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CONFIDENTIAL

November 30, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Bangladesh - Structural Adjustment Facility - Second Annual
Arrangement

Attached for the records of the Executive Directors is the text of the second annual arrangement under the structural adjustment arrangement for Bangladesh agreed at Executive Board Meeting 87/159, November 23, 1987.

Att: (1)

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 (EBD/87/276, 10/27/87)
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 accommodate 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 14.7 percent. Recourse to bank credit by the public sector is programmed to increase by not more than 7.9 percent in order to accommodate the credit needs of the private sector, especially agriculture. To facilitate replanting in flood-affected areas, the Government permitted increased access to bank credit and rescheduled some agricultural loans; crop loans will become due in the second half of the current fiscal year and repayment of the rescheduled portions of term loans will be spread over installments falling due beginning in January 1988. However, in order to sustain the improvements in credit discipline realized in 1986/87, new crop loans will be extended only to borrowers in good standing and with valid passbooks. Despite the special circumstances created by the flood, the agricultural loan recovery program will be sustained and a loan recovery target of Tk 5.5 billion has been established for end-June 1988.

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

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

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

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

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

	<u>1987</u> <u>Dec.</u>	<u>1988</u> <u>March</u>	<u>June</u>
	<u>(In millions of taka; end of period)</u>		
Net domestic assets <u>2/</u>	154,290	157,440	160,822
Net domestic bank credit to the public sector <u>2/</u>	72,487	73,487	73,793
	<u>(In millions of U.S. dollars; end of period)</u>		
Contracting or guaranteeing of new nonconcessional public external debt			
Over 1 year and not more than 12 years <u>3/</u>	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
	<u>(In percent; 1987/88)</u>		
Ratio of the overall deficit in central government operations to GDP			7.9
Ratio of central government total revenue to GDP			9.1
	<u>(In billions of taka; 1987/88)</u>		
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 est.
(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) <u>2/</u>	45.56	49.65
Other <u>2/</u> <u>3/</u>	5.91	4.67
Overall budget deficit	42.74	47.65
Net foreign financing <u>4/</u>	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.

