP to 7 percent. Moreover, by 1988/89 gross reserves would increase to cover 2.5 months of merchandise imports and the debt service ratio would decline to 22 percent of current receipts. The implementation of the adjustment program was also expected to significantly enhance the resource mobilization efforts--so that the ratio of government revenue to GDP would increase gradually to 10.5 percent by 1988/89--and to restore the viability of the banking system.

III. Performance Under the First Annual SAF Arrangement

Consistent with the medium-term strategy set forth in the original PFP and with the policy benchmarks established for the first annual SAF arrangement, wide-ranging structural measures were initiated in 1986/87. A major focus of these reforms was the liberalization of industrial and trade policy. In July 1986, industrial policy was liberalized considerably and investment regulations were relaxed. Approval powers were decentralized by doubling the sanctioning authority of commercial banks and the development finance institutions (DFIs) to Tk 30 million and Tk 60 million, respectively. Larger loan-financed projects must still be referred to government bodies; to expedite these cases, the Investment Board now meets once a month rather than quarterly. The policy also aimed at encouraging self-financed investment by expanding the number of "free sectors," where such projects are exempt from the sanctioning requirement, from 50 to 124 out of 150 sectors. Following these measures, the number of applications for registering industrial firms increased sharply.

The liberalization of investment policy was complemented by trade reforms that increased industry's access to imported raw materials and intermediate products. The 1986/87 Import Policy Order (IPO) reduced the restricted and banned imports lists by 34 percent and 18 percent, respectively. In October 1986, the requirement that firms must utilize their quotas for barter imports was eliminated. In the transition toward unification of the exchange system, export performance benefit (XPB) was granted to wet blue (unprocessed) leather, thereby leaving raw jute and loose tea as the only exports without any XPB entitlement. 1/ Furthermore, to promote backward linkages, indirect exporters (domestic suppliers of exporting firms) were also made eligible for XPB.

These reforms were supported by flexible exchange rate management. In 1986/87, the taka was depreciated by 2.3 percent against the U.S. dollar, and the real effective exchange rate was maintained below its reference level. 2/ During the first half of the year, the real effective rate depreciated substantially, mainly reflecting the fall of the dollar against other major currencies (Chart 1). Subsequently, this was partially reversed, reflecting the stabilization of the dollar and the acceleration of prices in Bangladesh; for the year as a whole, the depreciation in real effective terms amounted to 4 percent. In the relatively free secondary market, the exchange rate remained stable, as a surplus was recorded and the authorities intervened to prevent an appreciation. 3/ Progress was made during the year toward exchange rate unification. The gap between the official and secondary exchange rates

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1/ Under this scheme, exporters of eligible export products are allowed to sell a fraction of their foreign exchange receipts--40 percent, 70 percent, or 100 percent--in the secondary exchange market. (For details, see SM/87/26.)

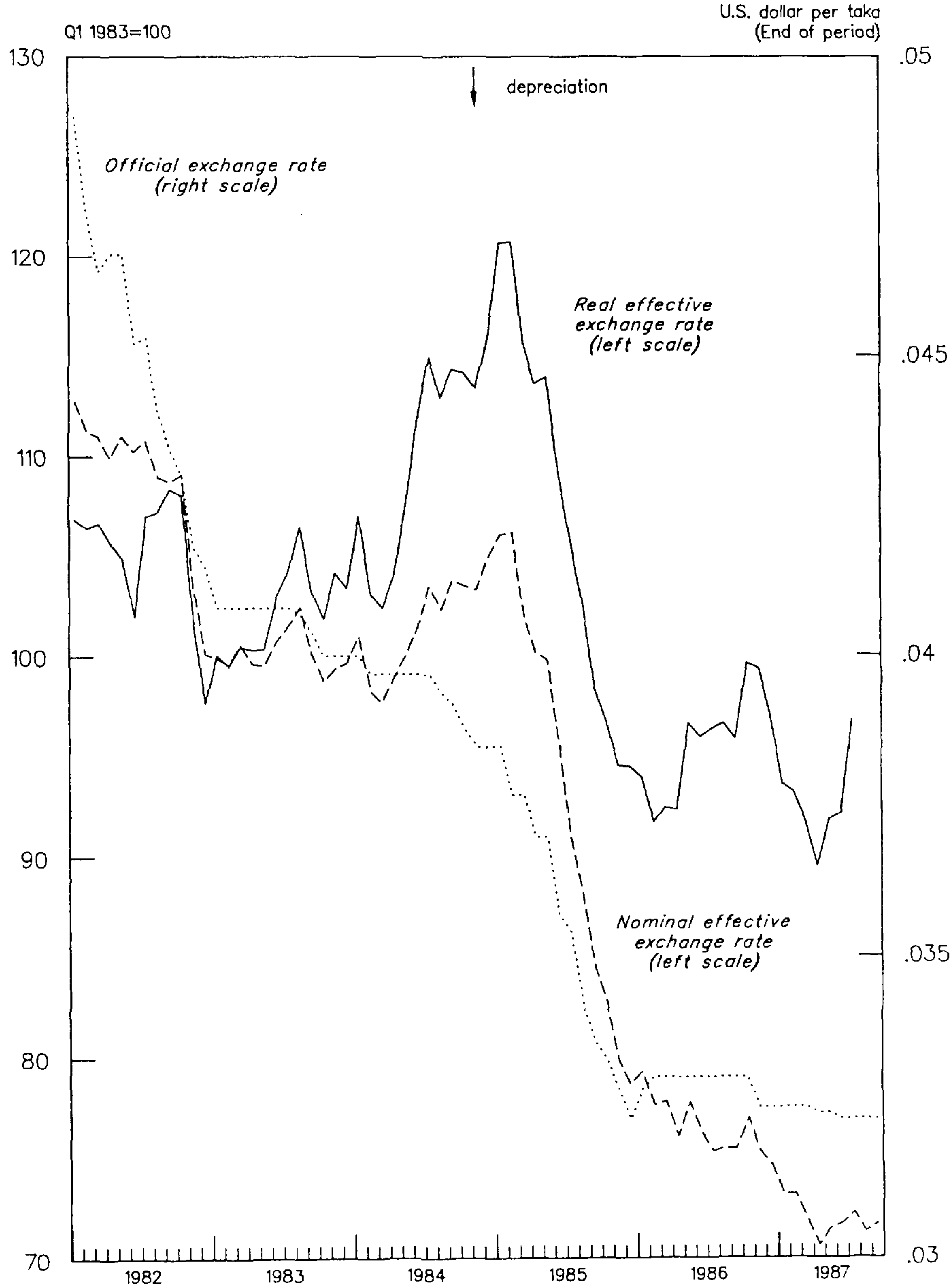
2/ Under the stand-by arrangement approved by the Executive Board in December 1985, the average real effective exchange rate during the first quarter of 1983 was established as the reference level.

3/ The authorities are committed not to intervene in the secondary market to prevent a depreciation.

CHART 1

BANGLADESH

EXCHANGE RATE DEVELOPMENTS, 1982–87



Sources: Data provided by the Bangladesh authorities; and International Monetary Fund, *International Financial Statistics (IFS)*.

was reduced from 9.5 percent at end-June 1986 to 6.5 percent at end-June 1987 through a depreciation of the official rate. The scope of the secondary exchange market (SEM) was enlarged, raising the share of export transactions that receive the SEM rate by 19 percentage points to 72 percent of total exports, and that of import transactions by 18 percentage points to 65 percent of non-aid imports (33 percent of total imports).

A second focus of the program was the strengthening of the financial system by increasing loan recoveries. Since 1982/83, a growing problem of loan arrears has weakened Bangladesh's financial institutions, distorted resource allocation, and reduced the effectiveness of monetary policy. By end-1985/86 the stock of arrears had reached a level equivalent to over 5 percent of GDP, threatening the viability of the nationalized commercial banks (NCBs) and, especially, the DFIS. Accordingly, the SAF program called for the adoption of strong loan recovery action plans.

Under the plan for agriculture, individual banks were given recovery targets and were instructed to deny new loans to willful defaulters and borrowers without valid passbooks. 1/ In addition, court cases were initiated against willful defaulters and legislation was introduced to bar defaulters from holding public office. To further encourage repayment, interest remission was granted to borrowers who repaid their overdue loans before end-May 1987. In this connection, it was later decided that the cost of interest remission, estimated at about Tk 4 billion, would be shared equally by the Government, Bangladesh Bank, and the affected banks. As a result of these measures, loan recovery in agriculture increased to Tk 11.1 billion, well above the benchmark of Tk 8.6 billion. In the case of overdue industrial loans, collection targets were established, credit and import licenses were denied to defaulters, and defaulters were removed from the directorship of private banks. Recoveries reached 95 percent of the authorities' target of Tk 1,270 million. Over the medium term, the authorities envisage a thorough reform of the financial system. Toward this end, they initiated a study, with assistance from the Bank and the Fund, aimed at developing a program to ensure the viability of financial institutions and to enhance the role of Bangladesh Bank in the formulation and conduct of monetary policy.

In the area of domestic resource mobilization, the Government introduced a number of measures to widen the tax base and improve cost recovery. In the 1986/87 budget, customs duty was imposed for the first time on crude oil imports, the budget subsidy for fertilizer was eliminated, and generalized food subsidies were reduced further. To lay the groundwork for tax reform over the medium term, the authorities--with

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1/ Under this system, borrowers seeking to obtain new loans are required to present a passbook. Passbooks serve to identify the holder and provide a record of his recent credit history.

assistance from the Bank and the Fund--continued work on a comprehensive review of tax policy and administration. It was envisaged that this review would be completed during the year so that reform measures could commence in 1987/88. Delays were encountered, however, and the review is now expected to be completed during the current fiscal year.

The financial program for 1986/87 aimed at a real GDP growth of 4.8 percent, and was designed to bring about further improvement in the external current account deficit and reduce the rate of inflation to 8.5 percent (Table 3). The overall balance of payments was projected to record a surplus of $40 million, and it was envisaged that gross reserves would cover slightly more than two months of merchandise imports. The fiscal targets were to increase government revenue to 9.5 percent of GDP and reduce the overall budget deficit to 7.2 percent of GDP. The Government's net recourse to domestic bank borrowing was to be limited to Tk 0.5 billion. Monetary policy was aimed at reducing the growth of broad money to 15.7 percent, while maintaining key interest rates positive in real terms.

Despite certain slippages, the overall economic performance was broadly satisfactory. The balance of payments outturn was stronger than envisaged and GDP growth was close to the targeted level. However, the rate of inflation was considerably higher than programmed. The SAF benchmarks for net domestic assets, agricultural loan recovery, and external debt were observed, but those for government revenue, the overall budget deficit, and net credit to Government were not met.

