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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 85/173

10:00 a.m., December 2, 1985

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	M. K. Bush
J. de Groote	
	G. Nguyen, Temporary
M. Finaish	
	M. Sugita
	B. Goos
J. E. Ismael	
	J. R. N. Almeida, Temporary
	M. Foot
H. Lundstrom	
	L. Leonard
	W. K. Parmena, Temporary
	C. A. Salinas, Temporary
	J. E. Suraisry
	J. E. Rodríguez, Temporary
J. J. Polak	
	A. V. Romuáldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
	N. Coumbis
	Yang W.

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

IBRD: A. Clift, South Asia Regional Office. Asian Department: K. A. Al-Eyd, B. Ames, E. Gurgen, S. Ishii. Central Banking Department: C.-J. Lindgren. Exchange and Trade Relations Department: E. H. Brau. Fiscal Affairs Department: R. j. Hurnard. Legal Department: Ph. Lachman, J. V. Surr. Bureau of Statistics: J. C. O'Connor. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: S. Ganjarerndee, I. Puro, M. Z. M. Qureshi, A. Vasudevan. Assistants to Executive Directors: A. Bertuch-Samuels, G. Ercel, S. Geadah, V. Govindarajan, N. Haque, G. D. Hodgson, Z. b. Ismail, S. King, H. Kobayashi, R. Msadek, J. Reddy, M. Sarenac.

1. BANGLADESH - 1985 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1985 Article IV consultation with Bangladesh (SM/85/264, 9/23/85), together with a request for a stand-by arrangement in an amount equivalent to SDR 180 million (EBS/85/251, 11/12/85). They also had before them a report on recent economic developments in Bangladesh (SM/85/276, 10/8/85).

The staff representative from the Asian Department mentioned that information on three items had been received too late to include in EBS/85/251. First, effective November 1, 1985, domestic air fares had been raised by 25 percent. Second, staff calculations indicated that as of end-September 1985--the latest date for which price data on major trading partners were available--there had been a slight real effective depreciation of the taka relative to its base level for the first quarter of 1983. Since the end of September, the authorities had further depreciated the official rate for the taka by 2.5 percent to Tk 30.50 per U.S. dollar. The premium of the secondary market rate over the official exchange rate was 8.9 percent at end-November 1985. Third, the authorities had decided to transfer more transactions into the secondary exchange market effective December 1, 1985, which affected goods and some invisible receipts and was estimated to raise the foreign exchange availability in that market by approximately 10 percent.

Mr. Sengupta made the following statement:

> The staff documents for the Article IV consultation and the stand-by arrangement cover much the same period--the economic developments and policy responses in 1984-85 as well as policy perceptions and economic prospects for 1985-86. They also give a useful analysis of Bangladesh's balance of payments prospects in the medium term. The paper on the request for a stand-by arrangement, however, contains more recent data for 1984-85, which provided the basis for the 1985-86 program estimates.
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> Directors are aware that Bangladesh is one of the least developed countries in the world, with the average annual per capita income estimated at about $150, and with high population growth and density. Natural resources and infrastructural facilities are limited. Agriculture accounts for about half of GDP, a sizable share of exports, and four fifths of total employment; it also provides raw materials for a number of industries. The country is vulnerable to the vagaries of weather and natural disasters. Industrial and export bases are narrow. In view of a very low ratio of domestic savings to GDP, Bangladesh has to rely heavily on external assistance to attain a minimum rise in per capita income.
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> Bangladesh successfully implemented a Fund-supported adjustment program--a stand-by arrangement--in 1982-83 for SDR 68 million. During this year, the authorities raised taxes; reduced subsidies

on fertilizers, foodgrains, and minor irrigation equipment; and adjusted key administered prices such as those of electricity, natural gas, and petroleum products. Bangladesh also adopted an Annual Development Program consistent with realistic resource estimates. These fiscal measures were supplemented by other actions aimed at increasing agricultural production, reducing inflation, facilitating external adjustment, and promoting private investment. To compensate the fall in public sector credit requirements, increased credit for the private sector was provided for. Exchange rate was managed flexibly, incentives for nontraditional exports were increased, and the import regime was further liberalized. To encourage inflows of remittances, interest rates on nonresident foreign currency deposits were set at London Interbank Borrowing Rates plus 1 percentage point. A New Industrial Policy was also promulgated. Under this policy, the authorities denationalized 55 jute and cotton textile mills, opened to private investment certain sectors previously reserved for public enterprises and simplified approval procedures for domestic and foreign private investment.

The economic performance in 1982-83 was favorable: real GDP growth exceeded 3 percent, the inflation rate was contained at 10 percent compared with 16.3 percent of the previous year, and the balance of payments position improved leading to an accumulation of gross international reserves equivalent to about two months' imports, as compared with three weeks in 1981-82.

In 1983-84, real GDP growth was maintained, the inflation rate was limited to the previous year's level, and the external current deficit was further reduced. Gross international reserves were further built up.

Economic performance in 1984-85, however, was affected by a substantial loss in the production of foodgrains and jute caused by severe floods. Real GDP growth was lower than in the previous year. The inflation rate, which had hovered around 10 percent in the previous two years, did not, however, go much beyond 11 percent in spite of domestic supply shortages and monetary and credit expansion. The strong credit demand from the public enterprises was mainly in response to higher jute prices. The authorities took a number of measures to meet the situation. Certain interest rates were adjusted upward including the Bank rate and the rates on rural savings. Bangladesh Bank imposed individual credit ceilings on banks and a penalty rate of 4 percent above the Bank rate for amounts of credit in excess of the individual ceilings imposed on banks. It also curtailed refinancing. Fiscal policy was cautious. The overall budget deficit declined in relation to GDP for the second successive year, with total revenue receipts increasing by 25 percent and total expenditure going up by only 14 percent. Fiscal deficit was largely financed from foreign and domestic nonbank sources, thus facilitating a reduction in the Government's net indebtedness to the banking system.

The current account deficit widened, however, mainly because of a large increase in food imports and a marked decline in private transfers. In view of reduced net capital inflows, the overall balance of payments shifted to a deficit, and gross international reserves declined to the equivalent of 1.8 months of imports. The Bangladesh Government responded to the situation by depreciating the official exchange rate, taking steps to expand the secondary exchange market, and encouraging nontraditional exports.

Notwithstanding these measures, and a general improvement in the overall economic performance of Bangladesh in recent years, the underlying situation continued to be one of stress. The narrow export base and the shifts in terms of trade, and the need to import to maintain economic momentum have posed constraints on the policy making in Bangladesh for gaining external viability and sustained improvement in living standards. The country has to rely heavily on external aid, and while most external borrowing has been concessional, the debt service ratio has risen to more than 20 percent.

It is in recognition of the need to pursue external adjustment within the framework of sustained economic growth and price stability that Bangladesh has formulated a comprehensive financial and economic program for 1985-86 and has requested the Fund to support it by way of a stand-by arrangement for the period December 1985 through June 1987 for SDR 180 million. Bangladesh has received assurances of continued financial support from its major aid donors in support of the additional resource requirements for the program period.

The Government's adjustment program for 1985-86 focuses on mobilizing additional domestic resources, promoting efficiency of resource use, and strengthening the competitiveness of the traded goods sector.

The program envisages a reduction in the external current account deficit by 1 percentage point to 7.3 percent of GDP. This would be consistent with an increase in real GDP growth of at least 4 percent, the projected inflation rate of about 12 percent and the expected impact of wage and other policy adjustments. From the existing trends in agricultural and industrial output, it appears that the program estimate of 4.1 percent in real GDP growth in 1985-86 would be exceeded. Recent price data indicate that there had been a rise of prices of only about 2.24 percent on the average during the quarter July-September 1985, giving an annualized rate of inflation of only 8.96 percent.

The Government has undertaken to reduce the ratio of the overall budget deficit to GDP from 8.3 percent in 1984-85 to 7.3 percent in 1985-86. It is the Government's objective to reduce this ratio further in 1986-87. To achieve the fiscal targets, for 1985-86, the Government took a number of measures, both in the budget and on subsequent occasions in August and September. Net indebtedness of the Government to the banking system would be reduced by 0.3 percent of GDP. Total revenue is projected to grow by about 22 percent and total expenditure by about 12 percent. Revenue increases largely reflect higher receipts from customs duties and sales taxes. A number of revenue measures were announced in the budget, which include a reduction in income tax rates, increases in the land tax rate, and adjustments in excise taxes and customs duties. Additional revenue measures were adopted subsequently, such as an increase in the rate of customs duty on sugar from 75 percent to 100 percent, the imposition of surcharges on select services, and the introduction of a 4 percent charge on interest paid on all savings and financial instruments. The tax revenue to GDP ratio is expected to rise from 7.2 percent to 7.8 percent.

The authorities intend to bring down the ratio of Government expenditure to GDP from 17.2 percent in 1984-85 to 16.8 percent in 1985-86, after taking into account the salary and wage increases granted at the outset of the fiscal year in accordance with the recommendations of two National Pay Commissions, which aid donors, as well as the World Bank, considered necessary for improving the efficiency of the civil service. A freeze has been imposed on new hiring in most areas of public service. Expenditure reductions have been made by the Government in other areas. The Government has ordered a mandatory cut of 5 percent minimum in all contingency expenditure included in the nondevelopment budget for 1985-86. Food and fertilizer subsidies were reduced by Tk 0.4 billion each during the fiscal year. The Government is committed to phasing out the fertilizer subsidy by July 1, 1986, and has accordingly raised fertilizer prices twice--on July 1 and October 1 of the current fiscal year. The Government has also raised the prices of administered items: natural gas, by 20 percent, electricity tariffs, by an average of 6 percent in July and 18 percent in September, water and sewerage prices, by 25 percent, railway fares by 5 to 20 percent, and domestic air fares by 15 percent. Public enterprises have been instructed to reflect actual production costs in their selling prices. The Government has also set up a special unit to monitor the performance of these enterprises.

