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EBS/86/176

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August 5, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Bangladesh - Staff Report for the First Review Under the Stand-By Arrangement

Attached for consideration by the Executive Directors is the staff report for the first review under the stand-by arrangement for Bangladesh. A draft decision appears on page 27.

It is understood that the Executive Director for Bangladesh will be requesting the Executive Board for a waiver of the circulation period in order to enable this subject to be brought to the agenda for discussion on Friday, August 29, 1986.

Mr. Al-Eyd (ext. 7335) or Mr. Itam (ext. 7340) 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 First Review Under the Stand-By Arrangement

Prepared by the Asian and Exchange and Trade Relations Departments

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

Approved by P.R. Narvekar and Eduard Brau

August 4, 1986

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I. Introduction

Discussions for the first review of the stand-by arrangement with Bangladesh were held in Dhaka during April 18-28 and June 30-July 9, 1986. The staff representatives met with the Advisor for Finance, Mr. M. Syeduzzaman; the Governor of Bangladesh Bank, Mr. M. Nurul Islam; and other senior government officials. The staff team consisted of Mr. K. Al-Eyd (Head, ASD), Mr. H.R. De Zoysa (FAD), Mrs. E. Gurgen (ASD), Mr. J. Felman (ETR), Mr. B. Ames (ASD), and as secretaries Mrs. A. Martini and Mrs. C. Francis (both ASD). The staff was assisted by Mr. S. Itam, the Fund's Resident Representative in Bangladesh.

Bangladesh is eligible for the use of Fund's resources under the Structural Adjustment Facility. The authorities have expressed interest in access to this facility, and preliminary discussions were held at the time of the mission's visits. Negotiations are expected to be continued in September.

The Executive Board approved the stand-by arrangement for Bangladesh on December 2, 1985 (EBS/85/251, 11/12/85) for the period through June 30, 1987. The amount of the arrangement, financed entirely from ordinary resources, is SDR 180 million (equivalent to 62.6 percent of quota, or to an annual access of 39.5 percent of quota). The purchases are phased as follows: SDR 36 million upon Executive Board approval of the arrangement, and the remaining amount in six equal installments of SDR 24 million each (Table 1). Three purchases have so far been made, the first upon Executive Board approval of the arrangement, and the subsequent two upon observance of the respective performance criteria for end-December 1985 and end-March 1986 (Table 2). The fourth purchase is contingent on compliance with the end-June 1986 performance criteria, as well as the completion of the first review.

The Government's economic and financial program for the remaining period of the stand-by arrangement is described in the attached letter from the Advisor for Finance, dated July 30, 1986. As of June 30, 1986, Bangladesh's use of Fund credit stood at SDR 385.8 million (134.1 percent of quota), of which SDR 101.3 million (35.2 percent of quota) was the amount outstanding under the compensatory financing facility. Assuming that the full amount available under the present stand-by arrangement is drawn, and taking into account the scheduled repurchases, total Fund credit outstanding to Bangladesh will decline to SDR 367.7 million or 127.9 percent of quota by June 30, 1987.

Table 1. Bangladesh: Fund Position During Period of Arrangement, 1985-87

	Outstanding Sept. 30, 1985	1985 Oct.-Dec.	1986 Jan.-March	1986 April-June	1986 July-Sept.	1986 Oct.-Dec.	1987 Jan.-March	1987 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	-11.1	-6.5
Purchases		--	--	--	--	--	--	--
Repurchases		-11.1	-11.1	-11.1	-11.1	-11.1	11.1	-6.5
Total Fund credit outstanding (end of period)	378.2	385.7	393.1	385.8	390.3	377.3	376.1	367.7
Under tranche policies	243.6	262.2	280.7	284.5	300.1	298.2	308.1	306.2
Special facilities	134.6	123.5	112.4	101.3	90.2	79.1	68.0	61.5
			(In percent of quota; end of period)					
Total Fund credit outstanding	131.5	134.2	136.7	134.1	135.7	131.2	130.8	127.9
Under tranche policies	84.7	91.2	97.6	98.9	104.3	103.7	107.2	106.5
Special facilities	46.8	43.0	39.1	35.2	31.4	27.5	23.6	21.4

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.

Table 2. Bangladesh: Performance Under the Stand-By Arrangement Through end-March, 1986

	End-December 1985		End-March 1986	
	Program	Actual	Program	Actual
	(In millions of taka)			
Credit ceilings 1/				
Net domestic assets	114,600	114,136	116,100	113,555
	(16.1)	(15.6)	(23.3)	(20.6)
Net credit to the Government	22,300	22,300	21,320	20,038
	(--)	(--)	(4.2)	(-2.1)
	(In millions of U.S. dollars)			
External debt ceilings				
External public debt 2/				
One to twelve years	100	--	100	5
Of which: One to five years	(75)	(--)	(75)	(--)
Outstanding external debt of less than one-year maturity	... 3/	30	... 3/	35
Outstanding external liabilities of Bangladesh Bank of less than one-year maturity	120	119	120	118

Source: Data provided by the Bangladesh authorities.

1/ At constant exchange rates prevailing at end-June, 1985; the figures in parentheses are percentage changes over the comparable quarter of the previous year.
2/ Contracting or guaranteeing of new nonconcessional external public debt.
3/ The ceiling is set for the end of the fiscal year only.

II. Background and Performance Under the Stand-By Arrangement

1. Recent developments and the 1985/86 program 1/

Bangladesh experienced a severe deterioration in its external position in the early 1980s, coupled with a slowing down in output growth and a high rate of inflation. Notwithstanding considerable progress in several areas since then in response to changes in domestic economic policies as well as to favorable exogenous developments, the economy remains structurally weak. Export earnings, which are heavily dependent on raw jute and jute goods, finance approximately one third of imports; budgetary resources draw heavily on import-related taxes and are, therefore, subject to the vagaries of external developments; and the low level of incomes constrains national savings to less than 5 percent of GDP and limits the ability to finance key investments.

Recent adjustment efforts in Bangladesh were designed to address the shortcomings mentioned above. The Government's economic program for 1985/86 focused on: mobilization of additional domestic resources; more efficient allocation of resources through appropriate pricing policies and reductions in subsidies; implementation of restrained monetary and credit policies in order to contain inflation and stimulate domestic savings; and export promotion and diversification through the provision of adequate incentives and further liberalization of the trade and payments system. The program was designed to bring about an improvement in the external current account deficit, while achieving real GDP growth of approximately 4 percent. The overall balance of payments was projected to revert to a surplus of $30 million from a deficit of about twice that amount in the previous year, allowing for a moderate buildup in gross reserves to $422 million, equivalent to 2.1 months of imports. Fiscal restraint and a tight credit program were expected to moderate demand pressures. Nonetheless, the program anticipated an initial acceleration in the rate of inflation to 12 percent, reflecting sizable wage increases, adjustments in administered prices, and the devaluations of the taka.

In the fiscal area, measures were adopted to increase domestic resource mobilization, reduce subsidies, and restrict the size of the Annual Development Program (ADP) in line with the expected inflow of foreign assistance and the availability of domestic nonbank resources. The overall budget deficit was envisaged to decline by 0.7 percentage point to 7.3 percent of GDP. The yield from new revenue measures was estimated at over Tk 2 billion (0.4 percent of GDP), raising the total revenue to GDP ratio to 9.5 percent from 8.9 percent in the previous year. The program also incorporated understandings with respect to price adjustments. Natural gas prices, electricity tariffs, railway fares, and water and sewerage charges were raised at the outset of the program. In addition, the ration prices of foodgrains and fertilizer

1/ Fiscal year ending June 30.

prices were raised twice during the year with a view to gradually phasing out subsidies.

The authorities undertook to implement a flexible exchange rate policy aimed at fully restoring and, thereafter, maintaining international competitiveness. As a step toward unification of the dual exchange markets, the scope of the secondary market was expanded significantly beginning in July 1985. In view of the heavy external debt service obligations in the years immediately ahead, the program included an understanding to curtail nonconcessional borrowing.

2. Performance under the 1985/86 program

Economic performance during 1985/86 was broadly satisfactory and in line with that envisaged under the program (Table 3 and Chart 1). Real GDP growth, estimated at 5 percent, was higher than anticipated, reflecting the favorable impact of the bumper crops in rice and jute, as well as some revival in industrial activity. The rate of inflation slowed to approximately 10 percent, well below the program projection of 12 percent. Increased foodgrain availabilities, tight monetary management, and the decline in import prices were the major factors contributing to the deceleration in inflation. The fiscal objectives, however, were not fully realized. All quantitative performance criteria relating to net domestic assets of the banking system, net bank credit to the Government, and external borrowing were met. Exchange rate management was in accordance with the understandings reached under the program, and was conducted with a view to achieving the program's objectives.

The balance of payments outcome for 1985/86 was more favorable than envisaged. The current account deficit remained below the program target, both in absolute terms and in proportion to GDP. Export earnings, however, were $40 million below the program estimate, and 3.5 percent lower than their 1984/85 level, reflecting sharply lower export prices of raw jute, jute goods, and tea. The downturn in jute prices was attributable partly to the sharp increase in the volume of Bangladesh's jute exports which, given their large share in world markets, helped depress international jute prices. The losses in export receipts resulting from adverse movements in the prices of traditional exports were partly offset by the considerable gains from the growth in nontraditional exports (mostly garments and shrimp) in response to the real depreciation of the taka and changes in the trade and payments system directed at promoting exports. Imports declined by close to 8 percent, slightly more than anticipated under the program, reflecting the halving of food imports. The growth in nonfood imports, however, was somewhat stronger than envisaged, in line with the revival in industrial activity. While remaining well below the levels attained in 1982/83 and 1983/84, workers' remittances rose by 26 percent to reach $555 million, due partly to a stronger response to the devaluation of the taka than foreseen under the program. The recent decline in the price of oil reduced Bangladesh's oil import bill by $79 million, while

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

	1983/84	1984/85	1985/86 Program 1/	1985/86 Prel. Actual	1986/87 Program
			(Annual percentage changes; unless otherwise specified)		
National income and prices					
GDP at constant market prices	4.3	4.2	4.1	5.0	4.8
Implicit GDP deflator	16.3	12.3	10.2	10.0	8.5
Consumer prices	9.7	10.9	12.0	10.0	8.5
External sector (in terms of U.S. dollars)					
Exports, f.o.b.	18.1	15.1	0.9	-3.6	11.3
Imports, c.i.f.	4.8	12.5	-6.6	-7.8	4.6
Export volume	3.2	-6.0	24.2	22.3	9.1
Import volume	7.1	13.9	-4.7	-2.2	1.7
Terms of trade	16.9	23.9	-17.2	-16.3	-0.8
Real effective exchange rate 2/	8.6	-2.6	...	-11.4	...
Government budget					
Revenue	12.6	27.5	22.1	15.4	20.5
Tax	12.4	22.5	25.0	12.6	24.6
Nontax	13.4	51.6	10.5	26.2	6.2
Total expenditure	4.9	14.0	11.7	12.8	14.4
Current expenditures	19.9	18.9	17.0	23.3	11.6
Annual Development Program	1.0	9.3	13.6	16.1	15.8
Money and credit					
Net domestic assets	31.0	27.9	15.1	15.1	15.0
Domestic credit	30.9	26.2	15.1	15.2	15.1
Government, (net)	21.5	-2.8	-5.5	-5.6	2.3
Other public sector	3.6	26.5	22.3	24.2	17.2
Private sector	58.7	40.2	18.7	18.0	17.5
Broad money	42.2	25.6	15.9	17.2	15.6
Income velocity (GDP/M2)	-15.9	-8.0	-1.0	-2.2	-1.8
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	-8.4	-7.3	-6.6	-6.6
External public debt (end of period) 3/	42.0	40.2	45.4	43.3	41.6
Debt service (percent of exports of goods and services and private transfers)	16.3	24.2	23.7	25.7	30.2
Debt Service, (excluding IMF)	12.7	18.6	16.4	18.4	21.1
Government budget					
Revenue	8.2	8.9	9.5	9.0	9.5
Expenditure	17.4	16.9	16.8	16.6	16.4
Overall balance	-9.2	-8.0	-7.3	-7.7	-7.2
Domestic bank financing (net)	1.2	-0.3	-0.3	-0.3	0.1
Foreign financing (net)	8.0	7.4	7.0	6.8	6.7
			(In millions of U.S. dollars; unless otherwise specified)		
External sector					
Current account balance	-948	-1,311	-1,090	-1,041	-1,132
Overall balance	218	-59	30	78	40
Gross official reserves (end of period)	539	395	422	470	449
In months of merchandise imports	(2.7)	(1.8)	(2.1)	(2.3)	(2.1)

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

1/ The 1985/86 program figures were based on an earlier estimate for 1984/85.
2/ End of period. Negative sign indicates real effective depreciation of the exchange rate; for 1985/86, the change is from end-June 1985 to end-May 1986.
3/ Includes use of Fund credit and short-term debt.