Real GDP growth in 1986/87 is estimated at 4.5 percent, slightly faster than the previous year's rate. Total foodgrain production increased by 2.6 percent, in line with population growth, after stagnating in 1985/86. Nevertheless, overall agricultural activity was sluggish, mainly reflecting the decline in raw jute output from the exceptionally high level of 1985/86. Industrial growth recovered strongly, boosted by a recovery in jute goods production and cotton textiles output and increased production of manufactured foodstuffs. The average annual rate of inflation rose to 10.4 percent, despite continued monetary restraint. Most major nonfood prices decelerated, but prices of food items rose rapidly, reflecting, in part, a drawdown of stocks and delays in the arrival of foodgrain imports.

The government budget deficit widened to 8.2 percent of GDP, exceeding the program target as well as the previous year's outturn by 1 percentage point (Table 4). The bulk of the deficit was financed from external sources, but the share of net domestic financing, particularly from the banking system, increased. The Government's net use of bank credit exceeded the programmed level by Tk 2.0 billion; of this, Tk 1.3 billion corresponded to the reclassification of credit to the private sector after the Government assumed one third of the interest remission cost under the agricultural loan recovery program.

Table 3. Bangladesh: Selected Economic and Financial Indicators, 1983/84-1987/88

	1983/84	1984/85	1985/86	1986/87 Program 1/	1986/87 Estimate	1987/88 Prog.
			(Annual percentage changes; unless otherwise specified)			
National income and prices						
GDP at constant market prices	4.2	3.7	4.4	4.8	4.5	1.3
Implicit GDP deflator	16.4	14.9	5.6	8.5	8.5	13.8
Consumer prices	9.7	11.0	9.8	8.5	10.4	13.0
External sector (in terms of U.S. dollars)						
Exports, f.o.b.	18.1	15.1	-12.3	11.3	29.5	6.4
Imports, c.i.f.	4.8	12.5	-10.7	4.6	10.1	17.6
Export volume	1.4	-6.7	21.5	9.1	23.8	-0.2
Import volume	6.9	21.0	-12.9	1.7	10.8	14.7
Terms of trade	19.5	30.3	-26.5	-0.8	4.1	-2.3
Real effective exchange rate 2/	6.5	4.1	-15.3	...	-4.0	...
Government budget						
Revenue	12.6	25.6	17.7	20.5	12.1	15.5
Tax	12.4	21.8	14.2	24.6	17.2	17.8
Nontax	13.4	44.1	31.8	6.2	-6.0	5.3
Total expenditure	4.9	11.0	12.3	14.4	19.2	13.7
Current expenditure 3/	19.9	20.3	24.7	11.6	15.4	19.6
Annual Development Program 3/	1.0	2.1	14.1	15.8	29.9	9.0
Money and credit 4/						
Net domestic assets	31.0	27.9	15.1	15.0	14.8	15.9
Domestic credit	30.9	27.0	20.0	13.6	8.7	14.8
Government (net)	21.5	-3.9	10.9	2.5	11.7	4.1
Other public sector	3.6	26.5	23.0	18.3	9.6	10.6
Private sector	58.7	40.2	21.3	14.3	7.4	19.8
Broad money	42.2	25.6	17.1	15.7	16.3	16.5
Income velocity (GDP/M2)	-14.7	-5.1	-5.8	-1.8	-2.5	-1.0
Interest rate (end of period, 1-2 year time deposits)	14.0	14.0	14.0	...	14.0	...
			(In percent of GDP; unless otherwise specified)			
External sector						
Current account balance	-6.8	-8.2	-7.1	-6.6	-5.6	-7.7
External public debt (end of period) 5/	39.8	37.8	45.0	41.6	44.6	44.4
Debt service (percent of exports of goods and services and private transfers)	16.3	24.5	28.2	30.4	27.6	22.7
Excluding IMF	12.4	18.7	20.3	21.1	18.8	16.2
Government budget						
Revenue	8.2	8.6	9.2	9.5	9.1	9.1
Expenditure 3/	17.3	16.1	16.4	16.7	17.3	17.0
Overall balance	-9.2	-7.5	-7.3	-7.2	-8.2	-7.9
Domestic bank financing (net)	1.2	-0.2	-0.3	0.1	0.5	0.2
Foreign financing (net)	8.0	6.9	6.9	6.6	7.4	7.4
GDP (in billions of taka)	349.9	417.0	459.9	532.7	521.6	601.4
			(In millions of U.S. dollars; unless otherwise specified)			
External sector						
Current account balance	-948	-1,317	-1,084	-1,132	-949	-1,414
Overall balance	218	-67	43	40	91	26
Gross official reserves (end of period)	539	395	476	449	715	715
In months of merchandise imports	2.7	1.8	2.4	2.1	3.3	2.8

Sources: Data provided by the Bangladesh authorities; and staff estimates.

1/ The program figures for 1986/87 were based on earlier estimates for 1985/86.
2/ Change in the index between fourth quarters of the fiscal year. A minus sign indicates a real effective depreciation of the exchange rate.
3/ Figures for 1987/88 include flood-related rehabilitation expenditure.
4/ Monetary data for 1985/86 and 1986/87 are at constant June 30, 1985 exchange rates; the 1987/88 projection is at constant June 30, 1987 exchange rates.
5/ Includes use of Fund credit and short-term debt.

Table 4. Bangladesh: Central Government Operations, 1984/85-1987/88

	1984/85	1985/86	1986/87 Prog. 1/	1986/87 Revised Est.	1987/88 Prog.
		(In billions of taka)			
Total revenue	35.93	42.28	50.69	47.39	54.71
Tax	28.87	32.98	40.74	38.64	45.50
Nontax	7.06	9.30	9.95	8.75	9.21
Total expenditure	67.47	75.63	89.20	90.13	102.44
Current expenditure	27.71	34.56	37.66	39.88	47.70
Food account deficit	4.26	1.68	2.80	-1.22	0.35
Of which: Foodstock change	(1.96)	(0.27)	(1.59)	(-1.08)	(0.68)
Annual Development Program (ADP)	30.88	35.07	44.25	45.56	49.64
Other capital expenditure and net lending 2/	4.62	4.32	4.49	5.91	4.75
Overall budget deficit	31.54	33.35	38.51	42.74	47.73
Excluding foodgrain stocking	29.58	33.08	36.92	43.87	47.13
Net foreign financing 3/	28.67	31.51	35.39	38.5	44.73
Project aid	14.40	20.17	23.31	30.24	26.51
Commodity aid	9.62	11.64	12.47	11.10	15.25
Food aid	4.92	4.99	6.52	4.50	7.10
Commercial food borrowing	2.56	-2.27	-3.46	-2.94	0.63
Debt amortization	-2.83	-3.02	-3.45	-4.40	-4.76
Net domestic financing	2.88	1.85	3.12	4.24	3.00
Banking system	-0.66	-1.35	0.50	2.58	1.00
Other	3.54	3.20	2.62	1.66	2.00
		(Annual percentage change)			
Total revenue	25.6	17.7	20.5	12.1	15.5
Total expenditure	11.5	12.1	14.4	19.2	13.7
Current expenditure	20.3	24.7	11.6	15.4	19.6
ADP	3.7	13.6	15.8	29.9	9.0
		(In percent of GDP)			
Total revenue	8.6	9.2	9.5	9.1	9.1
Tax revenue	6.9	7.2	7.7	7.4	7.6
Nontax revenue	1.7	2.0	1.9	1.7	1.5
Total expenditure	16.2	16.4	16.7	17.3	17.0
Current expenditure	6.7	7.5	7.1	7.6	7.9
ADP	7.4	7.6	8.3	8.7	8.3
Overall budget balance	-7.6	-7.3	-7.2	-8.2	-7.9
Excluding foodgrain stocking	-7.1	-7.2	-6.9	-8.4	-7.8

Sources: Data provided by the Bangladesh authorities; and staff estimates.

1/ The program figures for 1986/87 were based on earlier estimates.
2/ Comprises non-ADP project expenditure, the Food for Work Program, miscellaneous investment (nondevelopment), and net loans and advances. A major part of gross lending by the Government is included within the ADP.
3/ Including foreign grants.

The deviation from the budget deficit target was caused by both a shortfall in revenue and higher-than-programmed expenditure. Notwithstanding new measures, total government revenue amounted to 9.1 percent of GDP, below the program target of 9.5 percent and lower than the outcome in 1985/86 (9.2 percent). This slippage reflected shortfalls in tax and nontax revenue. Tax revenue was below target, mainly because of lower collections of trade-related taxes, partly reflecting the impact of procedural changes permitting provisional self-valuation of imports in order to expedite customs clearance. The decline in nontax revenue reflected lower-than-anticipated receipts from nonfinancial public enterprises, Bangladesh Bank, and the NCBs. Total expenditure was higher than programmed despite an unanticipated surplus in food operations. Current expenditure increased by 15 percent, faster than the 11.6 percent envisaged, primarily on account of additional outlays to cover the salaries and allowances for members of the newly constituted parliament, an increase in the Government's contribution to private school budgets, the filling of vacant government posts, and some increase in operations and maintenance expenditure. Higher-than-programmed capital expenditure reflected an acceleration in the construction of the Chittagong urea fertilizer factory. This project, which will be completed in the current fiscal year, accounted for about one seventh of total expenditure under the Annual Development Program (ADP).

Net domestic assets rose by 14.8 percent and broad money expanded by 16.3 percent (Table 5). Net credit to the Government remained below program benchmarks through end-March 1987. As noted above, the sharp increase in net credit during the last quarter reflects mainly the assumption by the Government of part of the cost of the interest remission granted under the loan recovery program. Total domestic credit grew by 8.7 percent, compared with a program target of 13.6 percent and the previous year's rate of 20 percent. Credit needs of public enterprises were lower than anticipated, reflecting mainly net repayments by the Bangladesh Jute Mills Corporation (BJMC), the Bangladesh Petroleum Corporation (BPC), and the Bangladesh Power Development Board (BPDB). The liquidity position of the BJMC improved as domestic raw jute prices fell by considerably more than export prices. The BPC benefited from the fall in world oil prices, while the BPDB's cash flow improved following the cost recovery measures adopted in the second half of the fiscal year. Private credit expansion decelerated sharply as measures adopted under the loan recovery program resulted in a 7 percent decline in outstanding agricultural credit, although this was offset by an 18 percent increase in credit outstanding to the nonagricultural private sector.