The 1985-86 program limits the growth in net domestic assets of the banking system to 15.1 percent, against 27.9 percent in 1984-85, and in credit to the public sector to 10.6 percent, against 12.3 percent in 1984-85. Growth in credit to the private sector is projected not to exceed 18.7 percent in 1985-86, against

40 percent in 1984-85. The objective is to ensure that a reduction takes place in the present proportion of overdue loans in total bank loans and that the truly productive sectors get the needed credit. In the case of agricultural loans, recovery targets have been set for individual banks with the understanding that refinancing limits will be reduced to those banks failing to meet their targets. Refinancing has been made restrictive. To encourage domestic savings, a flexible interest rate policy is being pursued. Key interest rates are positive in real terms. During the program period, interest rates would continue to be monitored.

The balance of payments of Bangladesh will remain under pressure in 1985-86, owing to an expected 20 percent decline in the terms of trade, notwithstanding a likely growth in foreign assistance and a projected fall in foodgrain imports. Moreover, workers' remittances are not expected to grow significantly. It will therefore be necessary to follow trade, exchange rate, and other policies that promote and help the diversification of exports. Bangladesh has followed a flexible exchange rate policy, with the taka being pegged to a basket of currencies. The authorities devalued the taka several times during the two-year period up to January 31, 1985, but they were not able to compensate for the unfavorable inflation differential relative to the major trading partners and for the strength of the intervention currency, the U.S. dollar. From February 1985, the Government embarked upon a policy of steadily depreciating the taka, so that by end-October 1985, the taka had been devalued by 13.3 percent in terms of the U.S. dollar relative to its value at end-January 1985. The authorities recognize that an active and flexible exchange rate policy is needed to promote external adjustment and will accordingly review the policy in this regard with the Fund before end-August 1986 and again before end-February 1987. The authorites also intend to pursue a policy of moving toward unification of the markets. Accordingly, they have expanded the scope of the secondary market considerably since July 1, 1985. Approximately 50 percent of all export earnings are sold in the secondary exchange market, compared with about 23 percent in the preceding year. It is the Government's intention to shift additional transactions from the official to the secondary market over time. Steps have also been taken to simplify the existing import procedures. During the program period, the Government does not intend to impose or intensify restrictions on payments and transfers for current international transactions or conclude new bilateral agreements. Bangladesh will restrict new borrowings with short maturities and on nonconcessional terms, in view of the already high debt service burden.

The Government continues to place priority on agriculture and rural development, in order to ensure food self-sufficiency at the earliest time, and to develop the industrial sector with a view to promoting exports. The Government will also continue the policy of encouraging the expansion of the provate sector.

The Government of Bangladesh is committed to the program. It believes that the policies envisaged will help achieve the main objectives of the program.

In view of the highly commendable measures that have already been taken and the commitment expressed in favor of the comprehensive adjustment program, I request the Executive Board to give Bangladesh's request for a stand-by arrangement a favorable consideration.

Mr. Finaish observed that in a poor developing economy like that of Bangladesh, with a relatively small and narrow production and export base, and the consequent vulnerability to exogenous shocks, the balance of payments problem was linked inextricably with the problem of growth. Without policies to promote broad-based growth and adequate financing in support of those policies, any balance of payments stabilization would largely be an exercise in short-run balancing of the external accounts. A payments equilibrium could no doubt be reached that way, but it would be an equilibrium that would not be viable in the long run, for it would not represent any fundamental improvement in the external position, nor would it be desirable, for it would not be compatible with adequate growth. Recently, there had been an increasing recognition of the need for promoting adjustment with growth in major debtor countries. Recognition of the need for growth-oriented adjustment policies in low-income countries like Bangladesh had existed longer, but unfortunately, intellectual recognition had not often been matched with efforts to translate it into actual results.

Faced with slowing growth and a weakening financial position at the turn of the decade, the Bangladesh authorities had initiated a number of adjustment measures that had contributed to some revival of growth and reduction of inflation and financial imbalances, Mr. Finaish recalled. The progress, however, had been interrupted and some of the earlier gains had been eroded in 1984/85 as a result of large production losses and the associated financial pressures caused by heavy floods, whose impact on the balance of payments had been compounded by a large drop in workers' remittances. Those developments demonstrated once again the economy's underlying structural weaknesses and its continued vulnerability to shocks. The year-to-year economic fortunes had also been affected considerably by fluctuations in the terms of trade. In those circumstances, it had quite appropriately been recognized in the preparation of the proposed program that a strategy for a gradual and durable improvement in the balance of payments would be one that sought over the medium term, and in the context of appropriate macroeconomic policies, the expansion and diversification of the economy's production and export base.

The proposed program would serve to strengthen and broaden the authorities' continuing efforts toward sustained growth with balance of payments viability, and he could support it, Mr. Finaish said. In addition to a tightening of the demand-management stance, the program included a useful complement of structural measures aimed at improving resource allocation, enhancing incentives for private investment, strengthening domestic resource mobilization, and diversifying exports. Those measures covered a broad spectrum of policies on taxation and expenditures, investment, pricing, public enterprise management, and exchange and trade. Such broad-based adjustment efforts would need to be sustained well into the medium term. The medium-term projections prepared by the staff indicated that the economy would remain subject to a tight external financial position in the years ahead, but they did hold out the prospect of a gradual improvement in the balance of payments situation.

The average GDP growth rate projected by the staff for the period 1986-90 was only 3 percent, Mr. Finaish commented. That would permit only a marginal increase in per capita income, which was among the lowest in the world. Moreover, the projected GDP growth rate was no higher than the average growth rate realized over the difficult period of the first half of the decade. A growth-oriented adjustment strategy should promise a better growth picture over the medium term than that. The achievement of a higher rate of growth consistent with the dictates of the balance of payments position would require, inter alia, a greater emphasis on policies to raise domestic savings and investment and an increase in external resource inflows on appropriate terms. The rate of domestic savings remained extremely low. While the difficulty of raising savings in an economy with such a low per capita income should not be minimized, the potential did exist for gradually raising the savings rate through the maintenance of an appropriate structure of incentives and opportunities in the private sector and through a more effective exploitation of the revenue-raising and expenditure-saving possibilities in the public sector. The rate of domestic investment, also relatively low, had been falling in recent years, owing mainly to a decline in public investment that had not been compensated for an anticipated pickup in private investment. To sustain investment at an adequate level, the authorities needed not only to continue to encourage private sector investment but also to protect essential public investment programs as far as possible from expenditure restraints.

Enhanced cooperation with the World Bank would be important in bringing about the needed improvements in project preparation, implementation, and maintenance, Mr. Finaish observed. The Bank and other major aid donors also had an important role to play by ensuring an adequate flow of concessional financial assistance to support the Bangladesh authorities' significant and courageous efforts to pursue adjustment with growth. In that regard, he noted that the staff had lowered its projections significantly for aid disbursements in the period up to 1990 from those presented earlier in the report for the 1985 Article IV consultation (SM/85/264, 9/23/85). One would have expected the strengthening of adjustment policies in Bangladesh to help catalyze additional aid inflows, or at least prevent a decline in them. Some explanation by the staff of the revision of projections for aid disbursements would be helpful.

It would also be useful to hear from the staff whether any increase in the domestic savings and investment rates was foreseen in its medium-term projections, Mr. Finaish added.

A key aspect of the medium-term adjustment strategy in Bangladesh should be to diversify exports, Mr. Finaish continued. The growth of certain nontraditional exports in recent years was an encouraging trend that should be sustained. He was dismayed to learn from the staff report that growth in exports of garments--the item among the country's nontraditional exports that had shown the greatest dynamism in recent years--was unlikely to continue because of international textile quotas. Such impediments to export growth in poor developing countries made a travesty of the homilies delivered to them on the virtues of out-wardlooking adjustment policies.

The recent increase in the debt service ratio, though projected to reverse itself later in the decade, emphasized the need for the authorities to maintain a cautious policy toward external debt management, one that limited external borrowing on nonconcessional terms, Mr. Finaish advised.

He concurred with the staff on the need for effective steps to improve the rate of loan recovery on the large accumulation of overdue bank loans in the domestic economy, and welcomed the measures that the authorities were taking in that respect, Mr. Finaish mentioned.

The fluctuations in Bangladesh's terms of trade had been particularly large in recent years, Mr. Finaish pointed out. For instance, the average annual movement in the country's terms of trade over the past five years had been about 17 percent, and the movement in 1985/86 was projected to be about 17 percent. Such large fluctuations, clearly a destabilizing factor in the economy, mainly reflected movements in the prices of jute, the country's major export. As Bangladesh accounted for a large proportion of world jute exports, fluctuations in domestic production levels were reported to have been an important influence on export prices. He would be interested to hear staff comments on the possibilities for better management of domestic jute stocks as a means of reducing the volatility of jute export prices in response to domestic supply variations. The sensitivity of jute export prices to variations in domestic jute supplies also had potential implications for the impact of exchange rate changes on the country's terms of trade. Depending upon the price elasticity of domestic jute supplies and the extent to which prices actually received by jute farmers were allowed to move with exchange rate changes, a devaluation could entail a significant drop in jute export prices. It would be useful to have the staff's view on the significance of such a relationship in the light of Bangladesh's actual experience.