CHART 1

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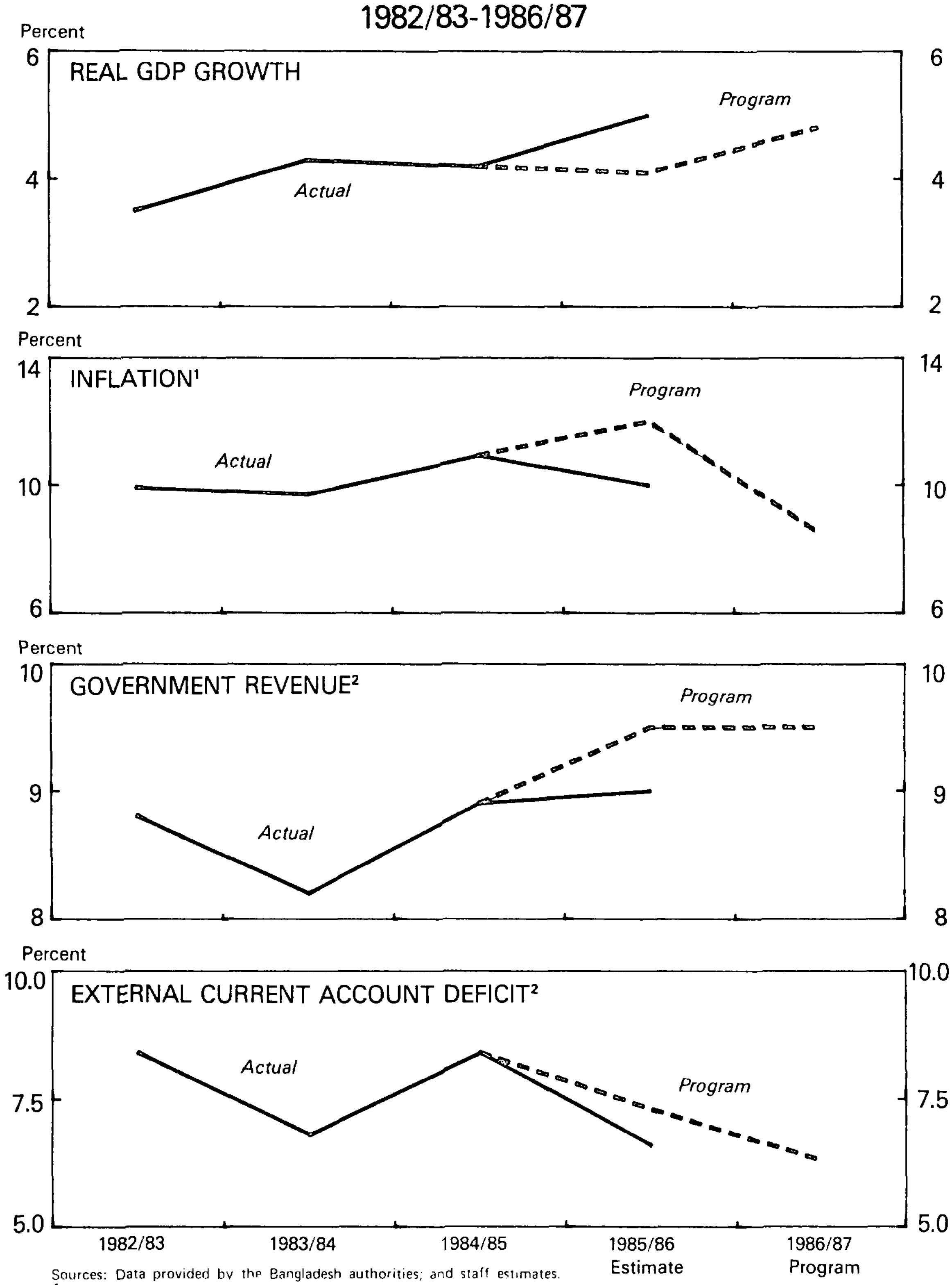
DEVELOPMENTS IN SELECTED ECONOMIC AGGREGATES, 1982/83-1986/87



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.

the impact on workers' remittances was not pronounced. Gross foreign aid disbursements totaled $1.3 billion, of which project aid inflows amounted to $690 million, representing 17 percent of the opening pipeline, compared with 16 percent achieved in recent years. In contrast to the sharp increase in project aid, food and commodity aid declined by 7.5 percent to a combined total of $625 million. The overall balance of payments surplus reached $78 million, more than twice the amount envisaged under the program. The gross reserves target for the year was exceeded by close to $50 million; at end-June 1986 gross international reserves stood at $470 million, equivalent to 2.3 months of imports.

During February-December 1985, the taka was depreciated in several small steps by 16.1 percent in terms of the U.S. dollar to Tk 31 per US$1. These adjustments, coupled with the weakening of the U.S. dollar vis-a-vis other major currencies in the latter part of the period, resulted in a reversal of the real effective appreciation of the taka relative to its base level (the first quarter of 1983). By September 1985, competitiveness lost since the base date had been fully restored, and a positive margin was subsequently achieved (Chart 2). In view of the sharp decline in Bangladesh's inflation rate during January-February 1986, and in order to give flexible signals on exchange rate moves, the authorities appreciated the official exchange rate in three steps by 2.3 percent between January 18 and February 11, 1986 to Tk 30.3 per US$1. Notwithstanding these adjustments, the real effective exchange rate depreciated to 3 percent below its base level by end-May 1986.

The scope of the secondary market was expanded significantly effective July 1, 1985. Additional export transactions, as well as certain commissions and fees, were moved to the secondary market effective December 1, 1985. As a result, the share of secondary market exports in total exports rose from 27 percent in 1984/85 to 53 percent in 1985/86, while the share of secondary market imports in total imports increased slightly to 28 percent. The authorities also took steps to ensure that the secondary market is a free interbank market, with no net foreign exchange sales by Bangladesh Bank in this market. The stepwise devaluations of the official exchange rate during the first half of 1985/86 helped reduce the premium of the secondary market rate over the official rate from 15 percent in June 1985 to 8 percent in January 1986. The premium rose to 9.5 percent in March, largely reflecting the appreciation of the official rate in the preceding two months, and has remained at approximately the same magnitude since then.

Fiscal performance fell somewhat short of the program targets. The overall budget deficit exceeded the program deficit by Tk 2.3 billion to reach Tk 35.9 billion (7.7 percent of GDP). This outcome was attributable to a revenue shortfall of Tk 1.6 billion, coupled with an excess of Tk 0.7 billion in total expenditure. The slippage in revenue reflected mostly lower collections from customs duties, sales taxes, and excise taxes. The smaller-than-programmed revenue from foreign trade-related taxes was due partly to the prevalence of a lower average nominal exchange rate of the taka than assumed under the program. The major shortfall in expenditure was in food operations, reflecting smaller imports and government procurement of foodgrains. The current expenditure overruns, estimated at Tk 1.7 billion, reflected mainly heavier debt service payments, as well as larger losses incurred by the Railways and the Post Office. The larger-than-programmed Annual Development Program was attributable primarily to an improvement in project aid utilization. In financing the overall deficit, a decline in net foreign financing was offset by an increase in domestic nonbank financing, while net indebtedness to the banking system was reduced by Tk 1.3 billion as programmed. The smaller-than-programmed net foreign financing of the budget reflected shortfalls in commodity and food aid disbursements, as well as accelerated foreign debt amortization, particularly on commercial food loans.

The monetary objectives for the year were largely achieved. The quarterly credit ceilings under the program for the period through March 1986 were observed, and actual data through May indicate that the end-June ceilings are likely to have been met. Accordingly, net domestic assets of the banking system are estimated to have increased by approximately 15 percent in 1985/86, compared with 28 percent in the previous year, reflecting the decline in net credit to the Government, as well as a sharp deceleration in the growth of credit to the private sector. Together with a stronger balance of payments outcome, the expansion in broad money is estimated at just over 17 percent for the year as a whole, slightly exceeding the program target but remaining substantially below the previous year's expansion of 26 percent. Monetary restraint has been supported by a restrictive refinance policy and increasingly positive real interest rates. There was virtually no growth in the outstanding stock of refinance credit from Bangladesh Bank during 1985/86, following a sizable increase in 1984/85. Despite the deceleration in inflation, interest rates were maintained at their June 1985 levels, with the exception of interest on term and working capital loans for industry which were reduced from 14.5 percent to 14.0 percent effective March 1, 1986 in order to stimulate industrial investment (Appendix Table 7).

Inadequate loan recovery by the Development Finance Institutions (DFIs) and, to a lesser extent, by the nationalized commercial banks continues to be a serious problem. The effectiveness of monetary management has been seriously impaired by the large and growing stock of overdue agricultural and industrial loans, concentrated mostly in the private sector. Under an Action Program agreed to by the principal aid donors, the Government implemented a number of measures during 1985/86 to address this problem. These measures included the strengthening of the legal framework to take effective action against defaulters, improved accounting and monitoring of overdue amounts, and the linkage of Bangladesh Bank refinance credit to improvements in loan recovery. Despite these efforts, progress in this area has been very slow and confined to some improvements in the amounts recovered in agricultural loans. The latter, however, has contributed to a decline in new disbursements of agricultural credit as pressures to recover resulted in

CHART 2

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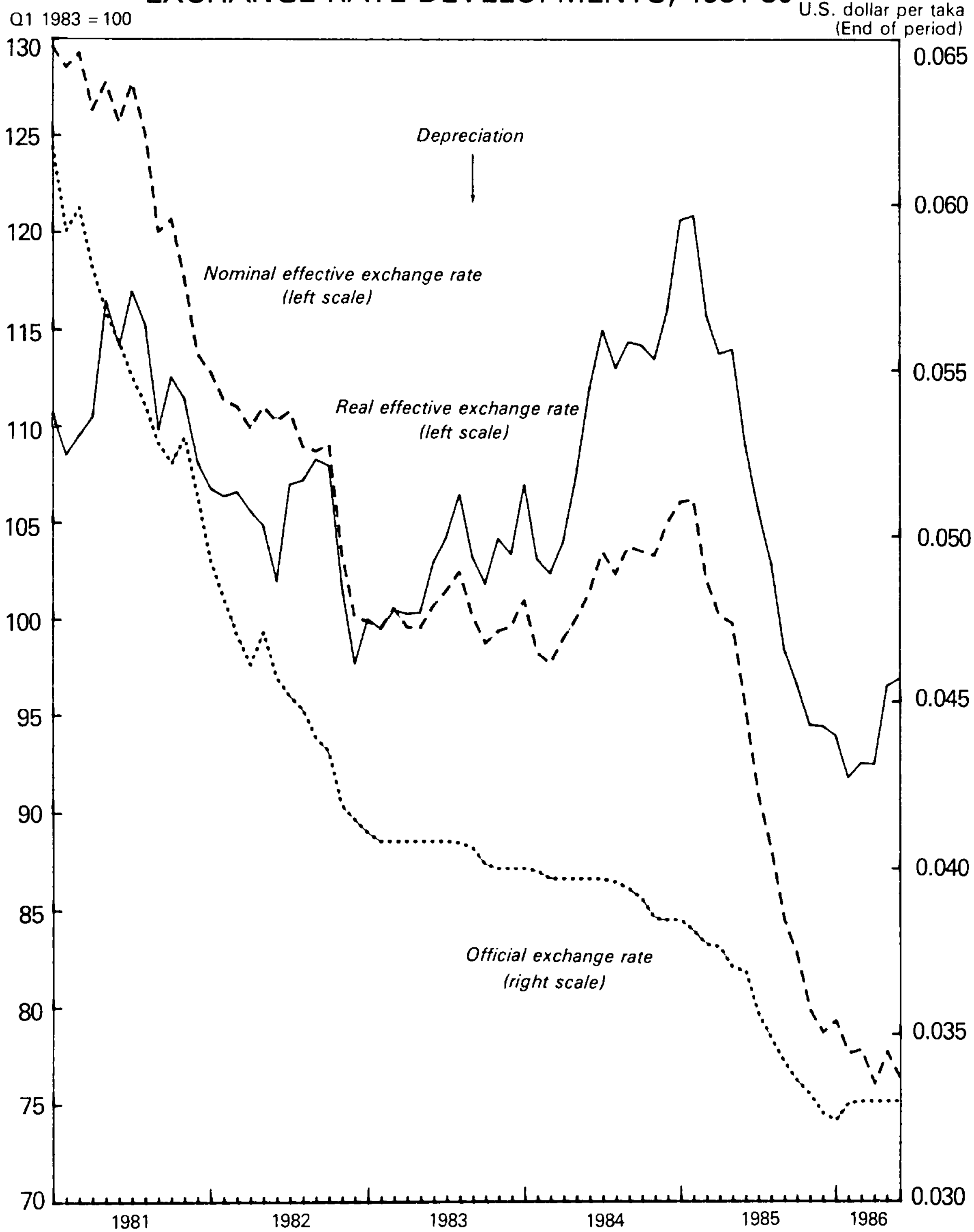
EXCHANGE RATE DEVELOPMENTS, 1981-86



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

a cutback in agricultural refinancing from Bangladesh Bank. This, in turn, constrained purchases of agricultural inputs, particularly fertilizers and irrigation equipment. The decline in agricultural credit also reflected more favorable weather in 1985/86. In the case of industrial DFIs, there was little evidence of improvements in loan recovery during the year. Two independent audits of the DFIs' portfolios were conducted under the joint donor-Government Action Program. The Government is presently considering the possibility of restructuring certain loans, making provisions for bad debt, and recapitalizing the two industrial DFIs. The process is expected to be difficult and protracted, and the authorities have requested technical assistance in this area from the International Development Association (IDA) and the Asian Development Bank (AsDB).