At midyear, the authorities relaxed monetary policy in order to counter a slowdown in economic activity. In January 1987, the liquid assets requirements on demand and time deposits were reduced from 25 percent and 23 percent, respectively, to a uniform rate of 20 percent. At the same time, interest rates on term deposits were reduced by

Table 5. Bangladesh: Monetary Survey, 1983/84-1987/88

	1983/84	1984/85	1985/86 1/	1986/87 1/ Program	1986/87 1/ Actual	1986/87 Revised base 2/	1987/88 Prog. 2/
	(In millions of taka)						
Net foreign assets	1,472	-25	2,139	3,280	4,316	4,730	6,320
Net domestic assets	82,387	105,367	121,242	139,440	139,215	138,801	160,822
Domestic credit	95,351	121,084	145,347	165,100	157,933	157,933	181,304
Public sector	46,206	52,177	61,785	69,600	68,193	68,193	73,793
Government, net	20,686	19,883	22,057	22,600	24,637	24,637	25,637
Other public sector	25,520	32,294	39,728	47,000	43,556	43,556	48,156
Private sector	49,145	68,907	83,562	95,500	89,740	89,740	107,510
Other items, net	-12,964	-15,717	-24,105	-25,660	-18,718	-19,132	-20,482
Broad money	83,859	105,342	123,381	142,720	143,531	143,531	167,142
	(Percentage change)						
Net domestic assets	31.0	27.9	15.1	15.0	14.8	14.8	15.9
Domestic credit	30.9	27.0	20.0	13.6	8.7	8.7	14.8
Public sector	11.6	12.9	18.4	12.6	10.4	10.4	8.2
Government, net	21.5	-3.9	10.9	2.5	11.7	11.7	4.1
Other public sector	3.6	26.5	23.0	18.3	9.6	9.6	10.6
Private sector	58.7	40.2	21.3	14.3	7.4	7.4	19.8
Broad money	42.2	25.6	17.1	15.7	16.3	16.3	16.5

Sources: Bangladesh Bank; and staff estimates.

1/ At constant June 30, 1985 exchange rates.
2/ At constant June 30, 1987 exchange rates.

0.25-0.75 percentage point to a range of 12.5-14.25 percent, and the rate on treasury bills was lowered by 1 percentage point to 8 percent. In March, the lending rate on commercial imports was made subject to a ceiling of 17 percent, compared with the previous fixed rate of 18 percent. Reflecting these adjustments and the increase in the rate of inflation, interest rates declined in real terms, although key rates remained positive.

The external current account deficit narrowed to 5.6 percent of GDP, compared with a program target of 6.6 percent, notwithstanding higher-than-programmed imports (Table 6). This improvement mainly reflected a 30 percent increase in export earnings and a 25 percent increase in workers' remittances. Nontraditional exports, especially ready-made garments and frozen shrimp, continued to record impressive gains; over the past three years they have tripled to nearly $500 million. With net capital inflows--notably project aid--also surpassing program expectations, the overall balance recorded a surplus of $91 million, more than twice the programmed level. The improvement in the external position enabled Bangladesh Bank to reduce its short-term external liabilities by $42 million. Gross reserves rose to $715 million, equivalent to 3.3 months of merchandise imports. The debt service ratio, including financial obligations to the Fund, declined marginally to 27.6 percent of current receipts, including private transfers. At end-June 1987, Bangladesh's total external debt stood at $7.6 billion, equivalent to 44.6 percent of GDP.

IV. The Second Annual SAF Arrangement

Consistent with the Government's medium-term adjustment strategy, most structural measures will continue to be implemented as envisaged in the original PFP. However, the targets for the current fiscal year have had to be modified to take into account developments in 1986/87 and the impact of the recent floods.

During July-September 1987, the monsoon was unusually severe, resulting in the worst floods experienced in the past 70 years. Damage to infrastructure was extensive; livestock and shrimp-bed losses were pervasive in the flooded areas; and crops on some three million acres were lost. Rice, jute, sugarcane, and vegetables were particularly affected. Even with a special agricultural rehabilitation program, total foodgrain production in 1987/88 is expected to decline and fall short by about 1.4 million tons of the Government's original production target of 17.5 million tons. Consequently, real GDP growth is projected to slow sharply to 1.3 percent. Inflation is expected to accelerate to 13 percent as a result of the shortfall in domestic food production, transportation bottlenecks, as well as adjustments in public sector salaries and administered prices. The external current account deficit is projected to widen to 7.7 percent of GDP, mainly reflecting higher imports of food and intermediate goods for post-flood reconstruction and

Table 6. Bangladesh: Balance of Payments, 1983/84-1987/88

(In millions of U.S. dollars)

	1983/84	1984/85	1985/86 Prov.	1986/87 Prog.	1986/87 Est.	1987/88 Prog.
Trade balance	-1,542	-1,713	-1,545	-1,550	-1,542	-1,932
Exports, f.o.b.	811	934	819	1,002	1,061	1,129
Imports, c.i.f.	-2,353	-2,647	-2,364	-2,552	-2,603	-3,061
Services (net)	-33	-78	-125	-82	-138	-148
Private transfers	627	475	586	500	731	665
Of which:						
Workers' remittances	(602)	(439)	(555)	(480)	(695)	(640)
Current account	-948	-1,317	-1,084	-1,132	-949	-1,414
Nonmonetary capital movements (net)	1,224	1,204	1,095	1,172	1,335	1,440
Aid disbursements	1,268	1,267	1,306	1,431	1,614	1,640
Amortization payments	-72	-110	-117	-135	-145	-163
Trust Fund (net)	-8	-13	-25	-27	-30	-30
Other capital (net)	36	69	-69	-97	-104	-7
Valuation adjustment	--	12	-63	--	-7	--
Errors and omissions (net)	-58	33	95	--	-288 1/	--
Overall balance	218	-67	43	40	91	26
Financing items	-218	67	-43	-40	-91	-26
Fund credit (net)	20	-6	-3	-21	159	13
Of which: SAF	--	--	--	--	70	112
Other	-238	72	-40	-19	-250	-39
Memorandum items:						
Current account deficit						
In percent of GDP	(-6.8)	(-8.2)	(-7.1)	(-6.6)	(-5.6)	(-7.7)
Gross reserves						
In months of merchandise imports	(2.7)	(1.8)	(2.4)	(2.1)	(3.3)	(2.8)
Debt service as percent of exports of goods and services and private transfers	16.3	24.5	28.2	30.4	27.6	22.7

Sources: Data provided by the Bangladesh authorities; and staff estimates.

1/ Includes an unusually large private short-term capital outflow (mainly export trade credits and SEM transactions in transit) totaling $190 million.

lower exports of fish and vegetables. The deterioration in the external current account position will be partly offset by a flood-induced increase in foreign aid, making it possible to program an overall balance of payments surplus of $26 million. Gross reserves are projected to remain unchanged in nominal terms, but, in terms of imports, fall to the equivalent of 2.8 months of merchandise imports.

The Government has introduced revenue measures estimated to yield additional revenue equivalent to 0.9 percent of GDP. Notwithstanding these measures, the revenue/GDP ratio in 1987/88 is now projected at 9.1 percent, substantially below the original PFP target of 10 percent. The shortfall reflects the inelasticity of the tax system and the revenue eroding effects of the tariff and financial sector reforms, which are expected to be larger than originally envisaged. Reflecting the downward revision of the revenue target, the overall budget deficit is programmed at 7.9 percent of GDP, compared with the original target of 7.3 percent.

A return to the original path of adjustment is expected in the third year of the program. Structural policies will, in general, be implemented in line with the original timetable. However, since the introduction of tax reform has been delayed by one year, the ratio of government revenue to GDP is expected to increase to only 9.5 percent in 1988/89, one percentage point below the original target. Economic performance is expected to improve considerably. The revised SAF program aims at increasing the rate of real GDP growth to 6.4 percent and reducing the rate of inflation to 8 percent. The external current account deficit is projected to decline to 7.1 percent of GDP, in line with the original target, and gross international reserves are projected to increase to around three months of imports.

1. Industrial and external sector policies

The authorities will undertake far-reaching reforms of the trade system in order to promote export-oriented industries. The growth of these industries has been hampered in the past by a restrictive import regime, a distorted tariff structure, and an inadequate system of export incentives. These problems are now being addressed through a three-pronged strategy. First, import regulations are being further liberalized by reducing the number of goods subject to restrictions and raising the entitlements on imports of restricted goods. In the 1987/88 Import Policy Order, the number of items--classified in terms of 4-digit SITC categories--on both the restricted list and the negative (banned) lists was reduced by about one fifth. Most of the reductions involve essential inputs for industry. The easing of restrictions will be especially beneficial to small firms, as it gives them the option of obtaining supplies from commercial importers; in general, items on the restricted list can only be imported by industrial firms. By July 1989, the Government intends to entirely eliminate the portion of the restricted list which applies to industrial imports, thereby enabling commercial firms to import on the same basis as industrial enterprises. The 1987/88 IPO also eased entitlement limits on individual firms. In view of the strong external performance in 1986/87 the authorities doubled the global limits on industrial firms' imports of restricted goods as well as the subceilings on raw materials, spare parts, and packing accessories.

Second, the tariff system is being reformed to ensure a more uniform rate of effective protection among industries. In the 1987/88 budget, tariff rates were reduced and rationalized not only in the textile and steel and engineering sectors, as originally envisaged, but also in the chemical and electronic sectors, where reductions were scheduled for 1988/89. With minor exceptions, customs duty rates were set at 0-20 percent for raw materials, 20-75 percent for intermediate goods, and 50-100 percent for final products. Sales taxes were reduced from four to three rates--0 percent, 10 percent, and 20 percent. For the textile sector, these changes resulted in halving of customs duties on synthetic yarns. In the steel and engineering sector, duties and sales taxes were lowered substantially on a wide range of raw materials and intermediate goods so that the maximum duty rate on these products fell from 100 percent to 50 percent. Duties on selected chemical raw materials and intermediate inputs were lowered to a range of 2.5-50 percent from 10-150 percent. During the remainder of the SAF period, tariff rationalization will be extended to products for other industries.

Third, export promotion efforts are being strengthened. Reform efforts aim at stimulating growth by ensuring duty-free status for all exporters, providing easier access to export financing and developing backward linkages. A Duty Exemption/Drawback Office is being established which, during the SAF period, will redesign the duty exemption system as well as revise the duty drawback schemes. For the garment industry, these changes are expected to be introduced by January 1988. The supply of export financing will be improved by expanding the coverage of the Export Credit Guarantee Scheme. As a first step, the authorities have undertaken a study of ways to improve the effectiveness of the scheme, which will be completed by November 1987. In order to increase the domestic value added of exports, incentives are being extended to indirect exporters. An inland back-to-back letter of credit system is being established, under which firms with export orders may pass on to their domestic suppliers the benefits of duty-free imports and export credits. The outline of the system was announced in April 1987 and operational guidelines will be issued during 1987/88. The extension of the XPB to indirect exporters in April 1987 has resulted in a small subsidy. To monitor the cost of this subsidy, which will be borne by Bangladesh Bank, a special account has been established from which disbursements will be made.

Exchange rate policy will remain flexible in order to support trade liberalization and promote nontraditional exports. During 1987/88, the real effective exchange rate will not be allowed to appreciate against its reference level. Moreover, the gap between the official and the secondary market exchange rates will be reduced further, through a depreciation of the official rate, to not more than 5 percent by end-December 1987. In the meantime, and in line with the authorities' stated objective of unifying the dual exchange markets, the scope of the SEM will be expanded. For the first time, aid imports will be transacted at the secondary rate. Virtually all of the recently approved $190 million IDA industrial sector credit will be channeled through the SEM. In July 1987, XPB was extended to tea, but removed from wet blue leather; consequently the proportion of export receipts effectively receiving the secondary rate is likely to remain unchanged.