He wished to draw the Board's attention to the severe cyclone that had hit Bangladesh in May 1985, causing heavy losses, Mr. Finaish concluded. He asked whether the staff had discussed with the authorities the possibility of a drawing under the Fund's policy on emergency assistance related to natural disasters.

Mr. Ismael remarked that the Bangladesh economy, after having achieved significant improvements for two successive years, had once again been affected by heavy floods that had caused large losses to agricultural production. As a result, real GDP growth had declined, inflation had accelerated, and the external current account deficit had widened. *Nonetheless, the Bangladesh authorities were to be commended for having* implemented corrective measures. Those measures, aimed primarily at expenditure restraint and credit tightening, had laid the groundwork for the 1985/86 economic and financial program, for which the authorities were requesting a stand-by arrangement. However, further measures were needed to strengthen the adjustment program if the major objectives of reducing the external current account deficit from 8.3 percent of GDP in 1984/85 to 7.3 percent in 1985/86, while achieving a real GDP growth of 4 percent, were to be achieved. The authorities had shown their commitment to strengthen their adjustment program and thus deserved support.

He welcomed the various new fiscal measures introduced by the authorities to generate more resources, Mr. Ismael stated. However, the revenue measures were still insufficient to offset the low elasticity of the revenue system, and more substantial efforts would be required in the coming years if a significant improvement in the revenue to GDP ratio was to be realized. Unlike the staff, he had no problem with the sizable salary and wage increases granted at the beginning of the fiscal year because those increases had been granted as a result of encouragement from aid donors, particularly the World Bank, to improve the efficiency of the civil service. However, like the staff, he believed that those increases should have been targeted toward the highly skilled segment of the civil service. Nonetheless, given such sizable salary and wage increases, he welcomed the measures taken by the authorities to control other expenditure components, including the imposition of a new hiring freeze in the public service, the implementation of measures to reduce food and fertilizer subsidies, and the significant adjustment in the prices charged by public enterprises. It was important for Bangladesh to utilize fully all available resources to enhance its development effort significantly. He agreed with the staff that the authorities needed to develop a program to overcome difficulties and bottlenecks in project preparation and implementation so that more use could be made of the sizable aid pipeline. The World Bank could play a major role in setting out the program, and he urged the authorities to work closely with the Bank to overcome the problem.

He was concerned about the continued rapid monetary expansion in 1984/85, Mr. Ismael continued. To contain inflation and improve the external balance for 1985/86, the authorities needed to restrain credit expansion. He was encouraged to note that the authorities had adopted measures to curtail credit growth, but they would have to be further strengthened if the monetary program for 1985/86 was to be successful. Another source of concern was the large and growing stock of overdue agricultural and industrial loans, which had not only seriously impaired the effectiveness of monetary management, but had also jeopardized the solvency of Bangladesh's financial institutions. The actions of the major aid donors, particularly the World Bank and the Asian Development Bank, in making new loans contingent on improvements in loan recovery were appropriate indeed. He noted that the authorities had recognized the crucial need to redress the situation; he welcomed the steps they had taken to improve the loan recovery, and he urged them to monitor the situation closely and take additional measures if needed. The authorities' commitment to a flexible interest rate policy was commendable. Key interest rates, which had continued to be positive in real terms, would continue to be monitored during the program period and would be adjusted as necessary to remain positive.

The authorities had taken steps in the right direction to strengthen public sector agricultural programs and promote private sector participation in the agricultural diversification efforts, and those steps should help Bangladesh achieve its agricultural policy aims of achieving sustained growth in foodgrain production, with a view to attaining self-sufficiency in foodgrains while diversifying production to include other crops with growth potential, Mr. Ismael commented. He also welcomed the authorities' denationalization program, which had increased the scope for private sector participation in the economy. Such measures, which were expected to promote competitiveness and efficiency of operations, should help to promote exports.

He was encouraged to note that the current account deficit was expected to be reduced significantly in 1985/86, despite a projected 17 percent decline in the terms of trade, Mr. Ismael indicated, but the staff's medium-term outlook clearly underscored the fragility of Bangladesh's balance of payments for a number of years. The heavy debt burden and the uncertainty of exogenous factors would also continue to constrain Bangladesh's external resources. Given such a situation, and the need to maintain gross international reserves at a minimum desirable level, Bangladesh would have no choice but to continue to rely heavily on foreign assistance over the medium term. The authorities' intention to put strict limits on new borrowing on nonconcessional terms was most welcome. He commended the authorities for their continued commitment to pursue a flexible exchange rate policy aimed at restoring external competitiveness. However, like the staff, he urged them to unify the exchange markets at the earliest opportunity. The fact that the authorities themselves had recognized the merits of the unification and had expanded the scope of the secondary exchange market should bring the unification a step nearer. Finally, he supported the proposed decisions.

Mr. Sugita commented that the Bangladesh economy had been hit hard by heavy floods and a severe cyclone in 1984/85. The balance of payments had deteriorated because of the decline in raw jute exports and the rise in foodgrain imports. The fundamental weakness of the economy was characterized by a narrow export base and an extremely low domestic savings ratio. Export earnings had covered only about one third of imports, the tax revenue to GDP ratio had remained around 7 percent, and Table 19 of SM/85/276 showed that total domestic savings had accounted for only 1 percent or 2 percent of GDP. The authorities should make persistent efforts to resolve those problems in order to achieve a higher growth rate over the longer term, although it might take many years before tangible results could be obtained. The country's debt service ratio had been kept at a manageable level thus far, owing to the authorities' prudent external borrowing policy, but the economy would be faced with an increased debt service over the next few years due to the recent accumulation of commercial food loans. It would be particularly important to attain the target of a moderate buildup in gross international reserves for 1985/86 to avoid payment difficulties arising from seasonal fluctuations of exchange receipts for unforeseeable weather conditions.

The authorities were aware that it would be important to raise the tax revenue to GDP ratio and to increase the relative proportion of domestically based taxes, Mr. Sugita indicated. The authorities had already taken a number of revenue-generating measures, including excise tax increases, but they should take further steps to broaden the base of domestic taxes. Although the tax revenue was expected to rise significantly in 1984/85, it should be kept in mind that that had been due partly to the higher customs duty, which reflected exchange rate adjustments. It would also be important to restrain current expenditure to increase public savings. He welcomed the authorities' intention to reduce fruit and fertilizer subsidies through price adjustments. He shared the staff's concern over the rate and the modalities of the recent increase in the public service wage bill, and he asked whether the World Bank staff had any comment on its reasons for having recommended a wage increase in the current year and on the assessment of the outcome.

Given the abundant human resources, Bangladesh might have a large potential for export expansion, Mr. Sugita commented. Indeed, the recent dynamic performance of the garment industry was particularly noteworthy, its exports having grown from a negligible level in the early 1980s to more than $100 million in 1984/85. The Government's policy of privatization of jute and textile mills seemed to be proceeding well and should help improve the production efficiency of those products, which accounted for the bulk of the traditional exports. As the key to export promotion was the exchange rate policy, he welcomed the authorities' recent resumption of a flexible exchange rate policy in the official market in order to reverse the trend of rate appreciation over the past two years. In addition, he welcomed the authorities' decision not to effect net sales of foreign exchange in the secondary market and their intention to transfer additional transactions to the secondary market. He hoped that they would be able to present a specific timetable for the unification in the near future. As the staff had rightly noted, the existence of an exchange rate fluctuation burden absorption was a source of concern for various reasons, including possible losses of the Bangladesh Bank and thus the authorities' intention to review the system was welcome.

The largest potential for import substitution seemed to lie in the area of food and energy production, Mr. Sugita observed. However, to realize that potential, the Government would need to devote sufficient funds to such areas as irrigation, fertilizers, and the development of natural gas resources. The recent delays in the implementation of foreign-aided projects, owing to various administrative problems, were a cause for concern. It was important to resolve those bottlenecks and to improve the efficiency of development spending to enhance the country's development potential. The staff's suggested operations and maintenance budget would be a useful technique by which the authorities could protect past investment and make completed projects more productive.

There was an impending need to tighten monetary policy further by restraining credit to both the private and public sectors and improving recovery of agricultural and industrial loans, Mr. Sugita concluded. It was also important to keep the key interest rates at positive levels in real terms. Finally, he supported the proposed decisions.

Mr. Coumbis commented that 1984/85 had not been a good year for the Bangladesh economy. Real GDP had increased by 2.6 percent, as compared with 3.5 percent in 1983/84, because of extremely bad weather conditions, while rapid monetary expansion, domestic supply shortages, and adjustments in administered prices had accelerated the rate of inflation slightly to 10.9 percent. For the same reasons and in spite of the substantial improvement in the terms of trade, the current account deficit and the overall balance of payments had deteriorated in 1984/85, compared with 1983/84, and, consequently, the debt service ratio had risen from 18.5 percent in 1983/84 to 21.5 percent in 1984/85. In 1984/85, fiscal policy had continued to be cautious, monetary and credit policies had been strongly expansionary, and the financial position of many public enterprises had deteriorated significantly. However, since the beginning of 1985, the authorities had started to implement corrective measures by restricting monetary policy, increasing prices of services of the parastatals, and applying a more flexible exchange rate policy, thus setting the grounds for the new IMF-supported program.

