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January 15, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Bangladesh - Staff Report for the 1986 Article IV Consultation, Second Review Under the Stand-By Arrangement, and Request for Arrangements Under the Structural Adjustment Facility

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Bangladesh, the second review under the stand-by arrangement for Bangladesh, and its request for arrangements under the structural adjustment facility (SAF). Draft decisions appear on pages 29 and 30.

This subject, together with Bangladesh's request for a purchase under the compensatory financing facility (EBS/87/8, 1/16/87), will be brought to the agenda for discussion on a date to be announced.

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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BANGLADESH

Staff Report for the 1986 Article IV Consultation, Second Review Under the Stand-By Arrangement, and Request for Arrangements Under the Structural Adjustment Facility

Prepared by the Asian and Exchange and Trade Relations Departments

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

Approved by P.R. Narvekar and Eduard Brau

January 14, 1987

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I. Introduction

A staff team visited Dhaka during November 14-December 3, 1986 to hold discussions for the 1986 Article IV consultation and the second review under the stand-by arrangement, and to conclude negotiations on the use of Fund resources under the structural adjustment facility (SAF). 1/ Discussions were held with Mr. M. Syeduzzaman, Minister of Finance; Mr. Nurul Islam, the Governor of Bangladesh Bank; Mr. Mustafizur Rahman, the Finance Secretary; and other senior officials. In the attached letter dated January 5, 1987, the Government of Bangladesh requests a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the SAF. The amount that will be available to Bangladesh under the SAF is currently projected at SDR 135.1 million, and the first loan thereunder is for SDR 57.5 million. The Government of Bangladesh is also expected to request a purchase under the compensatory financing facility equivalent to SDR 88.9 million in respect of an export shortfall in the year ended September 30, 1986.

On December 2, 1985, the Executive Board approved a 19-month stand-by arrangement for Bangladesh in an amount equivalent to SDR 180 million, equivalent to 62.6 percent of quota or to an annual access of 39.5 percent of quota (EBS/85/251, 11/12/85). The first review under this arrangement was completed on August 29, 1986 (EBS/86/176, 8/5/86, and Supplement 1). Bangladesh has observed all performance criteria through end-September 1986 (Table 1), and five drawings totaling SDR 132 million--all from the Fund's ordinary resources--have been made so far as scheduled (Table 2). The sixth and seventh drawings are conditional on meeting performance criteria for end-December 1986 and end-March 1987, respectively, and on the completion of this second review. The purpose of this second review is to assess performance under the program; all performance criteria for the remaining period of the stand-by arrangement were established at the time of the first review completed in August 1986.

In approving the current stand-by arrangement, the Executive Directors emphasized the structural weaknesses of the Bangladesh economy and stressed the need for the Bangladesh authorities to sustain the adjustment process in the coming years. Shortly after the establishment of the SAF, the authorities expressed interest in implementing a medium-term adjustment program to be supported by an SAF arrangement. Discussions, held jointly with the World Bank staff, on a policy framework paper (PFP) for the three-year period July 1986-June 1989 were initiated

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1/ The staff team consisted of Messrs. Al-Eyd (Head, ASD), De Zoysa (FAD), Villanueva, Banerjee (both ASD), and Felman (ETR), and Mrs. Martini (secretary, ASD); the staff team was assisted by Mr. H. Ghesquiere, the Fund's Resident Representative in Bangladesh. A World Bank staff team, headed by Mr. Holsen, participated in the joint discussions with the Bangladesh authorities on the policy framework paper.

Table 1. Bangladesh: Quantitative Performance Criteria and Actual Outturn Under the Stand-By Arrangement Through End-September 1986

	End-December 1985		End-March 1986		End-June 1986		End-September 1986	
	Program	Actual	Program	Actual	Program	Actual	Program	Actual
	(In millions of taka)							
Credit ceilings 1/								
Net domestic assets	114,600	114,136	116,100	113,555	121,270	121,242	124,600	121,810
Net credit to the Government	22,300	22,298	21,320	20,038	22,110	22,057	22,200	22,028
	(In millions of U.S. dollars)							
External debt ceilings								
External public debt 2/								
One to twelve years	100	--	100	5	100	5	100	--
Of which:								
One to five years	(75)	(--)	(75)	(--)	(75)	(--)	(80)	(--)
Outstanding external debt of less than one-year maturity	... 3/	30	... 3/	35	21	21	... 3/	31
Outstanding external liabilities of Bangladesh Bank of less than one-year maturity	120	119	120	118	120	118	80	78

Source: Data provided by the Bangladesh authorities.

1/ At constant exchange rates prevailing at end-June 1985.
2/ Contracting or guaranteeing of new nonconcessional external public debt.
3/ The ceiling is set for the end of the fiscal year only.

Table 2. Bangladesh: Fund Position During Period of the Stand-By Arrangement, 1985-87

	Outstanding Sept. 30, 1985	1985 Oct.-Dec.	1986 Jan.-Mar.	1986 April-June	1986 July-Sept.	1986 Oct.-Dec.	1987 (Proj.) Jan.-March	1987 (Proj.) April-June
	(In millions of SDRs)							
Transactions under tranche policies (net)		18.6	18.5	3.8	15.6	-1.9	9.9	-1.9
Purchases 1/		36.0	24.0	24.0	24.0 2/	24.0	24.0 2/	24.0
Repurchases		-17.4	-5.5	-20.2	-8.4	-25.9	-14.1	-25.9
Transactions under special facilities (net) 3/		-11.1	-11.1	-11.1	-11.1	-11.1	77.8	-6.5
Purchases		--	--	--	--	--	88.9	--
Repurchases		-11.1	-11.1	-11.1	-11.1	-11.1	-11.1	-6.5
Structural Adjustment Facility loans	--	--	--	--	--	--	57.5	--
Total Fund credit outstanding (end of period)	378.2	385.7	393.1	385.8	390.3	377.3	522.5	514.1
Under tranche policies	243.6	262.2	280.7	284.5	300.1	298.2	308.1	306.2
Under special facilities	134.6	123.5	112.4	101.3	90.2	79.1	156.9	150.4
Under Structural Adjustment Facility	--	--	--	--	--	--	57.5	57.5
	(In percent of quota; end of period)							
Total Fund credit outstanding	131.5	134.2	136.7	134.1	135.8	131.2	181.7	178.8
Under tranche policies	84.7	91.2	97.6	98.9	104.4	103.7	107.2	106.5
Under special facilities	46.8	43.0	39.1	35.2	31.4	27.5	54.5	52.3
Under Structural Adjustment Facility	--	--	--	--	--	--	20.0	20.0
Memorandum item:								
Trust Fund loans outstanding								
In millions of SDRs	90.1	87.8	78.0	75.6	65.8	63.4	53.6	51.3
As percent of quota	31.3	30.5	27.1	26.3	22.9	22.0	18.6	17.8

Source: International Monetary Fund.

1/ All under the Fund's ordinary resources.
2/ Subject to completion of review of policies with the Fund under the stand-by arrangement.
3/ Compensatory financing facility.

in April 1986. The review process, however, has been protracted as the authorities gave careful consideration to the PFP to ensure that the objectives and policies outlined therein were consistent with the national priorities established under the Third Five-Year Plan (1985/86-1989/90). Consequently, there has emerged a divergence of about seven months between the first annual SAF arrangement--now expected to commence in February 1987--and the first annual SAF program which coincides with fiscal year 1986/87. 1/ However, policy implementation has not suffered because the program for 1986/87 under the stand-by arrangement was formulated with a view to include the first annual program under the proposed SAF arrangement as well. The staff and the authorities consider it highly desirable that the annual SAF programs coincide with the fiscal year--the policymaking cycle in Bangladesh. Moreover, it would be desirable to avoid carrying over the divergence between the beginning dates of the first annual program and arrangement periods to the second and third SAF program years. However, minimizing such a discrepancy for the second year while retaining the fiscal year as a basis of the program implies a shorter than 12-month interval between the first two disbursements under the SAF. This, in turn, would require an amendment of the SAF regulations before Board consideration of the second annual program. Meanwhile, Executive Directors will have an opportunity to discuss this issue in the context of the forthcoming Board review of experience under the SAF in March 1987.

The proposed arrangements under the SAF are included in Attachment I, and the letter of transmittal from Bangladesh's Minister of Finance, the PFP, and the Memorandum on Economic and Financial Policies which the Government of Bangladesh intends to implement during the period of the SAF arrangement are included in Attachment II. Summaries of Bangladesh's relations with the Fund and the World Bank are presented in Attachments III and IV, respectively, and a note on statistical issues is included in Attachment V.

Bangladesh is on the standard 12-month consultation cycle. It continues to avail itself of the transitional arrangements of Article XIV.

II. Background and Recent Economic Performance

1. Background

In 1984/85, heavy floods caused large losses to agricultural production and adversely affected the rest of the economy. Real output growth slowed, the rate of inflation rose, and the external current account deficit widened because of emergency food imports and a large drop in workers' remittances. The overall balance of payments shifted to a deficit and gross international reserves declined significantly. A slippage in policy stance in the first half of the year, which permitted

1/ The fiscal year commences July 1.

excessive monetary expansion and a substantial loss in external competitiveness, also contributed to the deterioration in economic performance.

In the latter half of 1984/85, the Government initiated action to restrain expenditure, tighten credit, and restore international competitiveness. These corrective measures laid the groundwork for the comprehensive adjustment program covering the two-year period 1985/86-1986/87. The program, which is being supported by a 19-month stand-by arrangement from the Fund, stresses both demand management and structural adjustment policies.

2. Performance during 1985/86

Economic performance in 1985/86 was broadly satisfactory and in line with that envisaged under the program (Table 3 and Chart 1). Real GDP grew by 3.9 percent, slightly less than the program target and the previous year's rate of 4.1 percent. The marginal slowdown in economic activity largely reflected a deceleration in industrial growth on account of an absolute decline in production of jute goods and cotton textiles. Despite the stagnation in foodgrain production, agricultural growth was boosted by a sharp increase in raw jute output in response to high prices in the previous year. The rate of inflation for the year declined to 9.8 percent, well below the program target of 12 percent, reflecting the slower pace of domestic consumption and investment demand, and a moderate increase in import prices.

The 1985/86 overall government budget deficit of 7.3 percent of GDP--a slight decline from the deficit of 7.6 percent of GDP in 1984/85--was in accordance with the program target. However, both total revenue and total expenditure fell short of levels anticipated in the program. The slippage in total revenue of Tk 1.4 billion (0.4 percent of GDP) reflected lower collections from customs duties, and from sales and excise taxes. The smaller-than-programmed revenue from foreign trade-related taxes (customs duties and sales taxes) was due in part to lower imports and a lower average nominal exchange rate of the taka than assumed under the program, while the shortfall in excise duties was due principally to collection problems associated with the inability of the Power Development Board and the Bangladesh Chemical Industries Corporation (the two major consumers of natural gas) to settle their accounts with the Bangladesh Oil and Gas Corporation. The lower level of expenditure occurred on account of shortfalls in the Annual Development Program and in food operations; the latter reflected fewer imports and lower government procurement of foodgrains. These shortfalls were partly offset by current expenditure overruns on account of higher-than-expected losses incurred by the Railway and the Post Office, as well as heavier debt service payments.

Monetary developments during 1985/86 were broadly in line with the program. The expansion in net domestic assets of the banking system decelerated sharply from 27.9 percent in 1984/85 to 15.1 percent, reflecting the fall in net credit to the Government and a substantial

Table 3. Bangladesh: Selected Economic and Financial Indicators, 1983/84-1986/87

	1983/84	1984/85	1985/86 Program 1/	1985/86 Prelim. Actual	1986/87 Program 1/	1986/87 Estimate
	(Annual percentage changes; unless otherwise specified)					
National income and prices						
GDP at constant market prices	4.3	4.1	4.1	3.9	4.8	4.7
Implicit GDP deflator	16.3	14.9	10.2	7.3	8.5	8.0
Consumer prices	9.7	11.0	12.0	9.8	8.5	8.9
External sector (in terms of U.S. dollars)						
Exports, f.o.b.	18.1	15.1	0.9	-12.3	11.3	13.4
Imports, c.i.f.	4.8	12.5	-6.6	-10.7	4.6	7.3
Export volume	1.4	-6.7	24.2	15.7	9.1	12.6
Import volume	5.8	18.2	-4.7	-12.3	1.7	8.8
Terms of trade	18.1	25.9	-17.2	-22.0	-0.8	1.5
Real effective exchange rate 2/	8.7	-2.5	...	-11.9	...	...
Government budget						
Revenue	12.6	25.6	22.1	17.7	20.5	18.9
Tax	12.4	21.8	25.0	14.2	24.6	24.7
Nontax	13.4	44.1	10.5	31.7	6.2	-1.4
Total expenditure	4.9	11.5	11.7	12.9	14.4	15.3
Current expenditure	20.0	20.3	17.0	24.7	11.6	11.5
Annual Development Program	1.0	3.7	13.6	16.6	15.8	16.5
Money and credit						
Net domestic assets	31.0	27.9	15.1	15.1	15.0	15.0
Domestic credit	30.9	26.2	15.1	16.6	13.6	13.6
Government (net)	21.5	-2.8	-5.5	-5.8	2.5	2.5
Other public sector	3.6	26.5	22.3	23.0	18.3	18.3
Private sector	58.7	40.2	18.7	21.3	14.3	14.3
Broad money	42.2	25.6	15.9	17.1	15.7	15.0
Income velocity (GDP/M2)	-14.7	-4.7	-1.0	-4.8	-1.8	-1.7
Interest rate (end of period, 1-2 year time deposits)	14.0	14.0	...	14.0	...	...
	(In percent of GDP; unless otherwise specified)					
External sector						
Current account balance	-6.8	-8.2	-7.3	-6.9	-6.6	-6.7
External public debt (end of period) 3/	39.7	37.6	45.4	44.3	41.6	43.6
Debt service (percent of exports of goods and services and private transfers)	16.3	24.4	23.7	28.1	30.2	30.4
Excluding IMF	12.4	18.6	16.4	20.1	21.1	21.0
Government budget						
Revenue	8.2	8.6	9.5	9.1	9.5	9.5
Expenditure	17.3	16.1	16.8	16.4	16.8	16.7
Overall balance	-9.2	-7.6	-7.3	-7.3	-7.2	-7.1
Domestic bank financing (net)	1.2	-0.2	-0.3	-0.3	0.1	0.1
Foreign financing (net)	8.0	6.8	7.0	6.7	6.6	6.6
GDP (in billions of taka)	349.9	418.7	459.6	466.8	532.7	527.9
	(In millions of U.S. dollars; unless otherwise specified)					
External sector						
Current account balance	-948	-1,315	-1,090	-1,084	-1,132	-1,146
Overall balance	218	-59	30	77	40	12
Gross official reserves (end of period)	539	395	422	476	449	602
In months of merchandise imports	(2.7)	(1.8)	(2.1)	(2.4)	(2.1)	(2.9)

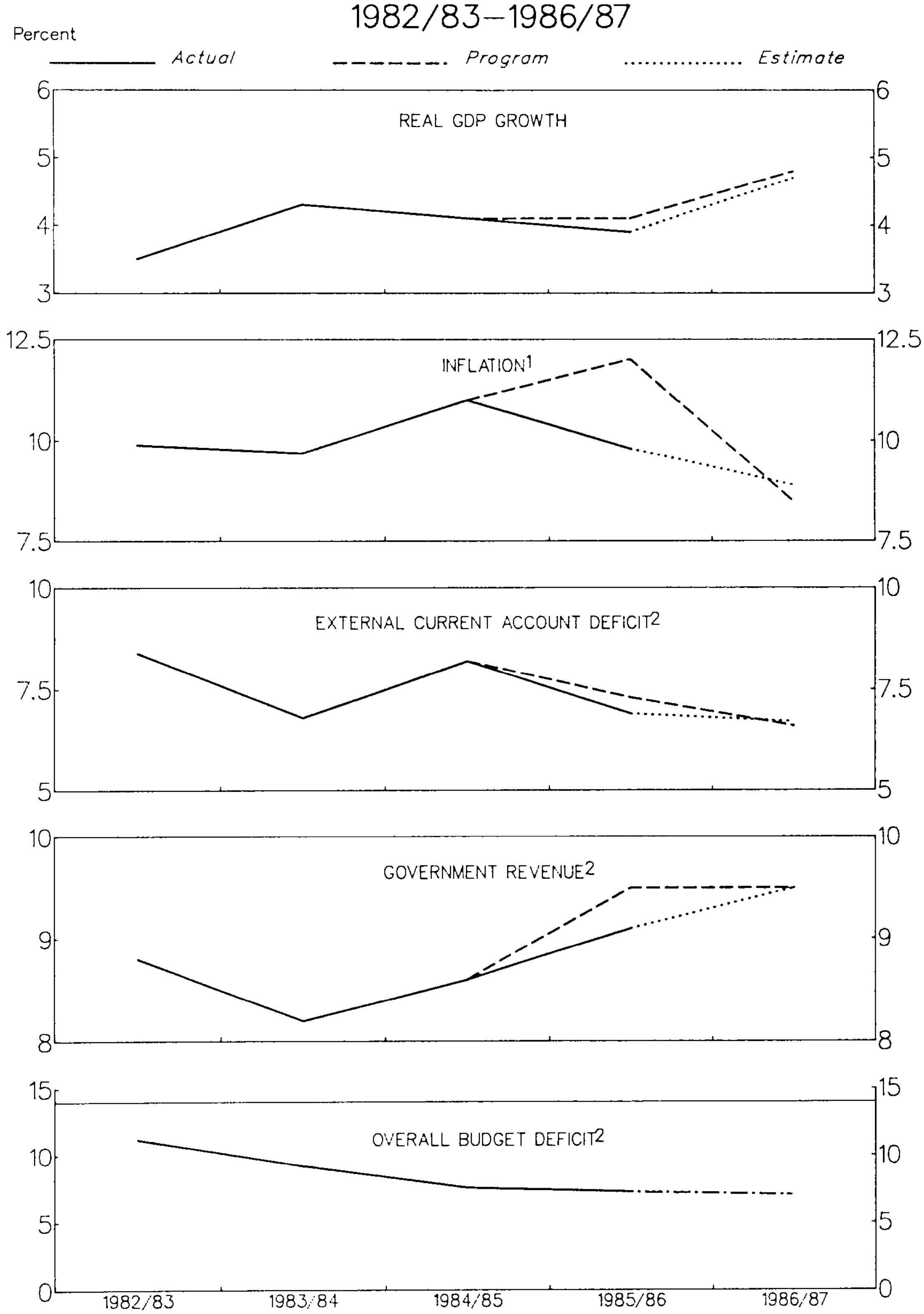
Sources: Data provided by the Bangladesh authorities; and staff projections.