III. Major Policy Issues and the Program for the Remaining Period of the Stand-By Arrangement

The program for 1986/87, described in the attached letter, is aimed at consolidating the stabilization gains and further reducing the rate of inflation, while continuing to implement structural measures to promote growth. Despite some favorable external developments, Bangladesh's balance of payments will continue to be under pressure in 1986/87. Jute prices are expected to remain stagnant, while the gain from lower oil prices is likely to be more than offset by the decline in workers' remittances in light of worsening economic conditions in the oil producing countries. There will not be much scope for an improvement in the current account deficit, which is expected to stabilize at about 6.6 percent of GDP. The program aims at achieving an overall balance of payments surplus of $40 million, and at maintaining the import coverage of gross reserves at slightly over 2 months' imports, after allowing for a reduction of $40 million in short-term foreign liabilities of Bangladesh Bank.

The contemplated external adjustment, which entails continuation of present exchange rate policies, is compatible with real GDP growth of about 4.8 percent, mostly on the strength of enhanced growth in the nonagricultural sectors (Appendix Table 8). The inflation rate is projected to decline further to 8.5 percent, reflecting continued fiscal and monetary restraint. The stance of fiscal policy is in accord with the original objectives of mobilizing additional domestic resources and constraining development spending to amounts that can reasonably be financed by projected aid flows and nonbank domestic resources. The revenue effort is of crucial importance given the slippage in this area in the initial program year. Efforts to mobilize additional resources are to be supported by structural measures to improve efficiency of resource allocation and use. To this end, the program includes structural reform measures in the areas of tax policy and administration, public sector corporations, financial intermediation, and liberalization of the trade and payments system.

1. Fiscal policy

a. The 1986/87 central government budget

Fiscal policy in 1986/87 is designed to further reduce the overall budget deficit as a proportion to GDP by 0.5 percentage point to 7.2 percent, and to limit net government recourse to domestic financing to 0.6 percent of GDP, 1/ of which net bank financing will be less than 0.1 percent of GDP (Table 4 and Chart 3). Excluding the impact of food-stocking operations, the improvement is projected to be more pronounced (0.8 percentage point of GDP). This outcome is to be realized primarily by implementing new measures to generate additional revenue and by restricting the growth in current expenditure to considerably below the rate attained in the previous year.

Including the impact of the new revenue measures, total revenue is programmed to increase by 20.5 percent. The revenue measures introduced with the 1986/87 budget entail modifications in the level and structure of taxes in order to promote investment, counter tax evasion, simplify and rationalize the collection of customs duties, and capture windfall gains or minimize losses ensuing from international price movements. The yield from these measures is estimated at Tk 4.8 billion (0.9 percent of GDP). The Government has decided to capture a large proportion of the gain accruing from the recent sharp decline in the international price of oil through the imposition of a customs duty on imports of petroleum and petroleum products at the rate of Tk 1,000 per metric ton ($4.50 per barrel). Domestic prices of these products were also reduced by an average of only 10 percent effective July 1, 1986. The yield from the duty on oil imports is estimated at Tk 1.7 billion, accounting for a major portion of the revenue generated from adjustments in customs duties, which also include changes in the rates and coverage of duties on edible oil and textile imports. Other revenue measures include increases in domestic excise taxes, notably on natural gas and cigarettes; increases in certain fees; and the imposition of new charges, including a charge on the purchase of airline tickets.

With the implementation of the above measures, the strengthening of income tax collections through wider coverage and improved enforcement, and increased profit transfers to the budget from selected nonfinancial public enterprises, total revenue is expected to reach Tk 50.7 billion. This represents an increase of 0.5 percentage point to 9.5 percent of GDP, the achievement of which would re-establish the target set in the initial program year. The ratio of tax revenue to GDP is also

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1/ In order to ensure that government recourse to nonbank domestic financing is limited to the amount envisaged under the program, the authorities have undertaken to confine such borrowing to items such as deposits and balances of the State Provident Fund and to self-financing by autonomous bodies of expenditures included in the ADP, and to refrain from market borrowing. It has been agreed that developments in these respects will be an element of the second review with the Fund.

Table 4. Bangladesh: Central Government Operations, 1982/83-1986/87

	1982/83	1983/84	1984/85 Prelim. Actual	1985/86 Program 1/	1985/86 Prov. Actual	1986/87 Program
			(In billions of taka)			
Total revenue	25.40	28.60	36.47	43.66	42.07	50.69
Tax	21.08	23.70	29.04	35.87	32.70	40.74
Nontax	4.32	4.90	7.43	7.79	9.37	9.95
Total expenditure	57.80	60.65	69.13	77.21	77.97	89.20
Current expenditure	19.20	23.03	27.38	32.03	33.76	37.66
Food account deficit	6.56	3.80	4.31	3.78	1.37	2.80
Of which: foodstock change	(-0.03)	(0.27)	(1.96)	(--)	(-0.04)	(1.59)
Annual Development Program (ADP)	29.80	30.11	32.91	37.36	38.20	44.25
Other capital expenditure and net lending 2/	2.24	3.71	4.53	4.04	4.64	4.49
Overall budget deficit	32.40	32.05	32.66	33.55	35.90	38.51
Excluding foodgrain stocking	(32.43)	(31.78)	(30.69)	(33.55)	(35.93)	(36.92)
Net foreign financing 3/	28.25	27.87	30.28	32.38	31.73	35.39
Project aid	13.44	13.31	15.74	18.52	20.65	23.31
Commodity aid	9.00	9.63	9.65	11.50	10.50	12.47
Food aid	6.40	6.97	4.92	6.55	5.90	6.52
Commercial food borrowing (net)	1.23	-0.41	2.55	-1.50	-2.49	-3.46
Debt amortization	-1.82	-1.63	-2.58	-2.69	-2.83	-3.45
Net domestic financing	4.15	4.18	2.38	1.17	4.17	3.12
Banking system	0.27	4.27	-1.39	-1.30	-1.30	0.50
Other domestic	3.88	-0.09	3.77	2.47	5.47	2.62
			(Annual percentage change)			
Memorandum items:						
Total revenue	9.5	12.6	27.5	22.1	15.4	20.5
Total expenditure	25.3	4.9	14.0	11.7	12.8	14.4
Current expenditure	29.7	19.9	18.9	17.0	23.3	11.6
ADP	11.2	1.0	9.3	13.6	16.1	15.8
			(In percent of GDP)			
Total revenue	8.8	8.2	8.9	9.5	9.0	9.5
Tax revenue	7.3	6.8	7.1	7.8	7.0	7.7
Nontax revenue	1.5	1.4	1.8	1.7	2.0	1.9
Total expenditure	19.9	17.4	16.9	16.8	16.6	16.8
Current expenditure	6.6	6.6	6.7	7.0	7.2	7.1
ADP	10.3	8.7	8.1	8.1	8.2	8.3
Overall budget deficit	-11.2	-9.2	-8.0	-7.3	-7.7	-7.2
Excluding food-stocking	(11.2)	(9.1)	(-7.5)	(-7.3)	(-7.7)	(-6.9)

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

1/ The 1985/86 program figures were based on an earlier estimate for 1984/85.
2/ Comprises non-ADP project expenditure, the Food for Work Program, miscellaneous investment (nondevelopment) and net loans and advances to nonfinancial public enterprises. A major part of gross lending by the Government is included within the ADP.
3/ Includes foreign grants.

expected to rise to 7.7 percent of GDP from 7 percent in the previous year. Nevertheless, the low elasticity of the tax system has been a source of serious concern, and is particularly apparent in years when GDP growth is led by agriculture which is inadequately taxed. Despite new tax measures adopted each year, the ratio of tax revenue to GDP has barely been maintained. In order to address this problem, and reduce excessive reliance on foreign trade-related taxes, the authorities have undertaken to initiate a review of tax policy and administration during the current fiscal year and will be seeking technical assistance from the Fund and the World Bank in this area.

The growth in total government expenditure is projected to be contained at about 14.4 percent in 1986/87. This will be achieved by curtailing the growth of current expenditure to 11.6 percent, compared with over 23 percent in the previous year. In view of the sizable wage and salary increases granted in 1985/86, the program does not provide for further adjustments in wage rates. Moreover, the freeze on new hirings imposed in most areas of public employment has been continued into the current fiscal year. The wage bill is thus projected to increase by only 4.6 percent, with its share in total current expenditure declining to 37 percent from 40 percent in the previous year. The growth in current expenditure other than wages and salaries is projected at about 16 percent, which accommodates the needed increase in operations and maintenance spending to promote the more efficient use of existing assets. The food account deficit is expected to rise to Tk 2.8 billion in 1986/87, reflecting mainly the projected strong increase in domestic procurement, as well as some recovery in foodgrain imports.

A number of price adjustments were undertaken during 1985/86 to reduce subsidies through the government budget. Fertilizer prices were raised in July and October 1985, resulting in a Tk 312 million reduction in the fertilizer subsidy. In the 1986/87 budget, the fertilizer subsidy has been completely eliminated, notwithstanding an average reduction of 4 percent in urea prices effective July 1, 1986 to bring domestic prices more in line with international urea prices which declined sharply in the preceding months. With regard to foodgrain subsidies, the ration prices of rice and wheat were raised in late 1985 which, coupled with lower volume of operations, resulted in a Tk 890 million reduction in the foodgrain subsidy, a drop of 40 percent from the previous year. The ration prices of wheat and rice were again raised effective June 15, 1986 by approximately 5 percent to realize a further reduction of Tk 200 million in the food subsidy in 1986/87.

The ADP for 1986/87 is projected at Tk 44.3 billion, 15.8 percent above the 1985/86 level. This represents a real growth of approximately 7 percent, and raises slightly the size of the ADP in terms of GDP to 8.3 percent. In recent years, ADP spending has generally remained below budget estimates due largely to bottlenecks in project preparation,