He agreed with the thrust of the fiscal policy in 1985/86--namely, to contain the rate of growth of expenditure to existing resources, as well as with the specific objectives of the tax policy to increase the relative importance of domestically based taxes, given the volatility of international trade and tax receipts, Mr. Coumbis indicated. With respect to government expenditures, he did not understand the stance of the staff on the salary and wage increases in June 1985. In SM/85/264 (9/23/85) and SM/85/276 (10/8/85), the staff had not seemed to object to the increases, which had been accompanied by a restructuring of wages. The restructuring had permitted a number of allowances to be merged with the basic pay scale and had abolished the system of automatic scale promotion. Moreover, the cost of the wage increase had been offset by expenditure reductions in other areas. However, in EBS/85/251 (11/12/85), the staff had written, "the salary and wage increases were undertaken with the encouragement of the aid donors, particularly the World Bank, with a view to improving the efficiency of the civil service. Given the tight budget situation, the staff believes that these increases were too large and not sufficiently targeted toward the highly skilled segments of the civil service." Moreover, no reference had been made to the abolition of the automatic scale promotion system. It seemed that there was some disagreement with the staff of the World Bank on the subject of wage increases. He asked for further comments from the staff on the matter and wished to know if the automatic scale promotion mechanism had been abolished.

He welcomed the authorities' efforts to control growth of domestic credit after its rapid rate of expansion in 1983/84 and 1984/85, as well as their commitment to a flexible interest rate policy in order to secure efficient allocation of domestic resources, Mr. Coumbis continued. Monetary restraint would be important in order to contain inflation and to improve external equilibrium. However, he was worried about the extent of overdue loans in the banking system, and it seemed that the effectiveness of interest rate management and credit controls had been seriously impaired in recent years by the large and increasing stock of overdue loans. Both the World Bank and the Asian Development Bank had been increasing their pressure on the authorities to improve loan recovery. The authorities had adopted a number of measures--strengthening the legal framework, withholding new credit to defaulters, improving accounting procedures, and monitoring of overdue loans--which seemed to indicate that the authorities believed the basic reason for overdue loans to be the unwillingness of the borrowers to fulfill their obligations and that strict monitoring and proper legal action would be sufficient to oblige the defaulters to fulfill their obligations. He did not share their view; instead, based on his experience in Greece, he feared that deep-rooted intractable economic problems and the deterioration of the economic situation might have led to those defaults. He would appreciate some comments from the staff on the subject.

The authorities were committed to continue pursuing flexible exchange rate policies, Mr. Coumbis noted, and he urged the authorities to unify the exchange market as soon as possible.

Table 8 of the Appendix to EBS/85/251 showed that Bangladesh would continue to face external resource constraint at least up to 1990, Mr. Coumbis said. In fact, under the assumptions of the staff's medium-term exercise, the permitted import growth until 1990 would support a 3 percent annual average real growth of GDP, while the expected population growth would be around 2.4 percent. Moreover, it was assumed that weather conditions during the whole period would be normal, appropriate adjustment policies would continue in the next few years, and real aid disbursements would continue to increase at the recent trend of 2 percent per year. As Mr. Sengupta had pointed out, Bangladesh had one of the lowest per capita incomes in the world, and its natural resources and infrastructural facilities were limited. Bangladesh had been trying hard to adjust its economy since 1984 but was nonetheless vulnerable to external conditions. Although Mr. Sengupta had indicated that Bangladesh had received assurances from its major aid donors of continued financial support for the program period, that might not be sufficient. He believed that higher rates of growth were necessary to avoid unpleasant surprises in the near future and thus urged the World Bank to increase its financial assistance and its involvement with Bangladesh as much as possible in order to have viable equilibrium in the long run.

He could support the proposed decisions, Mr. Coumbis concluded.

Mr. Suraisry remarked that since the previous consultation discussions, the economy of Bangladesh had suffered from adverse developments beyond the authorities' control. Heavy floods in 1984/85 had slowed output growth, and the sharp drop in private remittances had reduced the country's financial resource base. Partly as a result of those developments, the momentum of adjustment to tackle the country's deep-rooted internal and external imbalances had been lost. The proposed program signified a welcome development, as the authorities intended to reduce fiscal and external imbalances. He was encouraged to note that the adjustment effort, in conjunction with the program, would not sacrifice growth. The growth rate of GDP was projected to increase and the external position to strengthen as a result of the recovery in the agricultural sector. On the whole, the program's objectives were appropriate and attainable. However, as Bangladesh's problems were likely to extend well beyond the current period, it would be necessary for the authorities to continue their present adjustment policies into the future.

The new measures to increase taxes and strengthen the tax administration were steps in the right direction, Mr. Suraisry stated. In addition to increasing revenues, those measures diversified Bangladesh's revenue base and should contribute to a lasting improvement in public finances. However, revenues were equivalent to less than 10 percent of GDP and expenditures were almost twice revenues, which pointed to the need for additional revenues in the coming years. The authorities' intention to reduce the size of the budget deficit was welcome, but the size of the recent increase in the wage bill was a cause for concern. Wage rates had been increased at an average of 28 percent against an inflation rate of 11 percent in 1984/85. The authorities had made commendable efforts to offset the increase in wages by cutting other current expenditures. Nevertheless, he shared the staff's view that caution was needed. More important, the development budget remained restricted, with few domestic resources available for its financing, which could limit Bangladesh's medium-term prospects for growth. Consequently, some reductions in current expenditures might be needed so as to free additional resources for capital spending. In view of the financial constraints facing the authorities, it would not be an easy task. The staff's comments on that point would be helpful.

The performance of the public enterprise sector had not been satisfactory, Mr. Suraisry indicated. Current expenditures for the five major public industrial enterprises had exceeded total revenues in 1984/85. That sector was also likely to face increasing difficulties in the coming period because of higher wages and increased costs for imported inputs. Firm measures were needed to strengthen the finances and operations of public enterprises. The authorities had instructed the enterprises to reflect actual production costs in their selling prices, which was welcome; however, a wider-ranging approach to improve the operations of the public enterprises seemed necessary.

One of the monetary targets of the program was to reduce credit expansion, which should help reduce inflationary pressures, Mr. Suraisry continued. However, the large and increasing stock of overdue domestic loans was a cause for some concern. He welcomed the authorities' intended measures to tackle the problem, as its persistence undermined the integrity of the financial system and impeded the efficient allocation of resources.

In addition to demand-management policies, the authorities had undertaken commendable structural measures, Mr. Suraisry commented. The agricultural rehabilitation program in the wake of the floods had provided seeds, fertilizer, and credit, thus leading to the replantation of a large area. The industrial policy continued to promote the private sector in manufacturing, and a number of enterprises had been denationalized. To increase the efficiency of resource allocation, the authorities had also begun phasing out fertilizer subsidies and had also reduced other subsidies.

Despite the recent positive developments arising from increased export volume, private remittances, and reduced imports, the external accounts of Bangladesh remained under pressure, Mr. Suraisry observed. Debt service payments were also projected to remain substantial for some time to come. He commended the authorities on their cautious approach to external debt management. However, the overall external position called for an exchange rate policy that promoted the development of the tradable goods sector, and he endorsed the authorities' recent steps toward that end.

Like Mr. Finaish, he was interested in knowing if emergency assistance was being planned to help overcome the heavy human and financial costs caused by the natural disaster of the 1985 cyclone, Mr. Suraisry added. He would welcome the staff's comments on that point.

The authorities were facing difficult economic and financial problems, Mr. Suraisry concluded. Laudable progress had been made to tackle the problems, but given their magnitude, adjustment measures would need to be continued for some time. Finally, he supported the proposed decisions.

Mr. Leonard observed that events in 1984 and 1985 had demonstrated once again the structural weaknesses of the economy of Bangladesh and just how vulnerable it was to external shocks and natural disasters. Severe flooding had led to production losses and a deterioration in the external position, with reserves having fallen below the equivalent of two months of imports and the current account deficit having widened to 8.3 percent of GDP. Unfortunately, the authorities had been slow to react to the macroeconomic implications of the floods, and excessive monetary expansion and an appreciating exchange rate had only served to intensify the pressures on the external accounts. In the light of those events, the recent actions taken by the authorities to tighten monetary policy and to allow more flexibility in the exchange rate were a welcome contrast, as they provided the foundation for the 1985/86 adjustment program. Several measures, outlined in SM/85/264, to help strengthen the adjustment process and create conditions for higher rates of economic growth had been incorporated into a comprehensive Fund-supported program; accordingly, he was prepared to support the request by Bangladesh for a stand-by arrangement. Nonetheless, it was worth mentioning that credit from the Fund was a high-cost source of external financing for a poor country like Bangladesh and would be even more so if the problems with members' overdue obligations forced the Fund to increase its rate of charge substantially. It was therefore appropriate that the program accompanying the stand-by arrangement saw a net reduction, albeit a small one, in the use of Fund resources by Bangladesh, which needed external resources of a much more concessional nature.

A recurrent theme in past discussions of Bangladesh had been the need to strengthen and diversify the economy, Mr. Leonard recalled. The focus in the program on maintaining a realistic exchange rate would undoubtedly contribute significantly to that goal, but as the staff had pointed out, progress in expanding and diversifying exports would be slow. Even with no deterioration in the terms of trade and no external shocks, the staff's medium-term projections indicated that Bangladesh's serious external financing constraints would prevail over the period to 1990. The continued high debt service burden and the need to hold adequate reserves indicated that Bangladesh must continue to rely on foreign aid for many years to come. On that account, in an environment of declining aid flows, it was particularly important that adjustment efforts be vigorously pursued throughout and beyond the duration of the program and that the authorities improve their capacity for using aid flows efficiently. Otherwise, a danger of "donor fatigue" existed, and he was glad that the authorities appeared to be aware of that danger.