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

2. Financial sector policies

To facilitate the achievement of macroeconomic objectives, a monetary program for 1987/88 has been elaborated and quarterly benchmarks for net domestic assets of the banking system and for net credit to the public sector have been established. Broad money expansion is projected at 16.5 percent; the growth of net domestic assets will be limited to 15.9 percent; and that of domestic credit is projected at 14.8 percent. The increase in credit to the public sector is programmed not to exceed 8.2 percent so as to provide adequate credit to the private sector.

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

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

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

To improve the financial position of the NCBs, it has been decided that the cost of any interest subsidies will be borne by the Government or Bangladesh Bank, as appropriate. In line with this policy, the Government has assumed in the current fiscal year the interest subsidy associated with the segregation of jute mill losses; as noted earlier, the Government and Bangladesh Bank have each assumed one third of the cost of the interest remission granted in 1986/87 under the agricultural loan recovery program. The budgetary contribution of the NCBs has been reduced, and Bangladesh Bank has decided to pay interest on the additional reserves resulting from the increase in the cash reserve requirement. The modalities of loan classification, provisioning against bad and doubtful debt, and bank recapitalization are expected to be finalized during the current fiscal year, with implementation envisaged for 1988/89 and beyond. A program aimed at rehabilitating the DFIs is also being implemented with financial and technical assistance from IDA. Under this program, loan-loss provisions will be increased and loan portfolios will be thoroughly reviewed; some loans will be rescheduled or written off, as appropriate. The Government intends to recapitalize the DFIs so as to lower their debt/equity ratios to not more than 3:1. Privatization of NCBs and DFIs, through the sale of equity, will be phased in.

3. Public sector policies

a. Central Government

Mobilization of domestic resources by the public sector remains a major policy objective. Discretionary tax measures introduced in the 1987/88 budget and, subsequently, in September following the floods, are estimated to yield Tk 5.4 billion (0.9 percent of GDP). With these measures, total revenue is expected to increase by 15.5 percent, somewhat faster than in 1986/87. However, in relation to GDP, revenue would remain at 9.1 percent. The stability in the ratio, despite significant new measures, reflects the underlying inelasticity of the tax system and the revenue-eroding effects of the tariff and financial sector reforms. In the 1987/88 budget, the development surcharge on dutiable imports was raised from 2 percent to 5 percent, the regulatory duty on powdered and condensed milk was doubled to 5 percent, and the customs duty on wood pulp was increased from 10 percent to 30 percent. Natural gas prices were raised by 30 percent on gas supplied for electricity generation, fertilizer production, and commercial activities, and by 25 percent for residential users; four fifths of the increase is in the form of excise duties. 1/ Excise duties were also raised for tea, machine-made fabrics, power looms, television sets, and electric bulbs. In order to reduce tax avoidance, the personal income tax exemption was raised from Tk 30,000 to Tk 36,000 and taxpayers were encouraged to report previously undeclared income through special incentives. Other revenue measures included the elimination of the exemption limit on transfer of nonagricultural property, an increase in the land development tax, and adjustments to various fees and charges, such as tolls, railway fares, postal rates, and health and education fees.

The supplemental Tk 1.1 billion package of emergency measures introduced in September, to partly finance flood-related expenditures, include: surcharges of up to 10 percent on excise duties on cigarettes, spirits and liquor, soft drinks, cinemas, and hotels and restaurants; a 6 percent surcharge on income tax; and a 4 percent levy on dividends, interest earnings on deposits, and telex and telephone charges.

1/ Gas prices were not raised for industrial users, tea gardens, and seasonal customers. The average gas price increase is estimated at 20 percent.

A number of the measures introduced in the current fiscal year are considered to be symbolic first steps in efforts to widen the tax base and increase cost recovery of selected public services, although their yield is not likely to be large. As a next step, the review of tax reform and administration will be completed and a phased program of policy implementation will be finalized in time for action to be incorporated in the 1988/89 budget.

Total expenditure is projected to increase by 14 percent in the current fiscal year, compared with 19 percent in 1986/87. The growth of development spending was budgeted to slow to less than one half the previous year's rate, following the completion of several large projects. The authorities are accommodating the bulk of the flood-related spending within the existing budget, especially by redirecting local spending and the Food-for-Work subsidy programs toward flood rehabilitation and by redefining some projects to include reconstruction activities. In addition, many new projects are being postponed. Current expenditure is projected to grow by almost 20 percent, mainly reflecting a substantial increase in the wage bill. Public sector salaries were raised by 10 percent at the outset of the fiscal year and subsequently a festival allowance equivalent to two weeks salary was granted; public sector salaries were last adjusted in 1985/86. To partially compensate for the salary increase, the Government imposed a selective hiring freeze and issued guidelines for reducing other categories of current spending by 8.5 percent. In the wake of the floods, a levy of 2.5 percent was imposed on salaries of public sector officers earning in excess of Tk 2,000 per month.

The overall budget deficit is expected to fall to 7.9 percent of GDP in 1987/88. Concessional aid flows will continue to provide the bulk of the required financing. Recourse to net domestic bank borrowing by the central government will be limited to Tk 1 billion.

b. Public sector enterprises

Steps have been taken to strengthen the financial position of nonfinancial public enterprises. The measures focus on improving operational efficiency and ensuring realistic pricing policies. To improve efficiency, the Government is extending the Performance Contracting Process that was initiated on an experimental basis in 1986/87 to facilitate coordination between public enterprises and their suppliers and customers. During the current fiscal year, the Government will also accelerate the privatization process by selling shares to the public (up to 49 percent) in several units in the steel, sugar, and chemical corporations. As regards pricing policies, the Government has, since 1982, allowed enterprises to increase their prices by up to 10 percent without prior Government approval. At present, guidelines are being prepared that will allow most public enterprises even greater autonomy in setting prices.

Special efforts are being made to strengthen the energy and jute sector corporations. As noted above, in July 1987, natural gas prices were raised by an average of 20 percent. Of the additional revenue to be generated from this increase, one fifth will be retained by the Bangladesh Oil, Gas, and Mineral Corporation (BOGMC). In August 1987, electricity tariffs were increased by an average of 15 percent and an action plan, which will be supported by an IDA energy sector credit, was initiated to reduce accounts receivables and system losses of the BPDB. To reduce accounts receivable, special collection groups have been established, meters are being sealed, new meters installed, and the frequency of meter readings increased. As a result of these actions, nontechnical system losses are expected to be reduced by 1 percentage point per month and accounts receivable lowered from 5.5 months' billings at end-June 1987 to 4.5 months' billing by end-December 1987. As a result of the stronger revenue performance, the BPDB will be able to reduce substantially its outstanding arrears to the BOGMC and to the Bangladesh Petroleum Corporation over the remainder of the SAF period.

In recent years, the jute mills have incurred large operating losses that resulted in a sizable accumulation of debts with the banking system and in an erosion of the equity base. To improve their cashflow position, the losses incurred in 1984/85 and 1985/86 were segregated into separate medium-term loans on special terms. In order to tighten financial control, a Process Accounting Scheme was introduced in July 1987 in all public sector jute mills. Also, the program initiated in 1986/87 to increase floor level supervision and strengthen the monitoring and performance evaluation of employees is being continued.

4. Benchmarks for the second annual program

The quantitative benchmarks, indicated in Table 1 of the Memorandum of Economic and Financial Policies, are: (i) quarterly ceilings on the outstanding level of net domestic assets of the banking system and on net bank credit to the public sector; (ii) limitations on the contracting or guaranteeing of new nonconcessional public external debt; (iii) limitations on the outstanding stock of public debt and external liabilities of Bangladesh Bank of less than one-year maturity; (iv) targets, in relation to GDP, for the overall budget deficit and central government revenue; and (v) an annual target for agricultural loan recovery.

The authorities will also monitor fiscal performance, including the targets for revenue, expenditure, and domestic bank financing detailed in Table 2 of the Memorandum. In addition, a number of policy actions, specified in Table 3 of the Memorandum, will constitute benchmarks. These include: reduction of the differential between the official and secondary exchange rates to 5 percent by end-December 1987; elaboration of a phased action program for tax reform and inclusion of a significant number of measures in the 1988/89 budget to ensure that central government revenue will reach at least 9.5 percent of GDP; initiation of a study aimed at developing new monetary policy instruments and at establishing an operational framework for monetary intervention; and the maintenance of passbooks and certificates of "no objection" for extension of new credit to agriculture and industrial borrowers, respectively.

V. Medium-Term Scenario, 1987/88-1991/92

The medium-term scenario discussed in this section (Table 7) is based on the assumption that the policy measures described above will be implemented, normal weather will prevail, and the terms of trade will remain unchanged. Under this scenario, the average annual rate of real GDP growth is projected at 5 percent, allowing a significant increase in real per capita income. Growth will come mainly from the nonagricultural sector as the growth of agricultural output is projected to be only slightly higher than the rate of population growth. To ensure a modest rise in per capita consumption and to increase stocks to an adequate level, it will be necessary to maintain foodgrain imports at their current level.

Higher domestic resource mobilization, to be achieved through a reform of the tax system and an improvement in the financial position of public sector enterprises, would result in a steady increase in public sector savings. This would facilitate the implementation of development projects, improve the rate of foreign aid utilization, and make available an increasing share of domestic credit to the private sector. Financial sector reform would maintain credit discipline and promote private savings. These policies, together with liberalization of trade and industrial policies and the pursuit of flexible exchange rate management, would also tend to stimulate investment, particularly in export-oriented industries.