1/ The program figures for 1985/86 and 1986/87 were based on earlier estimates.
2/ End of period. Negative sign indicates a real effective depreciation of the exchange rate.
3/ Includes use of Fund credit (including SAF loans) and short-term debt.

CHART 1

BANGLADESH

DEVELOPMENTS IN SELECTED ECONOMIC INDICATORS, 1982/83–1986/87



Sources: Data provided by the Bangladesh authorities; and staff estimates.
1 Based on the CPI for middle-income families in Dhaka (1973/74 = 100).
2 In percent of GDP.

slowdown in the growth of other credit components. Although the growth of private sector credit was halved to 21.3 percent, it was somewhat higher than programmed owing to a larger-than-anticipated capitalization of accrued interest on overdue loans. 1/ With a stronger balance of payments outturn, broad money increased by 17.1 percent, slightly exceeding the program target of 15.9 percent, but remaining substantially below the previous year's rate of 25.6 percent. Interest rates were maintained at their June 1985 levels, except for certain lending rates which were reduced to provide incentives to exports and industrial investment. However, with the decline in inflation, most interest rates remained positive in real terms.

The efficiency of financial intermediation was adversely affected as the rate of loan recovery was below expectations. The rate of recovery on agricultural loans--defined as cash collections during the period as a percent of arrears plus amounts falling due during the period--fell further from 38 percent in 1984/85 to 27 percent in 1985/86, far below the target rate of 50 percent. The disappointing performance in this area was attributable to a number of important factors, including the collapse of jute prices, which reduced farmers' income, and, more significantly, the slippage in the implementation of loan recovery measures introduced under the stand-by arrangement.

The improvement in the balance of payments was significant. The current account deficit declined from 8.2 percent of GDP in 1984/85 to 6.9 percent of GDP, compared with a program target of 7.3 percent. The favorable outturn reflected lower food imports and higher workers' remittances; the latter development partly reflected the impact of the depreciation of the taka. Export earnings, however, fell sharply, contrary to expectations, owing to the steep decline in jute prices, a decline in the export volume of jute goods, and a smaller-than-envisaged increase in the volume of nontraditional exports. The overall balance of payments moved into a surplus of $77 million, more than twice the programmed level; gross international reserves rose to the equivalent of 2.4 months of merchandise imports and exceeded the program target by $50 million. Staff calculations show that the debt service ratio increased by about 4 percentage points to 28 percent of current receipts; the ratio was higher than programmed because of the shortfall in export earnings and early repayments of commercial food credits.

During 1985/86, the official exchange rate of the taka vis-a-vis the U.S. dollar was adjusted frequently, in small steps. These adjustments, coupled with the weakening of the U.S. dollar vis-a-vis other major currencies, resulted in a 20 percent depreciation in the nominal effective exchange rate of the taka (Chart 2). In real effective terms, the taka depreciated by 12 percent during the fiscal year, despite a 4 percent appreciation during the last quarter. The adjustments in the

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1/ This increase in outstanding credit was offset by a contra entry in bank income, reflected in a larger-than-projected decline in "net other items."

official exchange rate helped reduce the premium of the secondary market rate over the official rate from 15 percent in June 1985 to 9.5 percent in June 1986. More important, there was a substantial expansion in the volume of trade transacted through the relatively free secondary market. The share of the secondary market in total exports almost doubled to about 53 percent, while its share in total imports increased slightly to about 28 percent. These measures led to a small surplus in the secondary market which was absorbed by Bangladesh Bank to prevent an appreciation of the secondary rate.

3. Developments and prospects in 1986/87

The program for 1986/87 was designed to consolidate the gains achieved in 1985/86 and strengthen the structural adjustment measures. The main objectives were to achieve a real GDP growth of 4.8 percent while reducing the rate of inflation further to 8.5 percent. The target for the external current account deficit was set at 6.6 percent of GDP and the overall balance was expected to record a surplus of $40 million, which would allow gross reserves to cover slightly more than two months of merchandise imports. Fiscal policy was aimed at further reducing the overall budget deficit to 7.2 percent of GDP, most of which was to be financed from external sources. Government recourse to domestic bank credit was envisaged to be less than 0.1 percent of GDP.

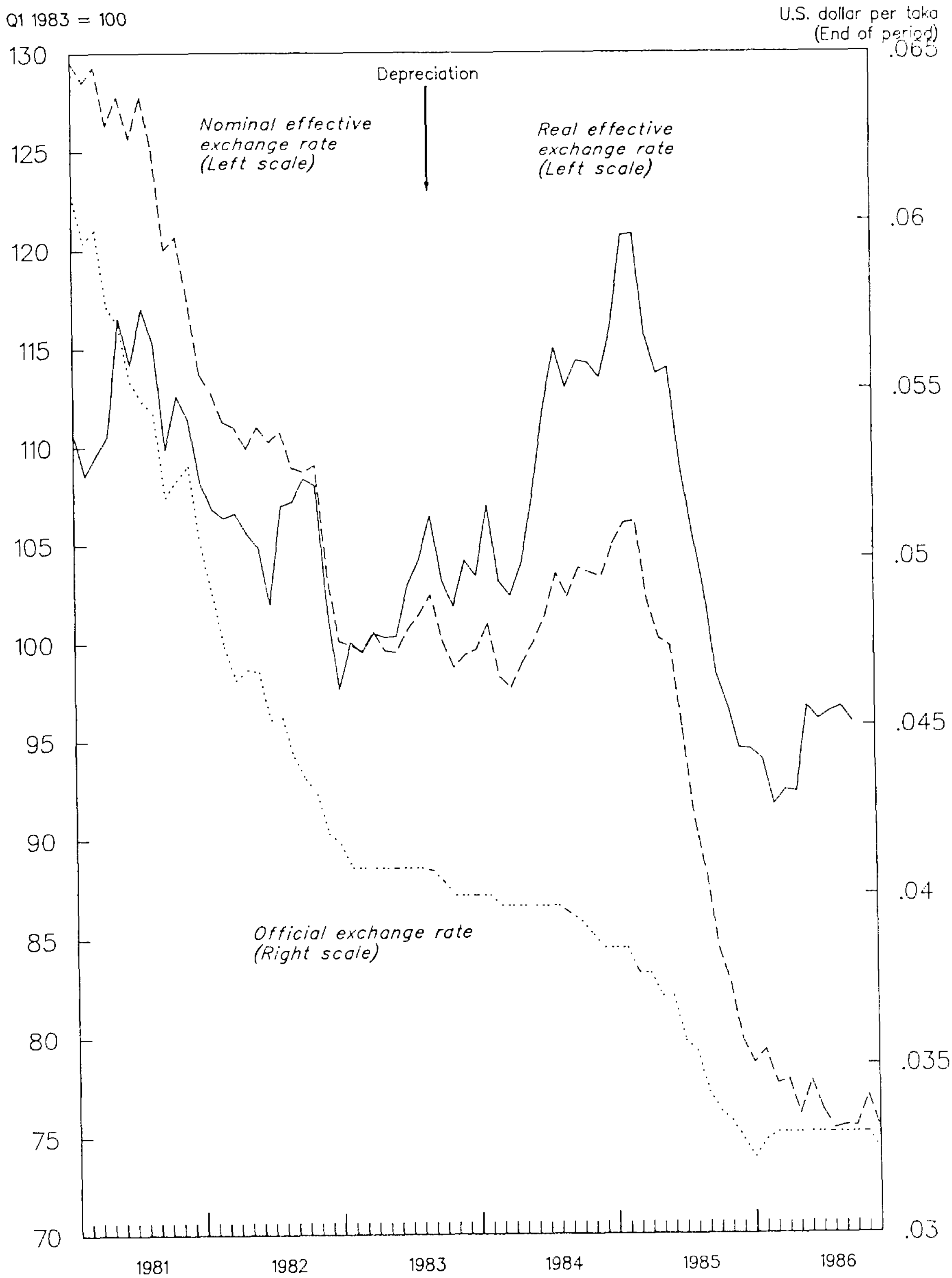
Developments in the first four months of the fiscal year suggest that real GDP growth is likely to be close to the program target, stimulated mainly by increased activity in the industrial and construction sectors. Agricultural growth is expected to slow marginally as raw jute output returns to its normal annual level of about 5 million bales from a record high of 7.6 million bales in 1985/86. In recent months, the rate of inflation has increased to over 12 percent, reflecting sharply higher food prices following temporary shortages of agricultural products caused by unseasonal rainfall and transportation bottlenecks. Although this trend is expected to be reversed in the coming months, the average rate of inflation for 1986/87 is now estimated by the staff at 8.9 percent, slightly higher than the program target.

The overall budget deficit is expected to decline to 7.1 percent of GDP, slightly below the program target (Table 4). Total revenue, though on target as a ratio to GDP, is expected to fall slightly short of the program target in absolute terms on account of a shortfall in nontax revenue, reflecting the poor performance of nonfinancial public enterprises. However, indications are that tax revenue for the year will be higher than programmed. More dutiable imports and improved measures to counter tax evasion are likely to result in a better-than-anticipated outturn for customs duties and income and profits taxes. Total expenditure is also likely to be below the program level. Current expenditure is expected to exceed the programmed level by Tk 1 billion (0.2 percent of GDP), owing to underbudgeting of the loss on railway operations and

CHART 2

BANGLADESH

EXCHANGE RATE DEVELOPMENTS, 1981–86



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

Table 4. Bangladesh: Central Government Operations, 1983/84-1986/87

	1983/84	1984/85	1985/86 Program 1/	1985/86 Prov. Actual	1986/87 Program 1/	1986/87 Estimate
			(In billions of taka)			
Total revenue	28.60	35.93	43.66	42.28	50.69	50.28
Tax	23.70	28.87	35.87	32.98	40.74	41.11
Nontax	4.90	7.06	7.79	9.30	9.95	9.17
Total expenditure	60.65	67.62	77.21	76.37	89.20	88.04
Current expenditure	23.03	27.71	32.03	34.56	37.66	38.52
Food account deficit	3.80	4.26	3.78	1.68	2.80	1.83
Of which: foodstock change	(0.27)	(1.96)	(--)	(0.27)	(1.59)	(0.52)
Annual Development Program (ADP)	30.11	31.23	37.36	36.41	44.25	42.43
Other capital expenditure and net lending 2/	3.71	4.42	4.04	3.72	4.49	5.26
Overall budget deficit	32.05	31.69	33.55	34.09	38.51	37.76
Excluding foodgrain stocking	31.78	29.73	33.55	33.82	36.92	37.24
Net foreign financing 3/	27.87	28.67	32.38	31.50	35.39	34.75
Project aid	13.31	14.40	18.52	20.17	23.31	23.90
Commodity aid	9.63	9.62	11.50	11.64	12.47	10.32
Food aid	6.97	4.92	6.55	4.99	6.52	7.44
Commercial food borrowing	-0.41	2.56	-1.50	-2.28	-3.46	-3.46
Debt amortization	-1.63	-2.83	-2.69	-3.02	-3.45	-3.45
Net domestic financing	4.18	3.02	1.17	2.59	3.12	3.01
Banking system	4.27	-0.66	-1.30	-1.35	0.50	0.54
Other	-0.09	3.68	2.47	3.94	2.62	2.47
			(Annual percentage change)			
Total revenue	12.6	25.6	22.1	17.7	20.5	18.9
Total expenditure	4.9	11.5	11.7	12.9	14.4	15.3
Current expenditure	20.0	20.3	17.0	24.7	11.6	11.5
ADP	1.0	3.7	13.6	16.6	15.8	16.5
			(In percent of GDP)			
Total revenue	8.2	8.6	9.5	9.1	9.5	9.5
Tax revenue	6.8	6.9	7.8	7.1	7.7	7.8
Nontax revenue	1.4	1.7	1.7	2.0	1.9	1.7
Total expenditure	17.3	16.1	16.8	16.4	16.8	16.7
Current expenditure	6.6	6.6	7.0	7.4	7.1	7.3
ADP	8.6	7.5	8.1	7.8	8.3	8.0
Overall budget deficit	-9.2	-7.6	-7.3	-7.3	-7.2	-7.1
Excluding foodgrain stocking	-9.1	-7.1	-7.3	-7.2	-6.9	-7.0

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

1/ The program figures for 1985/86 and 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.

supplementary provisions for education and health services. However, this increase will be more than offset by an estimated smaller food account deficit and a shortfall in planned development expenditure. The latter is, nevertheless, forecast to grow by 16 percent, the same rate as in 1985/86.

The monetary objectives of the program are likely to be achieved; the quarterly credit ceilings set for end-September were met and the ceilings set for the remainder of the program period are likely to be observed. During the four-month period through end-October 1986, broad money hardly increased and net domestic assets of the banking system rose by only 1.9 percent. 1/ For 1986/87 as a whole, with a smaller increase in net foreign assets than originally envisaged, the rate of growth of broad money is expected to decelerate further to 15 percent, compared with a program target of 15.7 percent. Net domestic assets are expected to increase by 15 percent and net credit to the Government to grow by 2.5 percent, both as programmed (Table 5).

The balance of payments outturn in 1986/87 is likely to be somewhat weaker than originally envisaged. Preliminary data for the first quarter show that while nontraditional exports were significantly higher than in the corresponding period in 1985/86, as originally expected, receipts from exports of raw jute and jute goods were markedly lower than anticipated, owing to depressed international prices. As jute prices are expected to remain weak during the remainder of the fiscal year, total exports in 1986/87 are forecast to fall short of the program target by some $70 million. The deficit in the services account is also likely to be higher, reflecting substantially lower interest receipts and higher nonfactor service payments. These shortfalls are expected to be partly offset by significantly higher-than-expected workers' remittances; data for the first quarter suggest that inflows for the year will be close to the level achieved in 1985/86. The current account deficit is forecast to be slightly higher both in absolute terms and relative to GDP (Table 6). Because net inflows of nonmonetary capital are also estimated to be lower than originally envisaged, owing to a shortfall in commodity aid, the overall balance of payments surplus is expected to be only $12 million. However, taking into account the anticipated use of Fund resources under the SAF and the CFF, gross reserves are likely to be equivalent to 2.9 months of merchandise imports, considerably higher than programmed. The debt service ratio is estimated to increase by 2 percentage points to 30 percent of current receipts, owing to higher repayments of medium-term food credits and Fund repurchases.

During July-October 1986, the official exchange rate of the taka appreciated by about 4 percent in real effective terms, reflecting the recent rise in the rate of inflation in Bangladesh. However, despite the recent appreciation, the real effective rate remains below its reference level in the first quarter of 1983. The authorities remain

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1/ At constant June 30, 1985 exchange rates.

Table 5. Bangladesh: Monetary Survey, 1983/84-1986/87

	1983/84	1984/85	1985/86 1/		1986/87 1/	
			Program	Actual	Program 2/	Estimate 3/
	(In millions of taka; end-June)					
Net foreign assets	1,472	-25	810	2,139	3,280	2,475
Net domestic assets 4/	82,387	105,367	121,270	121,242	139,440	139,440
Domestic credit	98,735	124,609	143,410	145,347	165,100	165,100
Public sector	49,590	55,702	61,620	61,785	69,600	69,600
Government (net) 4/	(24,070)	(23,408)	(22,110)	(22,057)	(22,600)	(22,600)
Other public sector	(25,520)	(32,294)	(39,510)	(39,728)	(47,000)	(47,000)
Private sector	49,145	68,907	81,790	83,562	95,500	95,500
Other items (net)	-16,348	-19,242	-22,140	-24,105	-25,660	-25,660
Broad money	83,859	105,342	122,080	123,381	142,720	141,915
	(Annual percentage change)					
Net domestic assets	31.0	27.9	15.1	15.1	15.0	15.0
Domestic credit	30.9	26.2	15.1	16.6	13.6	13.6
Public sector	11.6	12.3	10.6	10.9	12.6	12.6
Government (net)	(21.5)	(-2.8)	(-5.5)	(-5.8)	(2.5)	(2.5)
Other public sector	(3.6)	(26.5)	(22.3)	(23.0)	(18.3)	(18.3)
Private sector	58.7	40.2	18.7	21.3	14.3	14.3
Broad money	42.2	25.6	15.9	17.1	15.7	15.0

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

1/ At constant June 30, 1985 exchange rates.
2/ Based on a projected balance of payments surplus of $40 million.
3/ Based on a projected balance of payments surplus of $12 million.
4/ Subject to ceilings under the stand-by arrangement and benchmarks under the SAF.

Table 6. Bangladesh: Balance of Payments, 1983/84-1986/87

(In millions of U.S. dollars)

	1983/84	1984/85	1985/86		1986/87	
			Program	Prov.	Program	Estimate
Trade balance	-1,542	-1,713	-1,520	-1,545	-1,550	-1,607
Exports, f.o.b.	811	934	940	819	1,002	929
Imports, c.i.f.	-2,353	-2,647	-2,460	-2,364	-2,552	-2,536
Services (net)	-33	-78	-94	-125	-82	-117
Private transfers	627	477	524	586	500	578
Of which: Workers' remittances	(602)	(441)	(504)	(555)	(480)	(550)
Current account	-948	-1,315	-1,090	-1,084	-1,132	-1,146
Nonmonetary capital movements (net)	1,222	1,213	1,120	1,097	1,172	1,158
Aid disbursements	1,268	1,267	1,292	1,306	1,431	1,400
Amortization payments	-72	-110	-91	-117	-135	-135
Trust Fund (net)	-8	-13	-25	-25	-27	-27
Other capital (net)	34	69	-56	-67	-97	-80
Errors and omissions (net)	-56	43	--	64	--	--
Overall balance	218	-59	30	77	40	12
Financing items	-218	59	-30	-77	-40	-12
Fund credit (net)	20	-6	-3	-3	-21	154 1/
Other	-238	65	-27	-74	-19	-166
Memorandum items:						
Current account deficit						
In percent of GDP	(-6.8)	(-8.2)	(-7.3)	(-6.9)	(-6.6)	(-6.7)
Gross reserves	539	395	422	476	449	602
In months of merchandise imports	(2.7)	(1.8)	(2.1)	(2.4)	(2.1)	(2.9)
Debt service as percent of exports of goods and services and private transfers	16.3	24.4	23.7	28.1	30.2	30.4

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

1/ Includes SAF loan of about $70 million and CFF purchase of about $107 million.

committed to preventing an appreciation of the taka above this base level. Moreover, they have made further progress toward the unification of the exchange markets. In November 1986, the official exchange rate of the taka was depreciated by 1.6 percent vis-a-vis the U.S. dollar, thus narrowing the differential with the rate in the secondary market from 9.2 percent to 7.5 percent. In July 1986, the scope of the secondary exchange market was enlarged substantially, raising the share of export transactions conducted in this market to 73 percent of total exports, and the share of import transactions to 42 percent of total imports.