He was pleased by the realism shown in the fiscal plan for 1985/86, Mr. Leonard commented. The emphasis on revenue-generating measures was appropriate, especially in that they tended to concentrate upon more efficient collection and on taxation of imports. The general restraint of current expenditure was commendable. Reductions in food and fertilizer subsidies were not likely to be popular measures, but in the absence of a strong revenue base, such subsidies were hard to sustain. The authorities' planned price increase for fertilizer, as discussed with the World Bank, should also encourage efficient resource allocation. However, no further attenuation of investment and development expenditures should occur; such spending had been lower than budgeted for the past two years and needed to be increased in the interest of raising real incomes and living standards.

Development spending should be as productive as possible and should be fully integrated into medium-term development plans. The losses of public enterprises had also been a drain on the exchequer. Recent price and tariff increases would help reduce the drain as would the divestment process that was taking place, but the operation and management of those enterprises remaining in the public sector would need to be improved if future losses were to be minimized. A cause for concern was the payment by the authorities of wage and salary increases retroactive to June 1985. He could understand the authorities' desire to attract and keep skilled personnel in the public service, but he was not sure that a wide-scale pay increase would achieve that end. There seemed to be some disagreement between the Fund and Bank on that point, and he would appreciate any further comment the staff might have.

Monetary restraint would continue to play a critical role in the adjustment process, both in achieving the external target and in dampening potential wage pressures, Mr. Leonard continued. The introduction of measures to improve loan recovery was commendable, and he joined the staff in urging the authorities to consult with the World Bank on further steps that might be taken. The growth in the stock of overdue loans in the private sector had seriously constrained effective monetary management in the recent past, and the measures that were being put in place, along with the maintenance of positive real interest rates, could be expected to result in a more efficient allocation of financial resources. He was particularly supportive of the authorities' commitment to maintain a flexible exchange rate, to unify the exchange markets, and to liberalize trade. Action on those lines was integral to the diversification of the export base, although it might demand hard choices by the authorities from time to time. For example, the terms of trade had been, and would continue to be, an upsetting factor of long standing in the external account as long as traditional exports constituted such a large part of total sales. Therefore, while depreciation of the currency would help to build up the industrial sector, it might also at times exacerbate movements in the terms of trade and in the external balance, which would demand considerable determination on the part of the authorities to maintain their medium-term strategy of development.

Credit from the Fund was at the less-concessional end of the lending spectrum and was therefore not entirely suited to the needs of a country such as Bangladesh, Mr. Leonard reiterated. Even if the authorities adopted fully the measures suggested by the Board, concessional financing would still be needed for some time to come, not just from bilateral donors but also from multilateral sources, such as the IDA, in a context that would permit a continuation of the policy dialogue over the medium term. In that regard, Bangladesh was one more example of the need to find a solution to the global debt problem along perhaps even broader lines than were currently being explored.

Mr. Polak remarked that the willingness of Bangladesh to adopt needed adjustment policies justified the new stand-by arrangement from the Fund. The Government of Bangladesh had demonstrated that willingness in 1982/83 when it had made sharp policy corrections and had received a relatively small Fund stand-by arrangement in connection with those measures. In many respects, the policies remained quite good. In 1984/85, however, primarily external factors, accompanied by some slippage on the monetary side, had led to a deterioration of the situation. The new program, carefully worked out with the staff, reflected the realism of the authorities and thus provided a good basis for a stand-by arrangement. Although the funds available to the country through the new stand-by arrangement would be welcome, the Fund was nevertheless a major factor in the debt service burden of Bangladesh, and large payments were due to the Fund. The long-term payments situation of Bangladesh remained weak. At present, and as foreseen through 1990, exports of goods plus remittances paid only about half of imports and the other half had to come from aid. In that setting, the relatively expensive and relatively short-term credit from the Fund should not play too large a role in the overall debt structure of Bangladesh. In retrospect, it probably was a good thing that the extended Fund facility of SDR 800 million granted by the Fund to Bangladesh in 1980 had only been taken up for one quarter.

Bangladesh would need to expand its nontraditional exports and stimulate domestic output for the home market both in terms of food and nonfood, Mr. Polak observed. That was the only basis by which it could overcome its long-term payments problem and raise the growth rate that it would be able to support given its weak international position. To achieve that, the exchange rate was an important tool, and the real effective exchange rate ought to be kept down and perhaps lowered more. That was currently being done in two ways--by the depreciation of the official rate and by the transfer of transactions to the secondary market. It would have been useful if, in EBS/85/251, the charts on the real effective exchange rate had shown not only the official rate, but also the rate in the secondary market, which reportedly accounted for more than half of the total transactions.

More bothersome was the lack of explicit analysis from the staff with respect to growth, Mr. Polak continued. Listed as the major objectives of the program to be supported by the Fund were "improvement of the external position" and "a higher rate of growth." EBS/85/251 showed clearly that Bangladesh would achieve the first objective by relying on its exchange rate policy, subject to the disheartening effect of international textile protectionism, and on restraints in monetary and fiscal policies to improve its balance of payments. The tighter monetary and fiscal policies, however, would presumably have a negative impact on growth; indeed, for the medium term, when the beneficial effects of better competitiveness and better incentives would begin to be felt, the staff report (SM/85/264, 9/23/85) projected growth rates of only 3 percent a year, assuming that normal weather would prevail. That was only marginally above the 2.6 percent growth for 1984/85, a year of abnormal weather that had been disastrous for agriculture. The staff report had noted that the World Bank staff believed that a higher rate of economic growth could be achieved over the medium term, provided that import growth and accompanying aid disbursements were stronger and that adjustment efforts were intensified. However, in the stand-by arrangement paper (EBS/85/251), the staff had projected a figure for enhanced growth for 1985/86 of slightly over 4 percent, without giving any explanation for that figure. If that projection was perhaps due mainly to the expected sharp rebound of agricultural production, as shown in Table 5 in SM/85/264, then it had little to do with the policies of the program. All in all, it would have been helpful if in the stand-by arrangement paper, the staff had clarified how the growth objectives and the policies of the program were linked. Moreover, since the Fund staff and the Bank staff projections differed for the medium-term rate of growth, he would be interested to know the basis for the different estimates. If the Bank staff had simply assumed a higher aid flow, the explanation was relatively simple, but he wondered why the Bank staff anticipated higher aid flows and whether there were other factors that were expected to make a difference.

The staff had correctly pointed out that given the vagaries of the weather and its influence on the balance of payments, Bangladesh needed a protective stock of reserves, Mr. Polak concluded. Although the country had acquired such a stock in 1982/83 and 1983/84, part of those reserves had had to be drawn in 1984/85. In the medium-term outlook, the staff projected a further rebuilding of reserves, about $150 million over the next five years. Because Bangladesh was not a country that could borrow its reserves, it needed to earn them by restricting imports, which as the staff acknowledged, meant that the reserve accumulation requirement was one of the factors, albeit not major, holding down growth. That was one way of looking at the problem. A more constructive alternative would be to note that the failure of the Fund to allocate SDRs was one of the causes of the slow growth envisaged for Bangladesh. Finally, he supported the proposed decisions.

Mr. de Groote expressed his support for the proposed decision to grant a stand-by arrangement to assist Bangladesh in its comprehensive adjustment efforts to achieve a satisfactory growth rate and a sustainable balance of payments position over the medium term. Despite some improvement in the overall performance of the economy between 1982 and 1984, compared with the previous two years, adverse external factors as well as somewhat inadequate domestic policies in 1984/85 had placed further obstacles in the path of the country's adjustment and development efforts. Deep-seated domestic and external imbalances existed in Bangladesh. The very low level of per capita income, densely distributed population, scarcity of natural resources, and inadequate infrastructure clearly showed how important it was to implement well-designed financial and external policies in combination with a structural reform. The situation in the medium-term outlook also demonstrated that external aid and an increased flow of long-term assistance and loans from the World Bank were crucial to Bangladesh's future.

One of the weaknesses of the Bangladesh economy was the low level in domestic savings, which had adversely affected the increase in the investment capacity of the economy, Mr. de Groote said. It was especially worrying, for a country with Bangladesh's development needs, that the ratio of gross fixed investment to GDP was presently at the low level of about 12 or 13 percent. Therefore, policy and strategy with respect to domestic savings were a fundamental issue for the Bangladesh economy. In its development effort, Bangladesh should give priority to the stimulation of domestic savings. He asked what the estimated ratio of gross domestic savings to GDP was in the staff's medium-term outlook projections. In the recent economic developments paper (SM/85/276, 10/8/85), domestic savings were estimated to have declined in 1984/85 to less than 1 percent of GDP from 2.1 percent in the previous year, owing to the sharp deterioration in the financial position of major public enterprises. However, the impact of positive real interest rates on bank deposits had led to a substantial increase in time deposits in 1984/85. He wondered whether there was not a certain contradiction between such a halving of savings and the observed increase in time deposits--or whether one should assume that the large increase in personal savings in the form of time deposits, which was in turn hard to reconcile with the behavior of income, was more than offset by the deterioration in the position of the public enterprises--and requested some elaboration from the staff on those developments.