Exports are projected to increase at an average annual rate of 14 percent. While medium-term prospects for jute--Bangladesh's main traditional export--are not favorable, the potential for other exports appears bright. Under conservative assumptions, nontraditional export growth could be expected to average 21 percent during 1987/88-1991/92, compared with 41 percent during the previous five years. In this case, by 1991/92, nontraditional exports would exceed $1.2 billion and account for two thirds of Bangladesh's export earnings. Workers' remittances are expected to register slower growth, reflecting the prevailing economic situation in host countries. As imports are projected to grow at an annual rate of 10 percent, the current account deficit will narrow to about 6 percent of GDP by 1991/92. Aid disbursements are projected to rise by about 6 percent per annum. Thus, the overall balance of payments will remain in surplus and gross official reserves will be maintained at around three months of imports, up from the earlier estimate of two months. Bangladesh's external debt is projected to rise to $10.6 billion, most of which will be on concessional terms. However, as

Table 7. Bangladesh: Medium-Term Projections, 1985/86-1991/92

	1985/86 Actual	SAF Program 1986/87 Actual Prov.	1987/88 Prog.	1988/89	Projections 1989/90	1990/91	1991/92
			(In percentage change)				
Growth and inflation							
Real GDP	4.4	4.5	1.3	6.4	4.9	5.1	5.3
CPI	9.8	10.4	13.0	8.0	7.0	7.0	7.0
Trade							
Export value	-12.3	29.5	6.4	10.6	13.5	18.5	19.3
Export volume	21.5	23.9	-0.2	7.9	8.6	13.8	14.4
Import value	-10.7	10.1	17.6	5.4	7.3	9.8	12.0
Import volume	-12.9	10.8	14.7	-2.8	3.1	5.0	6.8
			(In millions of metric tons)				
Foodgrain							
Production	16.1	16.5	16.1	17.2	17.7	18.3	18.9
Imports	1.2	1.8	3.5	2.4	2.5	2.5	2.6
Consumption 1/	14.9	15.5	15.7	15.5	15.6	15.7	15.8
Closing official stocks	1.0	0.7	1.0	1.0	1.1	1.1	1.2
			(In percent of GDP)				
Government budget							
Total revenue	9.2	9.1	9.1	9.5	10.0	10.5	11.0
Total expenditure	16.4	17.3	17.0	16.6	17.0	17.3	17.6
Of which: ADP	7.6	8.7	8.3	7.8	8.0	8.3	8.6
Overall balance	-7.3	-8.2	-7.9	-7.1	-7.0	-6.8	-6.6
Investment and savings							
Gross investment	13.3	13.2	12.8	13.4	14.0	14.7	15.3
Of which: private investment	7.2	5.8	5.8	6.7	7.1	7.6	8.1
National savings	6.2	7.6	5.1	6.3	7.2	8.2	9.0
External current account deficit	-7.1	-5.6	-7.7	-7.1	-6.8	-6.4	-6.3
External debt							
Debt service ratio 2/	28.2	27.6	22.7	20.4	21.1	19.9	14.4
Of which: IMF	7.9	8.8	6.5	5.0	7.2	6.8	2.7
External debt outstanding 3/	45.0	44.6	44.4	43.7	42.6	41.4	40.7
			(In millions of U.S. dollars)				
Balance of payments							
Exports	819	1,061	1,129	1,248	1,417	1,679	2,003
Jute	417	400	433	440	452	470	489
Other	402	661	696	808	965	1,209	1,514
Imports	-2,364	-2,603	-3,061	-3,227	-3,461	-3,800	-4,256
Current account	-1,084	-949	-1,414	-1,428	-1,478	-1,535	-1,645
Gross reserves	476	715	715	833	856	929	1,147
(In months of merchandise imports)	2.4	3.3	2.8	3.1	3.0	2.9	3.2
External debt outstanding 3/	6,914	7,592	8,154	8,789	9,314	9,870	10,600
Of which: IMF 4/	443	668	681	649	496	320	237

Sources: Data provided by the Bangladesh authorities; and staff estimates.
1/ In ounces per capita per day.
2/ As a percentage of receipts from exports of goods and services; and private transfers.
3/ End-of-period.
4/ Excludes Trust Fund.

Fund repurchases are completed and assuming that commercial borrowing will be strictly limited, the debt service ratio will fall gradually to less than 15 percent of current receipts by 1991/92.

VI. Staff Appraisal

In 1986/87, the Government of Bangladesh began implementing a program of structural adjustment, supported by a SAF arrangement from the Fund. The program reinforced the efforts initiated under the stand-by arrangement that covered the two-year period 1985/86-1986/87. As envisaged in the PFP, wide-ranging structural measures were introduced in 1986/87. These focused mainly on liberalization of trade and industrial regulations, mobilization of domestic resources, and on restoring credit discipline and improving the viability of financial institutions. Despite some slippages, performance under the first year of the SAF arrangement was broadly satisfactory. The balance of payments outturn was stronger than envisaged, and real GDP growth was close to the target, although the rate of inflation was higher than programmed. The expansion of broad money and net domestic assets was in line with that programmed and the recovery of agricultural loans exceeded collection targets. In the fiscal field, government revenue fell short of expectations, while total expenditure exceeded the program target by a small margin. Consequently, the targets for the overall budget deficit and domestic bank borrowing by the Government were not met.

A major challenge facing the authorities in the current fiscal year is that of sustaining the adjustment efforts initiated in 1986/87. The vulnerability of the economy to external shocks has been again vividly demonstrated by the recent devastating floods. Crop losses and damage to infrastructure will result in substantially lower growth, higher inflation, and a weaker external position. With this prospect, and given the slippages in performance in the previous year, the targets for the second annual program under the SAF have had to be modified. The staff notes that the authorities see this deviation as being temporary, and welcomes their commitment to ensure a return to the medium-term adjustment path envisaged in the original PFP beginning in 1988/89. This will certainly be essential to the eventual achievement of the adjustment goals.

It is a matter of concern that government revenue has been below expectations and that the revenue targets originally established for the SAF period have had to be modified. The authorities have made a strong effort to prevent the fiscal stance from becoming unduly expansionary in the current fiscal year. Expenditure on rehabilitation and reconstruction will be largely met by reorienting all categories of expenditure, particularly capital spending. However, to ensure the success of the medium-term adjustment program, the authorities will need to implement tax reform measures vigorously, beginning with the 1988/89 budget. Determined action will also be needed to bring about the desired improvement in profitability of public sector entities over the medium term. In this connection, the staff commends the decision to place considerable emphasis on increasing the efficiency of public enterprises and to grant them greater autonomy in setting prices.

Steps toward increasing the effectiveness of monetary policy and improving the efficiency of financial intermediation are key elements of the adjustment program. The authorities have shifted away from quantitative credit ceilings and have assigned a greater role to indirect instruments of monetary control. Consideration should also be given to accelerating the pace of interest rate liberalization. To strengthen the position of the nationalized commercial banks and the development finance institutions, a program of reform has been initiated to make adequate provision for bad debts, strengthen the capital base, and modify existing accounting and managerial procedures. In the immediate period ahead, to meet the monetary benchmarks and maintain credit discipline, it will be important to reduce excess liquidity and ensure that agricultural loan recovery efforts are sustained during the second half of the fiscal year, as planned. In this context, the staff welcomes the recent increase in the cash reserve requirement and the liquid asset ratio.

To promote industry and exports, the authorities have embarked on an ambitious program to liberalize the industrial and trade system, reform the tariff system, and provide adequate incentives for exports. It is particularly commendable that tariff rationalization has been ahead of schedule. The staff would encourage the authorities to continue progress in this area and to accelerate import liberalization. Exchange rate policy has been managed flexibly and progress has been achieved in narrowing the spread between the official and secondary exchange rates. The staff welcomes the authorities' intention to unify the exchange markets at the earliest possible opportunity. The staff also welcomes the authorities' commitment to preserve Bangladesh's international competitiveness.

The staff considers that Bangladesh has made considerable strides in redressing structural impediments to growth. The medium-term program is wide-ranging and should contribute to a significant improvement in the efficiency of resource allocation. The structural policies and measures set forth in the authorities' memorandum and the updated PFP, while falling somewhat short of the original intentions, are appropriate in the difficult circumstances currently facing Bangladesh and, with concerted efforts in the future, should be sufficient to achieve the objectives of the medium-term program. Accordingly, the staff recommends approval by the Executive Board of Bangladesh's request for a second annual arrangement under the SAF.

VII. Proposed Decision

1. The Government of Bangladesh has requested the second annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Bangladesh in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/87/276).

3. The Fund approves the arrangement set forth in EBS/87/227.

Bangladesh--Structural Adjustment Facility Second Annual Arrangement

Attached hereto is a letter, with an annexed Memorandum of Economic and Financial Policies from the Minister of Finance of Bangladesh, requesting from the Fund the second annual arrangement under the three-year structural adjustment arrangement, and setting forth the objectives and policies of the program to be supported by the second annual arrangement.

To support these objectives and policies, the Fund grants the requested arrangement in accordance with the following provisions and subject to the Regulations for Administration of the structural adjustment facility:

1. The second loan in the amount equivalent to SDR 86.25 million is available for disbursement at the request of Bangladesh.

2. Before approving the third annual arrangement, the Fund will appraise the progress of Bangladesh in implementing the policies and reaching the objectives of the program supported by the second annual arrangement, taking into account primarily:

a. the indicators described in paragraph 17 of the Memorandum of Economic and Financial Policies and in Tables 1 and 3 attached to the Memorandum;

b. imposition or intensification of restrictions on payments and transfers for current international transactions;

c. introduction or modification of multiple currency practices other than modifications contemplated in paragraph 7 of the Memorandum annexed to the attached letter;

d. conclusion of bilateral payments agreements that are inconsistent with Article VIII; and

e. imposition or intensification of import restrictions for balance of payments reasons.

3. In accordance with paragraph 6 of the attached letter, Bangladesh will provide the Fund with such information as the Fund requests in connection with the progress of Bangladesh in implementing the policies and reaching the objectives supported by the second annual arrangement.

4. In accordance with paragraph 7 of the attached letter, Bangladesh will consult with the Managing Director on the adoption of any measures that may be appropriate at the initiative of the Government or whenever the Managing Director requests consultation because of deviations from any of the indicators under paragraph 2 above or because he considers that consultation on the program is desirable. These consultations may include correspondence and visits of officials of the Fund to Bangladesh or of representatives of Bangladesh to the Fund.

Bangladesh - Letter of Transmittal, Request for the Second Annual Arrangement Under Structural Adjustment Facility

Dhaka, Bangladesh

October 28, 1987

Mr. Michel Camdessus
Managing Director
International Monetary Fund
700-19th Street, N.W.
Washington, D.C. 20431

Dear Mr. Camdessus:

1. On behalf of the Government of Bangladesh, I am pleased to transmit herewith a policy framework paper prepared in collaboration with the staffs of the International Monetary Fund and the World Bank. This paper updates the policy framework paper of January 5, 1987.

2. I am forwarding today the same framework paper to the President of the World Bank.

3. To facilitate a wider distribution of the policy framework paper within the donor community, the Government of Bangladesh authorizes you, at your discretion, to transmit the document to any international organization providing assistance to Bangladesh that requests it.

4. The Government of Bangladesh will remain in close contact with the staffs of the Fund and the World Bank on developments and progress in implementing these policies, and the policy framework paper will be updated in connection with the third annual arrangement.

5. The annexed Memorandum of Economic and Financial Policies sets out the objectives and policies that the Government of Bangladesh intends to pursue under its program, for which balance of payments assistance is needed. In support of these objectives and policies, Bangladesh hereby requests from the Fund the second annual arrangement under the three-year structural adjustment arrangement.

6. Bangladesh will provide the Fund with such information as the Fund requests in connection with its progress in implementing the policies and reaching the objectives of the program.