III. Report on the Discussions

The staff team reviewed with the authorities recent economic and financial developments and held detailed discussions on the structural weaknesses of the Bangladesh economy identified by the Executive Directors on the occasion of the last Article IV consultation in December 1985, and also during the first stand-by review last August. The topics covered included mobilization of public sector resources, jute sector issues, financial sector issues, and liberalization of trade and industrial policies.

1. Mobilization of public sector resources

The mission stated that government revenue is relatively modest in terms of GDP, owing to the high dependence on trade-related taxes, administrative deficiencies in tax collection, and the continued deterioration in the financial position of nonfinancial public enterprises (NPEs). The authorities agreed with this assessment and reiterated their determination to address these issues. They pointed out that measures were introduced with the 1986/87 budget to increase government revenue and further enhance the mobilization of domestic resources. In the medium term, significant tax reforms are expected based on the findings of the comprehensive review of tax policy and administration currently under way with technical assistance from the Fund and the World Bank.

The staff team welcomed the intention of the authorities to reform the tax system and stressed, in particular, the importance of measures to mobilize resources in the short term. In this connection, the authorities were urged to improve tax collection, phase out food subsidies except for vulnerable groups, and adjust the prices of other publicly provided goods and services to gradually eliminate hidden subsidies. The authorities indicated that measures to counter tax evasion are being implemented and pointed out that the unit subsidy, as well as the total budget subsidy for food, will be further reduced in the current fiscal year. The modalities of eventually eliminating the food subsidy are being examined by an interministerial committee whose recommendations will soon be made available. Furthermore, the feasibility of adjusting fees and charges to reduce hidden subsidies for other goods and services is also being considered.

Although the potential contribution of the NPEs to the resource mobilization effort is quite large, their actual contribution has been minimal owing to the rapid deterioration in their financial performance. Staff calculations show that the consolidated net income of the ten largest NPEs declined from Tk 3.2 billion in 1983/84 to Tk 0.5 billion in 1985/86, and, consequently, the rate of return on their assets declined from 3 percent to a negligible figure over this period. A modest rate of return of the order of 5 percent on the assets of these NPEs would generate some Tk 6.0 billion, equivalent to 1.3 percent of GDP, in additional public savings.

The poor financial performance of the NPEs has increased the pressure on budgetary resources as it led to a sharp rise in the demand for loans or equity injection by the Government and to the emergence of arrears in tax payments and in the transfer of dividends and contributions by some NPEs. The financial problems of the NPEs are also manifested in the delays in settlement of due accounts among themselves and in increased recourse to borrowing from the domestic banking system. The mission urged the authorities to give high priority to clearing arrears, in particular by stepping up collections from commercial and private users of electricity. They were also urged to reform public pricing policies and take measures to improve efficiency and increase productivity. In this connection, the need for the timely availability of reliable statistics for budgetary control and analysis, greater accountability, and more autonomy in decision making were stressed. The authorities stated that short- and medium-term policies to rehabilitate public enterprises--including measures to reduce excessive lags in settlement of accounts due--are being formulated in consultation with the World Bank and with assistance from the United Nations Development Program.

2. The jute sector

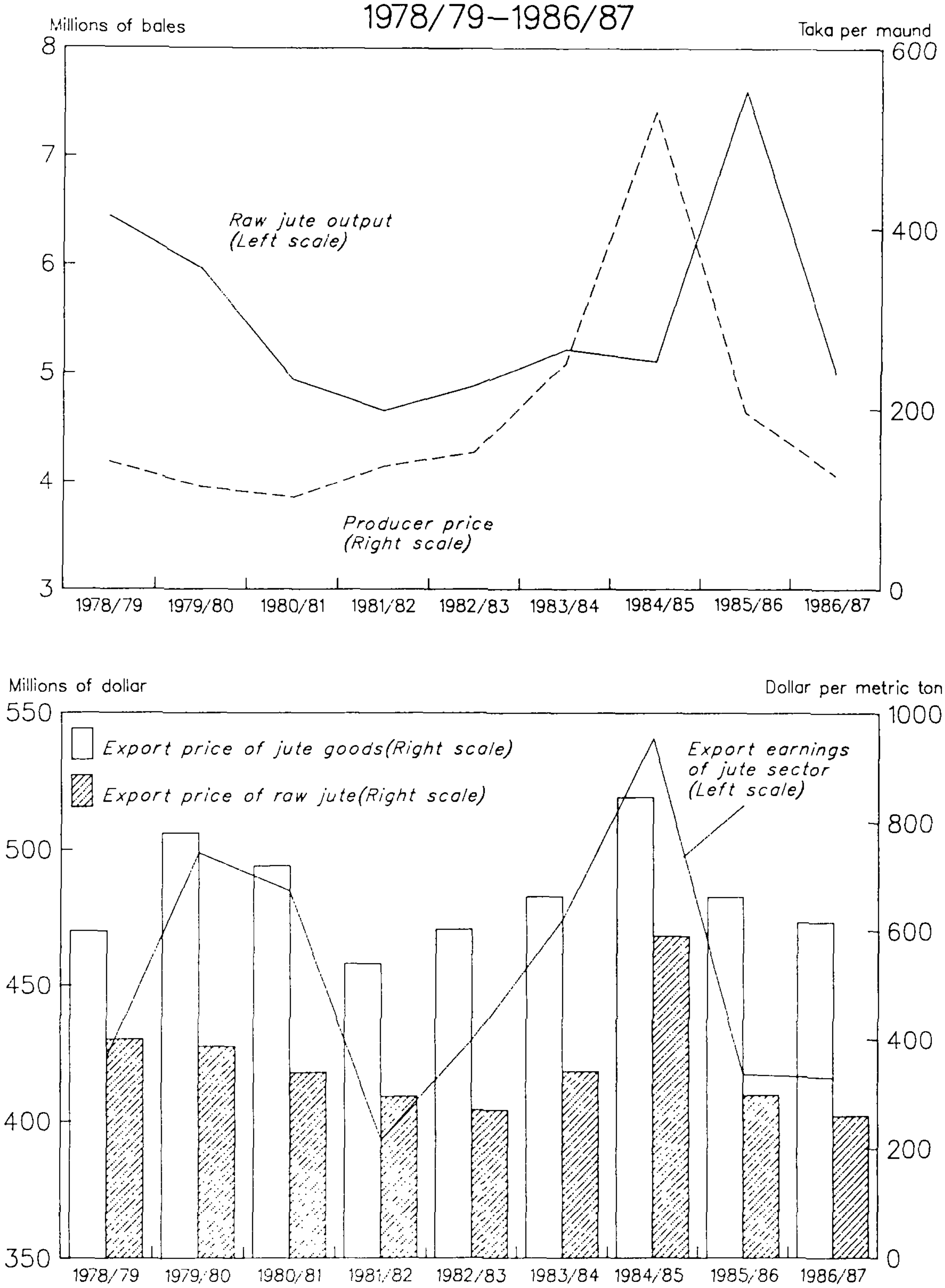
Recent developments in the jute sector are a major cause of concern to the authorities. The past two years have witnessed a spectacular collapse of jute prices as the average producer price fell from Tk 530 per maund 1/ in 1984/85 to Tk 200 per maund in 1985/86 and to Tk 128 per maund during the first four months of the current fiscal year (Chart 3). The drop in producers' prices has been accompanied by a sharp fall in export prices of raw jute, which declined from $590 per metric ton in 1984/85 to the current level of about $200 per metric ton. These developments are manifestations of the cyclical instability of the jute market. A relatively good harvest in 1986/87 following the bumper crop in 1985/86 added to the already high level of stocks and exacerbated the downward pressure on prices.

1/ One bale is equivalent to 4.86 maunds and one metric ton is equivalent to 26.79 maunds.

CHART 3

BANGLADESH

DEVELOPMENTS IN THE JUTE SECTOR, 1978/79–1986/87



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

During the 1985/86 season, the Government instructed the Bangladesh Jute Corporation (BJC) to maintain a floor price for growers (Tk 200 per maund). The BJC purchased about 2.4 million bales and its stocks at the end of that year stood at 1.9 million bales, consisting mostly of low quality jute not suitable for export. The entire operation put a considerable financial burden on the BJC and, consequently, its outstanding bank borrowing at end-1985/86 amounted to Tk 3.4 billion, compared with Tk 0.6 billion in the previous year. For 1986/87, the Government has discontinued its price support policy, and although insufficient storage facilities and financial difficulties have forced the BJC to scale down its procurement program, actual purchases so far have exceeded the annual target by a wide margin because private sector jute traders have remained inactive.

The jute mills sustained heavy losses in both 1984/85 and 1985/86. The losses of the government-owned Bangladesh Jute Mills Corporation amounted to Tk 1.43 billion in 1984/85 and Tk 1.58 billion in 1985/86. Virtually all of the 1985/86 losses were financed by interest-free medium-term loans; the Government will assume the cost of this interest subsidy. The 1984/85 losses were caused by the sharp rise in the price of raw jute and the substantial decline in the export volume of jute goods. The sharp decline in export prices and a further decline in the export volume account for the 1985/86 losses. In that year, the financial difficulties of the jute mill sector were compounded by heavy carrying charges associated with the large accumulation of stocks and by the minimum procurement price established by the BJC.

The authorities indicated that their major policy objective is to reduce the price and supply instability in the jute sector. To this end, the World Bank undertook a comprehensive study of jute sector issues. This study, which was completed in June 1986, is currently under review by the authorities. The study recommends timely dissemination of information to growers, traders, and mills; improved and enlarged private storage facilities; a limited buffer stock operation by the Government; and rationalization of the operations of government-owned mills. The mission encouraged the authorities to complete the review and take appropriate action. In particular, the need to rationalize the existing capacity, to grant operational autonomy to the jute mills, and to encourage them to operate on a commercial basis was stressed. The staff team also emphasized that subsidies extended to the jute sector should be viewed as temporary measures, while the structural weaknesses of the sector are addressed.

3. Financial sector issues

a. Loan recovery

Agricultural and industrial overdue loans have grown rapidly in recent years. Overdues in agriculture increased from Tk 4.6 billion in 1982/83 to Tk 17.2 billion in 1985/86. Over the same period, overdues on industrial loans extended by the two development finance institutions

(DFIs) rose from Tk 3.5 billion to Tk 9.2 billion. In total, these nonperforming loans accounted for 18.2 percent of total domestic bank credit outstanding on June 30, 1986. The rapid increase in overdue loans has been caused by expansionary credit policies and low loan recovery. Credit, particularly to the agricultural sector, expanded rapidly during the first half of the decade in line with the Government's policy to stimulate the growth of priority sectors. The sharp increase in lending was facilitated by the liberal refinancing policies of Bangladesh Bank and the availability of external loans. However, beginning in 1985/86, Bangladesh Bank refinancing of agricultural credit was linked to loan recovery and aid donors began to withhold new commitments from the two DFIs. These actions led to a sharp decline in loan disbursements by the financial institutions. 1/

The rapid rise in disbursements was accompanied by a steady decline in collection rates. In 1985/86, loan recovery rates deteriorated sharply to only 27 percent for agricultural loans and 8 percent for industrial loans held by the two DFIs. The loan recovery problem was exacerbated by poorly staffed financial institutions and managerial and accounting practices that have, in effect, masked the implications of nonperforming loans and thus delayed necessary action to restore credit discipline and rehabilitate affected banks. Financial institutions, prompted by the Government emphasis on lending to priority sectors and on meeting lending targets, extended credit without proper consideration of commercial criteria. The outstanding stock of overdue loans was also inflated as a result of capitalization by banks of interest and penalties 2/ and their reluctance to write off loans and absorb losses. In the agricultural sector, loan recovery was adversely affected by the inability of the understaffed rural bank branches to collect on a vast number of small loans, owing mainly to lack of support from local authorities and inadequate enforcement of legal procedures. Moreover, severe floods in 1985, together with the collapse of jute prices, reduced the capacity of farmers to service their debts, thereby causing the rate of loan recovery to drop sharply (Chart 4). The rapid growth of overdue industrial loans partly reflected the impact of the successive devaluations of the taka on loans denominated in foreign currencies and uncertainties regarding exchange rate guarantee arrangements, as well as the failure to clearly define the financial obligations to be assumed by the new owners of recently denationalized enterprises. Consequently, loans to several denationalized firms have been disputed, which also encouraged many willful defaulters not to service their debt. Furthermore, the inadequate legal framework has hampered loan recovery and encouraged willful defaulting.

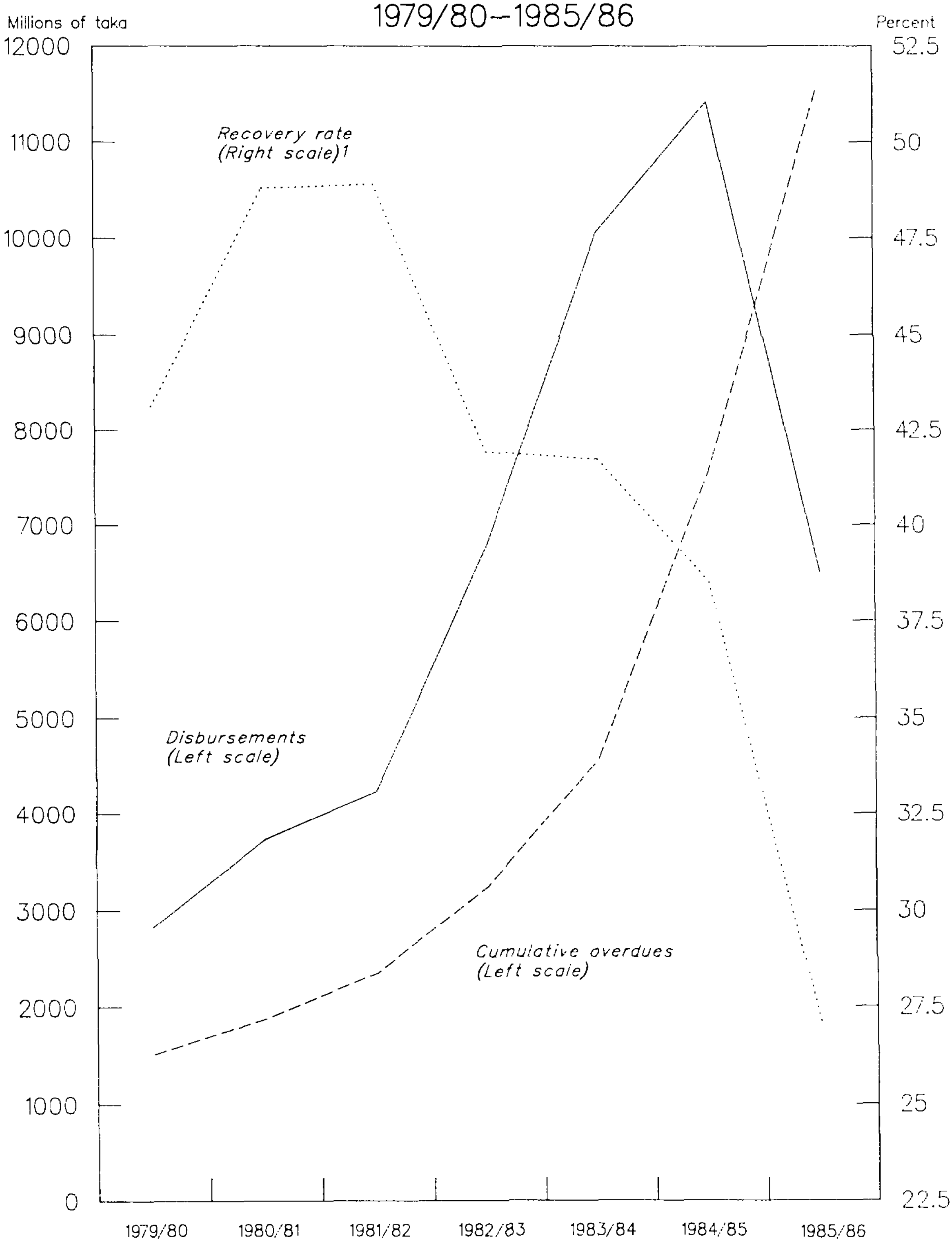
1/ Most loans were channeled through Bangladesh Krishi Bank (agriculture), Bangladesh Shilpa Bank and Bangladesh Shilpa Rin Sangstha (industry) and four nationalized commercial banks which extended agricultural as well as industrial credit.

2/ For example, in the case of Bangladesh Krishi Bank, accrued interest and penalties accounted for 29 percent of total overdue crop loans outstanding at June 30, 1986.

CHART 4

BANGLADESH

AGRICULTURAL LOAN DISBURSEMENTS AND RECOVERY, 1979/80–1985/86



Sources: Data provided by the Bangladesh authorities and the World Bank.
1 In percent of overdues, and principal and interest falling due during the period.

Loan recovery issues were the subject of intensive discussions. The authorities now recognize the serious adverse effects of the loan delinquency on resource allocation and on the efficiency of financial intermediation and the conduct of monetary policy. They also recognize that current management and accounting practices have concealed growing weaknesses in the state-owned banks that dominate the financial system in Bangladesh. The liquidity position of banks has been maintained only through their access to Bangladesh Bank refinancing facilities. Against this background, the authorities, in consultation with the staff of the Fund and the World Bank, have adopted short- and medium-term measures to improve loan recovery. These measures are briefly discussed in Section IV below.

b. Interest rates

The staff team reviewed with the authorities the structure of interest rates and examined its consequences for the mobilization of domestic financial resources, the efficient allocation of these resources, and the financial viability of the banking system. The present structure has had some unintended results. Banks are now reluctant to accept medium- and long-term deposits because it has become increasingly difficult to profitably lend such funds. For example, industrial term loans carry interest rates that are below the rate on three-year deposits. On the lending side, rates appear to be too low to generate a sufficient margin over the cost of funds, particularly if the need to make adequate provisions for bad and doubtful loans is taken into consideration. Interest subsidies, which are currently provided through the lending institutions and are subsumed in their accounts, are not clearly identified and their role is not regularly evaluated. Access to refinancing from Bangladesh Bank has enabled banks to extend loans at relatively low rates of interest.