CHART 3

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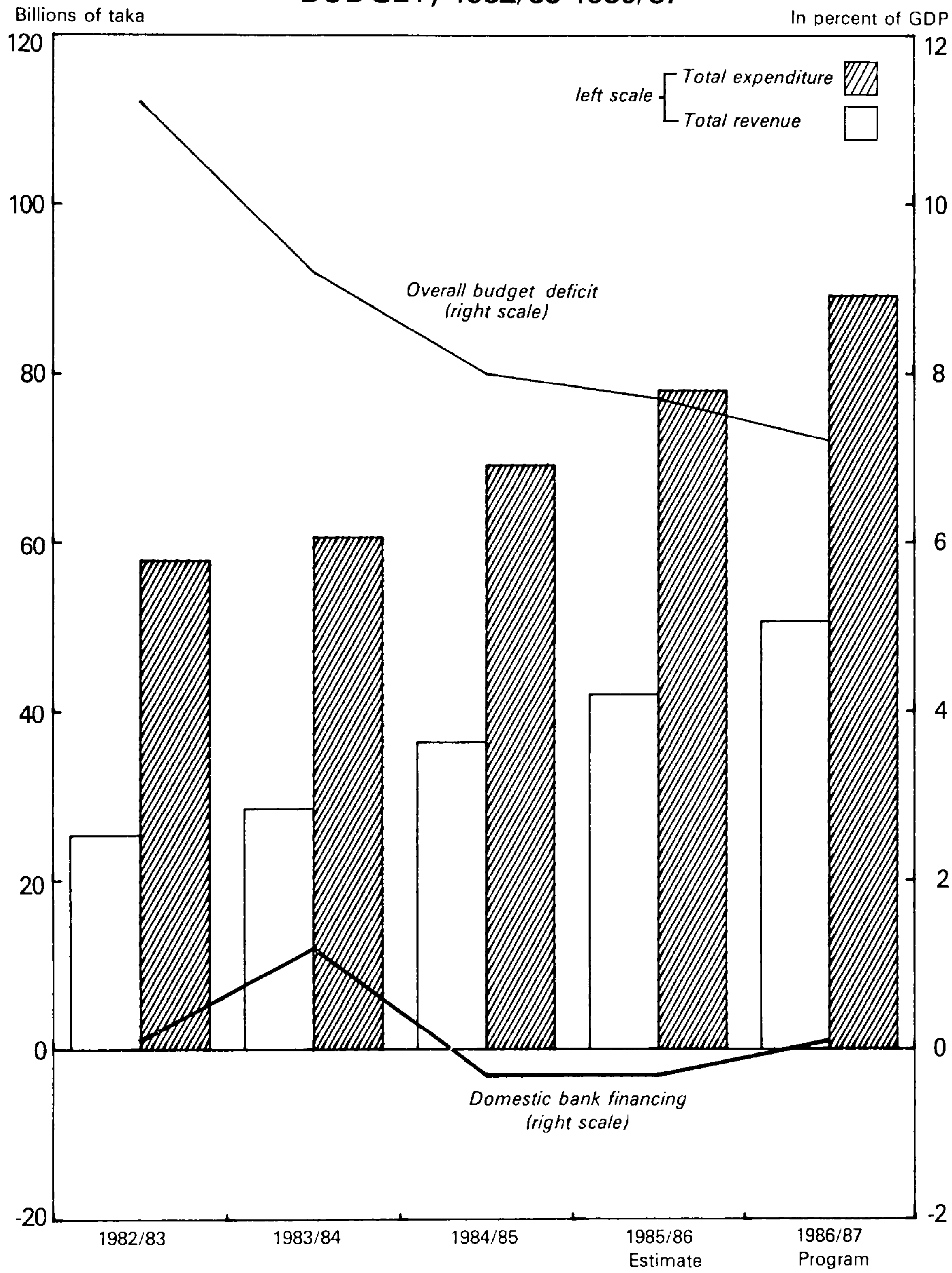
DEVELOPMENTS IN THE CENTRAL GOVERNMENT BUDGET, 1982/83-1986/87



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

approval, and implementation. The past year has witnessed some improvement in these areas, and the ADP for 1986/87 presumes further improvement in the ability to absorb foreign assistance. The ADP projection also takes into account the need to avoid underfunding of essential operations and maintenance expenditure to accommodate larger development spending as in recent years.

b. Operations of nonfinancial public enterprises

The public enterprise sector plays a dominant role in the Bangladesh economy, and will need to contribute significantly to the domestic resource mobilization effort. However, nonfinancial public enterprises have suffered from conflicts between social welfare obligations and commercial considerations, frequent changes in management and inadequate managerial skills, lack of accountability, and insufficient incentives for improved performance. In awareness of these weaknesses, the Government has initiated a number of changes to promote greater operational freedom and autonomy in decision making. In this connection, a project sponsored by the United Nations Development Programme (UNDP) is being implemented to identify and develop comprehensive indicators for a more accurate and timely assessment of the macroeconomic implications of public enterprise operations. The establishment and maintenance of a reliable data base for the public enterprise sector is also under way, supported by technical assistance from the Fund. A more reliable and comprehensive data base for the public enterprise sector should allow consolidation of public sector accounts, and improve the assessment of overall public sector activities and financing requirements.

2. Monetary and credit policies

The authorities recognize that continued monetary restraint will be essential to further moderate inflation, and to maintain the gains achieved in the external position. Accordingly, the credit program for 1986/87 has been formulated with a view to constraining overall domestic credit expansion to approximately the rate attained in the first year of the adjustment program (Table 5 and Appendix Table 9). The authorities are not in favor of overly restricting credit expansion to agriculture for the second year in succession, and have pointed to the special credit needs of the jute sector and the nontraditional export sector. In addition, some allowance for net bank credit to the Government was considered necessary, largely to finance the increase in foodgrain stocks.

The credit program for 1986/87 takes into account the above credit needs, and is consistent with the external objective of ensuring a continued overall balance of payments surplus, as well as with the expected developments in the demand for broad money. In 1985/86, there was an easing in the strong downward trend in the income velocity of broad money associated with the shift of financial assets into the banking system in response to improved financial intermediation in the

Table 5. Bangladesh: Monetary Survey, 1982/83-1986/87

	1982/83	1983/84	1984/85	1985/86 Estimate 1/	1986/87 Program 1/
			(In millions of taka; end-June)		
Net foreign assets	-3,909	1,472	-25	2,160	3,280
Net domestic assets	62,892	82,387	105,367	121,250	139,440
Domestic credit	75,406	98,735	124,609	143,500	165,100
Public sector	44,431	49,590	55,702	62,200	69,600
Government (net)	(19,805)	(24,070)	(23,408)	(22,100)	(22,600)
Other public sector	(24,626)	(25,520)	(32,294)	(40,100)	(47,000)
Private sector	30,975	49,145	68,907	81,300	95,500
Other items (net)	-12,514	-16,348	-19,242	-22,250	-25,660
Broad money	58,983	83,859	105,342	123,410	142,720
Money	26,343	35,500	42,318	...	...
Quasi-money	32,640	48,359	63,024	...	...
			(Annual percentage changes)		
Net domestic assets	11.2	31.0	27.9	15.1	15.0
Domestic credit	11.6	30.9	26.2	15.2	15.1
Public sector	1.2	11.6	12.3	11.7	11.9
Government (net)	(1.4)	(21.5)	(-2.8)	(-5.6)	(2.3)
Other public sector	(1.1)	(3.6)	(26.5)	(24.2)	(17.2)
Private sector	31.0	58.7	40.2	18.0	17.5
Broad money	29.7	42.2	25.6	17.2	15.6

Sources: Bangladesh Bank; and staff estimates.

1/ At constant exchange rates prevailing on June 30, 1985.

rural areas and the increasingly positive real rates of return on financial assets. The decline in velocity was less than 2 percent in 1985/86, compared with 8 percent and 16 percent in the two preceding years, respectively. This was partly a reflection of the sharp recovery in agriculture, the less monetized sector of the economy, coupled with a slowing down in the overall growth of nonagricultural sectors. A similar decline in velocity (i.e., close to 2 percent) is programmed for 1986/87. Accordingly, the projected broad money growth of 15.6 percent is consistent with real GDP growth of about 4.8 percent and a slowing down in inflation to 8.5 percent. The programmed growth in net credit to the Government and to the other public sector (mostly nonfinancial public enterprises) accommodates an adequate flow of credit to the private sector. Even after allowing for a 2.3 percent growth in net bank credit to the Government, the share of outstanding bank credit to the Government in total domestic credit is projected to decline from 18.8 percent at end-June 1985 (beginning of the initial program year) to 13.7 percent at end-June 1987. The growth in credit to the remainder of the public sector is projected to slow down to 17.2 percent, from 24.2 percent in the initial program year. The strong growth in this item in both years represents largely the special financing needs of the jute sector following the sharp drop in jute prices; excluding jute enterprises, the growth in credit to the other public sector is 14.1 percent and 10.9 percent in 1985/86 and 1986/87, respectively. In awareness of the need to address the structural weakness in the jute sector and improve its financial viability, the authorities are currently engaged in reviewing prospects and policy issues in this sector jointly with the World Bank.

The Government remains committed to a flexible interest rate policy with a view to ensuring an efficient allocation of resources and promoting domestic savings. Bank deposit rates, which have not been adjusted in recent years, have remained positive in real terms. Key lending rates also continue to be positive in real terms, notwithstanding certain selective adjustments to promote priority sectors. In response to the further slowing down in domestic inflation and in view of recent international price and interest rate movements, a number of changes were introduced in the level and structure of interest rates effective July 1, 1986 (Appendix Table 7). The rate of interest on industrial term loans was further reduced to 12.0-13.5 percent, conditional on compliance with specified debt-to-equity ratios. This adjustment was undertaken primarily to encourage equity contributions to industrial projects. A further reduction of 2 percentage points (from the range referred to above) became applicable to loans for domestically produced capital goods, and a preferential rate of 10 percent was introduced for loans to small cottage industries. In order to strengthen the competitiveness of traditional exports, particularly jute, at a time of sharp and persistent decline in international commodity prices, the interest rate on working capital loans for traditional exports was reduced from 12 percent to 9 percent and brought in line with the rate applicable to nontraditional exports. Finally, in response to evidence of sluggish growth in certain sectors of the economy and increasing strains on the liquidity position of banks, the Bangladesh Bank rate was lowered from 11.25 percent to 10.75 percent, with simultaneous reductions in refinance rates linked to the Bank rate. Interest rates will continue to be monitored during the remainder of the program period, and further adjustments undertaken with a view to maintaining key interest rates positive in real terms.

Of immediate concern is the problem of inadequate loan recoveries in the domestic banking system which undermines the effectiveness of interest rate policy and impedes overall monetary management. 1/ The solvency of financial institutions has been jeopardized by the increasing share of delinquent loans in their asset portfolios, and the capital adequacy of banks has been undermined in light of this growing risk factor. An Action Program aimed at strengthening the Development Finance Institutions, where the loan recovery problem is prevalent, was agreed to between IDA, Kreditanstalt fur Weideraufbau (KFW), AsDB, and the Government, and is being implemented. The limited progress to date, however, underscores the need to address the problem within the context of a broader reform in areas such as the autonomy of the banking system, strengthening of Bangladesh Bank supervision, and legal recourse of lenders to collect from defaulters. Hence, the authorities will conduct, jointly with the World Bank, a financial sector review later in the year, while also addressing the urgent problem of loan recovery in the two industrial DFIs under a proposed industrial sector credit from the World Bank. Agricultural loan recovery issues are likewise being addressed under a recent Import Program Credit (IPC XIII) from IDA.

3. External prospects and policies

a. Prospects for 1986/87

The balance of payments outlook for 1986/87 is influenced by the continued weak prospects for jute exports, and the impact on imports and workers' remittances of the recent decline in the price of oil. Bangladesh's terms of trade are projected to stabilize in 1986/87, following a 16 percent deterioration in 1985/86. Export earnings, while recovering from the previous year's very depressed level, will be constrained by stagnant jute prices, which will not be fully compensated by the anticipated revival in the prices of other traditional exports. Nontraditional export growth is expected to be strong, with pronounced increases in the volumes of garment and shrimp exports. Imports will be influenced by the price-induced savings in the oil import bill, estimated at about $73 million, as well as the continued low level of foodgrain imports. Workers' remittances are projected to decline by close to 14 percent (Table 6 and Appendix Table 10), largely on account of a lowering of wages paid to Bangladeshi workers in oil producing countries. Although a significant repatriation of workers is not

1/ For a detailed discussion of this subject, see SM/85/276, 10/8/85, pp. 34-35.

Table 6. Bangladesh: External Indicators, 1982/83-1986/87

(In millions of U.S. dollars; unless otherwise specified)

	1982/83	1983/84	1984/85	1985/86 Program	1985/86 Estimate	1986/87 Program
Exports of goods and services	917	1,090	1,219	1,230	1,190	1,296
Imports of goods and services	-2,589	-2,665	-3,007	-2,844	-2,806	-2,928
Workers' remittances	634	602	441	504	555	480
Current account balance	-1,019	-948	-1,310	-1,090	-1,040	-1,132
As percent of GDP	(-8.4)	(-6.8)	(-8.4)	(-7.3)	(-6.6)	(-6.6)
Gross aid disbursements	1,345	1,268	1,267	1,292	1,315	-1,431
Overall balance	341	218	-59	30	78	40
Terms of trade (percentage change)	16.1	16.9	23.9	-17.2	-16.3	-0.8
External debt 1/	5,432	5,886	6,301	...	6,784	7,151
As percent of GDP	(44.8)	(42.0)	(40.2)	(...)	(43.3)	(41.6)
Debt service ratio 2/	16.8	16.3	24.2	23.7	25.7	30.2
Debt service ratio (excluding IMF)	11.2	12.7	18.6	16.4	18.4	21.1
Gross reserves	358	539	395	422	470	449
In months of merchandise imports	(1.9)	(2.7)	(1.8)	(2.1)	(2.3)	(2.1)

Sources: Appendix Tables 10 and 11.

1/ Includes use of Fund credit and short-term loans.
2/ As percent of exports of goods and services and private remittances.

anticipated, there is likely to be a reduction in the number of workers seeking and obtaining employment abroad.