As fiscal measures were vital components of the adjustment efforts, he welcomed the authorities' fiscal policy for 1985/86, the design of which was consistent with the available resources, Mr. de Groote indicated. Moreover, the additional revenue measures, together with a significant adjustment in the prices charged by public enterprises, showed the determination of the authorities to address the problem of the budget deficit. Despite those measures, coupled with foreign borrowing and the use of available grants for financing the deficit, the ratio of the overall budget deficit to GDP was still high. Bangladesh's budget deficit was undoubtedly due to the low level of tax revenue, which had hovered around 7 percent of GDP for the past four years, with a total tax revenue lower than 10 percent of GDP. It was of interest to compare those ratios with the average ratio of tax revenues in African countries having the same level of income; he understood from one of Mr. Tanzi's recent studies that the ratio of tax revenue to GDP in the African countries stood at about 18 percent. However, total revenue in Bangladesh was heavily dependent on receipts from import-related taxes: the share of income and profit taxes in total revenue was around 12 percent. He asked whether it would be possible for the authorities to concentrate their revenue-increasing efforts on income and corporate earnings and requested some elaboration on that point from the staff.

He welcomed the authorities' intention to tighten the monetary policy further and to pursue a positive real interest rate policy, Mr. de Groote continued. On the other hand, the situation with respect to the large and increasing stock of overdue bank loans to the private sector was worrying. The authorities had implemented a number of measures to recover overdue loans, but they could accelerate the recovery process by implementing additional measures in consultation with the World Bank.

To restore international competitiveness and efficient resource allocation, Bangladesh would have to continue pursuing a flexible exchange rate policy and unify the exchange rate market, Mr. de Groote stated. He fully supported the authorities' intentions with respect to the exchange rate policy and was pleased to learn of recent measures taken by the authorities, which had been mentioned by Mr. Sengupta and the staff and had been included in the authorities' letter of intent. Two questions that remained were whether the policy of shifting additional transactions from the official to the secondary market would be sufficient and whether the totality of transactions might be absorbed by the secondary market, as had been done recently in several other countries.

The authorities had recently taken some steps to liberalize the trade and payments system, Mr. de Groote noted. Although he believed, on the basis of the experience of many member countries, that a high degree of liberalization was generally conducive to growth, he could understand the staff's view that the balance of payments difficulties and the medium-term outlook currently prevented the further liberalization of the system, so that a gradual approach seemed appropriate at least for awhile.

The policies being pursued by the Bangladesh authorities were correctly oriented, Mr. de Groote concluded, and he hoped that the economic program supported by the proposed stand-by arrangement would produce the desired restructuring and create the conditions for sustainable economic growth and external adjustment.

Mr. Goos remarked that at the previous discussion of Bangladesh (EBM/84/113, 7/20/84), Directors had praised the authorities for their prudent and effective programs and the resulting improvement in overall economic performance since 1982/83. At the same time, it had been noted that, "the improvement was fragile, as the economy remained structurally weak and highly vulnerable to exogenous shocks." Against such a background, he was not completely surprised by the recent significant deterioration in Bangladesh's economic performance, inasmuch as it was largely due to adverse weather conditions, but he was disappointed that expansionary monetary policies had also been an important contributing factor, and he thus welcomed the authorities' initiation of a program that indicated a return to their earlier cautious and more appropriate policy stance. If implemented effectively, the program held the promise for more satisfactory growth, improved economic efficiency, and a more sustainable balance of payments situation.

Nonetheless, given the severe resource constraints facing the country, as reflected in its very low per capita income, it would be unrealistic to expect the program to yield quick or substantial progress toward overcoming the underlying economic problems, Mr. Goos observed. As the staff's medium-term projections suggested, rather marginal improvements could be expected until 1989/90. Accordingly, for the foreseeable future the country would continue to need development assistance, with a correspondingly predominant role to be played by IDA and other sources of highly concessional assistance. Furthermore, the authorities should continue to make every effort to increase domestic savings. Against that background, it was appropriate that the adjustment program was aiming at the mobilization of domestic resources and strengthening the efficiency of resource allocation. He therefore believed that the program deserved support, although he noted with some concern that in financial terms the stand-by arrangement was essentially a refinancing of Fund credit that would come due in the course of the program period.

He was in broad agreement with the staff appraisal and had only a few specific comments to make, Mr. Goos continued. The authorities' fiscal adjustment measures were important steps in the right direction, particularly their apparent effort to increase the income elasticity of the tax base. Unfortunately, the scope for reducing the fiscal deficit had been severely restricted by the recent massive increase in public salaries and wages, and he shared the staff's concern regarding its overall size and lack of differentiation among the various occupational groups. It was clear that current expenditure cuts had to pay due regard to the country's ability to maintain and operate the existing capital, and that the authorities, while increasing prices and curtailing subsidies, had to keep in mind the extremely low living standard of most of their population. Nevertheless, he encouraged them to seek ways and means, preferably in collaboration with the World Bank, of broadening the scope for market-determined pricing of goods and services, supported by better targeting of subsidies to the neediest part of the population. Close collaboration with the World Bank in the preparation and implementation of the development programs would also be advisable for the reasons mentioned in the staff report.

He welcomed the authorities' intention to reduce the excessive monetary expansion of recent years to a distinctly slower pace in order to contain the pressure on the balance of payments, Mr. Goos indicated. However, in view of the considerable buildup of domestic liquidity that must have taken place in recent years, he was, contrary to the views expressed by some previous speakers, somewhat concerned that the monetary stance envisaged under the program might still be too expansionary. Thus, one had to note that the main monetary aggregates were to expand at a rate that was higher than the projected rate of growth in the nominal GDP. At the same time, it seemed reasonable to expect that the growth in the demand for broad money would slow down to the extent that the authorities succeeded in reducing the worrisome amounts of overdue domestic bank loans. However, the rising inflationary expectations projected by the staff would probably exert some restrictive influence on money demands. That influence would probably remain limited as long as positive real interest rates were maintained. Moreover, the staff had projected a short-lived upsurge in inflationary pressures, which seemed to be consistent with Mr. Sengupta's report of the recent pronounced decline in the annualized inflation rate. Thus, at a minimum, the authorities should keep the monetary policy under constant review in order to react without delay to any unwarranted slippages in the external account targets. In that context, some adjustment in interest rates might also become necessary, after the introduction of a charge on interest income, to preserve the attractiveness of domestic saving instruments compared with foreign investment opportunities.

He strongly endorsed the staff's recommendation that the authorities maintain a flexible exchange rate policy with a view to unifying the foreign exchange markets, and he welcomed the authorities' intention to follow that recommendation, Mr. Goos concluded. Such a policy stance, supported by effective measures to diversify exports and further efforts to liberalize the payments system, should go a long way toward reducing the vulnerability of the external sector. Finally, he supported the proposed decisions.

Mr. Foot said that a number of speakers had already pointed out the extent to which Bangladesh was vulnerable to external shocks, and clearly policy needed to be predicated on that basis. Accordingly, he saw that given the nature and extent of those possible shocks, the authorities would need, if possible, to allow the level of exchange reserves to rise over the years because their current level was low.

He endorsed the concern expressed by previous speakers on the need to ensure that when more money was spent--for example, in the increase in wages of public servants--that it was targeted in the most efficient manner possible, Mr. Foot remarked. Like Mr. de Groote, he had found it difficult to establish the extent to which the financial position of the major public enterprises, which represented an important part of the economy, threatened the fiscal policies envisaged by the authorities. A more detailed consideration of that point in the staff report would have been useful.

He welcomed the monetary measures taken to curb the strong rate growth in credit, as well as the authorities' measures mentioned by Mr. Sengupta to maintain interest rates as necessary, Mr. Foot continued. He concurred with Mr. Coumbis, however, that setting restrictive targets for the growth of credit would not in itself do much to improve the quality of existing loan portfolios, which clearly were in some cases poor and posed problems that would require additional measures.

As the balance of payments position remained vulnerable, the authorities intended to end official interventions in the secondary foreign exchange markets and to continue moves toward unifying the official and secondary markets, Mr. Foot noted. Exchange rate unification remained an important objective, and he hoped that it would soon be possible to agree upon a timetable for that unification.

The authorities' commitment to strictly limit borrowing on short term or nonconcessional terms was appropriate, Mr. Foot went on. As other speakers had noted, Fund resources were not inexpensive; that, coupled with the relatively slow degree of adjustment envisaged in certain areas under the program, would suggest that access to Fund credit at the proposed level was broadly appropriate.

The Bangladesh authorities faced a difficult background in attempting to achieve sustainable growth and development, but they had shown commendable resolution in their efforts, Mr. Foot concluded. Mr. Polak had rightly noted that it was difficult to draw together the threads in the staff papers to see the nature of the choices and problems and to ascertain what extent the World Bank would be involved in diversifying the economy and boosting export capacity. Finally, he supported the proposed decisions.

Mr. Yang noted that Bangladesh's economic performance in 1984/85 had been greatly affected by adverse exogenous factors: heavy floods had resulted in large losses to the economy, and a significant increase in the emergency food imports and a sharp drop in raw jute exports, as well as in workers' remittances, had led to a notable deterioration in the balance of payments position. At the same time, excessive monetary expansion and inefficient management of the public enterprises had exacerbated the situation. Against that background and as pointed out by Mr. Sengupta, the Bangladesh authorities had initiated a timely series of corrective measures during mid-1984/85, including a restrictive monetary policy, more flexible exchange arrangements, improvement in the tax administration, export diversification, and continued pursuit of selfsufficiency in food production. He was pleased to note that progress had been made in the improvement of the economy and that a comprehensive and economic financial program for 1985/86 had been worked out to further the adjustment efforts. The adjustment program, if effectively implemented, would lead to satisfactory economic growth and a sustainable balance of payments position. In view of Bangladesh's past impressive adjustment record, the authorities' request for a new stand-by arrangement was justifiable, and he supported the proposed decisions.