Several proposals that would improve the term structure of bank deposits, enhance the allocative function of interest rates, and assign a greater role to market forces were discussed. The staff team proposed that Bangladesh Bank establish a reference deposit rate on the basis of which banks would be free to competitively set their other deposit rates. The reference rate would be adjusted periodically so as to maintain a positive real rate of return. On the lending side, banks should be encouraged to give a greater weight to risk and maturity considerations, and interest subsidies deemed desirable for socioeconomic reasons should not be borne by banks, but be treated as a budgetary item, or financed through special funds maintained by Bangladesh Bank. The authorities agreed with the assessment that the present interest rate structure is unduly complex and not very efficient. Although it is their intention to undertake a thorough review of interest rate policy and introduce changes, the authorities stressed that the move toward a more market-oriented interest rate system would have to be gradual, particularly on the lending side. Furthermore, the implications of transferring interest subsidies to the budget would need to be carefully assessed.

c. Monetary policy instruments

In controlling liquidity and regulating the flow of credit to the various sectors, the authorities have relied mainly on credit ceilings for individual banks, administratively determined interest rates, margin requirements on selected bank advances, minimum shares of total lending for priority sectors, and refinancing facilities from Bangladesh Bank. These monetary instruments have not been conducive to the efficient allocation of financial resources or to promoting competition among banks, and have tended to impede the growth of recently established banks. Therefore, the mission stressed the importance of market-related interest rates and of indirect instruments of monetary policy, such as reserve requirements and open market operations, and the need to strengthen the role of the central bank. Bangladesh Bank should be given sole authority to change reserve and liquid assets requirements; 1/ consideration should also be given to the issuance by Bangladesh Bank of its own bonds at market-related interest rates. At present, most treasury bills are held by banks as approved securities under the liquid asset requirement and carry below market rates of interest. The issuance of central bank paper and treasury bills at market-related interest rates, together with measures to encourage trading in such securities, will help establish secondary markets and enable Bangladesh Bank to engage in open market operations.

4. Industrial and trade policies

In recent years, the authorities' efforts to strengthen the balance of payments have focused on diversification of exports through the development of export-oriented industries. The authorities view export diversification as necessary to reduce the country's dependence on jute, and industrialization as essential in order to provide employment opportunities for a rapidly growing labor force. Export-oriented industries are being promoted through flexible exchange rate policies and reforms of the exchange, trade, and industrial systems. Since 1985, the official exchange rate has been adjusted periodically in order to ensure that competitiveness is maintained. Beginning in July 1985, Bangladesh Bank has also refrained from intervening to prevent depreciation in the secondary exchange market (SEM), where the exchange rate is now determined by foreign exchange dealers on the basis of supply and demand. Equally important, the authorities have transferred a large proportion of trade transactions to the SEM.

Exchange rate flexibility, together with the adoption of more prudent financial policies, has reduced somewhat the pressure on the balance of payments, enabling the authorities to liberalize the trade regime significantly. In July 1985, the positive list of permitted imports was replaced by negative lists of banned and restricted imports; the negative list was shortened considerably in July 1986. Industrial

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1/ At present, changes in these requirements are subject to Government approval.

policy was also liberalized considerably beginning in 1986/87. Official approval of new investment is no longer required if the resulting expenditure is financed by the firm's own resources; enterprises need only register with the Director General of Industries to obtain import licenses and tariff reductions for imports of capital goods. For investment financed by domestic borrowing, sanctioning procedures have been streamlined so as to expedite approval. In particular, the limits on the amounts that the nationalized banks and the DFIs may sanction on their own authority have been doubled to Tk 30 million and Tk 60 million, respectively. Direct foreign investment is also being encouraged, especially in export-oriented industries. For this purpose, the Government has recently strengthened the bonded warehouse system and has granted greater autonomy to the duty free Export Processing Zone.

While welcoming these policy reforms, the staff stressed that further progress in these areas was needed. The dual exchange regime should be unified in order to reduce relative price distortions. For example, under the current system, aid-financed imports are effectively subsidized, since they are transacted at the official rate. This subsidy tends to encourage capital-intensive investment, although Bangladesh has a comparative advantage in labor-intensive industries. The staff team also expressed the view that frequent exchange rate adjustments may be required in the future to accommodate changes in the structure of the economy or in the terms of trade, and to facilitate further trade liberalization measures.

The authorities indicated that the SEM will be further enlarged and the differential between the official and secondary exchange rates will be gradually narrowed by adjusting the official rate. The authorities also stated that they remain committed to exchange rate unification at an appropriate level and time. A gradual approach was necessary, however, because a sudden elimination of the preferential rate might have severe short-term consequences for workers' remittances and unduly raise the cost of aid-financed imports. According to the authorities, such imports are usually overpriced and therefore require an offsetting subsidy. On this point, the mission was of the view that, while prices of some aid-financed imports are above world market levels, the existing uniform subsidy through the exchange system on all tied imports may well be aggravating relative price distortions rather than reducing them. As for workers' remittances, inflows were unlikely to fall if the exchange rates were unified at an appropriate level and if exchange rate flexibility were maintained. The mission agreed, however, that the gradual approach to unification currently pursued will make it possible to monitor the impact of changes in the exchange system and take measures to minimize any adverse consequences.

The staff team noted that considerable restrictions remain in the trade system. The banned and restricted lists remain fairly comprehensive and commercial imports of raw materials are severely limited, which especially affects new and small firms. Similarly, the maintenance of ten barter agreements, five of which are with Fund members, has distorted the flow of resources and raised industrial costs. The Bangladesh representatives explained that further trade liberalization measures are planned under the SAF program, including the easing of restrictions on commercial imports. As for barter agreements, these provided useful outlets for exporting primary products, especially when world demand was depressed. The authorities indicated, however, that firms are no longer required to first import barter products, as this regulation was eliminated in October 1986.

The authorities agreed with the mission that, at present, prices of imported goods are distorted by a complex tariff system, which produces wide variations in the rates of effective protection. For many products, the tariff structure might actually discourage industrialization as raw materials receive higher rates of protection than intermediate inputs, which are, in turn, more heavily protected than final products. The authorities, therefore, intend to rationalize the tariff structure in the context of the SAF program and the forthcoming Industrial Sector Credit from IDA.

Bangladesh's exchange and trade system has several features which are subject to approval under Article VIII. The exchange system includes multiple currency practices arising from the operation of the SEM, and minimum deposit margins on letters of credit for imports of certain commercial goods. Bangladesh maintains a bilateral payments agreement with the People's Republic of China, which is also subject to approval under Article VIII. Bangladesh also maintains bilateral payments agreements with Hungary, Poland, Romania, and Yugoslavia in accordance with traditional arrangements under Article XIV.

IV. The Structural Adjustment Program

The Government's macroeconomic objectives under the proposed three-year SAF arrangement are to raise the annual rate of real GDP growth to at least 5 percent on average, moderate the rate of inflation to 7 percent by 1988/89, and contain the external current account deficit and the budget deficit of the central government at about 7 percent of GDP. The achievement of the external target is expected to lead to a reduction in the external debt service ratio to about 21 percent by 1988/89, while maintaining the level of gross reserves at the equivalent of over two and a half months of merchandise imports. The macroeconomic targets for the program under the first annual SAF arrangement coincide broadly with those established for the 1986/87 program under the stand-by arrangement. However, the external targets have been revised to take account of recent external developments and the availability of Fund resources under the CFF and the SAF.

To achieve these objectives, the Government will pursue restrained demand management policies and implement structural measures to improve resource allocation and mobilize domestic savings. These latter measures include reforms in tax policy and administration, improvements in financial management of public sector enterprises, and intensification of loan recovery in the agricultural and industrial sectors. In the first year of the SAF program, policy measures along these lines will supplement those already incorporated in the 1986/87 program supported by the stand-by arrangement. A summary of the main policies to be implemented under the SAF program, together with related specific actions and their time frame, is contained in Table 1 of Annex I, Attachment II.

Mobilization of public sector resources will constitute a major element of the adjustment program. In the fiscal field, the objective is to increase total government revenue from 9.1 percent of GDP in 1985/86 to 10.5 percent of GDP in 1988/89 by reforming tax policy, improving tax administration, and identifying areas of potential additional revenue. Other measures to improve fiscal performance will include improved tax enforcement; progressive reductions in food subsidies; appropriate economic pricing of energy; improved cost recovery in public services such as irrigation, transport, education, and health; and improved profitability of nonfinancial public enterprises.

The financial performance of NPEs will be improved by giving them greater operational freedom, establishing higher standards of accountability, improving performance evaluation, and ensuring adequate price adjustments. Toward this end, a management information system has been developed to gather key data needed for budgeting control and for an assessment of the macroeconomic impact of these enterprises. Furthermore, a new system of performance evaluation has been established this year on a pilot basis in two manufacturing units. Privatization on a selective basis will be continued. Special attention will be given to the jute mills sector, which competes with oil-based synthetics in world markets. In particular, measures will be taken to better utilize existing capacity and to improve technical efficiency.

Given the resource availability constraints, public expenditure policies will be directed toward improving the quality of development expenditure. Operations and maintenance expenditure will rise substantially in real terms to ensure the adequate maintenance of existing assets. In addition, the budgeting, planning, appraisal, and implementation of investment projects will be improved in order to utilize external aid more effectively.

Financial sector reforms will aim at enhancing the viability of financial institutions, strengthening the effectiveness of monetary policy, and eliminating distortions in the allocation of financial savings. To improve the viability of financial institutions, the authorities have adopted a comprehensive program aimed at significantly improving loan recovery and strengthening the financial positions of state-owned banks. The main features of this program include legal and judicial reforms, vigorous prosecution of willful defaulters (as distinguished from borrowers unable to service their debt owing to adverse weather and price movements), the establishment of a credit information system in the Bangladesh Bank, and greater operational autonomy of banks combined with strengthened bank supervision. In addition, the program calls for improved accounting practices, a stricter loan classification, adequate provisioning for problem loans, and partial privatization of state-owned commercial banks and DFIs.

In the case of agricultural loans, the action program has set a collection target during 1986/87 of at least Tk 8.6 billion, which is 30 percent higher than the level achieved in 1985/86. To provide incentives for repayments of overdue loans, accrued interest and penalties on small overdue crop loans will be waived if the principal is repaid by February 28, 1987; the Government will take measures to appropriately compensate banks and offset any budgetary consequences of this waiver. Since November 1986, crop loans have not been given to farmers not possessing valid passbooks, in which loans are recorded, and this policy will be maintained. Necessary changes in the relevant laws will be made to bar defaulters from holding local official positions. The policy of linking Bangladesh Bank refinancing to loan recovery performance will be continued, and disbursement of the 1986/87 development grants to the local authorities will be linked to the success of the credit recovery program in their districts. A high level committee has been established to oversee this action program and take policy decisions on agricultural credit reforms.

Recovery targets have also been established for the two development finance institutions, and the three nationalized commercial banks participating in IDA-financed small industrial projects. To restore credit discipline, measures are being implemented to deny commercial bank credit and import licenses to defaulters, remove defaulters from the Boards of Directors of banks, take over assets of large and willful defaulters through special procedures, and initiate court action against other defaulters.

Beyond these immediate measures, broader financial reforms will be implemented gradually to strengthen the effectiveness of monetary policy and reduce distortions in the financial system. These include strengthening the role of Bangladesh Bank, further developing money and capital markets, and placing greater emphasis on indirect instruments of monetary policy. Moreover, to enhance the allocative function of interest rates, the interest rate structure will be rationalized, and made more flexible and responsive to market forces.

Reforms of the exchange and trade system will continue during the SAF period to strengthen the external position. The authorities have reaffirmed their commitment to a flexible exchange rate policy, aimed at strengthening the competitiveness of the export sector and diversifying the export base. To pave the way for the eventual unification of the exchange markets, the gap between the official and the secondary exchange rates will be narrowed significantly, and the scope of the secondary exchange market will be expanded further. To improve the efficiency of resource allocation and to stimulate export-oriented industries, the trade system will be further liberalized and tariffs will be rationalized. Such industries will be permitted to import raw materials and intermediate inputs which are otherwise restricted. Quantitative restrictions will be reduced by progressively paring down the lists of banned and restricted imports, and commercial imports of raw materials will generally be allowed on the same basis as industrial imports. As a part of the liberalization process, the requirement that importers must first utilize their barter allocations was eliminated in October 1986. Finally, the wide range of tariffs will be narrowed and similar products will be assigned equivalent tariff rates.

Demand management policies during the SAF program period will aim at ensuring that structural reforms are carried out in an environment of financial stability. Prudent financial policies will continue to be pursued in order to reduce the rate of inflation and achieve the external targets. The rate of monetary expansion will be consistent with the targeted growth in nominal GDP. To ensure adequate credit for the private sector, government recourse to the banking system will be minimized. In addition, external borrowing on commercial terms will be strictly limited so that debt servicing obligations remain at a sustainable level.

The Bangladesh authorities will be monitoring progress under the SAF program for 1986/87 with reference to two sets of benchmarks, one relating to quantitative performance indicators and the other to the implementation of selected policy actions.

The quantitative benchmarks (Table 1, Annex II, Attachment II) cover targets for (1) net domestic assets; (2) net credit to the Government; (3) contracting and guaranteeing of new nonconcessional public external debt; (4) outstanding stock of Bangladesh Bank's external liabilities of less than one year maturity; (5) overall budget deficit and total revenue of the central government; and (6) agricultural loan recovery. In view of the importance of the fiscal adjustment in the SAF program, the authorities will monitor revenue, expenditure, and domestic bank financing of the central government budget (Table 2, Annex II, Attachment II). Benchmarks of policy implementation (Table 3, Annex II, Attachment II) relate to (1) liberalization of import and exchange controls; (2) public sector resource mobilization; (3) public expenditure; and (4) financial sector reform. The authorities believe that these benchmarks will provide an adequate guide for policy adjustments when necessary to achieve the program's objectives.

V. Medium-Term Outlook

The mission discussed with the authorities a medium-term scenario for the period 1986/87-1991/92 (Table 7). The scenario is based on the assumptions that structural adjustment will be pursued, normal weather will prevail, and the terms of trade will improve marginally during the first two years, but will decline by 2-3 percent annually thereafter. Under this scenario, annual growth of real GDP is projected to average 5 percent, permitting real per capita income to increase by about 2.5 percent per annum.

Over the medium term, exports are projected to increase by 12 percent annually in value terms and by 8.5 percent in volume. Although traditional exports are not expected to grow rapidly, the potential for growth of nontraditional exports appears bright. Under the export-oriented policies envisaged in the SAF program, these exports are likely to grow by 21 percent per annum and their share in export earnings should rise from one third at present to over one half by 1991/92. Thus far, frozen seafood and ready made garments have been the most dynamic nontraditional export items, and this trend is likely to continue. Frozen seafood is expected to grow by about 25 percent per year, as new projects come on stream. The growth of ready made garments is also expected to be rapid, despite the imposition of quotas in the main export markets, as production shifts to goods in classifications which are not restricted. Furthermore, there is considerable scope for growth in other nontraditional exports, such as vegetables. Prospects for jute exports, however, remain poor. The cyclical recovery in prices is likely to be limited and the secular growth in export volume is expected to be small. Technological changes in transportation, packaging, and storage, and the development of synthetic substitutes for jute products have permanently shifted demand out of jute since the late 1960s, particularly in the industrial countries. Workers' remittances, which account for one third of foreign exchange earnings, are expected to remain constant in real terms, given the prevailing conditions in oil exporting countries.

To achieve the projected rate of GDP growth, staff calculations show that domestic investment in real terms and import volumes would need to rise by 8.5 percent and 5 percent per year, respectively. Given the outlook for exports and workers' remittances, the required increase in imports would only be possible with greater utilization of concessional aid. Accordingly, the scenario assumes that aid disbursements will grow by 7 percent per annum in real terms. In particular, disbursements of project aid (mainly from the existing pipeline) are projected to increase by 8.5 percent per year in real terms to meet the investment targets. To efficiently absorb these resources, a substantial increase in the availability of local counterpart funds will be necessary. Toward this end, the scenario assumes that the authorities will intensify their efforts to mobilize domestic resources by reforming

Table 7. Bangladesh: Medium-Term Balance of Payments and External Debt Projections, 1985/86-1991/92

	1985/86 Prov.	1986/87 SAF	1987/88 SAF	1988/89 SAF	1989/90 Projections	1990/91 Projections	1991/92 Projections
	(In millions of U.S. dollars)						
Trade balance	1,545	-1,607	-1,721	-1,942	-2,145	-2,341	-2,593
Exports, f.o.b.	819	929	1,057	1,162	1,284	1,427	1,594
Imports, c.i.f.	-2,364	-2,536	-2,778	-3,104	-3,429	-3,768	-4,187
Of which: Nonfood imports	(-2,144)	(-2,236)	(-2,529)	(-2,835)	(-3,139)	(-3,454)	(-3,848)
Services, net	-125	-117	-117	-118	-121	-123	-123
Private transfers	586	578	601	625	650	676	703
Of which: Workers' remittances	(555)	(550)	(572)	(595)	(619)	(643)	(669)
Current account	-1,084	-1,146	-1,238	-1,435	-1,616	-1,788	-2,013
Nonmonetary capital, net	1,097	1,158	1,343	1,505	1,741	1,948	2,203
Of which: Concessional aid disbursements	(1,306)	(1,400)	(1,520)	(1,712)	(1,952)	(2,172)	(2,421)
Monetary movements (-increase)	-77	-12	-105	-70	-125	-160	-190
Of which: Fund credit, net 1/	(-3)	(154)	(-45)	(-30)	(-127)	(-163)	(-89)
	(In percent; unless otherwise specified)						
Memorandum items:							
GDP (in billions of US$)	15.6	17.1	18.7	20.7	22.8	25.1	27.8
Investment/GDP	13.1	12.9	13.6	14.3	14.8	15.3	15.9
National savings/GDP	6.1	6.2	6.9	7.4	7.7	8.2	8.7
Current account/GDP 2/	-6.9	-6.7	-6.6	-6.9	-7.1	-7.1	-7.2
Aid disbursements/GDP	8.4	8.2	8.1	8.3	8.6	8.6	8.7
External public debt outstanding 3/ (In millions of US$)	6,909	7,472	7,979	8,564	9,163	9,819	10,674
Of which: Fund credit (excluding Trust Fund)	(443)	(617)	(571)	(542)	(415)	(252)	(162)
External debt/GDP	44.3	43.6	42.8	41.5	40.2	39.1	38.4
Of which:							
Fund credit/GDP	2.9	3.6	3.1	2.7	1.8	1.0	0.6
Gross reserves (end of period)							
(In millions of US$)	476	602	662	702	700	697	798
(In months of imports)	2.4	2.9	2.9	2.7	2.5	2.2	2.3
Terms of trade (percentage change)	-22.0	1.5	3.2	-2.7	-2.4	-2.4	-2.3
Debt service ratio 4/	28.1	30.4	21.5	20.9	21.9	22.3	17.5
Of which:							
Fund repurchases and charges 4/	8.0	9.4	6.4	5.1	6.7	7.3	3.5
Fund credit/quota	134.1	178.7	165.6	157.0	120.2	72.9	47.0

Sources: Data provided by the Bangladesh authorities; and staff estimates.
1/ Assumes purchases from the Fund under the current stand-by arrangement, the CFF, and the SAF.
2/ Averaged 8.4 percent of GDP over period 1981/82-1985/86.
3/ Includes use of Fund credit (including SAF loans) and short-term debt.
4/ In percent of exports of goods and services; and private transfers.

the tax and financial systems and maintaining positive real interest rates. With these measures, national savings are expected to rise by 2.6 percentage points to 8.7 percent of GDP in 1991/92, while investment will rise by 2.8 percentage points to 15.9 percent of GDP.