The above developments will not leave much room for an improvement in the current account deficit, which is projected to increase in absolute terms, but to stabilize at 6.6 percent of GDP (Chart 4). Net nonmonetary capital flows are projected to increase only slightly, as continued heavy debt repayment obligations offset the growth in aid disbursements. The composition of foreign aid is expected to remain approximately the same as in 1985/86, with project aid disbursements accounting for over 50 percent of total disbursements. An overall balance of payments surplus of $40 million is projected for the year, which will allow for a 2.1 months' import coverage of gross international reserves. The above scenario will be consistent with a slight reduction in the external debt to GDP ratio to approximately 42 percent at end-June 1987 (of which approximately 90 percent would be concessional).

b. Exchange and trade policies

The authorities are committed to a flexible exchange rate policy with a view to promoting and diversifying exports by ensuring adequate incentives to the export sector. The several small adjustments of the exchange rate since the beginning of 1985, in conjunction with the weakening of the U.S. dollar since late 1985, resulted in a 3 percent real effective depreciation of the taka relative to its base level by mid-1986. While recognizing the merits of giving mixed signals to the market on exchange rate actions, the staff stressed to the authorities the importance of sustaining the competitiveness thus achieved. The authorities will aim at avoiding an erosion in the margin of competitiveness and, in any event, will not allow a real effective appreciation of the taka from its base level. The discount of the official rate relative to the secondary market rate has been approximately stable at about 9.5 percent. By adjusting the official exchange rate as and when needed, the authorities will continue to ensure that the official rate is not at an excessive discount relative to the secondary market rate.

Substantial progress was made toward unification of the dual exchange markets during 1985/86 through measures to expand the scope of the secondary market. Effective July 1, 1986 additional measures were adopted which are expected to raise the share of export transactions conducted in the secondary market by about 18 percentage points to 71 percent of total exports, and the share of import transactions by about 14 percentage points to 42 percent of total imports. In the case of exports, the above result will be achieved by the application of a

CHART 4

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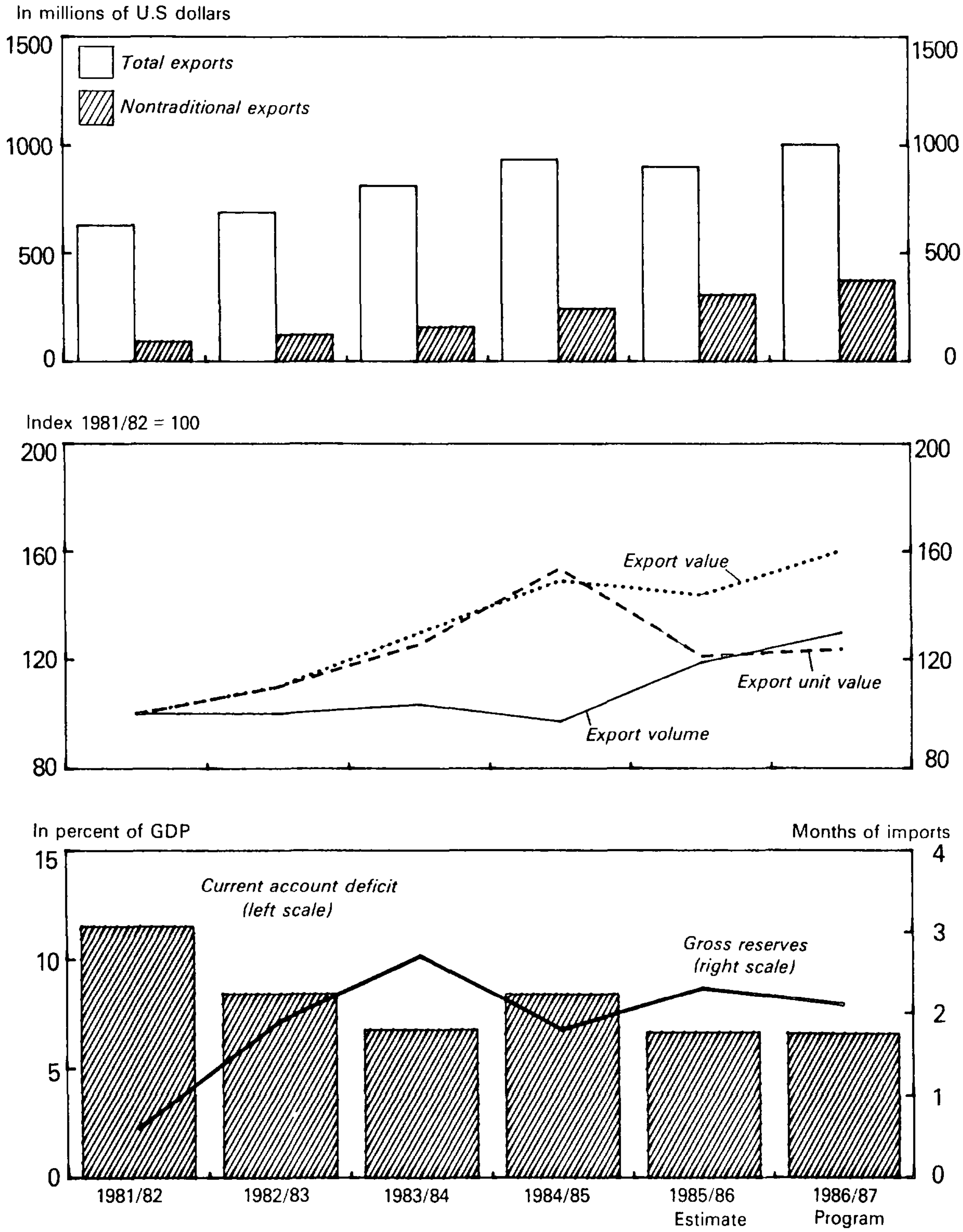
EXTERNAL INDICATORS, 1981/82-1986/87



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

100 percent Export Performance Benefit coefficient (XPB) 1/ to all eligible exports other than ready made garments using imported fabric, to which a coefficient of 40 will apply in order to discourage the use of imported inputs. The latter move is part of a wider effort to set XPBs on the basis of domestic value added, and to strengthen the linkages between domestic industry and the export sector. As a result of the above changes, raw jute, tea, and wet blue leather will be the only exports which will continue to be transacted at the official exchange rate. With regard to imports, all nongovernment imports except those financed by foreign aid or through barter arrangements will be transacted at the secondary market rate. The major items transacted at the official exchange rate will be imports of foodgrains, fertilizer, and certain capital equipment for officially sponsored projects. The authorities will continue to explore the possibilities of further broadening the coverage of the secondary market in a balanced fashion during 1986/87.

In recent years, the authorities' trade policies have increasingly emphasized export promotion rather than import substitution. In line with this policy, the trade and payments system has been liberalized substantially. In 1985/86, negative (i.e., banned goods) and restricted import lists replaced a positive import list. The Import Policy Order (IPO) for 1986/87 contains changes that indicate further progress in this direction. First, the negative and restricted lists have been shortened. Restrictions on imports of 140 items have been lifted, including diesel engines, trucks, buses, books, and certain inputs of the electric goods industry. The number of items on the special negative and restricted lists for spare parts and accessories of jute and textile mills has been reduced by 537. Finally, restricted List Part B, which had reserved 25 categories of goods for commercial importers, has been eliminated. The second major change introduced pertains to import regulations applicable to export-oriented firms. Henceforth, such firms may request permission to import banned or restricted items which are needed to meet an export order. A third change allows for specification of import entitlements for broad categories of goods rather than for individual items. Under this provision, industrial enterprises receive global entitlements for restricted raw materials, packing accessories, and spare parts. Within these broad categories, specific items, not subject to quantitative restrictions under the IPO, may be imported liberally. A fourth liberalization measure eases the rules regarding import permits for export-oriented industries operating under the bonded warehouse system. In contrast to the above liberalization measures, the only notable new restrictive element of the IPO for 1986/87 pertains to the imposition of quantitative restrictions on fabric imports to counter the

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1/ Under the XPB system introduced in 1985/86, all eligible exports are assigned coefficients ranging from 40 percent to 100 percent, which allows exporters to receive an equivalent amount of their export earnings at the secondary market rate. For details see SM/85/276, 10/8/85, pp. 49-50.

impact of customs duty reductions on such imports and to maintain the share of domestic fabrics in the garment industry. Finally, to complement the IPO, the Export Policy for 1986/87 introduces a number of incentives (such as preferential credit and the easing of administrative impediments) for exporters, some of which are aimed specifically at encouraging the use of local inputs.

Notwithstanding the considerable easing of restrictions in Bangladesh's trade and payments system in recent years, restrictive elements remain in order to encourage domestic industry, and also because of the persistent foreign exchange constraints. Over the medium term, the authorities intend to phase out the remaining restrictions, while at the same time increasing reliance on exchange rate and tariff policies to promote exports. Toward this end, a medium-term program to encourage investment in export industries has been formulated with donor support. As a first step, in early July, the Government announced that official approval will no longer be needed for investment projects in certain industries. For cases in which sanctions remain necessary, sanctioning powers have been decentralized and time limits for processing applications have been imposed in order to expedite approval.

Under the provisions of the Exchange Rate Fluctuation Burden Absorption Scheme (EFAS), Bangladesh Bank stands ready to provide exchange rate guarantees on certain concessional project loans against the payment of a 2.5 percent annual premium of the outstanding amount. Although the Scheme is largely inoperational as only a few eligible borrowers have opted to benefit from it, a blocked account was established in Bangladesh Bank effective October 1985 in order to ensure that funds are set aside to cover any possible losses incurred under the Scheme. As of end-May 1986, the balance on this account was Tk 0.32 million. The authorities will continue to maintain this account until the expiration of the EFAS, presently scheduled for end-June 1988.

c. External debt management

In the management of external debt, the authorities will continue the cautious policy of avoiding commercial borrowing. In this regard, the accelerated repayment of commercial food loans effected in 1985/86 and those projected for 1986/87 are moves in the right direction. This will contribute to a 4 percentage point jump in the debt service ratio to approximately 30 percent 1986/87. However, a notable relief is expected in 1987/88 as the bunching of repayments eases. Hence, the debt service ratio is projected to drop to 21 percent in 1987/88 and to remain at about this level through 1990/91 (Appendix Table 11).

In support of the policy to strictly curtail new borrowing on nonconcessional terms and with short-term maturities, the contracting or guaranteeing of new external loans with maturities of 1-12 years on nonconcessional terms by the public sector will be limited to $100 million through end-March 1987. Within this ceiling, a subceiling of $80 million will apply to loans in the maturity range of 1-5 years.

However, the authorities intend to limit borrowing in this range to emergencies or to the rollover of existing debt. In addition, the outstanding stock of publicly guaranteed external short-term debt (i.e., with a maturity of less than 1 year) will not increase by more than \$15 million to \$36 million by end-March 1987, and short-term external liabilities of Bangladesh Bank will be reduced by \$40 million to \$80 million by end-September 1986, and will be maintained at this level through March 1987.

d. <u>Medium-term balance of payments outlook</u>

Even on the assumption of continuation of present economic policies, Bangladesh will face a balance of payments constraint over the medium term. Despite recent efforts at export diversification, traditional exports (jute, jute goods, tea, and leather) still account for about two thirds of total exports. Raw jute and jute goods, which constitute over 80 percent of traditional exports, do not hold strong prospects for growth in light of the declining world demand for these products. Moreover, since Bangladesh is a major exporter of raw jute, a significant increase in the volume of its jute exports tends to depress the international price of jute which, in turn, results in reduced jute cultivation and exports with an ensuing price revival. In the years immediately ahead, Bangladesh's jute exports cannot be expected to display much real variation beyond such cyclical fluctuations. Jute goods exports, on the other hand, will be increasingly constrained by the strong competition from synthetics. Among nontraditional exports, ready-made garments have constituted the most dynamic item, rising to 16 percent of total exports in 1985/86 from a virtually nonexistent base in 1981/82. The future of this export sector, however, will depend on accessibility to foreign markets in the face of rising protectionism. In view of these considerations, average annual export growth over the medium term cannot be expected to exceed 10 percent, with real growth in the range of 6-7 percent.

Workers' remittances, the second largest source of current foreign exchange receipts, cannot be relied upon to finance as significant a proportion of total imports as in the recent past. Thus, the share of this item in import financing is projected to decline from 23 percent in 1985/86 to 16 percent in 1990/91. The services account will continue to record a net deficit in the order of \$70 million to \$80 million annually over the period in question. Under this scenario, and given a minimum gross reserves target of 2.1 months' import coverage, the size of the import bill will depend crucially on the ability to absorb increased concessional foreign aid flows. To achieve a steady rate of economic growth while maintaining a safety margin against unanticipated shortfalls in foreign exchange earnings, concessional aid disbursements are projected to increase by about 10 percent annually. The implied real annual growth in commodity aid is about 2.5 percent, and in project aid close to 5 percent on the assumption of further improvements in project implementation. In light of the officially stated objective of achieving foodgrain self-sufficiency in the longer run, food aid disbursements are projected to remain approximately stable in nominal terms.