7. The Government of Bangladesh believes that the policies set forth in the annexed Memorandum of Economic and Financial Policies are

adequate to achieve the objectives of its program but will take any further measures that may become appropriate for this purpose. Bangladesh will consult with the Managing Director on the adoption of any measures that may be appropriate, at the initiative of the Government of Bangladesh or whenever the Managing Director requests such consultation.

Sincerely yours,

M. Syeduzzaman
Minister of Finance

Annexes: Policy Framework Paper
Memorandum of Economic and Financial Policies

Memorandum of Economic and Financial Policies
of the Government of Bangladesh for the Period
July 1, 1987-June 30, 1988

1. In 1986/87, the Government of Bangladesh began implementing a medium-term program, supported by a three-year arrangement under the structural adjustment facility (SAF) and the first annual arrangement thereunder from the International Monetary Fund. The program seeks to raise real per capita income while reducing inflation and making significant progress toward achieving a sustainable external payments position. The policy package intended for the period 1986/87-1988/89 to achieve these objectives was described in a Policy Framework Paper (PFP), and the details of the first annual program were set out in a memorandum of economic and financial policies transmitted to the Managing Director on January 5, 1987.

2. The medium-term program has been extended by an additional year, and revised in light of developments in 1986/87 and more recent months. The Government's broad objectives and development strategy, however, remain unchanged. It is our intention to build on the structural reform measures initiated in 1986/87. Policies to be implemented during the three-year period beginning in 1987/88 are outlined in the updated PFP accompanying this memorandum.

3. Economic performance during 1986/87, the first year under the SAF arrangement, was broadly satisfactory. The outcome in the external sector was better than programmed. The overall balance recorded a surplus of $91 million, more than twice the programmed level; gross reserves rose to the equivalent of 3.3 months of merchandise imports. The current account deficit narrowed to 5.6 percent of GDP, compared with a target of 6.6 percent, reflecting the impact of stronger growth of nontraditional exports and higher workers' remittances. Real GDP is estimated to have grown by 4.5 percent, slightly faster than in the previous year but lower than the program target of 4.8 percent. The average rate of inflation rose to 10.4 percent, significantly above the program target of 8.5 percent, as delays in the arrival of foodgrain imports contributed to a sharp increase in food prices.

4. The fiscal outturn fell short of program expectations. Total government revenue amounted to 9.1 percent of GDP, below the 9.5 percent specified in the program, mainly because of lower collections of trade-related taxes and a decline in nontax revenue. Consequently, the overall budget deficit widened to 8.2 percent of GDP, exceeding the programmed level by 1.0 percentage point. Government recourse to domestic bank financing was higher than programmed by about Tk 2.0 billion, of which Tk 1.3 billion corresponded to the reclassification of private sector credit in connection with the interest remission program. Nevertheless, credit to the public sector as a whole and total domestic credit were below program levels; net domestic assets and broad money

expansion were in line with the program. Efforts to recover overdue agricultural and industrial loans yielded satisfactory results, particularly in the agricultural sector, where the collection target was surpassed. Consistent with its commitment, the Government assumed one third of the total cost, now estimated at about Tk 4 billion, of the interest remission granted under the loan recovery program, thus raising bank credit to the Government correspondingly.

5. The prospects for 1987/88, the second year of the SAF program, have been marred by repeated floods in July-September, the worst in 70 years. Infrastructure suffered extensive damage and crops on some three million acres were totally destroyed; rice, jute, and vegetables were particularly affected. Rice losses are estimated at above three million tons. It is expected that, even with a special agricultural rehabilitation program in the coming months, total foodgrain production in 1987/88 will fall short of the Government's original production target of 17.5 million tons by at least 1.4 million tons. Accordingly, real GDP growth is projected to slow down markedly to 1.3 percent. The average rate of inflation is projected to rise to 13 percent, mainly reflecting a rise in the price of foodgrains and other essential items and transportation bottlenecks, as well as adjustments in administered prices. The external current account deficit is expected to widen to 7.7 percent of GDP; flood-related damage to shrimp beds and jute will constrain export growth, while the crop losses will necessitate large foodgrain imports. Because of the anticipated increase in food aid disbursements, the overall balance of payments is projected to record a small surplus. Nevertheless, gross reserves will decline to the equivalent of 2.8 months of merchandise imports.

6. Notwithstanding the setbacks caused by the floods and the need for rehabilitation and reconstruction, the Government remains committed to sustaining the structural adjustment efforts. Trade liberalization efforts have been expanded to cover two sectors more than had been originally envisaged and the restricted and negative lists have been reduced by about one fifth from the end-1986/87 level. It is our intention to steadily reduce the size of the two lists. Moreover, we will ensure that, by 1989/90, industrial inputs are freely importable, including those by commercial firms. To alleviate the problems caused by entitlement limits placed on firms, the Government will continue to expand the scope of the secondary exchange market (SEM), where global entitlements do not apply. In particular, the bulk of imports financed by the recently approved $190 million industrial sector credit from IDA will be channeled through the SEM. The easing of administrative controls has been accompanied by a rationalization of the tariff system in order to ensure an efficient allocation of resources. With minor exceptions, the maximum nominal import tariff (defined to include the development surcharge, customs duties, and sales taxes) on final goods in the textile, steel and engineering, chemical, and electronics sectors, was reduced in the 1987/88 budget from over 200 percent to 125 percent. Maximum customs duty rates have been set at 20 percent for

raw materials, 75 percent for intermediate products and materials, and 100 percent for final products. Sales taxes were reduced from four to three rates, 0 percent, 10 percent, and 20 percent. This customs duty structure will be extended to other sectors in 1988/89 to ensure a more uniform rate of effective protection among industries. In addition, nominal tariffs on textile and steel and engineering goods will be further reduced to a range of 0-85 percent. Export promotion efforts are also being enhanced. It is our intention to gradually extend duty-free status to all exporters and to all inputs used in the manufacture of exports. Exporters will also be allowed to choose the duty drawback/exemption scheme that most suits their operations. In April 1987, the inland back-to-back letter of credit system, previously applicable only to the garment industry, was extended to exporters and to indirect exporters (domestic suppliers of exporting firms) in other industries. In addition, the export performance benefit scheme was extended to indirect exporters. To monitor the cost of this scheme, all disbursements to indirect exporters are being made from a special account in Bangladesh Bank.

7. Our trade liberalization efforts are being supported by flexibility in exchange rate management. Between the final quarters of 1985/86 and 1986/87, the taka depreciated by 4 percent in real effective terms. Given the prospects of an acceleration in the rate of inflation in Bangladesh, appropriate action will be taken to prevent an undue erosion of the margin in international competitiveness achieved to date; in any case, we will not allow a real effective appreciation of the taka relative to its 1983 reference level. During 1986/87, the gap between the official and secondary market exchange rates was reduced to 6.5 percent through a depreciation of the official rate, and it is our intention to reduce it further to not more than 5 percent by end-December 1987. The Government remains committed to unifying the dual exchange markets. We are currently conducting a study, with assistance from the Fund, of the various aspects of the unified exchange system with a view to ensuring operational flexibility. In the meantime, we will continue to expand the scope of the SEM. During the period of the SAF arrangement, the Government does not intend to impose or intensify restrictions on payments or transfers for current international transactions, or introduce or modify multiple currency practices other than as stated above, or conclude new bilateral agreements which are inconsistent with Article VIII, or impose or intensify import restrictions for balance of payments reasons.

8. As in the past, external borrowing on commercial terms will be strictly limited so that debt-servicing obligations remain at a sustainable level. However, in order to meet the larger requirement this year for public foodgrain distribution and to maintain stocks at reasonable levels, it will be necessary to obtain commercial food credits of about $45 million. The debt service ratio is projected to decline to 22.7 percent of current receipts in 1987/88 and stabilize at about 20 percent over the medium term. A further substantial reduction in the

short-term external liabilities of Bangladesh Bank is planned during the current fiscal year.

9. The 1987/88 budget, the first in six years to be submitted for consideration by Parliament, contains a number of measures aimed at improving the structure of the economy. These include, in particular, rationalization of the tariff system described in paragraph 7 above; measures to strengthen the equity base of financial institutions; and efforts to improve cost recovery for goods and services provided by the Government. The tariff rationalization constitutes the first step toward reform of the tax system; it has cost the Government an estimated Tk 1.2 billion in revenue losses. Additional revenue losses will also be incurred as a result of the ongoing reform of financial institutions. The yield of some of the cost recovery measures, particularly the increase in educational fees and health charges, though modest, represents a significant change in policy direction, signaling our intention to widen the domestic base of revenue.

10. In the 1987/88 budget and subsequently in September, after the floods, the Government introduced revenue measures estimated to yield Tk 5.3 billion (0.9 percent of GDP). The revenue package introduced in the budget included: an increase in the development surcharge on dutiable imports from 2 percent to 5 percent; an increase in the regulatory duty on powdered and condensed milk; increases in excise tax rates on various items such as natural gas, sugar, aerated water, tea, and electrical products; withdrawal of the exemption limit on transfer of property; incentives for reporting previously unreported income; rate increases in the land development tax; and increases in various fees and charges such as tolls, railway fares, postal rates, and education fees. The package of emergency revenue measures announced in September comprises: surcharges of up to 10 percent on excise duties on cigarettes, spirits and liquor, soft drinks, cinemas, and hotels and restaurants; a 6 percent surcharge on income tax; and a 4 percent levy on dividends, interest earnings on deposits, and telex and telephone charges. With these measures, which we consider to be a significant effort, total revenue in 1987/88 is now estimated at 9.1 percent of GDP. Given the present tax structure, with its underlying income inelasticity, and the revenue losses emerging from the rationalization of the tariff structure and financial sector reforms, it would not be feasible to increase government revenue to 10 percent of GDP in the current fiscal year, as originally targeted. We believe that a significant and lasting increase in the revenue ratio is possible only after an expansion of the tax base and a thorough reform of the tax structure. The Government of Bangladesh is firmly committed to such reform beginning with the 1988/89 budget. The reform program will aim at increasing the ratio of government revenue to GDP to at least 9.5 percent in 1988/89 and ensuring a steady rise in this ratio thereafter. To this end, it is our intention to complete the ongoing tax review, for which studies conducted by the Fund and the World Bank will provide

important input, and put in place a dated program of tax reform by the time of the 1988/89 budget.

11. Total expenditure growth is projected to slow down to 14 percent in 1987/88. Development spending was budgeted to increase at less than one half the previous year's rate, reflecting the completion of certain major projects. In the wake of the floods, we are reorienting all categories of expenditure to accomodate rehabilitation needs. Current expenditure is projected to grow by almost 20 percent, mainly reflecting a substantial increase in the wage bill. At the outset of the current fiscal year, government employees received salary increases averaging 10 percent and a festival allowance equivalent to two weeks' salary in order to compensate for the loss in purchasing power since the last major salary adjustment in 1985/86. To minimize the impact of the wage increase, the Government imposed a selective hiring freeze and issued guidelines for reducing other categories of current expenditure by 8.5 percent. Following the floods, it was also decided to impose a 2.5 percent levy on the salaries of all public sector officers drawing a basic pay of more than Tk 2,000 per month. Over the medium term, it would be important to improve the efficiency of public expenditure. Toward this end, the Government intends to carry out in 1987/88 a comprehensive review of public expenditure, in cooperation with the World Bank.