Under this scenario, the external current account deficit is projected to remain near 7 percent of GDP. This deficit will be more than offset by the assumed aid inflows, permitting overall payments surpluses to be achieved and gross reserves to be maintained at over two months of merchandise imports. Considering that virtually all borrowing will remain on highly concessional terms, the debt service ratio is projected to decline from 28 percent in 1985/86 to 18 percent in 1991/92, as outstanding commercial food credits are repaid and Fund resources repurchased.

The above scenario is based on an ambitious program of structural reform, as set out in the authorities' policy framework paper. Should there be slippages in policy implementation or in donor support or should there be adverse exogenous developments, growth will be significantly lower. However, given the authorities' determination to maintain international reserves at an adequate level, developments less favorable than those assumed in the baseline scenario are not likely to lead to debt servicing difficulties.

VI. Staff Appraisal

The Government of Bangladesh has been implementing a comprehensive adjustment program, supported by a stand-by arrangement from the Fund. The important elements of the adjustment policies have included significant revenue measures, tight monetary policy, liberalization of trade and industrial policies, depreciation of the exchange rate in real terms and progress toward the unification of the exchange markets. Economic performance during 1985/86 and thus far in 1986/87 has been broadly in line with that envisaged under the program. Internal financial imbalances have been reduced substantially and the external current account deficit has narrowed significantly. However, there were shortfalls in exports and government revenue and further deterioration in loan recovery in 1985/86. These developments underscore the structural weaknesses of the Bangladesh economy, notably its vulnerability to external shocks, which have led to protracted balance of payments difficulties. It is, therefore, commendable that the authorities have decided to sustain the adjustment process through the adoption of a medium-term program, to be supported by an SAF arrangement from the Fund. The program, designed to strengthen the economic structure and achieve satisfactory growth in a stable financial environment, incorporates significant measures aimed at generating substantial additional domestic savings; redressing problems facing the financial institutions, particularly in the area of loan recovery; and enhancing the present flexibility in exchange rate management while further liberalizing the trade and payments system.

It is a matter of concern that the tax system is highly inelastic and that revenue collections have been below expectations owing mainly to administrative difficulties. To ensure the achievement of the revenue objectives established under the SAF, it will be necessary to implement far-reaching tax reforms and strengthen tax collections. The staff, therefore, welcomes the authorities' decision to review, in the current fiscal year, tax policy and administration with technical assistance from the Fund and the World Bank. The staff would encourage the authorities to complete this review expeditiously in order to ensure early implementation of the envisaged tax reform.

The recent deterioration in the financial position of state enterprises has adversely affected the resource mobilization effort and increased the dependence of these enterprises on domestic bank borrowing. The financial difficulties of these enterprises are also manifested in the emergence of arrears in tax payments and delays in settlement of accounts due. The authorities intend to address these problems during the period of the SAF arrangement. Appropriate pricing policies will be implemented, collection procedures will be vigorously enforced, and measures will be undertaken to reduce costs and improve efficiency. In particular, the authorities are considering rationalizing the operations of the jute mills along the lines recommended by the World Bank. However, given the complexity of the problems faced by state enterprises, it should be recognized that the rehabilitation process will be difficult as well as time consuming.

Tight monetary policy has been a key element in the adjustment process and will continue to play a crucial role. However, the effectiveness of monetary policy and the efficacy of financial intermediation have been seriously undermined by the growing problem of overdue loans. To address this problem, the authorities have adopted a comprehensive program aimed at substantially reducing overdue loans in both the agricultural and industrial sectors. The success of this program requires unequivocal and sustained commitment by the authorities. Key interest rates continue to be positive in real terms, despite selective reductions earlier in the current fiscal year to promote priority sectors. However, the present interest rate structure is complex and not conducive to the efficient allocation of scarce financial resources. The staff's view is that the interest rate structure needs to be rationalized so as to improve the term structure of bank deposits, strengthen the allocative function of interest rates, and enhance the viability of the banking system. The staff welcomes the intention of the authorities to emphasize indirect instruments of monetary control and strengthen the role of Bangladesh Bank. These measures will be in line with the Government's policy to promote competition in the financial system.

The authorities have pursued a flexible exchange rate policy and have made substantial progress toward the unification of the dual exchange markets. Flexible exchange rate management will continue to be crucial to the authorities' efforts to strengthen the structure of the balance of payments. The staff welcomes the authorities' intention to achieve unification of the exchange markets at an appropriate exchange rate by narrowing the gap between the official and secondary exchange rates and shifting additional transactions to the secondary market, while further liberalizing the trade and payments system. The recent easing of investment sanctioning procedures and the elimination of the requirement that importers fully use their barter allocations are highly commendable as they will encourage investment in the traded goods sector and improve the efficiency of resource allocation. To achieve further progress, the authorities should continue to replace quantitative restrictions with a rationalized tariff structure and phase out existing barter arrangements.

Even on the assumption of a successful implementation of the proposed SAF program and a strong export performance, Bangladesh will continue to rely heavily on external aid over the medium term. Substantial aid flows will be required to finance imports necessary for the achievement of the ambitious investment and growth targets set under the SAF program. Therefore, improved aid utilization and greater domestic resource mobilization will be necessary. The staff considers feasible the envisaged increases in aid flows and domestic savings, and is of the view that the resulting external current account deficit and debt service burden will be sustainable over the medium term.

The structural policies under the proposed SAF program are far-reaching in both their content and expected consequences and are, in the staff's judgment, sufficient to achieve the objectives of the program. Accordingly, the staff recommends approval by the Executive Board of the proposed decisions on the completion of the second review under the stand-by arrangement and on the granting of arrangements under the structural adjustment facility.

It is recommended that the next Article IV consultation with Bangladesh be held on the standard 12-month cycle.

VII. Proposed Decisions

The following draft decisions are proposed for adoption by the Executive Board:

A. 1986 Consultation

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 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/... The Fund welcomes the progress to date towards 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.

B. Review Under the Stand-By Arrangement

1. Bangladesh has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for Bangladesh (EBS/85/251, Supplement 1, December 4, 1985) and paragraph 26 of the letter dated November 5, 1985 from the Advisor for Finance of Bangladesh, in order to assess performance under the program supported by the arrangement.

2. The letter dated January 5, 1987 from the Minister of Finance shall be attached to the stand-by arrangement and the letter dated November 5, 1985 as amended shall be read as supplemented and modified by the letter of January 5, 1987.

3. The Fund decides that the second review contemplated in paragraph 4(c) of the arrangement is completed.

C. Structural Adjustment Facility

1. The Government of Bangladesh has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the Structural Adjustment Facility.

2. The Fund approves the arrangements set forth in EBS/87/7.

BANGLADESH

Three-Year and First Annual Arrangements Under the Structural Adjustment Facility

Attached hereto is a letter with an annexed policy framework paper and an annexed Memorandum on Economic and Financial Policies dated January 5, 1987 from the Minister of Finance for Bangladesh, requesting from the Fund a three-year structural adjustment arrangement and the first annual arrangement thereunder, and setting forth

(i) the objectives and policies of the program to be supported by the three-year arrangement, and

(ii) the objectives and policies of the program to be supported by the first annual arrangement.

To support these objectives and policies, the International Monetary Fund grants the requested arrangements in accordance with the following provisions and subject to the regulations for the administration of the structural adjustment facility:

1. For a period of three years from ...., 1987 Bangladesh will have the right to obtain three successive loans from the Fund under the structural adjustment facility in a total amount equivalent to SDR 135.125 million.

2. The first loan, in an amount equivalent to SDR 57.5 million, is available for disbursement at the request of Bangladesh.

3. The second and third loans will be available upon approval by the Fund of the corresponding annual arrangements and will be disbursed at the request of Bangladesh. The amount of the second loan will be equivalent to SDR 38.8125 million, and the amount of the third loan will be equivalent to SDR 38.8125 million.

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

a. the indicators described in paragraph 15 of the Memorandum on Economic and Financial Policies and specified in Tables 1 and 3 attached to the Memorandum,

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

c. introduction or modification of multiple currency practices,

d. conclusion of bilateral payments agreements which are inconsistent with Article VIII,

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

5. In accordance with paragraph 3 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 first annual arrangement.

6. In accordance with paragraph 5 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 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.

Dhaka, Bangladesh
January 5, 1987

Dear Mr. de Larosiere:

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. The paper describes the major economic problems facing Bangladesh and sets forth the broad macroeconomic and structural adjustment policies which we will implement during the three-year period 1986/87-1988/89 to resolve these problems.

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

3. Bangladesh will provide the Fund with such information as the Fund requests in connection with the progress of Bangladesh in implementing the policies and achieving the objectives of the program. 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 annually as the program is implemented.

4. The annexed Memorandum on Economic and Financial Policies pursuant to the policy framework paper referred to in paragraph 1 above describes the structural adjustment program which the Government of Bangladesh intends to pursue during the period July 1, 1986 to June 30, 1989, and the policies for the first year of this period. In support of this program, Bangladesh hereby requests from the Fund a three-year structural adjustment arrangement in the amount that will be available to Bangladesh under the Fund's structural adjustment facility, and the first annual arrangement thereunder.

5. The Government believes that the policies set forth in this Memorandum 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 of the Fund

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,

//s//
M. Syeduzzaman
Minister of Finance

Annexes: (I) Policy Framework Paper
(II) Memorandum on Economic and Financial Policies

Mr. Jacques de Larosiere
Managing Director
International Monetary Fund
700 19th Street, N.W.
Washington, D.C. 20431

BANGLADESH

Policy Framework Paper, 1986/87-1988/89

I. Background

1. Bangladesh is a country with a very high population density, limited natural resources, and widespread poverty. Annual per capita income was only about $150 in 1985/86. A high rate of population growth (2.5 percent per annum) acts as a major constraint on economic and social development.

2. Agriculture is the mainstay of the economy, accounting for about half of GDP and three fourths of employment and exports. The ability to grow sufficient foodgrain has always occupied the highest priority on the authorities' agenda. Although considerable success has been achieved in this regard, foodgrain production remains vulnerable to natural disasters, and the country continues to require annual foodgrain imports of about one tenth of total consumption. While growth in the agricultural sector has contributed to employment and exports, it has not been sufficient to fully absorb the rapidly growing labor force or to generate adequate foreign exchange earnings. Rapid growth in industry, which accounts for about 10 percent of GDP, and expansion in labor-intensive exports have therefore become important development policy objectives. However, the labor force in Bangladesh is largely unskilled and lacks the human capital requirements in education, health, and nutrition, necessary for this transition. The adult literacy rate is only about 26 percent and per capita public expenditure on education is among the lowest in the world. Other constraints on industrial development include a weak infrastructure (power, transportation), inefficient public enterprises, continuing restrictions in the trade and payments system, and an underdeveloped financial system.

3. The economy is also characterized by very low savings, which in part reflects the low level of incomes, and by a large structural balance of payments gap. National savings finance less than half of total investment, which has averaged about 13 percent of GDP in recent years. Export earnings cover only about one third of the import bill, with raw jute and jute goods still accounting for over half of total merchandise exports. The capacity to finance imports can be severely affected by external factors (e.g., falling jute prices, declining remittances) that are largely beyond the control of the Government. The effect of such adverse factors on the economy is amplified by the heavy dependence of budgetary resources on imports. Inadequate growth in domestic resources also seriously constrains the financing of key public investments, and operations and maintenance of existing assets. Even though most development projects are largely aid-financed, the shortage of local currency resources, compounded by weaknesses in public administration, have tended to impede project implementation in Bangladesh.

4. Despite the country's structural constraints indicated above, and repeated disruptions caused by natural disasters, Bangladesh has made significant progress in several areas during the Second Five-Year Plan (SFYP, 1980/81-1984/85). Policies toward agricultural, industrial, and export sectors have been strengthened, permitting the economy to grow by about 4 percent per annum during the second Plan period. Foodgrain production growth averaged 3.5 percent per annum during the second Plan period, which was faster than in the previous five years, and significantly above the rate of population growth. Such growth was achieved despite adverse weather, notably the severe flooding in 1984/85. Industrial output rebounded in the 1983/84- 1984/85 period after the stagnation evident in the early 1980s. This has been led by efficient import substitution and export-oriented, labor-intensive activities (e.g., ship-breaking and garments). Growth of nontraditional exports (items other than jute, tea, and leather) has averaged about 25 percent annually in real terms during the past five years. Development of domestic commercial energy supplies, especially natural gas, has increased rapidly in recent years, enabling relatively high growth in the power and fertilizer sectors and significant import substitution for petroleum products.

5. The improvements in economic performance can be attributed for the most part to a wide range of policy reforms undertaken in recent years. In foodgrain and agricultural production, key policy improvements have been the increased emphasis on the private sector in the distribution of inputs (fertilizer, irrigation equipment), elimination or reduction in subsidies on these inputs, increased outlays for other agricultural development activities, and the rapid spread of high-yield variety seeds (HYV), fertilizers, and irrigation equipment. In industrial development, under the Government's New Industrial Policy (NIP) key policy improvements have included an enhanced role for the private sector through large-scale denationalization of public enterprises, liberalization of imports by significantly broadening the scope of the relatively free secondary foreign exchange market, and some relaxation of investment sanction and control procedures. These have contributed to a rise in private investment in labor-intensive and efficient import-substitution and export-based activities. In export development, the main policy improvements have included more flexible exchange rate policies and export incentives, and improvements in export policy administration, including the introduction of a more efficient duty drawback system, the establishment of bonded warehouses, and improved access to export financing. The result has been an important breakthrough, particularly in garment exports, which were practically nonexistent prior to 1982/83. Although earnings from this source rose to $131 million (16 percent of total exports) in 1985/86, exports of certain garments have been recently restrained by quotas of importing countries; this could reduce the prospects for future expansion unless new markets or products not subject to quotas are developed.

6. In addition to generally sound development strategies in key sectors, the Government has recently taken important steps to improve

short-term economic management in response to weaknesses exhibited in 1983/84-1984/85. During this two-year period, there was an extremely fast growth in money supply and private sector credit, accompanied by a rapid deterioration in credit recoveries in agriculture and industry. These developments contributed to an acceleration in inflation and a deterioration in the balance of payments. Additional pressures on the balance of payments in 1984/85 were generated by a decline in workers' remittances and a poor rice harvest caused by flooding. In response, the Government adopted in 1985/86 an adjustment program comprising, in particular, cautious fiscal and monetary measures and a substantial real depreciation of the exchange rate. These measures are being supported by a stand-by arrangement from the Fund in the amount of SDR 180 million covering the period December 1985 to June 1987. Partly as a result of these measures, the current account deficit of the balance of payments improved from 8.2 percent of GDP in 1984/85 to 6.9 percent in 1985/86, and foreign exchange reserves rose to 2.4 months of imports in mid-1986. Inflation has moderated from 11 percent in 1984/85 to below 10 percent in 1985/86 and is expected to fall to about 9 percent in 1986/87.

7. In contrast, progress in several other areas has been less satisfactory. At the macroeconomic level, two problems continue to be of particular concern. First, public resource mobilization efforts have been less successful than had been hoped; at 9 percent of GDP, government domestic revenue is among the lowest in the world and, despite some recent progress, contributions from public agencies and enterprises remain inadequate. Second, the current extremely low recovery rates on loans made by domestic financial institutions threaten financial stability, distort resource allocation, and hinder the effectiveness of monetary policy. Recovery of credit as a percentage of current dues and arrears fell in 1985/86 to about 27 percent for agricultural loans, and 6-12 percent for loans from the two development finance institutions (DFIs). As of end-June 1986, current dues and arrears, including penalties on agricultural and industrial loans, amounted to the equivalent of about $600 million and $260 million, respectively; in total, equal to over 5 percent of GDP. Past efforts to recover arrears and restructure portfolios have met with limited success. Other areas in which progress is required include project implementation, public expenditure planning, and the provision of adequate resources to operate and maintain existing infrastructure. Government intentions in each of these areas are described in the next section.

II. Framework for a Structural Adjustment Program, 1986/87-1988/89

8. Sustained economic growth, with financial stability, is essential if a gradual improvement in the present extremely low standard of living in Bangladesh is to be realized. The Government's structural adjustment program (1986/87-1988/89) seeks to improve real per capita income while lowering the rate of inflation and making significant

progress towards balance of payments viability. In view of the lower-than-planned growth in 1985/86 and the prospects for 1986/87, the Government's proposed target of 5.4 percent per annum growth in GDP during the 1985/86-1989/90 period covering the Third Five-Year Plan (TFYP) would require exceptional efforts. These would include mobilizing domestic savings on a substantial scale, enhancing the efficiency of resource allocation, and implementing projects more expeditiously. To achieve the growth target, it is essential that there is no slippage in policy implementation or in enhanced donor support.