The above scenario allows for average nominal import growth of 7 percent per annum, with nonfood imports growing at a slightly higher rate. The implied real growth of about 3 percent in the nonfood component of imports will constrain nonagricultural GDP growth, particularly the growth of industry, which is heavily dependent on imports of raw materials and capital goods. Under this basic scenario, which allows GDP growth to be maintained at close to 5 percent, the external current account deficit is projected to stabilize at slightly over 6 percent of GDP, the external debt to GDP ratio to be reduced to 38 percent by 1990/91, and the debt service ratio to be maintained at approximately 21 percent after 1986/87. The improvement in the debt service ratio will also reflect a reduction in debt service obligations to the Fund (Appendix Table 11). As in the past, Bangladesh is not expected to encounter difficulties during the period ahead in making timely debt service payments, while maintaining a minimum level of gross reserves.

Three alternative medium-term scenarios were constructed, based on different assumptions regarding developments in the price of oil, real growth in foreign aid flows, and real growth in nontraditional exports. A stronger recovery in the price of oil beyond 1986/87 had a negligible impact on the external current account since losses arising from a higher import bill were mostly compensated for by the gains in workers' remittances ensuing from improved labor market conditions in the oil producing countries. The impact of this scenario on GDP growth was not pronounced and depended primarily on the choice of import categories to be reduced to accommodate a larger oil import bill, given the overall constraint on imports. More optimistic assumptions on real foreign aid flows allowed for larger nonfood imports which were reflected in a higher current account deficit, but the impact on GDP growth was not significant given the low share of industry (the sector most dependent on imports) in the base period. Similarly, a stronger real growth in nontraditional exports produced a limited improvement in export earnings and the current account deficit because of the narrow base from which such export growth is projected. These tentative results underscore the crucial need to undertake structural changes in the economy in order to improve medium-term prospects for stronger and sustainable economic growth. The authorities have identified the major areas for economic reform and broadly determined the framework of policies to be implemented over the coming years. These include foodgrain production and distribution, industrial development, export promotion and diversification, financial sector policies and private savings, public resource mobilization, and public expenditure policies.

4. Performance criteria and phasing of purchases 1/

The following quantitative performance criteria will apply during the remaining period of the stand-by arrangement: (1) quarterly ceilings on net domestic assets of the banking system, including subceilings on net credit from the banking system to the Government; (2) a continuous ceiling on the contracting or guaranteeing of public nonconcessional external debt of 1-12 years maturity, including a subceiling on external debt of 1-5 years maturity; (3) a ceiling on the outstanding stock of public short-term external debt; and (4) a ceiling on the outstanding stock of Bangladesh Bank's short-term foreign liabilities. The customary clauses regarding the intensification of exchange and trade restrictions will continue to be effective. In addition, as a performance criterion, there will be a second review with the Fund to be completed before end-February 1987.

Purchases to date under the stand-by arrangement total SDR 84 million. The remaining SDR 96 million is phased into four equal installments of SDR 24 million each, to be purchased successively upon completion of the present review and observance of the end-June 1986 performance criteria; observance of end-September 1986 performance criteria; observance of end-December 1986 performance criteria, as well as the completion of the second review; and, observance of end-March 1987 performance criteria. Purchases will not exceed SDR 132 million (45.9 percent of quota) until the completion of the second review.

IV. Staff Appraisal

During 1984/85, Bangladesh's adjustment effort was impeded by the need for additional food imports resulting from adverse weather, and an unprecedented decline in workers' remittances brought about by a deteriorating external environment, as well as weakening confidence in domestic economic prospects. As a result, considerable pressure was exerted on the balance of payments, aggravated also by inadequate demand management policies. The need for an intensified adjustment effort became apparent, the more so given the country's heavy external debt service obligation and the likelihood of adverse developments in its terms of trade. Hence, the Government of Bangladesh adopted an economic program for the period through mid-1987 that was supported by a stand-by arrangement from the Fund.

During 1985/86, considerable progress was made in achieving the objectives of the program. Real GDP growth rebounded to 5 percent, and inflation was contained at 10 percent, well below the programmed level. Despite a significant decline in Bangladesh's terms of trade, the improvement in the external situation exceeded expectations--mainly on account of an unexpectedly large increase in workers' remittances--

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1/ End-March 1987 is the last date for which performance criteria were set.

and the balance of payments recorded a sizable surplus. Significant progress was also made in the tightening of financial policies, as evidenced by the sharp slowing down in monetary expansion, a reduction in the fiscal deficit, and a net repayment by the Government to the banking system. Nonetheless, there were some deviations from program targets in the fiscal area.

The task facing the authorities in the period ahead is to consolidate the stabilization effort at the same time that major structural weaknesses are addressed. The staff believes that it is essential not to allow a weakening in demand management policies which would risk the reversal of progress made in reducing inflation and strengthening Bangladesh's external position. While the authorities are to be commended for taking a series of measures toward attaining the budgetary objectives, a sustained improvement in the fiscal position will be crucial to the success of the program. Developments in 1985/86 have underscored the need to counter the long-standing weaknesses in the tax structure, and to reduce the vulnerability of central government operations to external disturbances. In this connection, it is encouraging to note that the authorities intend to review tax policy and administration. With regard to government expenditure, the authorities are to be commended for placing increased emphasis on operations and maintenance expenditure, and setting the size of the ADP within the bounds of domestic and foreign financing which can reasonably be expected. The envisaged further reduction in the food subsidy--the price adjustments for which are already in place--and the complete elimination of the fertilizer subsidy through the government budget are moves that will help alleviate distortions in the allocation and use of resources. Finally, the Government's undertaking to strictly limit its recourse to the domestic banking system, and not to engage in market borrowing to finance the budget deficit, should help release scarce financial resources to the private sector and enhance private investment.

The nonfinancial public enterprise sector, a major contributor to economic activity in Bangladesh, continues to be an area of concern in the face of persistent problems of managerial inefficiency, inadequate accountability, and lack of autonomy in decision making. These shortcomings have been reflected in inadequate capital contributions and increased recourse to bank credit. Recent efforts to streamline public enterprise operations have involved the transfer of activities to the private sector in certain instances, and further divestment may prove necessary to increase the efficiency of operations and ensure financial viability. In the meantime, it is encouraging to note that the Government is engaged in a number of projects, in collaboration with the principal aid donors, notably the World Bank, to redress the weaknesses in this sector.

Monetary policy will continue to carry a heavy burden in the stabilization effort. Policies to slow down the recent excessive monetary expansion have been successful. The credit program for 1986/87, which maintains the growth in domestic credit at the previous year's rate, is consistent with the external targets and accommodates credit needs associated with sustained growth of the economy. The recent strong credit requirements of the jute sector, however, is an area of concern. The staff urges the authorities to contain the growth of credit to the jute sector, while pursuing the longer-term objective of addressing structural weaknesses in this sector.

The recent reductions in selected interest rates were undertaken in light of the moderation in inflationary expectations and the need to provide relief to sectors of the economy that were badly hit by adverse external developments. While the thrust of monetary policy has been appropriate, the longer-term health of the financial system will depend crucially on the ability to deal with inadequate loan recoveries in the banking system. The staff urges the authorities to take further measures to address this serious problem, and welcomes the intention of the authorities to undertake a comprehensive review of the financial sector to ameliorate the existing weaknesses and strengthen the supervisory role of Bangladesh Bank.

External adjustment during 1985/86 appears to have been sufficient to put the balance of payments on a relatively stable footing, assuming the continuation of appropriate adjustment policies. Nevertheless, a slight widening of the current account deficit is expected in 1986/87, largely on account of stagnant export prices and the decline in workers' remittances. A modest recovery in imports, associated with increased capital inflows, is also envisaged. The projected overall balance of payments surplus, while considerably below the previous year's surplus, should permit gross reserves to be maintained at a relatively comfortable level. While the debt service ratio is projected to rise further in 1986/87, the authorities are to be commended for accelerating repayments on commercial food credits which, together with sizable Fund repurchases, will contribute to the heavy debt service burden. A notable relief in this respect is expected in 1987/88 when the bunching of debt repayments eases. Over the medium term, balance of payments viability will depend crucially on the success in diversifying the narrow export base.

The authorities are committed to a flexible exchange rate policy. The adequacy of the official exchange rate must be kept under close scrutiny, and the spread between the exchange rates in the official and secondary markets should continue to serve as an indicator in judging the appropriateness of policies. While welcoming the authorities' reiterated stand that the exchange rate will be adjusted if necessary to attain the balance of payments objectives of the program, the staff urges the authorities to at least maintain the small margin of competitiveness thus far achieved. The significant progress made toward the unifications of the official and secondary exchange markets has also constituted an important element of exchange rate policy. The authorities are urged to continue reviewing the coverage of the secondary market, with a view to shifting additional transactions to this market and thereby paving the way for an early unification of the dual markets. The recent moves toward liberalization of the trade and payments system, as well as changes aimed at encouraging export promotion, are steps in the right direction. The authorities should continue to replace quantitative restrictions with tariffs as instruments of policy, with a view to eventual modification and rationalization of the tariff structure. The recent easing of investment sanctioning procedures is an important step toward encouraging investment in export industries.

The economic and financial program for 1986/87 entails the continuation of policies formulated at the time of the program's inception. The sustained pursuit of adjustment policies can be expected to consolidate the gains already realized and strengthen medium-term growth prospects. However, in view of the prevailing uncertainties, particularly in the international environment, it will be necessary to continue to monitor developments closely and take timely action as warranted in order to ensure the achievement of program targets.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

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 and to set performance criteria for the remaining period of the arrangement.

2. The letter dated July 30, 1986 from the Advisor for Finance shall be attached to the stand-by arrangement and the letter dated November 5, 1985 shall be read as supplemented and modified by the letter of July 30, 1986.

3. Accordingly,

(a) the limits on net domestic assets of the banking system and net credit to the central government from the banking system referred to in paragraph 4(a) of the arrangement will be as set forth in Table 2 of the letter of July 30, 1986; and

(b) the limits on contracting of new public or publicly guaranteed external loans with maturities of one to twelve years and one to five years, and on the outstanding stocks of external public debt and of external liabilities of Bangladesh Bank, both of less than one-year maturity, referred to in paragraph 4(b) of the arrangement, will be as set forth in Table 1 of the letter of July 30, 1986.

Table 7. Bangladesh: Selected Interest Rates, 1983-86 1/

(In percent per annum)

	1983 Oct.	1984 March	1985 March	1986 March	1986 July
Bank rate	10.5	10.5	11.0	11.25	10.75
Bank deposits					
Savings account					
Without checking	10.0	10.0	10.0	10.0	10.0
Fixed deposits					
Three months to less than six months	12.0	12.0	12.0	12.0	12.0
One year to less than two years	14.0	14.0	14.0	14.0	14.0
Three years and over	15.0	15.0	15.0	15.0	15.0
Bank lending					
Government					
Treasury bills	8.5	8.5	8.5	8.5	8.5
Tap treasury bills	9.5	9.5	9.5	9.5	9.5
Two-year bonds					
Issued at discount	--	15.7	15.7	15.7	15.7
Issued at par	--	14.2	14.2	14.2	14.2
Export 2/	12.0	12.0	12.0	12.0	9.0
Agriculture 2/	16.0 3/	16.0 3/	16.0 3/	16.0 3/	16.0 2/
Socioeconomic 2/	13.0	15.0 4/	15.0 4/	15.0 4/	15.0 3/
Industry 2/	14.5	14.5	14.5	14.0	12.0-13.5 5/
Other (nonpriority)	16.0	16.0	16.0-20.0	16.0-20.0	16.0-20.0

Source: Data provided by the Bangladesh authorities.

1/ Dates in the table indicate dates on which interest rates were adjusted.
2/ Actual lending rates may be lower than representative rates depending on the subsector involved; for exports, 9 percent interest applies to nontraditional exports.
3/ Includes service charge of 4 percent per annum.
4/ Includes service charge of 2 percent per annum.
5/ Actual rate within this range depends on compliance with specified debt to equity ratios; interest on loans to small cottage industries is 10 percent and loans for domestically produced capital goods 2 percentage points below the given range.