While he sympathized with the Bangladesh authorities in their present unfavorable situation, he wished to share with them his concern over some policy matters, Mr. Yang continued. Caution should be exercised with respect to prices. While wages in the public sector had been markedly raised, increases in administered prices were also substantial, and a further exchange depreciation would only add pressure on domestic inflation. Under such circumstances, particularly while total liquidity growth remained high, the authorities would not find it easy to contain inflation while maintaining a 4 percent growth rate of real output. He asked the staff to comment further on the necessary policy measures that would ensure the reduction of inflation after its initial acceleration.

He was also concerned about the limited import capacity of Bangladesh, Mr. Yang added. According to the staff projections, real import growth would have to be limited to about 2 percent annually, which would only support a 3 percent annual growth of GDP. He wondered whether such a low import growth could meet the goal of the proposed adjustment program and asked for staff comments.

He was glad to learn from Mr. Sengupta that the major aid donor countries had pledged to continue their financial support to Bangladesh, Mr. Yang concluded. Moreover, he noted that Bangladesh's nontraditional exports, particularly ready-made garments, had grown rapidly. Given the high debt service payments facing Bangladesh in the years ahead, such expansion and diversification in the export sector appeared to be imperative. It was, however, regrettable that Bangladesh's exports, particularly the newly developed textile exports, had been severely hurt by rising protectionism. He could not understand why a country like Bangladesh, with a per capita income among the lowest in the world, could not be spared from protectionism.

Mr. Salehkhou observed that the performance of the Bangladesh economy since the previous Article IV consultation had been largely affected by the serious odds that the economy had had to face both internally and externally. The disastrous flood that had swept the country in 1984 had continued to hamper the growth of the economy. Large losses--human, animal, and matériel--had been sustained, paralyzing an already poor agricultural sector to an unprecedented degree and lowering GDP growth to a level barely equivalent to the increase in population. The drop in jute production, the main export item, as well as the massive return of workers from the Middle Eastern countries, had left Bangladesh little opportunity to avert the deterioration of its current account position. In response to the difficult economic situation, as outlined by Mr. Sengupta, the authorities of Bangladesh had presented an economic program for 1985/86, for which it was requesting the use of Fund resources, and which aimed at achieving a higher rate of growth and an improvement in its external financial position. The program's comprehensive measures should ensure, through fiscal restraint and tight credit policy, a reduction in the current account deficit and should help contain inflation. At the same time, the program aimed at raising revenues while reducing certain subsidies. Finally, through the maintenance of a flexible exchange rate, the authorities hoped to stimulate trade and exports and improve competitiveness.

The fiscal policy envisaged by the authorities for 1985/86 aimed at matching expenditures to available resources, without excessive dependence on bank credit and in expectation of external assistance, Mr. Salehkhou said. That would require adequate control of the Annual Development Program through the reduction of subsidies so that the overall deficit would not exceed 7.3 percent of GDP, which was 1 percent below that of 1984/85. Revenue estimates were favorable on account of better agricultural results for the year and expected dividends and transfers for 1985/86. The new revenue measures introduced earlier in the budget were estimated to yield the equivalent of 0.4 percent of GDP, thus bringing the total revenue to GDP ratio to 9.5 percent in 1985/86, against 8.9 percent in 1984/85. The authorities were committed to applying firm control on various components of expenditures, despite the effect of the exchange rate adjustment, such that the ratio of total government expenditures to GDP would decline half a percentage point in 1985/86, in comparison with the previous year. The authorities had granted a sizable increase in public sector wages and salaries, retroactive to June 1985, in line with recommendations by the World Bank for reasons of administrative efficiency. However, they would be phasing out expenditures related to fertilizer subsidies and were adjusting the food distribution system to a new schedule of prices. Moreover, the authorities were overhauling the pricing system of public enterprises to reflect their production costs. The burden on the budget would also be reduced through improvement in capacity utilization and management efficiency.

The monetary program for 1985/86 was concerned with credit expansion because of its significant contribution to inflationary pressure, Mr. Salehkhou indicated. The considerable reduction in the growth of net domestic assets of the banking system from 27.9 percent in the previous year to 15.1 percent in the current year was indicative of the authorities' determination to maintain a tight credit policy to bring about an improvement in inflation and a reduction in the external sector deficit.

The balance of payments estimates for 1985/86 showed a relative improvement despite the projected deterioration in the terms of trade, Mr. Salehkhou commented. The reduction in foodgrain imports and the growth of private transfers as a result of a more flexible exchange rate were credited as the main factors in the improved overall balance of payments situation. While exports were projected to grow in volume, prices for jute and tea were expected to decline sharply, thus limiting the net gains in exports. At the same time, imports were expected to fall both in value and volume, because the improvement in agricultural production had reduced the need for foodgrain imports. As a consequence, the current account deficit would be 1 percentage point lower than the previous year. Although the debt service ratio would remain at 24 percent in 1985/86, the balance of payments should reflect a surplus of $30 million, compared with a deficit of $59 million a year earlier. Reserves were expected to build up to the equivalent of 2.1 months of imports.

The prospects for the medium term had to take into consideration Bangladesh's narrow resource base and limited growth of exports, particularly in textile garments, which were increasingly subject to restrictions from industrial countries. Unless a consistent and sufficient flow of financial aid was forthcoming to provide the necessary imports, Bangladesh would not be able, in the foreseeable future, to raise its per capita income, one of the lowest in the world. Frequent floods and other natural calamities had pushed the Bangladesh economy a step backward. It was normal for emergency assistance and concessional loans to be made available to countries affected by such circumstances. Like Mr. Finaish and Mr. Suraisry, he recalled that in certain cases, the Fund had volunteered such assistance, and he asked whether Bangladesh had been considered for the Fund's emergency facility after the 1984 flood. As to the viability of the staff's medium-term scenario, there appeared to be little room for maneuver for the country, considering that it controlled so few of the input factors necessary for growth. The staff projections emphasized the need for greater assistance from the World Bank and other multilateral institutions. Finally, he supported the proposed decisions.

Ms. Bush expressed her support for Bangladesh's request for a stand-by arrangement. In the two years since the expiration of the previous stand-by arrangement, the Bangladesh authorities had continued the process of fiscal adjustment, although economic performance had been otherwise adversely affected by an expansionary credit policy and exogenous developments, such as adverse weather conditions.

With regard to the fiscal effort and the specifics of the fiscal package, the program included several appropriate elements, Ms. Bush observed. For example, the revisions in the tax code that would reduce the high income tax rates while broadening the tax base should strengthen the budgetary position and at the same time enhance producer incentives. Having heard Mr. de Groote's comments about income tax rates, she indicated that her impression had been that Bangladesh had high marginal tax rates in effect even at very low income levels. She wondered whether the staff could offer any additional factual information about tax rates at various levels of income, and any further comment on the efficacy of the income tax rate reduction.

Growth in expenditures was being contained, and total expenditure as a percentage of GDP was declining, Ms. Bush said. Unfortunately, development spending was bearing the burden of the adjustment, since current expenditures as a percentage of GDP were continuing to creep upward. One reason for the recent decline in gross aid disbursements might be the inability of the Bangladesh economy to absorb the inflows; she wondered whether that included lack of adequate local currency funding. She would appreciate staff comment on the adequacy of domestic funding, especially since one of the stated goals of the program was to increase "domestic resource mobilization." Noting the importance of budgeting for recurrent expenditures related to past capital investments, she supported the authorities' efforts to improve their budgetary process and wondered whether such budgetary improvements would be extended to public enterprises. She asked what fiscal adjustments could be expected in the year 1986/87.

She welcomed the reduction in the net indebtedness of the Government to the banking system and the restrained growth in credit and hoped that adequate quality controls for credit overall would be developed, Ms. Bush said. She urged the authorities to keep their interest rate policies under constant review, in the light of exchange rate and domestic pricing developments. Attractive incentives for savings were important if adequate domestic resources were to be mobilized for development. She asked whether the staff had any projections of the domestic savings rate. According to SM/85/276, it had been less than 1 percent of GDP in 1984/85. She also wondered how savings would be affected by the new 4 percent charge on interest paid on all savings and financial instruments.

Bangladesh had introduced flexibility in its exchange rate system and real adjustment had occurred during the year, Ms. Bush continued. She hoped that the authorities' welcome commitment to prevent any excessive discount of the official exchange rate from the secondary market rate meant that a unified exchange system was soon forthcoming, in the expectation that the domestic pricing effects might permit new exportables to emerge.

The medium-term outlook was tenuous, as it was difficult to expect exceptionally strong export growth or significant increases in private transfers, despite some recent improvement, Ms. Bush added. Even with an assumed 8 percent growth in exports each year, the expectation was that the current account deficit would remain above 7 percent of GDP for the remainder of the decade. The debt service ratio was expected to remain fairly high, even though over 90 percent of the debt was on concessional terms. Obligations to the Fund would clearly constitute a higher proportion of the debt servicing burden in the very near future. She was therefore encouraged by the authorities' recognition of the need to contain external debt service obligations, which was particularly important for the relatively short maturity debt such as that to the Fund.