9. While resource constraints on economic growth in the medium term are common to many other low-income countries, Bangladesh faces particularly severe long-term development problems. Even with a vigorously and successfully implemented fertility reduction program, the population will continue to rise rapidly; generating adequate employment and incomes, and providing the basic needs for the growing population will, therefore, require exceptional efforts. First, it is essential that agriculture, the dominant sector of the economy, continues to grow rapidly. Since almost all available land is already under cultivation, further growth will depend almost entirely upon greater intensity of cultivation. But even with vigorous growth, the rapidly growing labor force cannot be entirely absorbed in agriculture. Second, therefore, the industrial sector will have to play an increasing role in the economy, both in providing for the growing domestic market and for export. However, the difficulties that stand in the way of increasing the output of industrial goods able to compete in the world market are especially daunting in Bangladesh, given the limited industrial base and skills, distortions in relative prices and the regulatory environment, and the remaining restrictiveness of the trade and payments system. Third, economic development in Bangladesh will remain heavily dependent on imported goods. However, under present trends, the outlook for substantially increased external resource availability is not bright. In the near term, sharply lower jute prices and stagnant or declining workers' remittances are expected to outweigh gains from lower oil prices; thus, the external current account will remain under pressure. Over the longer term, higher debt service obligations and slow real growth of new aid commitments will imply that the sustainable ratio of current account deficit to GDP will fall. Vigorous export promotion, especially of nontraditional products, and efficient import substitution are therefore essential. Fourth, the development of both agriculture and export-oriented industries will need to depend primarily on private sector initiative and resources, which in turn will require measures to promote private savings and to improve the efficiency of financial intermediation. But the organized financial sector lacks depth and suffers from various institutional weaknesses. Fifth, Government investment and expenditure are at inadequate levels to meet basic infrastructure and human resource development needs of the economy. To permit accelerated project implementation over the short run and to enable some substitution for aid inflows over the longer run, a major effort to mobilize domestic resources will be required; such an effort will be difficult, however, in light of the present tax structure and

given the narrow revenue base, the heavy dependence on import-related taxes, and the highly subsistence character of the economy. Finally, there are a large number of competing demands for scarce public resources, with the result that not all of them can be satisfied; a sharper prioritization in the use of public resources and improvement in the efficiency of project and program implementation are therefore essential. This will require hard choices to be made and substantial improvements in central and local administrative capacity.

10. The above-mentioned six areas of policy adjustment, which are described in more detail below, constitute the core of the three-year policy framework. Some are more urgent than others. For example, the restoration of financial discipline is being given the highest immediate attention. Progress will, however, be required systematically in all areas if robust growth and poverty alleviation are to be achieved during the program period and beyond. In most of these areas, policies and programs are being undertaken, or are planned; some of these are listed in the attached Table 1. In others, detailed analysis and policy prescriptions will be initiated. In this regard, the Fund and the World Bank have offered to assist the Government in identifying specific problems and policy requirements, and in establishing timetables for measures to be implemented over the next three years. It is expected that IDA sector policy and structural adjustment credits will be proposed to support satisfactory progress on many of the adjustment measures described below.

Agriculture and food policy

11. Growth in foodgrain production of about 3.5 percent to 4.0 percent per annum will need to be achieved to increase per capita food consumption and ensure food security. The achievement of this rate of growth will depend on renewed and efficient expansion in private small-scale irrigation facilities for dry-season crops, improvement in the performance of public sector agencies, and the strengthening of medium-term credit facilities. Increased emphasis will also need to be given to the growth potential for monsoon season crops through greater use of HYVs, fertilizers, and supplementary irrigation. While not burdening the budget further, effective output price support policies will be maintained while the needs of small farmers (e.g., access to inputs, credits, and markets) will be specifically addressed through a revitalization of the cooperative system. Despite relatively rapid growth in foodgrain production, annual imports equivalent to one tenth of total consumption would still be necessary, mostly financed by food aid. A large part of such aid would be targeted toward the rural poor and other vulnerable groups. Foodgrain subsidies to the better-off groups in the public distribution system would be phased out.

Industrial and trade policies

12. The emphasis on improving industrial efficiency and exports through deregulation and other industrial and financial reforms under the New Industrial Policy would be continued and strengthened. Resource allocation in industry will be improved through liberalization of the investment sanctioning process in combination with careful appraisal of investments; commercial banks will be given greater autonomy in lending decisions and will be required to observe commercial criteria in their lending operations. Progress toward liberalizing the trade system will also continue. The lists of restricted and banned imports will be reviewed and substantially reduced during the program period. Protection for domestic infant industries will instead be provided by tariffs. The efficiency of resource allocation will be assured by progressive tariff harmonization. Initially, tariff rationalization will concentrate on products in the steel and textile sectors, which account for 40 percent of industrial value added. The program of privatization will continue, and those industrial enterprises remaining in the public sector will be given greater autonomy and made more accountable for financial performance. A new Public Enterprise Management Ordinance defining responsibilities and objectives is being implemented and a system of performance evaluation has been introduced for a number of public enterprises. Special attention will be given to the jute mill sector, as it attempts to compete with low-priced synthetics on world markets. Measures will be taken to better utilize existing capacity, investments will be made to improve technical efficiency, and excess capacity will be progressively reduced.

13. In view of the urgent need for continued growth in nontraditional exports, special measures have been or are being introduced to promote efficiency and profitability in this area. These include: provision of duty free status for direct and indirect exporters; greater autonomy to the export processing zone; adequate export credit and guarantees; and back-to-back letters of credit for all indirect exporters, thus encouraging backward linkages.

External policies and debt management

14. The industrial policies outlined above will help maintain the rapid growth of nontraditional exports. These policies will continue to be complemented by a flexible exchange rate policy so as to ensure that Bangladesh improves its competitiveness over a broad range of export and import substitution manufactured goods. Over the life of the three-year program, the scope of the secondary foreign exchange market will be progressively enlarged and the differential between the official rate and the secondary market rate will be reduced. Gross international reserves will have to be maintained above an essential minimum level equivalent to about two months of imports. Appropriate debt management policies will be implemented that would serve to contain debt service obligations and lower the debt service ratio over the medium term.

Toward this end, short- and medium-term borrowing on nonconcessional terms would be strictly limited to exceptional circumstances.

Financial sector and monetary policies

15. The most urgent need in the financial sector is to restore financial discipline and raise credit recovery rates in both the agricultural and industrial sectors. Toward this end, the Government has adopted a comprehensive agricultural loan recovery program that includes the establishment of collection targets on overdue loans, incentives for repayment of small loans, denial of loans to farmers not possessing passbooks, setting up of a credit information system to prevent defaulters from obtaining new loans, prosecution of willful defaulters, and proposals for necessary changes in the relevant laws to ban defaulters from holding local official positions. The Government has established a high-level committee to supervise this program, as well as take policy decisions on agricultural credit reforms. In the case of overdue industrial loans, the Government has established collection targets for the two DFIs and has taken measures to restore credit discipline, including denial of commercial bank credit and import licenses to defaulters, removal of defaulters from directorships of private banks, takeovers of assets of large and willful defaulters through special procedures, and court action against all other defaulters. In addition, an action plan has been drawn up to restructure the two DFIs, including adequate provisioning for bad and doubtful loans, greater equity participation by the private sector, and greater autonomy in operations. Beyond these immediate measures, broader financial reforms recommended in the recent Banking Commission Report will be implemented gradually. These include a movement away from direct credit controls in overall credit management toward indirect controls, such as the use of reserve requirements, open market operations, and a refinance policy subordinated to overall monetary considerations. The Commission recommended the introduction of new financial instruments and the development of money and capital markets. It also recommended that the move toward increased competition and institutional autonomy in the financial system be accompanied by the strengthening of central bank supervision.

16. Credit policy will be managed with a view to curbing inflation and easing pressure on the external balance. Recourse to net bank borrowing by the public sector would be minimized. The growth in credit to the private sector would be consistent with overall monetary objectives and would take into account the need to not unduly constrain the productive sectors of the economy. The credit program would be consistent with the projected movements in net foreign assets of the banking system and the expected development in the demand for broad money. The growth of broad money supply should be consistent with the projected growth in nominal GDP. To enhance the allocative function of interest rates, it will be necessary to rationalize the interest rate structure and make it more flexible, and to ensure that key interest rates remain positive in real terms; at the same time, measures designed to improve

the efficiency of financial intermediation will be required in order to maintain rates charged to borrowers at reasonable levels.

Public resource mobilization

17. A major feature of the adjustment program will be a strong effort to mobilize additional public sector resources through an enhanced tax effort, subsidy reductions, and public sector pricing policies. Over the program period, the Government intends to increase domestic public revenue from 9 percent of GDP in recent years to about 9.5 percent in 1986/87, and to 10.5 percent by 1988/89. Success in this area will be necessary to gradually increase the ratio of development-oriented expenditures in the budget to GDP, while allowing for increased operations and maintenance (O&M) expenditure in the current budget and ensuring consistency between the overall budget deficit and the external objectives. Under current projections, the budget deficit as a proportion of GDP is expected to be reduced during the program from the current year level; a higher budget deficit could be sustainable only insofar as the utilization of foreign aid increases significantly.

18. In addition to these short-term measures to ensure fiscal balance, a substantial restructuring of the tax system is planned with a view to reducing dependence on volatile trade-based taxes. Tax administration and procedures are being improved. For this purpose, a review of tax administration and procedures, sources of additional revenue, and measures that can be taken to offset the negative effect upon revenues of import tariff liberalization will be undertaken during the first year of the program.

19. Other resource mobilization efforts would include phasing out of food subsidies to the better-off groups; appropriate economic pricing of energy (natural gas, power); improved cost-recovery in irrigation, transport, education, and health; considerably strengthened collection performance in certain sectors where it is inadequate (e.g., power, water, irrigation); and improved profitability of public enterprises through appropriate pricing policies and more efficient operations. The economic performance of public enterprises will be reviewed with a view toward making them operationally and financially viable. Privatization on a selective basis is also being continued. Public sector enterprises, which will continue to account for a large part of industry despite recent disinvestment, will be given much greater operational freedom, and performance monitoring systems will be implemented, as envisaged under the Public Enterprise Management Ordinance, promulgated in 1986.

20. These public resource mobilization efforts, taken together with the improvements in financial sector policies aimed at increasing private sector savings, would be expected to significantly improve the overall savings rate in the economy by the end of the three-year program and beyond.

Public expenditure policies

21. Given the constraints of resource availability, emphasis will be directed toward an improvement in the quality of development expenditure; this will involve a higher level of operations and maintenance expenditure to ensure the adequate maintenance of existing assets, strict evaluation of investment projects to assess both economic and social benefits, and improved project implementation capacity to use more effectively available external assistance.

22. Following an extended period of relative neglect of operations and maintenance, the rate of return on incremental public expenditure during the next few years is likely to be the highest for outlays to improve the usefulness and operational life of existing infrastructure. This is true for both the social sector (e.g., medical supplies, textbooks) and for the physical infrastructure (e.g., maintenance of roads and irrigation canals). The Government will, therefore, aim to increase O & M expenditure substantially in real terms and as a proportion of total government expenditure; within this category, it will aim to achieve a better balance in manpower and other costs. At the same time, the Government will implement measures to enhance the effectiveness of planned development expenditure. Within the ADP allocation, about three fourths of projected available resources over the three-year program are already committed to ongoing projects or others which were identified, evaluated, and agreed with donors before July 1985. The scope for starting new projects will therefore be limited. In this context, a careful review of priorities in resource allocation in the investment and O & M budgets will be undertaken to ensure the maximum benefits in terms of poverty alleviation. In some high priority sectors (such as education and energy) the Government will be assisted in defining their expenditure programs and supported under IDA sectoral policy credits. The Government has recently established the framework for multiyear rolling budgetary plans, including the formulation of public investment and financing programs, allowing a more realistic assessment of expected resources and feasible expenditure; over time this will become an integral tool of the budgetary planning.

23. Improvements in project and program implementation are urgently required. Although disbursement rates 1/ of externally aided projects have improved to about 16.6 percent in 1985/86 from 15 percent in 1982/83, they still remain well below the rates of above 20 percent achieved between 1977/78-1981/82. Some of the highest priority programs, such as the family planning program, are lagging seriously behind schedule. Some problems are already being addressed; these include procurement procedures, delays in the decision making and approval process, lack of delegation of authority, and inadequate guidelines.

1/ This rate is the amount of project aid disbursements during a fiscal year expressed as a percentage of the undisbursed project aid balance at the beginning of the same fiscal year.

The Government will further streamline the review and approval process and procurement procedures in 1986/87. Part of the reason for slow project implementation is the lack of adequate domestic resources. However, more efficient implementation of projects would help strengthen the case for increased commodity assistance and local cost financing to supplement domestic resources for project implementation.

III. The Social Impact of Adjustment

24. The adjustment measures proposed are expected to encourage greater efficiency and permit a more rapid growth in income and consumption than would otherwise be possible. In designing the program, care has been taken to ensure that increased savings mobilization does not entail declining consumption levels, especially among the poor. With overall growth of GDP of 5 percent per year, it should be possible to raise domestic savings from 3.2 percent of GDP in 1985/86 to 4.9 percent in 1988/89 (as shown in the attached Table 2), while still maintaining real average per capita consumption growth of about 1.8 percent per year. In addition, the renewed emphasis on human resource development is expected to generate increased economic opportunities as well as an enhanced quality of life.

25. Inevitably, some groups will suffer negative consequences from the adjustment program, at least in the short term. In particular, defaulters on loans from the industrial and agricultural credit agencies and major beneficiaries from government subsidies may suffer declining real consumption levels as a result of the strong measures required to restore financial discipline and to gradually raise cost recovery levels. All available evidence, however, suggests that the bottom half of the income distribution in Bangladesh will not be adversely affected by the reforms, even in the short run. The poor are generally not defaulters on loans; the poorest one third are landless and have very little access to credit, and the smallest farmers generally have a good loan repayment record. In addition, the poor are not the principal beneficiaries of subsidies; the bulk of subsidies on food, energy, tertiary education, water supply, and public transportation are enjoyed by urban dwellers in the top half of the income distribution. Similarly, changes in the tax system will be designed so as to make the system more progressive in its overall incidence. Some unemployment may result from the closure of a small number of inefficient plants but this is expected to be more than offset by increased opportunities in other industrial subsectors.

26. Care must, however, be taken to protect the poor from internal and external shocks. For example, some small farmers may be unable to repay loans following a poor harvest; an improved system of loan restructuring will therefore be required for this purpose. Similarly, the elimination of general subsidies on fertilizer and food must be phased so as to ensure the avoidance of declining food intake by the poor; in the event of sharp rises in food prices, the program may have

to be rephased, although this would require offsetting budgetary savings from other sources. In general, increased government revenue and the curtailment of general subsidies will permit more attention and resources to be targeted at programs and subsidies to specific vulnerable groups; in particular the special food programs, such as those for low-income mothers and children and Food for Work, would be expanded, and programs to encourage greater economic opportunities among the assetless would continue to be given a high priority.

IV. External Assistance Requirements, 1986/87-1988/89

27. Bangladesh has made heavy use of external assistance. The large current account deficits, which averaged 8.4 percent of GDP during the 1981/82-1985/86 period (attached Table 2), have been financed almost exclusively by disbursements of grants and concessional loans. Foreign aid disbursements have accounted for about 45 percent of total government resources, 65 percent of total investment, and 55 percent of import payments in recent years. Even under the most optimistic assumptions regarding the growth of exports and national savings, the country will continue to require substantial external assistance. The Government expects that, with the adjustment program described in this paper, Bangladesh would continue to receive such assistance.

28. Aid commitments have fallen substantially in recent years--from 16 percent of GDP during 1980/81-1981/82 to 12 percent during 1982/83-1985/86. Disbursements of aid funds have also fallen as a proportion of GDP--from an average of 9 percent in 1980/81-1981/82 to 8 percent in 1983/84-1985/86--although they have risen slightly during the 1980s in current dollars. The structural adjustment program described in this paper will permit substantial increases in aid disbursements and is hoped to act as a catalyst for additional aid commitments as well.

29. In some recent years, poor harvests have made it necessary to borrow from commercial sources for supplementary food imports; in the year following the 1984 floods, for example, disbursements of commercial loans reached 1.2 percent of GDP. Since access to such funds must be protected for times of special need, the Government intends to strictly *limit commercial borrowing for normal investment and consumption purposes*. This strategy also reflects the authorities' determination to reduce the debt service burden to a sustainable level.

30. Achieving this program's growth target will require three complementary programs of action in relation to capital inflows. First, project implementation must be improved substantially to permit increased disbursements of project aid of at least 10 percent per year in real terms over the program period. This would require the ratio of disbursements to the opening pipeline to rise from 16.6 percent to about 20 percent. The pipeline of undisbursed project aid now stands at over

$4.6 billion, and no real increases in annual commitment levels (currently about $1.1 billion) will be required.

31. Second, commitments of commodity and program aid, currently about $500 million per year, must be increased by about 5 percent per year in real terms over the program period. Food aid will continue to be required at about its present level ($250 million per year) to help bridge the gap between domestic production and effective demand, and to provide for the rural poor and other vulnerable group programs.

32. Finally, the reforms described in this paper must be implemented expeditiously to permit a higher rate of economic growth with a lower average current account deficit than in the first half of the 1980s. It is recognized that even with good progress in improving project implementation and raising additional commodity aid, a current account deficit of more than 7.5 percent of GDP is unlikely to be sustainable over the medium term due to debt servicing considerations; this contrasts with an average deficit of 8.4 percent over the last five years. Improvements in the mobilization of national savings and in the efficiency of investment will be essential if growth targets are to be reached.

33. The SAF program assumes that substantial progress in each of these three areas will be made and that an average annual growth rate of 5.0 percent will be achieved. Under favorable conditions, growth during the program period could reach the 5.4 percent level envisaged in the Third Plan. This would require a combination of favorable weather and higher levels of foreign aid. It is estimated that aid disbursements over the three-year period would have to be $150 million per annum higher than in the base case; this in turn would require exceptional improvements in absorptive capacity and in domestic resource mobilization.

34. Under the SAF scenario, required aid disbursements over the three-year period (July 1986-June 1989) are projected to be $4.6 billion, of which about one fourth ($1.2 billion) would be in the form of program or commodity credit (attached Table 2). The ability of IDA to support the program described will depend on translating these general statements into monitorable measures, of sufficient scope, for early implementation. This will be a challenging and difficult task. But if agreement is reached on adequate progress on trade decontrol, financial rehabilitation and resource mobilization, the annual level of quick disbursing assistance from IDA could rise to finance about one third of Bangladesh's requirement for this type of finance. In addition, Fund resources under the structural adjustment facility are expected to amount to about $160 million, of which about $70 million will be disbursed during the first year of the program.