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

(Amounts in millions of SDRs; unless otherwise indicated)

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:	650.7
(As percent of quota)	(226.3)
(c) Fund credit:	385.8
(As percent of quota)	(134.1)
Credit tranches	149.6
(As percent of quota)	(52.0)
Extended Fund Facility	86.9
(As percent of quota)	(30.2)
Supplementary Financing Facility	47.9
(As percent of quota)	(16.7)
Compensatory Financing Facility	101.3
(As percent of quota)	(35.2)
(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	02/12/85	19 months	180.00	60.00
(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:	11.5
(As percent of net cumulative allocation)	(24.4)

V. Administered accounts

(a) Trust Fund loans:	
(i) Disbursed	122.2
(ii) Outstanding	75.6
(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 June 1986, the exchange rate was Tk 30.30 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) CBD and Legal: A mission led by Mr. Sundararajan visited Bangladesh in February 1985 to review bank regulations and financial developments. There was a follow-up mission in late-June, headed by Ms. Lachman, to help draft proposed legislative changes.

(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 the nonfinancial public sector, 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. Samuel Itam was appointed Resident Representative in August 1984, and his term expired in July 1986. A new representative will shortly be assigned to replace Mr. Itam.

Relations with 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 Import Program Credits (IPCs). 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 IPCs 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 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 fish, 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 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; May 31, 1985)	
Completed projects and import program credits	1,599.34	--
IBRD	54.90	--
IDA	1,544.44	--
Projects in execution (all IDA)	560.45	1,322.12
Agriculture and rural development	147.99	422.58
Industry	81.27	137.34
Education	62.65	152.96
Population	26.57	83.43
Transportation	35.92	69.80
Telecommunication	12.57	23.32
Technical assistance	13.17	27.52
Power and gas	165.58	399.90
Water supply and sewerage	14.73	5.27
Import program credits	52.12	162.66
Total	612.57	1,484.78
Repayments	15.00	
Total debt outstanding 1/	3,625.11	
IFC investment	15.29	

Import Program Credit: The thirteenth import program credit (IPC-III) for an amount of $200 million was approved on February 4, 1986, and became effective on March 27, 1986.

1/ Includes undisbursed amounts.

Bangladesh - Summary of the 1986/87 Economic and Financial Program

	1985/86	1986/87 Program
I. Targets	(In millions of U.S. dollars)	
External current account balance	-1,040	-1,132
Overall balance of payments	78	40
Gross official reserves	470	449
(In months of imports)	2.3	2.1
	(Percentage change)	
Real GDP	5.0	4.8
CPI (annual average)	10.0	8.5
II. Assumptions		
Export volume	22.3	9.1
Import volume	-2.2	1.7
Of which: Nonfood imports	8.3	2.1
Terms of trade	-16.3	-0.8
Income velocity of broad money	-2.2	-1.8

III. Principal Elements of the Program

1. Central government budget

a. New revenue measures adopted with the 1986/87 budget include the imposition of a customs duty on imports of petroleum and petroleum products; increases in other customs duties; increases in domestic excise duties, particularly on natural gas and cigarettes; wider coverage of and improved enforcement for income taxes; and the imposition of and increases in a number of charges and fees. The new measures are expected to generate Tk 4.8 billion (0.9 percent of GDP) in additional revenue. With these measures in place, the ratio of total government revenue to GDP is expected to rise by 0.5 percentage point to over 9.5 percent in 1986/87.

b. Total government expenditure as a share of GDP is projected to increase marginally to 16.8 percent in 1986/87. The size of the Annual Development Program is estimated to increase by Tk 6 billion to Tk 44.3 billion, slightly increasing its share in GDP to 8.3 percent. The budget places considerable emphasis on operations and maintenance expenditure, while allowing for only a moderate increase in other categories of current expenditure. In addition, the food subsidy will be reduced by Tk 200 million, and the fertilizer subsidy has been eliminated.

c. The overall budget deficit is projected to increase by Tk 2.62 billion to Tk 38.51 billion. As a share of GDP, however, the deficit will decline by 0.5 percentage point to 7.2 percent (6.9 percent excluding the impact of foodstocking operations).

2. Money and credit

As performance criteria, there will be quarterly ceilings on net domestic assets of the banking system, and on net credit of the banking system to the Government through March 1987. For the year as a whole, the increase in net domestic assets is to be limited to 15.0 percent, while the increase in net credit to the Government will be contained at 2.3 percent. Quarterly ceilings on net domestic assets of the banking system and on net bank credit to the Government are as follows: Tk 124,600 million and Tk 22,200 million (end-September 1986); Tk 131,700 million and Tk 22,400 million (end-December 1986); and Tk 133,300 million and Tk 21,600 million (end-March 1987), respectively.

3. External sector

a. The authorities will pursue a flexible exchange rate policy aimed at preserving the margin of international competitiveness achieved, and are committed not to allow an appreciation of the real effective exchange rate of the taka relative to its base level during the program period.

b. In line with their intention of unifying the dual exchange markets, the authorities have transferred a large portion of export and import transactions to the secondary market. Effective July 1, 1986, only raw jute, tea, and wet blue leather exports are to be transacted at the official rate. All other eligible exports are assigned an Export Performance Benefit (XPB) coefficient, mostly 100 percent of their value, allowing them to receive the more depreciated secondary market rate. Approximately 71 percent of total export receipts will thus be sold in the secondary market during 1986/87, compared with about 53 percent in 1985/86.

c. As of July 1985, the positive list of permissible imports was replaced by negative and restricted lists of imports. The 1986/87 Import Policy Order further liberalizes the trade system by removing several industrial inputs from the restricted list, and by allowing export-oriented firms to request permission to import banned or restricted items that are necessary to meet an export order.

d. The Government will continue to take the required steps to ensure that losses are not incurred under the Exchange Rate Fluctuation Burden Absorption Scheme (EFAS), and that the operation of the EFAS does not affect the exchange system.

e. Through end-March 1987, the contracting or guaranteeing of new external loans with maturities of 1-12 years will be limited to $100 million; within this ceiling, a subceiling of $80 million will apply to new commitments of 1-5 years' maturity (both ceilings constitute performance criteria). In addition, the outstanding stock of publicly guaranteed short-term debt with maturity of less than one year will not be increased by more than $15 million through March 1987, and short-term liabilities of Bangladesh Bank will be reduced by $40 million.

LETTER OF INTENT

BANGLADESH

Dhaka, Bangladesh
July 30, 1986

Dear Mr. de Larosiere:

1. On December 2, 1985, the Fund's Executive Board approved a 19-month stand-by arrangement with Bangladesh in support of an economic and financial program described in our letter dated November 5, 1985. The economic program for 1985/86 was designed to bring about an improvement in the external current account while achieving real GDP growth of approximately 4 percent. The major elements of the program included a further reduction in the government budget deficit in relation to GDP through expenditure restraint and measures to generate additional revenue; tightening of monetary and credit policies; flexible exchange rate management and pricing policies; progress toward unification of the exchange markets; and further liberalization of the trade and payments system.

2. The results achieved in the first year of the program, through June 1986, are encouraging. GDP growth has rebounded to 5 percent largely on the strength of the recovery in agriculture, particularly in rice and jute production. Reflecting improved foodgrain availability, as well as the slow pace of domestic demand and a moderate increase in import prices, the rate of inflation has decelerated to approximately 10 percent, remaining below the program target of 12 percent. Despite a sharp deterioration in the terms of trade, the turnaround in the balance of payments has been stronger than envisaged under the program. The current account deficit was reduced by some $270 million mostly on account of a larger inflow of workers' remittances and lower foodgrain imports. In relation to GDP, the current account deficit declined by close to 2 percentage points to 6.6 percent. The overall balance of payments surplus, estimated at $78 million, is well above the programmed surplus of $30 million, and the gross reserves target for end-June 1986 has been exceeded by $50 million, raising the import coverage of reserves to 2.3 months of imports.

3. The fiscal targets of the program were not fully realized. The overall budget deficit of Tk 35.9 billion (7.7 percent of GDP) was Tk 2.3 billion (0.4 percent of GDP) in excess of the program target, due both to revenue shortfalls and expenditure overruns. The slippage of Tk 1.6 billion in revenue collection was attributable mostly to lower collections from customs duties, and from excise and sales taxes, while the performance of nontax revenue was stronger than anticipated. The Annual Development Program (ADP) reached Tk 38.2 billion and was larger than envisaged under the program owing to improved absorption of project aid flows. Current expenditure exceeded the program amount by Tk 1.7 billion due mainly to larger-than-anticipated payments for wages

and salaries, interest and charges, and to losses incurred by the Railways and the Post Office. The food account deficit, on the other hand, was significantly lower than initially estimated, reflecting smaller imports and domestic procurement. Nonbank market borrowing to finance the budget deficit was larger than envisaged, while net government indebtedness to the banking system was reduced by Tk 1.3 billion as programmed.

4. The monetary targets for the year were largely achieved. The credit ceilings under the program for end-December 1985 and end-March 1986 were observed, and indications are that the end-June ceilings have also been met. Accordingly, net domestic assets of the banking system are estimated to have increased by approximately 15 percent in 1985/86, compared with 28 percent in the previous year, reflecting the decline in net credit to the Government, as well as a sharp deceleration in the growth of credit both to the private sector and to public enterprises, although inadequate loan recovery by the private sector remains a matter of serious concern. The growth in broad money is estimated at about 17 percent, slightly exceeding the program target on account of a stronger balance of payments outcome, but remaining substantially below the previous year's growth of 26 percent. Monetary restraint was supported by a restrictive refinancing policy and increasingly positive real interest rates. Despite the slowing down in inflation, interest rates were maintained at their June 1985 levels, with the exception of those on term and working capital loans for industry which were reduced by 0.5 percentage point in March 1986 to stimulate industrial investment.

5. Flexible exchange rate management, in conjunction with the expansion of the secondary exchange market, constituted the cornerstone of policies aimed at export promotion. As a result of the sizable shift of transactions to the secondary exchange market in July and December 1985, the share of exports and imports transacted in the secondary market both rose sharply to 60 percent and 30 percent, respectively. The gains achieved in international competitiveness through the adoption of appropriate exchange rate policies were reflected in sizable increases in nontraditional exports, as well as in private transfers.

6. Flexible exchange rate management was accompanied by flexible pricing policies. A number of adjustments were undertaken in the prices and tariffs charged by nonfinancial public enterprises, including increases in natural gas prices and electricity tariffs. Fertilizer prices were raised in July and October 1985, resulting in a Tk 312 million reduction in the fertilizer subsidy. In order to reduce the burden on the budget of the public food distribution system, the ration prices of rice and wheat were raised in November 1985 which, coupled with a lower volume of operations, resulted in a Tk 890 million (approximately 40 percent) reduction in the foodgrain subsidy.

7. The overall thrust of economic policy in 1985/86 was appropriate to achieve the principal objectives of the program. Sustained economic growth with financial stability will be essential if a gradual improvement in the standard of living in Bangladesh is to be achieved. In 1986/87, it is the Government's intention to consolidate the stabilization effort and further reduce the rate of inflation, while at the same time initiating structural measures to promote economic growth. Accordingly, the Government's adjustment program for 1986/87 will continue to focus on generating additional domestic resources; strengthening the economic performance of public enterprises; addressing financial sector issues, particularly in the area of loan recovery; maintaining the present flexibility in exchange rate management and pricing policies; achieving further progress toward unification of the exchange markets through the shifting of additional transactions to the secondary market; and further liberalizing the trade and payments system. The program for 1986/87 is designed to contain the external current account deficit at about 6.6 percent of GDP, to achieve real GDP growth of close to 5 percent despite an anticipated slowing down in agriculture, and to reduce inflation further to 8.5 percent. The overall balance of payments is expected to record a surplus of approximately $40 million, allowing for a significant reduction in Bangladesh Bank's short-term external liabilities while maintaining the import coverage of gross reserves at slightly over two months' imports. Needless to say that these targets will be affected to the extent workers' remittances fall below expectation.

8. Fiscal policy in 1986/87 will aim at further reducing the overall government budget deficit by 0.5 percentage point in relation to GDP, and by 0.8 percentage point excluding the impact of food stocking operations. The budget deficit is projected at approximately Tk 38.5 billion, equivalent to 7.2 percent of GDP. A larger deficit will be sustainable only if foreign aid disbursements prove to be stronger than presently envisaged and the size of the ADP is concomitantly higher. Measures to generate revenue and redirect expenditure to priority areas have been adopted to ensure the realization of the fiscal targets. Net domestic financing of the budget is expected to be in the order of Tk 3.1 billion, including net government recourse to bank credit in the amount of Tk 0.5 billion. It is the intention of the Government not to resort to nonbank market borrowing. However, to the extent that such borrowing takes place, in order to tap idle resources, the net indebtedness of the Government to the banking system will be reduced by an equivalent amount. Performance in this respect will be an element of the second review of policies under the stand-by arrangement.