12. On the basis of the above revenue and expenditure policies, the overall budget deficit is projected to narrow slightly to 7.9 percent of GDP in 1987/88. The Government's net recourse to domestic bank credit will be limited to Tk 1 billion, thus containing the increase in outstanding net credit to the Government at 4.1 percent.

13. In recognition of the need for mobilization of additional domestic resources, the Government is also improving the cost recovery and operating efficiency of nonfinancial public enterprises. A number of adjustments have recently been undertaken in the prices and tariffs charged by these enterprises. These include a 20 percent average increase in the price of natural gas in July; a 15 percent average increase in the electricity tariff in August; and a 9 percent increase in the price of sugar in August. The Government is currently preparing guidelines which will allow most public enterprises greater autonomy in setting prices. To improve operational efficiency, the Government is implementing a Performance Contracting Process on an experimental basis in selected public enterprises. This program, which focuses on strengthening coordination of these enterprises with their suppliers and customers, was initiated in 1986/87 and is being extended this fiscal year. In July 1987, a Process Accounting Scheme was introduced in all public sector jute mills, with a view to tightening financial control. Also, the program initiated in 1986/87 in these mills to increase floor-level supervision and strengthen the monitoring and performance evaluation of employees is being continued. During the course of the current fiscal year, the Government also intends to partially privatize,

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

14. During 1987/88, monetary policy will be conducted consistent with the growth, inflation, and balance of payments objectives of the program. Consequently, broad money is projected to increase by 16.5 percent, in line with that of nominal GDP, while domestic credit expansion will be held to 14.8 percent. Recourse to bank credit by the public sector is programmed to increase by not more than 8.2 percent in order to accommodate the credit needs of the private sector, especially agriculture. To facilitate replanting in flood-affected areas, the Government permitted increased access to bank credit and rescheduled some agricultural loans; crop loans will become due in the second half of the current fiscal year and repayment of the rescheduled portions of term loans will be spread over installments falling due beginning in January 1988. However, in order to sustain the improvements in credit discipline realized in 1986/87, new crop loans will be extended only to borrowers in good standing and with valid passbooks. Despite the special circumstances created by the flood, the agricultural loan recovery program will be sustained and a loan recovery target of Tk 5.5 billion has been established for end-June 1988.

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

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

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

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

Table 1. Bangladesh: Quantitative Benchmarks Under the Structural Adjustment Facility Arrangement, 1987/88 1/

	1987	1988	
	Dec.	March	June
	(In millions of taka; end of period)		
Net domestic assets 2/	154,290	157,440	160,822
Net domestic bank credit to the public sector 2/	72,487	73,487	73,793
	(In millions of U.S. dollars; end of period)		
Contracting or guaranteeing of new nonconcessional public external debt			
Over 1 year and not more than 12 years 3/	60	60	60
Of which: Over 1 year and not more than 5 years	(45)	(45)	(45)
Outstanding stock of external public debt of less than 1 year maturity	22	22	15
Outstanding stock of external liabilities of Bangladesh Bank of less than 1 year maturity	40	40	40
	(In percent; 1987/88)		
Ratio of the overall deficit in central government operations to GDP			7.9
Ratio of central government total revenue to GDP			9.1
	(In billions of taka; 1987/88)		
Recovery on agricultural loans			5.5

1/ Fiscal year ending June 30, 1988.
2/ At constant June 30, 1987 exchange rates.
3/ Excludes possible borrowing of $67 million to finance the purchase of an aircraft.

Table 2. Bangladesh: Central Government Operations, 1986/87-1987/88 1/

	1986/87 Revised est.	1987/88 Program
	(In billions of taka)	
Total revenue	47.39	54.71
Tax	38.64	45.50
Nontax	8.75	9.21
Total expenditure	90.13	102.36
Current expenditure	39.88	47.70
Annual Development Program (ADP) 2/	45.56	49.65
Other 2/ 3/	5.91	4.67
Overall budget deficit	42.74	47.65
Net foreign financing 4/	38.50	44.65
Net domestic financing	4.24	3.00
Banking system	2.58	1.00
Other domestic	1.66	2.00

1/ July 1 to June 30.
2/ Includes rehabilitation expenditure in 1987/88.
3/ Comprises non-ADP project expenditure, the Food for Work Program, miscellaneous investment, the food account deficit, and net loans and advances to state economic enterprises. A major part of gross lending by the Government is included within the ADP.
4/ Includes foreign grants.

Table 3. Bangladesh: Benchmarks of Policy Implementation Under the Structural Adjustment Facility Arrangement, 1987/88

Policy Measures

1. Improve allocation efficiency of the exchange system

Reducing the differential between the official and secondary market exchange rates to not more than 5 percent by end-December 1987, by adjusting the official rate.

2. Public sector resource mobilization

Completing technical study of the tax structure and administration; putting in place a dated program for implementation of tax reform; and incorporating in the 1988/89 budget measures sufficient to raise the revenue-to-GDP ratio to at least 9.5 percent.

3. Financial sector reform

a. Monetary management

Initiating a study aimed at developing new monetary policy instruments and at establishing an operational framework for monetary intervention.

b. Credit discipline

Maintaining use of passbook system for disbursing agricultural loans and of certificates of "no objection" for industrial loans.

Bangladesh - Fund Relations
(As of September 30, 1987)

(Amounts in millions of SDRs; unless otherwise specified)

I. Membership Status

(a) Date of Membership:	August 17, 1972
(b) Status:	Article XIV

A. Financial Relations

II. General Department

(a) Quota:	287.5
(b) Total Fund holdings of taka:	700.9
(As percent of quota)	(243.8)
(c) Fund credit:	
General Resources Account	435.8
(As percent of quota)	(151.6)
Credit tranches	208.5
(As percent of quota)	(72.5)
Extended Fund facility	66.4
(As percent of quota)	(23.1)
Supplementary financing facility	17.1
(As percent of quota)	(5.9)
Compensatory financing facility	143.9
(As percent of quota)	(50.0)
Structural adjustment facility	57.5
(As percent of quota)	(20.0)
(d) Reserve tranche position:	22.4
(e) Current operational budget:	None
(f) Lending to the Fund:	None

III. Stand-By and Extended Arrangements

(a) Current stand-by arrangement: None

(b) Stand-by and extended arrangements during the last ten years.

Type of Arrangement	Date of Approval	Duration	Amount	Utilization
SBA	7/28/75	1 year	62.50	62.50
SBA	7/30/79	1 year	85.00	85.00
EFF	12/8/80	3 years 1/	800.00	220.00
SBA	3/28/83	5 months	68.40	68.40
SBA	12/2/85	19 months	180.00	180.00

1/ Arrangement became inoperative in June 1981 and was canceled in June 1982.

Table 2. Bangladesh: Benchmarks of Policy Implementation Under the Structural Adjustment Facility Arrangement, 1988/89

Benchmarks	Policy Measures
1. Public sector resource mobilization	Achieve the government revenue target of 9.2 percent of GDP.
2. Financial sector reform	Issue a central bank security through a tender system and replace existing refinance facilities by a general rediscount window.
	Publish a structure of bank deposit and lending rates that are linked to market criteria.
3. Import liberalization	Reduce the banned list to 19 percent and the restricted list to 16 percent of the total number of imported items at the 4-digit international trade classification level.
4. Maintain competitiveness	Keep the real effective exchange rate index below the reference level, which is the first quarter of 1983.
5. Improve allocative efficiency of the exchange system.	By November 1988, reduce the spread between the official exchange rate and the secondary market rate to a maximum of 2 percent, and keep the spread at or below that level thereafter.

Bangladesh - Fund Relations
(As of October 31, 1988)

(Amounts in millions of SDRs; unless otherwise specified)

I. Membership Status

(a)	Date of Membership:	August 17, 1972
(b)	Status:	Article XIV

A. Financial Relations

II. General Department

(a)	Quota:	287.5
(b)	Total Fund holdings of taka:	623.3
	(As percent of quota)	(216.8)
(c)	Fund credit:	
	General Resources Account	358.1
	(As percent of quota)	(124.6)
	Credit tranches	180.0
	(As percent of quota)	(62.6)
	Extended Fund facility	48.0
	(As percent of quota)	(16.7)
	Compensatory financing facility	130.1
	(As percent of quota)	(45.3)
	Structural adjustment facility	143.8
	(As percent of quota)	(50.0)
(d)	Reserve tranche position:	22.4
(e)	Current operational budget:	None
(f)	Lending to the Fund:	None

III. Stand-By and Extended Arrangements and Special Facilities

(a) Current stand-by arrangement: None

(b) Emergency assistance: SDR 71.875 million approved on November 14, 1988

(c) Stand-by and extended arrangements during the last ten years.

Type of Arrangement	Date of Approval	Duration	Amount	Utilization
SBA	7/30/79	1 year	85.00	85.00
EFF	12/8/80	3 years 1/	800.00	220.00
SBA	3/28/83	5 months	68.40	68.40
SBA	12/2/85	19 months	180.00	180.00

1/ Arrangement became inoperative in June 1981 and was canceled in June 1982.

(c) Special facilities

Type of Special Facility	Date of Approval	Amount
CFF	2/17/82	60.00
CFF	8/30/82	71.20
CFF	4/10/85	54.95
CFF	2/6/87	88.90

(d) Structural adjustment facility

SAF	2/6/87	57.50

IV. SDR Department

(a) Net cumulative allocation:	47.1
(b) Holdings:	27.5
(As percent of net cumulative allocation)	(58.4)
(c) Current designation plan	None

V. Administered Accounts

(a) Trust Fund loans:	
(i) Disbursed	122.2
(ii) Outstanding	41.4
(b) SFF Subsidy Account:	
(i) Donations to Fund	--
(ii) Loans to Fund	--
(iii) Payments by Fund	16.0

VI. Repurchases and Charges

	10/1/87-12/31/87	1988	1989	1990
Repurchases	25.95	58.65	81.81	146.41
Charges	6.65	25.08	20.44	14.13

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

Since August 13, 1979 the taka has been pegged, within margins, to a currency-weighted basket. On January 11, 1983, the intervention currency was changed to the U.S. dollar from the pound sterling and initial buying and selling rates of Tk 24.48 and Tk 24.52 per U.S. dollar, respectively, were announced. The authorities also maintain a secondary exchange market in which proceeds from workers' remittances, and most services and exports are sold at a more depreciated rate, set by a committee of authorized foreign exchange dealers. At end-September 1987, the exchange rate was Tk 31 per U.S. dollar in the official market and Tk 33.03 per U.S. dollar in the secondary market.