35. It is also recognized that the Bangladesh economy is vulnerable to exogenous shocks, in particular, adverse weather and sharp fluctuations in the terms of trade. Additionally, workers' remittances

cannot be relied upon to finance as significant a proportion of total imports as in the past. Accordingly, in the event of shortfalls in export earnings or in workers' remittances, the achievement of the program's growth target will require not only intensified structural adjustment efforts, but also additional aid flows beyond those currently anticipated.

Table 1. Bangladesh: Summary and Time Frame for Structural Adjustment Policies, 1986/87-1988/89

	Objectives and Targets	Strategies and Measures		Timing of Measures
I. Agriculture and Food Policy				
Public expenditure in agriculture	Improve operation and maintenance of existing and new agricultural infrastructure.	Complete study on Operations and Maintenance (O&M) needs in irrigation, water management and flood control.	*	1986/87
		Implement reccommendations of study.		
		Incorporate specific agricultural O&M needs in budget on the basis of the study.		1987/88 onward
	Expand private irrigation facilities.	Ensure continued unsubsidized private sector role in distribution of minor irrigation equipment. Bangladesh Agricultural Development Corporation (BADC) to improve its distribution and GOB to ensure adequate credit to creditworthy borrowers.		Ongoing
Institutional reforms	Greater private sector involvement in the distribution of agricultural inputs and equipment to farmers.	Undertake comprehensive study to review the functions, operational role and organization of BADC.		1986/87
		Reform Bangladesh Rural Development Board activities to revitalize cooperatives.		Ongoing
Food policy	Improve public domestic procurement and distribution operation. Phase out subsidies, except for Food for Work and targeted distribution programs.	Implementation of action program based on the recommendations of the National Committee on Rationing as approved by GOB.	*	1987/88
Fertilizer pricing	Eliminate economic subsidy for wholesale fertilizer prices.	Elimination of economic subsidy on fertilizers at the wholesale level.		1986/87
		Quarterly reviews of fertilizer prices. Price adjustments at least twice each fiscal year to ensure that economic subsidy remains zero.	*	Ongoing
Agricultural support programs	Improve efficiency of research extension and water distribution.	Management training and reorganization in extension and research services and in Irrigation Management Program (IMP)		Ongoing

* Supported under ongoing IDA policy credits.

Table 1. Bangladesh: Summary and Time Frame for Structural Adjustment Policies, 1986/87-1988/89 (continued)

	Objectives and Targets	Strategies and Measures	Timing of Measures
II. Industrial and Trade Policy			
Investment sanctioning	Liberalize and simplify investment procedures.	Expand number of sectors in which investment is unrestricted.	1986/87
		Increase authority of financial institutions to approve investments.	
Tariff reform	Improve efficiency in traded goods sector.	Rationalize import regime	Ongoing
		Reduce and narrow the band of net effective level of protection for textile and steel on the basis of TIP study.	1986/87-1988/89
Import Restrictions	Facilitate imports of raw materials, intermediate goods, and capital goods to encourage industrial production.	Review restrictive and banned lists with a view to reducing them substantially.	Ongoing
		Phase out requirement that barter facilities must be fully used before imports under any other financing source are allowed.	1986/87
		Allow commercial firms to import on the same basis as industrial firms; except for some limited exceptions.	1987/88

Table 1. Bangladesh: Summary and Time Frame for Structural Adjustment Policies, 1986/87-1988/89 (continued)

	Objectives and Targets	Strategies and Measures	Timing of Measures
Public Sector Enterprises (PSEs)	Improve efficiency by enhancing enterprise autonomy, clarifying accountability and improving evaluation.	Implement Public Enterprise Management Ordinance (promulgated June 1986).	Ongoing
		Develop system of performance evaluation and implement in two pilot enterprises.	1986/87
		Extend to five additional PSEs.	1987/88
	Restructuring of jute mills	Adopt measures to better utilize existing capacity; invest in improved technical efficiency; and progressively reduce excess capacity.	Ongoing
Industrial export promotion	Provide free trade status for exporters.	Remove restrictions on all required imports for direct and indirect exporters.	1986/87
		Ensure duty-free status for exporters by establishing Duty Exemption/Drawback Office.	1986/87
		Grant additional autonomy and provide additional infrastructure for Export Processing Zone.	1986/87
	Ensure improved export credit finance.	Prepare and implement plan to strengthen provision and guaranteeing of export credit.	1987/88
	Promote backward linkages.	Extend coverage of back-to-back letters of credit to all products and all indirect exporters.	1987/88

Table 1. Bangladesh: Summary and Time Frame for Structural Adjustment Policies, 1986/87-1988/89 (continued)

	Objectives and Targets	Strategies and Measures		Timing of Measures
III. External Sector Policy				
Exchange rate management	Strengthen the balance of payments position.	Exchange rate management will remain flexible to improve competitiveness and promote export diversification.		Ongoing
	Unification of dual exchange markets.	Steadily increase the proportion of external transactions conducted in the secondary exchange market.		1986/87-1988/89
External debt management	Limit debt service obligations to sustainable levels.	Limit nonconcessional borrowing to exceptional circumstances.		Ongoing
IV. Monetary Policy and Financial Sector Reforms				
Monetary policy	Support economic growth while steadily reducing the rate of inflation.	Growth of broad money to be consistent with targeted growth in nominal GDP.		Ongoing
	Encourage savings and efficient allocation of resources.	Maintain positive real interest rates.		Ongoing
Financial sector reforms	Significant improvement in credit recovery.	Setting of annual overall recovery targets subject to close monitoring. Improvement of information system on defaulters.	*	1986/87 onward
		Expansion of credit passbook system for agricultural crop loans.	*	1986/87
		Establishment of a comprehensive data base on credit recoveries and a new credit information system at the Bangladesh Bank; and creation of a high-level committee comprising the Cabinet Secretary, Governor of Bangladesh Bank, Finance Secretary, Agriculture Secretary, and the Home Secretary to take policy decisions on agricultural and industrial credit reforms.		1986/87

* Supported under ongoing IDA policy credits.

Table 1. Bangladesh: Summary and Time Frame for Structural Adjustment Policies, 1986/87-1988/89 (continued)

	Objectives and Targets	Strategies and Measures	Timing of Measures
Financial sector reforms (continued)	Strengthen rural credit institutions.	Complete study by Bangladesh Bank on agricultural credit institutions' capability to collect.	1986/87
		Implement recommendations of study	Ongoing
	Reform credit guarantee system.	Establishment of Agricultural and Rural Guarantee Fund (ARGF) with participation of Bangladesh Bank, the banks and Government. *	1986/87-1987/88
	Encourage development and deepening of financial sector over the medium term.	Based upon Banking Commission recommendations (July 1986) and the follow-up study in November 1986, identify and implement medium-term reform programs.	1986/87-1988/89
V. Public Resource Mobilization			
Revenue	Steadily raise government revenue to 10.5 percent of GDP.	Implement improved tax administration and required increases in rates.	By 1988/89
Tax system reform	Move away from a heavy dependence on trade-related taxes toward domestic output/consumption based taxes.	Undertake a detailed technical study of (a) the tax system; (b) scope for improving tax administration, and achieve higher rates of collection.	1986/87
Fees and charges	Improve cost recovery in energy sector.	Raise gas prices and rationalize gas price structure.	1986/87-1988/89
		Adjust power tariffs in light of recommendations of tariff study (September 1986).	1986/87-1988/89
		Implement program for reduction of technical losses in power sector.	Ongoing

* Supported under ongoing IDA policy credits.

Table 1. Bangladesh: Summary and Time Frame for Structural Adjustment Policies, 1986/87-1988/89 (concluded)

	Objectives and Targets	Strategies and Measures		Timing of Measures
Fees and charges (continued)	Improve cost recovery in transport sector.	Undertake a study of cost recovery and financing of road transportation.		1986/87
	Improve cost recovery in health sector.	Undertake a study of cost recovery and financing of health care services.		1986/87-1987/88
VI. Public Expenditure Policies				
Budget deficit	Reduce bank financing of budget deficit.	Tailor expenditure to level of available resources.		Ongoing
Planning and implementation	Improve efficiency of expenditure.	Undertake a study to identify key constraints affecting efficiency of public administration in key ministries.	*	Study 1986/87 Implement 1987/88
	Improve budget execution and review.	Review and improve accounting and fiscal reporting		Ongoing
	Develop multiyear budgeting system.	Extend and strengthen system of "Shadow ADP," introduced on pilot basis.	*	Ongoing
	Improve project implementation.	Review and revise contract award procedures. Prepare new manual of procedures. Design and implement training program.	*	1986/87
Operations and Maintenance	Ensure adequate allocation of funds for O&M.	Identify specific O&M needs for each sector at time of budget preparation, taking into account the requirements of completed projects.		1986/87 onward
		Undertake studies on key sectors: (a) flood control, drainage and irrigation; (b) highways; (c) education.	*	1986/87

* Supported under ongoing IDA policy credits.

Table 2. Bangladesh: Key Economic Indicators and Projections, 1979/80-1989/90 1/

	1979/80	1980/81	1981/82	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90
GDP growth rate	3.7	6.5	0.8	3.5	4.3	4.1	3.9	4.7	5.2	5.1	5.0
GDP deflator	18.5	10.6	12.7	5.1	16.3	14.9	7.3	8.0	8.6	6.3	6.8
GDP/capita growth rate	1.1	3.8	-1.8	0.9	1.8	1.6	1.4	2.1	2.6	2.5	2.4
Consumption/capita growth rate	0.8	4.5	-1.9	1.3	0.9	0.5	0.7	1.8	1.8	1.9	2.0
Gross investment/GDP	13.6	13.1	15.0	13.6	12.3	13.3	13.1	12.9	13.6	14.3	14.8
Domestic savings/GDP	1.7	1.2	1.1	0.7	1.5	2.7	3.2	3.5	4.3	4.9	5.3
National savings/GDP	2.9	3.5	3.5	5.2	5.6	5.1	6.1	6.2	6.9	7.4	7.7
Marginal national savings rate	...	6.5	3.5	24.5	7.3	2.6	15.3	7.1	11.8	11.3	10.3
Public investment/GDP	7.8	7.2	6.2	6.2	5.6	6.1	5.9	6.8	6.8	7.0	7.2
Public savings/GDP	1.7	2.2	1.7	0.7	0.5	1.1	0.4	0.9	1.4	1.8	2.1
Private investment/GDP	5.8	5.9	8.9	7.4	6.7	7.1	7.1	6.2	6.7	7.4	7.6
Private savings/GDP	0.1	-1.0	-0.6	--	1.0	1.5	2.7	2.6	2.9	3.1	3.3
Ratio of public/private investment	1.4	1.2	0.7	0.8	0.8	0.9	0.8	1.1	1.0	0.9	1.0
Government revenue/GDP	8.7	9.3	8.8	8.8	8.2	8.6	9.1	9.5	10.0	10.5	10.9
Government expenditure/GDP	20.5	18.5	17.4	20.0	17.3	16.1	16.4	16.7	17.3	17.4	17.6
Deficit (-)/GDP	-11.8	-9.3	-8.7	-11.2	-9.2	-7.6	-7.3	-7.2	-7.3	-6.9	-6.7
Export growth rate	21.8	-4.9	-11.6	9.7	18.1	15.1	-12.3	13.4	13.8	10.0	10.5
Nontraditional export growth rate	41.7	-13.7	16.5	35.1	28.6	53.8	20.6	30.6	18.6	18.6	18.7
Exports/GDP	5.8	5.0	4.7	5.7	5.8	5.8	5.2	5.4	5.7	5.6	5.6
Nontraditional exports/GDP	0.7	0.5	0.7	1.0	1.1	1.5	1.9	2.2	2.4	2.6	2.8
Import growth rate	53.4	6.7	1.2	-10.3	4.8	12.5	-10.7	7.3	9.5	11.7	10.5
Imports/GDP	18.1	17.3	18.9	18.5	16.8	16.5	15.2	14.8	14.9	15.0	15.0
Current account (in US$ mn.)	-1,361	-1,374	-1,524	-1,019	-948	-1,315	-1,084	-1,146	-1,238	-1,435	-1,616
Current account/GDP	-10.6	-9.6	-11.5	-8.4	-6.8	-8.2	-6.9	-6.7	-6.6	-6.9	-7.1
Aid disbursements (in US$ mn.)	1,222	1,147	1,239	1,345	1,268	1,267	1,306	1,400	1,520	1,712	1,952
Aid disbursements/GDP	9.6	8.0	9.4	11.1	9.0	7.9	8.4	8.2	8.1	8.3	8.6
Debt service (in US$ mn.)	249	269	214	263	280	414	467	538	418	435	493
Debt service ratio 2/	20.6	19.7	16.5	16.8	16.3	24.4	28.1	30.4	21.5	20.9	21.9
Debt service/GDP	10.4	8.4	6.2	5.8	4.7	5.8	6.0	5.8	3.6	3.1	2.9

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

1/ Data are for fiscal years ending June 30.
2/ Debt service as a percentage of receipts from exports of goods and services; and private transfers.

Memorandum on Economic and Financial Policies of the Government of Bangladesh for the period July 1986 - June 1989

1. In the context of its Third Five-Year Plan (1985/86-1989/90), the Government of Bangladesh has decided to implement a structural adjustment program from July 1, 1986 to June 30, 1989 that would seek to raise real per capita income while reducing inflation and achieving a sustainable external payments position. A description of the structural problems facing Bangladesh and of the policy package the Government intends to implement to resolve them are set forth in the policy framework paper (PFP) accompanying this memorandum.

2. Bangladesh is currently implementing an adjustment program supported by a stand-by arrangement from the Fund. The 19-month stand-by arrangement in the amount of SDR 180 million, equivalent to 62.6 percent of quota, was approved by the Fund's Executive Board on December 2, 1985. The main objectives of the adjustment program are to reduce the internal and external imbalances and moderate the rate of inflation while maintaining a satisfactory rate of economic growth. Policies to achieve these objectives were described in the letters of the Government of Bangladesh to the Managing Director dated November 5, 1985 and July 30, 1986.

3. Macroeconomic performance during 1985/86, the first program year under the stand-by arrangement, was broadly satisfactory. Real GDP is estimated to have increased by 3.9 percent, somewhat below the program target of 4.1 percent, reflecting virtual stagnation in foodgrain production as well as slower growth in industrial output, particularly of jute goods and cotton textiles. The average rate of consumer price inflation slowed to 9.8 percent, well below the program target of 12 percent, owing to the slow pace of domestic demand and a moderate increase in import prices. The outcome in the external sector was also better than programmed. An overall balance of payments surplus of $77 million was achieved, more than twice the programmed level; the target for gross official reserves was exceeded by $50 million, raising the level to 2.4 months of imports. The current account deficit narrowed to 6.9 percent of GDP, compared with a target of 7.3 percent, as food imports declined while workers' remittances increased in response to the depreciation of the taka. These two developments more than offset the shortfall in export earnings caused mainly by the sharp decline in jute prices. The central government budget deficit declined slightly to 7.3 percent of GDP, as envisaged under the program, enabling the Government to reduce its indebtedness to the banking system. Total government revenue, which amounted to 9.1 percent of GDP, was 0.4 percentage point of GDP below the program target, due principally to lower collections from customs duties, sales taxes, and excise taxes. However, this shortfall was offset by lower-than-programmed expenditures.

4. Monetary developments during 1985/86 were broadly in line with the program targets, except in the area of loan recovery. In particular, the credit ceilings under the program were observed. The expansion of net domestic assets of the banking system decelerated sharply to 15.1 percent, reflecting the fall in net credit to the Government and a substantial decline in the rate of increase in other credit components. The growth rate of broad money was 17.1 percent, slightly higher than the program target of 15.9 percent, owing to a stronger balance of payments outcome. Interest rates remained positive in real terms, but their allocative function was undermined by the persistence of the loan recovery problem. Poor performance in this area has brought to the fore the structural weaknesses of the financial sector. A comprehensive program to address these weaknesses has been initiated and will be vigorously pursued during the period of the three-year SAF arrangement.

5. The 1986/87 program was designed to realize a real GDP growth rate of close to 5 percent while containing the rate of inflation to 8.5 percent. The target for the external current account deficit was set at 6.6 percent of GDP, and an overall balance of payments surplus of $40 million was targeted. The government budget deficit was programmed to decline to 7.2 percent of GDP while the growth in net domestic assets of the banking system was limited to 15.0 percent. Developments thus far indicate that the program's objectives are likely to be achieved. We expect to realize the fiscal and monetary targets set under the program. It is now estimated that real GDP growth will be 4.7 percent. The aman rice harvest is estimated to be close to the level of 1985/86 and industrial production is accelerating owing to the improvement in export demand and in the power supply situation. Although consumer price inflation has risen in recent months because unseasonal rainfall has caused temporary shortages of food, this trend is expected to be reversed in the coming months as restrained monetary policies continue to be implemented. For the year as a whole, the average rate of inflation is now estimated to be less than 9 percent. In the external sector, available data indicate that workers' remittances will be substantially higher than programmed, but this will be more than offset by lower-than-envisaged exports, owing mainly to the continued weakness of jute prices, and a higher deficit in the services account. Consequently, the current account deficit is now estimated to be somewhat larger than evisaged in absolute terms, but not significantly different from the original program target in terms of GDP. With net capital inflows estimated to be below the program level due to a shortfall in commodity aid, the overall balance of payments surplus is expected to be only $12 million. However, taking into account the expected utilization of Fund resources under the CFF and the SAF, gross official reserves are estimated to be higher than programmed, equivalent to 2.9 months of imports. All performance criteria for end-September 1986 have been met and we remain committed to implementing the policies described in the Letter of the Government of Bangladesh to the Managing Director dated July 30, 1986 with a view to assuring that performance criteria continue to be observed.

6. The Government's macroeconomic objectives under the three-year SAF program include raising the annual rate of real GDP growth to at least 5.0 percent on average, reducing the rate of inflation to 7 percent by 1988/89, and stabilizing the external current account deficit and the budget deficit of the central government at about 7 percent of GDP. The achievement of the external targets would lead to a reduction in the external debt service ratio to about 21 percent by 1988/89 while maintaining the level of gross reserves at over two months of imports.