9. To further strengthen the domestic resource mobilization effort, the Government has adopted several measures with the 1986/87 budget to raise additional revenue. The recent sharp decline in the international price of oil has been only partially reflected in domestic prices of petroleum and petroleum products which were reduced by an average of 10 percent effective July 1, 1986. The Government will

capture a large proportion of the gains accruing from this source through the imposition of a customs duty on imports of petroleum and petroleum products. In addition, the structure of other taxes has been modified with a view to promoting investment in export industries, countering evasion of customs duties, and simplifying and rationalizing the collection of duties. Accordingly, a number of duties have been raised while others have been lowered, and certain exemptions have been modified. The major reductions pertain to duties on imported raw materials and certain imported inputs of the textile industry, while the most significant increases apply to customs duties on fresh fruit and edible oil, and to domestic excise duties, notably on natural gas and cigarettes. Income tax revenue will also be enhanced through wider coverage and improved enforcement. Finally, with a view to strengthening nontax revenue collections, a number of charges and fees have been raised or imposed, including increases in postal and telephone rates and imposition of charges on airline tickets. The net revenue impact of the above measures, coupled with a number of other changes, is estimated at Tk 4.8 billion, equivalent to 0.9 percent of GDP. With the implementation of these measures and the strengthening of tax administration, the total revenue to GDP ratio is expected to rise by 0.5 percentage point to over 9.5 percent in 1986/87. The tax revenue to GDP ratio will rise by 0.7 percentage point to 7.7 percent. Moreover, in recognition of the crucial need to further strengthen the resource mobilization effort, the Government will undertake a comprehensive review of tax policy and administration during 1986/87. Technical assistance from the Fund in this area is already under way.

10. As a ratio to GDP, total government expenditure, including the ADP, is projected to increase marginally to 16.8 percent in 1986/87. The Government is aware of the urgent need to make sufficient allowance for the recurrent expenditure requirements of new investments and of existing assets. Accordingly, the 1986/87 budget gives considerable emphasis to those expenditures essential for the operation and maintenance of the existing capital stock, while allowing for only a moderate increase in other current expenditure categories. The size of the adjusted ADP, reflecting some areas of possible shortfalls, is estimated at Tk 44.3 billion, an increase of Tk 6 billion which raises its share in GDP slightly to 8.3 percent. Within the global amount, an increasing proportion of funds have been allocated to agricultural and rural development, transportation, education, health, and family planning. The food account deficit is estimated at Tk 2.8 billion, including Tk 1.6 billion for a foodgrain stock buildup. The ration prices of wheat and rice were further raised effective June 15, 1986 by approximately 5 percent to realize a reduction of Tk 200 million in the food subsidy in the current fiscal year. The Government's longer-term objective is to further reduce and better target foodgrain subsidies by directing them to the lowest income groups. The fertilizer subsidy through the government budget has been eliminated, notwithstanding an average reduction of 4 percent in urea fertilizer prices effective July 1, 1986 in light of the continuing drop in international fertilizer prices which, however, has not been fully reflected in domestic prices.

11. The overall performance of nonfinancial public enterprises over the past year has been influenced significantly by a deterioration in the financial positions of enterprises engaged in jute operations due to the sharp decline in jute prices, and because of certain internal constraints, mainly power shortages and labor strikes. Even on the assumption that the cyclical trough in jute prices has been reached, funds will continue to be needed to finance jute stocks and exports in the current fiscal year, while ensuring a certain minimum income to jute growers. The profitability of the textile mills has been adversely affected by competition from synthetics as well as by imports through unauthorized channels which have resulted in lower domestic sales and the building up of stocks. The Power Development Board has suffered from interruptions in power generation in its hydro stations, with repercussions on production in a number of sectors. These adverse developments have strained the availability of resources to the Government from the public enterprise sector, curtailed capital contributions by enterprises, and resulted in increased demand on banking resources to provide the needed financing. While a major improvement in this area cannot be expected in 1986/87 in the absence of a strong revival in jute prices and immediate elimination of the bottlenecks mentioned above, the Government is fully aware of the urgent need to improve the efficiency of the public enterprise sector and to promote its contribution to domestic savings. As such, efforts supported by the principal aid donors are under way to examine ways of enhancing enterprise performance and improving central monitoring of activities while according greater autonomy in decision making to the nonfinancial public enterprises. The establishment and maintenance of a comprehensive and consistent data base for the public enterprise sector will be an important element in this exercise, and work in this area has progressed with recent technical assistance from the Fund.

12. The balance of payments will continue to be under pressure in 1986/87. There is little prospect for a recovery in jute prices, while exports of the dynamic garment industry will be constrained by recent protectionist measures. The decline in international oil prices will reduce the oil import bill, which, however, will be more than offset by the anticipated reduction in workers' remittances as economic conditions in the oil producing countries deteriorate. Given these developments, there will not be much room for a further improvement in the current account deficit, which is expected to stabilize at about 6.6 percent of GDP. *Assuming improved project implementation, as well as a recovery in* commodity aid utilization, aid disbursements are expected to rise by approximately 9 percent. The Government recognizes the crucial role of export promotion and diversification in the strengthening of the adjustment effort. Toward this end, a medium-term program for ensuring that private industrial investment is directed at export expansion has been formulated. The program covers tariff reforms, simplification of investment sanctioning procedures, and strengthening of incentives for

export-based industries through appropriate modification of import procedures.

13. Flexible exchange rate management will continue to be an essential element of the adjustment program. The official exchange rate for the taka was depreciated by 7.6 percent during 1985/86. By end-May 1986, the real effective exchange rate had depreciated by approximately 3.5 percent relative to its base level. The Government will make every effort not to erode the margin in international competitiveness achieved and will, in any case, not allow a real effective appreciation of the taka relative to its base level. Moreover, by adjusting the official exchange rate as and when needed, we will ensure that the official rate is not at an excessive discount relative to the rate prevailing in the secondary market.

14. Considerable progress has been made over the past year toward unification of the dual exchange markets by significantly expanding the scope of the secondary market where a more depreciated exchange rate prevails. As a result of further moves in this direction, effective July 1, 1986, raw jute, tea, and wet blue leather are the only remaining major exports which are transacted entirely in the official market. All other exports are assigned Export Performance Benefit coefficients (XPB), which allow them to receive 40 percent, 70 percent, or 100 percent of earnings at the secondary market rate. With the application of higher coefficients in increased instances, approximately 71 percent of total export receipts will be sold in the secondary market in 1986/87 compared with about 53 percent in 1985/86. Moreover, in certain instances, the Government has adopted the principle that XPB should be related to domestic value added in order to strengthen linkages between the export sector and domestic industry, and to encourage exports of processed goods. The share of imports transacted in the secondary market is also being raised from about 28 percent of the total to 42 percent, leaving only imports financed by foreign aid and through barter arrangements to be transacted at the official rate. It is the Government's intention to shift additional transactions from the official to the secondary market in a balanced fashion as the external situation permits. The exchange rate in the latter market will continue to be determined freely by the commercial banks, with no net sales on a quarterly basis by Bangladesh Bank in the market.

15. In 1985/86, the positive list of permissible imports was replaced by negative and restricted lists of imports. Through modifications of the latter lists, the Import Policy Order for 1986/87 further liberalizes the trade system, with a view to encouraging domestic industry, particularly in the export sector. Several industrial inputs have been removed from the restricted list and may now be imported liberally. Furthermore, export-oriented firms may now request permission to import banned or restricted items which are necessary to meet an export order. Despite these measures, our exchange

and trade system retains some restrictive elements, largely to protect domestic industry and conserve foreign exchange resources. It is our intention to continue to relax these restrictions as the balance of payments position permits.

16. Since the effective date of the present stand-by arrangement, the Government has set aside premia collected under the Exchange Rate Fluctuation Burden Absorption Scheme (EFAS) in a blocked account to cover any possible costs incurred under the Scheme. At end-June 1986, the outstanding amount in the blocked account amounted to Tk 0.32 million. Moreover, the coverage of EFAS has been restricted to term loans in foreign currency disbursed principally by the three Development Finance Institutions. The Government will continue to monitor the operation of the EFAS with a view to ensuring that losses are not incurred under the Scheme, and that provisions of the EFAS do not affect the exchange system.

17. Notwithstanding the significant but declining share of concessional external assistance to Bangladesh, the debt service burden has been increasing and is projected to remain heavy in the years immediately ahead. The Government will continue the policy, therefore, of strictly limiting new borrowing with short maturities and on nonconcessional terms. Through end-March 1987, the contracting or guaranteeing of new external loans on nonconcessional terms by the public sector will be limited to the amount set forth in the attached Table 1. During 1986/87, new borrowing on nonconcessional terms directly contracted or guaranteed by the public sector with maturities of 1-12 years will be limited to $100 million. Within this ceiling, a subceiling of $80 million will apply to new commitments of 1-5 years' maturity. It is our intention, however, to avoid borrowing with maturity of 1-5 years except in emergencies or to finance the rollover of existing debt. In addition, the outstanding stock of publicly guaranteed short-term debt, i.e., with maturity of less than one year, will not be increased by more than $15 million during 1986/87, and short-term liabilities of Bangladesh Bank will be reduced by $40 million.

18. The monetary program for 1986/87 will contain domestic credit expansion in order to moderate inflation and sustain the gains achieved in the external position. Accordingly, the growth in net domestic assets of the banking system will be limited to 15.1 percent during 1986/87. This increase is consistent with the expected increase in the demand for broad money and the projected developments in net foreign assets of the banking system. Within the global net domestic asset ceiling, the envisaged expansion of credit to the public and private sectors is designed to allow only a moderate increase in outstanding bank credit to the Government; contain the growth of public enterprises' recourse to the banking system; and extend sufficient credit to the private sector to promote productive activity. At end-June 1987, the stock of net credit outstanding to the central government will not

exceed Tk 22.6 billion. The quarterly ceilings on net domestic assets of the banking system and on net bank credit to the Government through March 1987 are set out in the attached Table 2.

19. The Government is committed to a flexible interest rate policy with a view to ensuring an efficient allocation of resources and promoting domestic savings. While care has been exercised to maintain key interest rates positive in real terms, in response to the slowing down in domestic inflation and in view of recent price and interest rate developments in international markets, a number of changes were introduced in the level and structure of interest rates effective July 1, 1986. The rate of interest on industrial term loans was reduced from 14 percent to a range of 12 percent to 13.5 percent, conditional on compliance with improved debt to equity ratios. The primary objective behind this move is to encourage private investors to increase their equity contributions to industrial projects. In order to strengthen the competitiveness of traditional exports, particularly jute, at a time of sharp and continuous decline in international commodity prices, the rate of interest on working capital loans for traditional exports was reduced from 12 percent to 9 percent. Finally, in response to evidence of sluggish growth in certain sectors of the economy and increasing strains on the liquidity positions of banks, the Bangladesh Bank rate was lowered from 11.25 percent to 10.75 percent. The Government will continue to monitor interest rates and undertake further adjustments as warranted in light of changes in domestic and international conditions.

20. Inadequate loan recovery by the Development Finance Institutions (DFIs) and, to a lesser extent, by the nationalized commercial banks, continues to be a serious problem. Under an Action Program agreed to with the principal aid donors, the Government implemented a number of measures during 1985/86 to address this problem. Progress to date has been modest. Additional measures will be implemented during 1986/87 to restore loan recoveries in the agricultural sector to more viable levels, and to assist the DFIs in their effort to recover arrears and restructure their portfolios. These measures will include strengthening of the legal framework to take effective action against defaulters; improved accounting and monitoring of overdue amounts; and stricter limits on Bangladesh Bank refinancing related to recovery performance. In addition, during 1986/87, the Government will initiate a review of the financial sector as a whole in order to identify broader policies to promote more efficient financial intermediation and generate additional private savings.

21. The Government of Bangladesh believes that the policies and measures described in this letter are adequate to achieve the objectives of the program, but will take any additional measures that may become appropriate for this purpose in light of prevailing domestic and external circumstances. During the remaining period of the arrangement, the Government will periodically consult with the Fund, in accordance

with the Fund's policies on such consultations, on the progress being made in the implementation of the program and any policy adaptations judged to be appropriate for the achievement of its objectives.

Sincerely yours,

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Advisor for Finance

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Table 1. Bangladesh: Ceilings on External Public and Publicly Guaranteed Debt, September 1986-March 1987

(In millions of U.S. dollars; end of period) 1/

	Sept. 1986	Dec. 1986	March 1987
		Program	
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 one-year maturity	...	...	36
Outstanding stock of external liabilities of Bangladesh Bank of less than one-year maturity	80	80	80

1/ End of period refers to the last working day of the month.

Table 2. Bangladesh: Ceilings on Net Domestic Assets and Net Credit to the Central Government, September 1986-March 1987

(In millions of taka; end of period) 1/

	Sept. 1986	Dec. 1986	March 1987
	Program		
Net domestic assets	124,600	131,700	133,300
Net credit to the central government	22,200	22,400	21,600

1/ End of period refers to the last working day of the month.