VIII. Last Article IV Consultation

The 1986 Article IV consultation report (SM/87/26) was discussed by the Executive Board on February 6, 1987 (EBM/87/23). The following decision (Decision No. 8516-(87/23)) was adopted:

1. The Fund takes this decision relating to Bangladesh's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1986 Article XIV consultation with Bangladesh, in the light of the 1986 Article IV consultation with Bangladesh conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Bangladesh maintains certain restrictions on payments and transfers for current international transactions and multiple currency practices as described in SM/87/26. The Fund welcomes the progress to date toward the simplification of the exchange system and the authorities' intention to eliminate the multiple currency practices arising from the dual exchange markets and margin requirements on import letters of credit, and encourages Bangladesh to take these actions as soon as possible. The Fund also encourages Bangladesh to eliminate the restrictive features of the bilateral payments arrangements with Fund members. In the meantime, the Fund grants approval for the maintenance by Bangladesh of the multiple currency practices until March 31, 1988, or the completion of the next Article IV consultation with Bangladesh, whichever is the earlier.

IX. Consultation Cycle

A consultation cycle of 12 months was specified in the Summing-Up of the 1986 Article IV consultation.

X. Technical Assistance

(a) Central Banking: In 1985 two technical assistance missions visited Bangladesh; the first mission, headed by Mr. Sundararajan reviewed bank regulations and monetary policy practices and a follow-up mission, headed by Ms. Lachman (LEG), advised the authorities on measures to strengthen bank supervision and establish a more efficient system of loan recovery; this included the preparation of draft loan recovery legislation. In November 1986 and May 1987, Mr. Lindgren participated in Bank-sponsored missions that conducted a comprehensive review of financial sector issues and is scheduled to visit Dhaka again in January 1988.

(b) Fiscal: Mr. Premchand visited Bangladesh in January 1985 to identify technical assistance requirements in the area of revenue forecasting. Messrs. Garnier and Wilson visited Bangladesh in March-April 1985 to suggest ways of improving revenue forecasting and tax administration management. Mr. Feeney, a member of the panel of fiscal experts, was stationed in Dhaka for four months to follow up on the implementation of the recommendations made by the earlier missions. Mr. Blondal visited Bangladesh in February 1986 to provide technical assistance in establishing a system to improve the monitoring of government expenditure. Mr. Shome and Mr. Williams (a member of the panel of fiscal experts) visited Bangladesh in May 1987 to provide assistance in the area of tax administration and to identify measures that will raise government revenues in the short run.

(c) Bureau of Statistics: A mission led by Mr. O'Connor visited Bangladesh in September-October 1985 to establish a new monetary data base and to determine areas where further technical assistance from the Fund would be desirable. Mr. Quin was in Bangladesh on a follow-up mission on monetary statistics in April 1986. Mr. Salgado visited Bangladesh in November 1985 to review statistics on prices, production, merchandise trade, external debt, and national accounts. During May-June 1986, Mr. Gschwindt de Gyor visited Bangladesh to assist in the compilation of data on the operations of nonfinancial public enterprises, and to review the compilation and classification of central government budgetary data. Mr. O'Connor is scheduled to visit Dhaka in November 1987 and January 1988 to assist the authorities to further refine monetary statistics.

XI. Resident Representative

The Resident Representative's office was established in Dhaka in 1972. Mr. Henri Ghesquiere was appointed Resident Representative in October 1986.

Relations with the IBRD and IDA

A. Role of the World Bank in Bangladesh

Cumulative World Bank commitments to Bangladesh total $3,948.3 million. This figure includes reactivation of 11 IDA credits ($151.41 million) made to Pakistan before 1971, a consolidation IBRD loan ($54.90 million), and a consolidation IDA credit ($37.45 million) approved in 1975 to cover liabilities arising from projects completed prior to independence. In addition, the Bank has approved 99 new IDA credits since Bangladesh became a member of IBRD and IDA in 1972. The country is currently the largest IDA-only recipient of IDA funds. Bangladesh became a member of IFC in 1976 and five investments have been approved to date.

In response to the urgent need for sustained transfer of substantial financial resources, the World Bank's assistance strategy for Bangladesh provides for a significant proportion of its lending (about 40 percent) to be in the form of quick-disbursing, policy-based lending. Also, IDA project financing continues to cover all foreign exchange costs and a significant portion of local currency expenditures. Until recently, such lending was in the form of program credits but the focus has now shifted to sector adjustment credits. In addition to providing foreign exchange and local counterpart financial support, these operations have been a useful vehicle for initiating and supporting sectoral and macroeconomic structural and policy reforms.

Since 1982, IDA has extended 13 Import Program Credits (IPCs) totaling $1,650 million. The scope and objectives of the IPCs have evolved in line with the needs of the country. After supporting critical post-independence rehabilitation needs, the emphasis changed to improving the efficiency of the jute and cotton textile industries; thereafter, the focus changed to export development and structural problems of the industrial sector as a whole and, subsequently, to increasing agricultural production and improving foodgrain distribution. In response to the country's severe macroeconomic difficulties, IPCs XI (1982/83) and XII (1983/84) addressed broader issues of effective resource utilization and appropriate levels of government expenditures along with initiatives in agriculture, trade, and industry. IDA has provided further support under IPC XIII to promote improvements in fiscal planning and budgetary management and development project administration, accelerate project implementation, and strengthen agricultural policies and institutions.

With respect to ongoing projects, IDA lending to agriculture (about one quarter of the total) focuses on increasing food production through the augmentation of essential inputs (irrigation equipment, fertilizer, and improved seeds), the development of drainage flood control infrastructure, extension services, research programs and rural cooperatives, the provision of credit, and the promotion of input and output pricing policies that would provide adequate incentives to farmers. In the future, more emphasis will be placed on agricultural diversification into areas such as fishing, livestock, and forestry production.

IDA's lending for industry (about 13 percent of total) seeks to help the Government: (a) increase efficiency in public sector enterprises; (b) reform trade, industrial, and financial policies; (c) strengthen existing financial institutions; (d) formulate export promotion programs; and (e) promote rural and small-scale industries. In addition to assistance under program credits and a recent industrial sector adjustment credit, IDA has financed projects to increase fertilizer production, rehabilitate the jute and textile industries, strengthen the development finance institutions, and promote small-scale industries. A financial sector credit is being prepared.

With an inadequate supply of energy constituting a major constraint to growth in Bangladesh, IDA's lending for power and gas investments (amounting to about 27 percent of lending) supports the use of natural gas as a substitute for imported oil, promotes conservation measures and more efficient energy use, and encourages further gas and oil exploration. Other projects support expansion of the country's rural electrification system and power generation and transmission capabilities. An energy sector credit is also planned for FY 88. In transport, IDA's lending (around 10 percent) has focused on the development of the inland water transport system. Future lending will also concentrate on maintaining and upgrading the existing road network.

In the social sectors, lending for primary education supports the national goals of achieving universal primary education and reducing illiteracy, expanding access to education, and upgrading its quality. In order to alleviate the severe and increasing pressures of Bangladesh's population on its scarce resources, IDA, together with other donors, is assisting the Government in implementing an accelerated family planning program. In response to Bangladesh's rapid urban population growth, future IDA lending will also help provide low-cost shelter and infrastructure services for the urban poor; IDA is already financing water supply and sanitation improvements in Chittagong and Dhaka. A more broad-based poverty alleviation credit is also under preparation.

IDA chairs the annual Bangladesh Aid Group meetings that provide a forum for aid donor consultation, and IDA's Resident Representative chairs regularly scheduled donor meetings in Dhaka to exchange views on policy issues, project implementation, and aid coordination. The most recent Aid Group meeting was held in Paris in April 1987.

Import Program Credit: The thirteenth import program credit for an amount of $200 million was approved on February 4, 1986, and became effective on March 27, 1986. The second tranche of $90.0 million was released in May 1987.

Sector Credit: An industrial sector credit for an amount of $190 million was approved on June 9, 1987.

Latest World Bank Economic Report: Bangladesh: Promoting Higher Growth and Human Development, March 10, 1987.

Aid Consultative Group: April 21-22, 1987 in Paris, France.

Table 1. Bangladesh: IBRD/IDA Lending Operations

(In millions of U.S. dollars; June 1987)

	Disbursed	Undisbursed
Completed projects and import program credits	1,874.84	--
IBRD	54.90	--
IDA	1,819.94	--
Projects in execution (all IDA)	491.88	1,557.47
Agriculture and rural development	178.40	323.15
Industry	7.68	267.50
Education	95.94	144.14
Population	5.46	90.75
Transportation	35.27	170.52
Telecommunications	15.26	23.21
Technical assistance	2.90	27.43
Power and gas	127.41	430.15
Water supply and urban	23.56	80.62
Import program credits	167.42	61.16
Total	659.30	1,618.63
Repayments	24.82	
Total debt outstanding 1/	4,127.95	
IFC investment	15.29	

1/ Includes undisbursed amounts.

Table 2. Bangladesh: Disbursements from and Debt Service Payments to World Bank, 1983-87

(In millions of U.S. dollars)

	1983	1984	1985	1986	1987 1/
IBRD (net)	--	--	-1.5	-1.5	-1.6
Disbursements	--	--	--	--	--
Amortization	--	--	1.5	1.5	1.6
IDA (net)	197.9	240.7	282.9	341.7	360.0
Disbursements	199.8	243.3	288.0	348.1	367.9
Amortization	1.9	2.6	5.1	6.4	7.9
Interest					
IBRD	4.9	3.1	2.3	3.5	3.2
IDA	8.0	13.1	17.3	21.6	24.0
Total	12.9	16.2	19.6	25.1	27.2

1/ Projected.

Social and Demographic Indicators

	Bangladesh	Low Income Reference Group
Area		
Total	144,000 sq. km.	
Agricultural	67.6 percent of total	
Population (1986)		
	103.1 million	
Rate of growth	2.5 percent per annum	2.1
Population characteristics (1980-86)		
Crude birth rate (per thousand)	40	29
Crude death rate (per thousand)	1.5	10
Life expectancy at birth (years)	51	60
Urban population (percent of total)	18	22
Access to safe water (1980-86)		
In percent of population		
Total	40	...
Urban	29	...
Rural	43	...
Nutrition (1980-86)		
Per capita supply of		
Calories (per day)	1,804	2,339
Proteins (grams per day)	36	55
Population density (1980-86)		
Per sq. km. of agricultural land	1,007	349
Health		
Population per physician (in thousands)	5.9	8.9
Population per hospital bed (in thousands)	3.6	1.1
Infant mortality rate (per thousand)	123	72
Education (1980-86)		
Enrollment rates (in percent)		
Primary	60	97
Secondary	14	32
Pupil-teacher ratio		
Primary	51	36
Secondary	22	18

Source: World Bank.