7. To achieve these broad objectives, the Government will undertake major structural reforms in several important areas, particularly the public sector, the financial sector, and trade and industry. At present, a key constraint on investment and growth is low public sector revenue, mainly due to weaknesses in the tax system and a deterioration in the financial position of public enterprises. To increase central government revenue, we will review and reform tax policy and administration during the period of the three-year SAF arrangement, with a view to increasing government revenue to 10.5 percent of GDP by 1988/89. Other policies we intend to implement include progressive reductions in subsidies and improved cost recovery in public services. The deterioration in the financial position of nonfinancial public enterprises has resulted in excessive delays in tax payments and hampered the transfer of dividends to the exchequer. The Government has been monitoring this development and is implementing corrective measures so that excessive lags in payments are eliminated during the SAF program period. Profitability of the public enterprises will also be enhanced through the adoption of appropriate pricing policies and increased operational efficiency. We also intend to privatize certain enterprises and sell government-owned shares in others to the public. To improve the allocation of public sector resources, the Government will continue to increase expenditures for the operations and maintenance of existing capital assets. In addition, the budgeting, planning, appraisal and implementation of investment projects will be improved so as to utilize external aid more effectively.

8. Financial sector reforms will focus on strengthening the banking system, promoting savings and efficient investment, and enhancing monetary policy. In recent years, inadequate loan recovery in agriculture and industry has affected the viability of the banking system. Recognizing the seriousness of this problem, the Government has recently put into effect a comprehensive loan recovery program, details of which are described in paragraph 14 below. To mobilize domestic savings and promote the efficient allocation of financial resources, the interest rate structure will be rationalized as necessary and made more flexible. Interest rates will continue to remain positive in real terms. The effectiveness of monetary policy will be enhanced by strengthening the role of Bangladesh Bank, further developing the money and capital markets, and placing increased emphasis on indirect instruments of monetary control.

9. Reforms of the exchange and trade systems will continue during the SAF program period in order to strengthen the external position. As in recent years, we will make progress toward exchange rate unification in order to reduce the distortions arising from the dual foreign exchange regime. The proportion of external transactions conducted through the secondary market, where the exchange rate is determined by authorized dealers, will be steadily increased. At the same time, the differential between the official and the secondary rates will be gradually reduced by adjusting the official rate. To promote competitiveness, exchange rate policy will remain flexible. The Government is encouraging export-oriented industries by permitting them to import raw materials and intermediate inputs which are otherwise restricted. The lists of banned and restricted goods will be progressively rationalized and reduced, and protection for domestic infant industries will be appropriately provided by a rationalized tariff system. To ensure that new and small firms have access to imports, commercial firms will be allowed, in general, to import on the same basis as industrial enterprises.

10. Demand management policies during the SAF program period will aim at ensuring that structural reforms are carried out in an environment of financial stability. Prudent financial policies will continue to be pursued in order to reduce the rate of inflation and achieve the external targets. The rate of monetary expansion will be set in line with the targeted growth in nominal GDP. It is the intention of the Government to minimize its recourse to credit from the banking system. This policy will ensure that the flow of credit to the private sector is adequate to finance the envisaged higher levels of private investment. As in the past, external borrowing on commercial terms will be strictly limited so that debt servicing obligations remain at a sustainable level.

11. The SAF program for 1986/87 builds on the measures being implemented under the current stand-by arrangement. In order to promote diversification of exports and industrial growth, we have considerably liberalized the trade system. In July, the negative and restrictive import lists were further shortened; export-oriented firms were permitted to import banned or restricted items on request; and regulations on import permits for industries operating under the bonded warehouse system were eased. In October 1986, we eliminated the requirement that firms with quota for barter products must fill such quotas before importing these products under any other arrangement. This important liberalization measure will reduce the cost of imported inputs and improve resource allocation. A portion of SAF resources may be sold, as required, in the secondary market to satisfy part of the additional demand generated by this measure.

12. To pave the way for the eventual unification of the dual exchange markets, in July 1986 we enlarged further the scope of the secondary exchange market, raising the share of export transactions conducted in this market from about 53 percent to 73 percent of total exports, and the share of import transactions from about 28 percent to 42 percent of

total imports. In November, the differential between the official and secondary exchange rate was narrowed from 9.2 percent to 7.5 percent through a depreciation of the official rate.

13. Mobilization of additional public sector resources is necessary to facilitate the utilization of external aid, thereby increasing investment. To meet this objective, we intend to restructure the tax system in ways that would increase the proportion of revenue obtained from domestic sources. As a first step, during the current fiscal year, we intend to undertake a study on tax policy and administration with technical assistance from the Fund and the World Bank. It is our intention to incorporate appropriate policy measures in future budgets based on the findings of this study. Other resource mobilization efforts being undertaken include improved enforcement of taxes; elimination of the budget subsidy for fertilizer; a further reduction of food subsidies; and better cost recovery by nonfinancial public enterprises. To improve the efficiency of these enterprises, a management information system has been developed to gather key data needed for budgeting control and for an assessment of the macroeconomic impact of these enterprises. Furthermore, a new system of performance evaluation has been established this year on a pilot basis in two manufacturing units.

14. The deterioration in loan recovery in both the agricultural and industrial sectors is undermining the effectiveness of monetary policy and poses a threat to the viability of financial institutions. Therefore, we are implementing a comprehensive program to significantly increase loan recovery in both agriculture and industry. In the case of agricultural loans, the program aims at increasing collections during 1986/87 by at least 30 percent (to Tk 8.6 billion) over the level realized in 1985/86. To achieve this objective, banks have been instructed to establish and pursue quarterly cash recovery goals. To provide incentives for early repayment of overdue loans, accrued interest and penalties will be waived on all crop loans not exceeding Tk 10,000 if the principal amount is repaid by February 28, 1987. In connection with this incentive scheme, the Government will take measures to appropriately compensate the affected banks. The budgetary impact of these measures, if any, will be offset by appropriate actions so as to ensure that the fiscal objectives envisaged under the program are achieved. As of November 1986, crop loans have not been given to farmers not possessing valid passbooks. Also, during the current fiscal year, Bangladesh Bank will establish a comprehensive data base and a new credit information system in order to prevent willful defaulters from obtaining new loans. Willful defaulters will be prosecuted to the fullest extent of the law. Necessary changes in the relevant laws will be made to bar defaulters from holding certain local elected positions. The Government has established a high-level committee comprising the Cabinet Secretary, the Governor of Bangladesh Bank, the Finance Secretary, the Agriculture Secretary, Secretary to the President, and the Home Secretary to coordinate and supervise the agricultural loan recovery program and to take policy decisions on agricultural credit reforms. In the case of industrial loans, the

Government has set collection targets for the two development finance institutions (DFIs), and is implementing measures aimed at establishing credit discipline. These measures include denial of commercial bank credit and import licenses to defaulters on DFI loans, and takeovers of defaulters' assets through special procedures. In addition, we intend to restructure the DFIs and strengthen their financial position.

15. Close monitoring of several key indicators should permit us to assess performance under the SAF program for 1986/87 and the remaining period of the stand-by arrangement and alert us to the need for timely remedial action in case of deviations. Attention will center on developments in net domestic assets; net credit to the central government; 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). In view of the importance which the Government attaches to the achievement of the fiscal objectives under the SAF program, individual components of revenue and expenditure and financing of the deficit through the domestic banking system (Table 2) will be watched closely. Benchmarks of policy implementation in the structural areas are presented in the attached Table 3.

Table 1. Bangladesh: Quantitative Benchmarks Under the Structural Adjustment Facility Arrangement, 1986/87 1/

	1986	1987	
	Dec.	March	June
	(In billions of taka; end of period)		
Net domestic assets 2/	131.7	133.3	139.4
Net credit to the central government 2/	22.4	21.6	22.6
	(In millions of U.S. dollars; end of period)		
Contracting or guaranteeing of new nonconcessional public external debt			
Over 1 year and no more than 12 years	100	100	100
Of which: Over 1 year and no more than 5 years	(80)	(80)	(80)
Outstanding stock of external public debt of less than 1 year maturity	...	36	36
Outstanding stock of external liabilities of Bangladesh Bank of less than 1 year	80	80	80
	(In percent; 1986/87)		
Ratio of the overall deficit in central government operations to GDP			7.2
Ratio of central government total revenue to GDP			9.5
	(In billions of taka)		
Recovery on agricultural loans	3.4	5.6 3/	8.6

1/ Fiscal year ending June 30, 1987.
2/ At constant June 30, 1985 exchange rates.
3/ Target is for February 1987.

Table 2. Bangladesh: Central Government Operations, 1985/86-1986/87 1/

	1985/86 Actual Prov.	1986/87 Program	1986/87 Estimate
	(In billions of taka)		
Total revenue	42.28	50.69	50.28
Tax	32.98	40.74	41.11
Nontax	9.30	9.95	9.17
Total expenditure	76.37	89.20	88.04
Current expenditure	34.56	37.66	38.52
Annual Development Program (ADP)	36.41	44.25	42.43
Other 2/	5.40	7.29	7.09
Overall budget deficit	34.09	38.51	37.76
Net foreign financing 3/	31.50	35.39	34.75
Net domestic financing	2.59	3.12	3.01
Banking system	-1.35	0.50	0.54
Other domestic	3.94	2.62	2.47

1/ July 1 to June 30.
2/ 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.
3/ Includes foreign grants.

Table 3. Bangladesh: Benchmarks of Policy Implementation Under the Structural Adjustment Facility Arrangement, 1986/87

Policy Measures

1. Liberalization of import and exchange system
   Reducing the differential between the official and secondary exchange rates by adjusting the official rate.

2. Public sector resource mobilization
   Undertaking a detailed technical study of the tax structure and administration; and

   Implementing measures to increase tax collection, and improve enforcement of taxes.

3. Public expenditure
   Improving project implementation through revised contract award procedures; and

   Granting greater operational autonomy to implementing agencies.

4. Financial sector reform

   a. Agricultural credit

   Setting loan recovery targets;

   Linking Bangladesh Bank refinancing to loan recovery performance;

   Strengthening of legal procedures for effective prosecution of willful defaulters, and the disbarment from elective positions; and

   Establishing a comprehensive data base on credit recoveries and a new credit information system at the Bangladesh Bank.

   b. Industrial credit

   Denying commercial bank credit and import licenses to defaulters on DFI loans;

   Taking over by the DFIs assets of large and willful defaulters; and

   Increasing provisions for doubtful loans, write-offs where necessary, and recapitalizing the DFIs.

Bangladesh - Fund Relations
(As of November 30, 1986)

(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 (General Resources Account)

(a) Quota:	287.5
(b) Total Fund holdings of taka:	638.4
(As percent of quota)	(222.0)
(c) Fund credit:	373.3
(As percent of quota)	(129.8)
Credit tranches	165.0
(As percent of quota)	(57.4)
Extended Fund facility	84.7
(As percent of quota)	(29.5)
Supplementary financing facility	44.6
(As percent of quota)	(15.5)
Compensatory financing facility	79.0
(As percent of quota)	(27.5)
(d) Reserve tranche position:	22.4
(e) Current operational budget:	None
(f) Lending to the Fund:	None

III. Stand-By and Extended Arrangements

Type of Arrangement	Date of Approval	Duration	Amount	Utilization
(a) Current stand-by arrangement.				
SBA	12/02/85	19 months	180.00	132.00
(b) Stand-by and extended arrangements during the last ten years.				
SBA	07/28/75	1 year	62.50	62.50
SBA	07/30/79	1 year	85.00	85.00
EFF	12/08/80	3 years 1/	800.00	220.00
SBA	03/28/83	5 months	68.40	68.40

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

(c) Special facilities

Type of Special Facility	Date of Approval	Amount
CFF	02/17/82	60.00
CFF	08/30/82	71.20
CFF	04/10/85	54.95

IV. SDR Department

(a) Net cumulative allocation:	47.1
(b) Holdings:	6.2
(As percent of net cumulative allocation)	(13.3)

V. Administered Accounts

(a) Trust Fund loans:	
(i) Disbursed	122.2
(ii) Outstanding	63.4
(b) SFF Subsidy Account:	
(i) Donations to Fund	--
(ii) Loans to Fund	--
(iii) Payments by Fund	13.9

VI. Overdue Obligations to the Fund — None

B. Nonfinancial Relations

VII. Exchange Rate Arrangement

Since August 13, 1979 the taka has been pegged, within margins, to a currency-weighted basket. The exchange rate of the taka in terms of the pound sterling, which had been the intervention currency from 1972 to January 10, 1982, was changed from Tk 38.422 to Tk 39 per pound sterling on August 24, 1982. On January 11, 1983, the intervention currency was changed to the U.S. dollar 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, tourism, and nontraditional exports are auctioned off. At the end of November 1986, the exchange rate was Tk 30.80 per U.S. dollar in the official market and Tk 33.17 per U.S. dollar in the secondary market.

VIII. Last Article IV Consultation

The 1985 Article IV consultation report (SM/85/264) was discussed by the Executive Board on December 2, 1985 (EBM/85/173). The following decision (Decision No. 8142-(85/173)) 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 1985 Article XIV consultation with Bangladesh, in the light of the 1985 Article IV consultation with Bangladesh conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes that Bangladesh maintains certain restrictions on payments and transfers for current international transactions and multiple currency practices as described in SM/85/264. The Fund encourages Bangladesh to eliminate the margin requirements on import letters of credit, to continue channeling more transactions through the secondary exchange market with a view to an early unification of the exchange markets, and to terminate the bilateral payments arrangements with Fund members.

IX. Consultation Cycle

A consultation cycle of 12 months was indicated in the Summing Up of the 1985 Article IV consultation.

X. Technical Assistance

(a) Central Banking: A mission led by Mr. Sundararajan visited Bangladesh in February 1985 to review bank regulations and monetary policy practices. In June-July 1985, a follow-up mission, headed by Ms. Lachman (LEG), visited Bangladesh primarily to advise the authorities on measures to strengthen bank supervision and establish a more efficient system of loan recovery; this included the preparation of a draft loan recovery legislation. In November 1986, Mr. Lindgren participated in a Bank-Fund financial secor mission that conducted a comprehensive review of financial sector issues. The authorities plan to implement financial reforms, taking into consideration the recommendations of this mission.

(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.

(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.

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 $3,640.11 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 94 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 one third) to be in the form of program credits (Import Program Credits (IPCs) and other policy-based lending). Also, IDA project financing continues to cover all foreign exchange costs, and a significant portion of local currency expenditures. In addition to providing foreign exchange and local counterpart financial support, the program credits have been a useful vehicle for initiating and supporting sectoral and macroeconomic structural and policy reforms.

Since 1982, IDA has extended 13 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 new 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 projects, IDA lending to agriculture (about 21 percent 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 9 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, IDA has financed projects to increase fertilizer production, rehabilitate the jute and textile industries, strengthen the development finance institutions, and promote small-scale industries.

With an inadequate supply of energy constituting a major constraint to growth in Bangladesh, IDA's lending for power and gas investments (16 percent) 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. In transport, IDA's lending (6 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.

IDA chairs the annual Bangladesh Aid Group meetings which 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 1986.

B. IBRD/IDA lending operations:

	Disbursed	Undisbursed
	(In millions of U.S. dollars; November 30, 1986)	
Completed projects and import program credits	1,622.85	--
IBRD	54.90	--
IDA	1,567.95	--
Projects in execution (all IDA)	636.42	1,296.20
Agriculture and rural development	175.38	340.71
Industry	113.86	142.31
Education	71.09	161.13
Population	--	91.26
Transportation	38.90	70.79
Telecommunication	14.40	22.80
Technical assistance	1.34	27.47
Power and gas	201.10	360.13
Water supply and sewerage	20.35	79.60
Import program credits	98.76	124.22
Total	735.18	1,420.42
Repayments	19.13	
Total debt outstanding 1/	3,871.44	
IFC investment	15.29	

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 has not yet been released.

1/ Includes undisbursed amounts.

Bangladesh - Statistical Issues

1. Outstanding Statistical Issues

a. Real sector

There is a need for the regular reporting of data on the expenditure components of gross domestic product (GDP). At present, only data on aggregate gross domestic product are published in IFS. There are two consumer price indices reported by the authorities: one published in IFS is based on the 1973-74 household survey, and the other stored in the Bureau of Statistics' data base is based on the 1969/70 household survey. A new consumer price index needs to be constructed to reflect the more recent consumption pattern in the country. Technical assistance has been provided by the Fund in this respect, but the implementation of the recommendations is being delayed because of manpower constraints.

b. Monetary accounts

The present system of compiling monetary data has been established with technical assistance from the Fund. A recommendation was also made for revising the reporting system by commercial banks, which is planned for implementation in 1987.

c. Government finance

The latest data published in IFS and in the Government Finance Statistics Yearbook (GFSY) refer to 1982/83; the Government reports data only after the budgetary accounts have been finalized and closed. Data appearing in the Bureau of Statistics' data base differ significantly from the RED presentation in many instances notably with regard to nontax revenue, expenditure, financing, and the treatment of the food account. The authorities have expressed their desire to eliminate these differences at an early stage.

Data appearing in GFSY in respect of lending minus repayments by function and financing by type of debt holder and debt instrument are incomplete after 1978. In addition, data are lacking on expenditure and lending minus repayments by economic type and on the stock of government debt.

d. External accounts

The balance of payments data published in IFS are reasonably current.

2. Coverage, Currentness, and Reporting of Data in IFS

The table shows the currentness and coverage of data published in the country page for Bangladesh in the January 1987 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Bangladesh Bank, which during the past year have been provided on a timely basis.

Status of IFS Data

		Latest Data in January 1987 IFS
Real Sector	National Accounts	1984/85
	Prices (consumer)	August 1986
	Production (industrial)	July 1986
	Employment	n.a.
	Earnings	n.a.
Government Finance	Deficit/Surplus	1982/83
	Financing	1982/83
	Debt	n.a.
Monetary Accounts	Central Bank	September 1986
	Deposit Money Banks	September 1986
	Other Financial Institutions	n.a.
Interest Rates	Discount Rate	Q4 1985
	Bank Lending/Deposit Rate	Q4 1985
	Bond Yield	n.a.
External Sector	Merchandise Trade: Value	June 1986
	Merchandise Trade: Unit values	June 1986
	Balance of Payments	Q1 1986 1/
	International Reserves	November 1986
	Exchange Rates	November 1986

1/ Data for the second quarter of 1986 have recently been submitted and will be published in the February 1987 issue of IFS.