With such a tenuous medium-term outlook and the continued high fiscal imbalance, the structural measures being put in place by the authorities were crucial to the future economic performance of Bangladesh, Ms. Bush concluded. Therefore, she welcomed both the planned and already implemented structural measures, including privatization and rehabilitation of some public enterprises, pricing adjustments to reflect actual production costs incurred by the public enterprises; the trade liberalization steps; the reductions and phaseout of some subsidies; and reductions in income tax rates. Those and other measures to improve efficiency of enterprises and to appropriately maintain capital equipment should be helpful in bringing about a more positive and sustainable financial position over the medium term. However, like Mr. Polak, she wished to hear more about the realization of the projected growth and resource mobilization. In view of the importance of such structural measures for Bangladesh, she was interested in hearing about the World Bank's medium-term plans in Bangladesh, specifically what the prospects were for a structural adjustment loan and what impact the import program credits were expected to have.

Mr. Romuáldez pointed out that his reaction to the staff report had been ambivalent. On the one hand, he had found the recitation of facts and the appraisal sufficiently comprehensive and germane; on the other hand, he had not been entirely satisfied with the overall tone of the report. He did not think that it adequately conveyed how urgently the authorities needed to commit themselves to sustained adjustment efforts or how important it was for the Fund and Bank to cooperate closely in the design of Bangladesh's adjustment program.

The need for sustained adjustment merited emphasis, given the relative inconsistency of developments in the economy--the seesaw of success and setback--since 1982/83, Mr. Romuáldez added. No small measure of Bangladesh's present difficulties derived from the violent turns of the weather in 1984/85. However, much adjustment was still required in the short and medium term. Fiscal policy had been for the most part cautious and could be characterized generally by the authorities' readiness to raise revenue as much through new tax measures as through improved tax administration. Nevertheless, more needed to be done, particularly toward offsetting or eliminating the low elasticity of the revenue system. Wage increases of 20-30 percent in 1984/85 and about 28 percent in 1985/86 had been overgenerous. While those increases had had the good effect of forcing significant reductions in subsidies to various sectors, they also had had less favorable consequences: savings had been attempted in operations and maintenance expenditures and in relief and rehabilitation, at the cost of some deterioration in existing capital stock and much-needed infrastructure. Greater consistency was needed in dealing with the public enterprises; the authorities had allowed the salutary impact of improved management efficiency and more realistic tariff structures in some enterprises to be offset by continued mismanagement and an unwillingness to undertake necessary adjustments in others.

Monetary and credit policies, somewhat accommodative and expansionary in 1983/84 and 1984/85, had at last become restrictive, Mr. Romuâldez noted. The laxity of the past two years, however, had spawned more serious problems that had undermined the structure of monetary management--namely the "large and increasing stock" of overdue loans. A more comprehensive and structural approach to the problem seemed more appropriate than a mere exertion of pressure toward bringing about improvements in loan recovery rates or more effective application of existing laws and regulations. He asked whether the World Bank and the Asian Development Bank had any views as to how the financial system might be structurally rehabilitated.

The authorities' commitment to maintain flexibility in the exchange system was a major step forward, Mr. Romuâldez went on. Nevertheless, the staff had rightly emphasized the importance of unifying the exchange markets and further liberalizing the payments system. The authorities should not be too gradualist in their efforts, because they risked losing more in terms of setbacks to the competitiveness of Bangladesh's exports and of resulting inefficiencies in resource allocation.

He was troubled that the staff report had failed to stress the need for closer cooperation between the Fund and the Bank in the design of Bangladesh's adjustment program, Mr. Romuâldez reiterated. A significant observation of Executive Directors during the previous Article IV consultation had been that Bangladesh's economy "remained structurally weak and vulnerable to exogenous shocks" and that its situation, in spite of gains in 1982/83, had continued to be "fragile." Those observations remained as true as they had been a year earlier, and they would continue to be true unless a more coherent approach was taken by the Fund and Bank toward establishing the country's economic infrastructure as well as providing a proper direction to its policy. Thus, while he was glad to learn that negotiations were in progress on a program of adjustment under a Fund stand-by arrangement, he was nevertheless concerned that no World Bank role had been indicated either in the preparation or discussions with the authorities about the program, and he requested staff comments on that point. Finally, he supported the proposed decisions.

Mr. Lundstrom said that he shared the concern expressed by others with regard to the projected rise in inflation, which was partly due to domestic policies. In addition to rises in several prices and tariffs, as well as reductions in food and fertilizer subsidies, public sector salaries had increased considerably. A tightening of demand-management policies was called for, especially monetary policy, which in broad terms had been rather accommodating.

It was worth noting that key interest rates had been maintained at positive levels in real terms, which would undoubtedly improve resource allocation, Mr. Lundstrom indicated. At the same time, however, the problem of overdue loans, which had sharpened, might undermine the functioning of the monetary system, and, therefore, finding a solution to the problem merited high priority. As the measures taken to date seemed insufficient, he urged the authorities to strengthen their efforts to improve loan recovery. Comprehensive measures seemed to be needed to redress the situation.

He welcomed the flexible exchange rate policy adopted by the authorities as well as their apparent intention to unify the exchange markets, Mr. Lundstrom remarked. Such moves would contribute to restoring export competitiveness and improving resource allocation, thus gradually reducing the vulnerability of the balance of payments.

The situation of Bangladesh was a good illustration of the case for rolling back protectionism and for increasing concessional capital flows to low-income countries, Mr. Lundstrom concluded. Finally, he supported the proposed decisions.

The staff representative from the Asian Department explained that in projecting a medium-term growth rate in the order of 3 percent, which was rather small given the very low per capita income of Bangladesh, the staff had been guided by whether the necessary ingredients for higher rates of economic growth would be present within the next two or three years. One of those requirements--higher rates of investment--would call, in turn, for higher rates of domestic savings and aid utilization, which at present did not seem likely to rise substantially. The staff had assumed a small, gradual improvement in the rate of domestic savings, given the very low per capita income and the difficulties that the authorities would have to overcome to improve the financial situation of the state economic enterprises, which would provide the bulk of public savings and through which most investment would take place. However, a higher rate of savings in the public sector might be achieved if the authorities consistently pursued the matter over the coming years as they had stated in their letter of intent. Of course, the question of project implementation would then arise.

As had been noted by several Directors, actual development expenditures in the past two years had been less than budgeted, the staff representative said. Prior to 1983/84, domestic resource mobilization had been the limiting factor, but during the past two years, administrative difficulties had also become significant. The staff had consulted the World Bank, which through its import program credit (IPC) projects had been working with the authorities to improve their ability to implement projects at a faster rate and to be able to utilize available domestic resources. The staff had provided a baseline in its report and hoped that a higher rate of investment could be achieved if the authorities applied their adjustment policies more consistently, placed a higher emphasis on domestic resource mobilization, and engaged in further cooperation with the World Bank and other donors to overcome delays in project implementation.

The staff was currently projecting aid disbursements to grow by about 2 percent in real terms over the next four years, a slightly higher rate of disbursement than in the past few years, the staff representative indicated. In absolute terms, the projections were lower than those in the staff report because the base figure for 1984/85 had been revised to reflect actual information provided to the staff during the mission in October 1985.

The differences between the World Bank and Fund staff regarding medium-term projections were not large, the staff representative mentioned. The World Bank had projected a 3-4 percent real rate of economic growth over the medium term, reflecting greater optimism on project disbursements, and slightly higher agricultural growth rate assumptions than those of the Fund staff.

The components of GDP growth had been detailed in Table 5 of the Appendix to the staff report (SM/85/264), the staff representative said. The explanation of the 1985/86 rate of economic growth of 4.2 percent was that the harvest was expected to be much better, although industrial growth was expected to slow owing to lower import volume, and construction growth was also expected to drop.

Such heavy dependence on one export--jute--meant that Bangladesh suffered from particularly pronounced shifts in its terms of trade as a result not only of developments with respect to volume and cost of local production but also with respect to the level of jute production in other countries, competition from synthetics, and economic conditions in importing countries, the staff representative continued. An exchange rate adjustment and higher prices for jute might not improve the balance of payments directly but might help Bangladesh to diversify or promote other exports, preferably nontraditional exports. It was essential for Bangladesh to reduce its dependence on one export product, contain its vulnerability to movements in terms of trade, and provide sufficient incentives to import competing industries.

The decline in gross investment was related to the lack of recovery in private investment, which was due to the liquidity problems of the two development finance institutions; overdue loans had prevented them from disbursing foreign exchange to private investors, the staff representative noted. The World Bank was working with the authorities to help solve the problem. Meanwhile, private investment would remain depressed not because of a lack of domestic savings but because of the nonavailability of the foreign exchange component of otherwise qualified investment projects.

There was an undeniable need for gradual increases in the wages of public servants, the staff representative said. In fact, the World Bank resident office in Bangladesh had concluded in 1983 that low wages and the lack of other incentives to public employees were among the reasons for the slow implementation of development projects. Therefore, the World Bank had recommended that wages be raised sufficiently to attract qualified people into the public service, that the wage increases should be selective and aimed basically at the upper grades, and that an incentive system with bonuses for superior performance should be established; the Fund staff was in agreement with the World Bank's recommendations. However, the authorities found it much easier to grant wage increases uniformly. The staff of the World Bank and the Fund had indicated that if uniform wage increases were necessary, they could perhaps be phased in over a two-year rather than a one-year period, especially in view of the need to contain current expenditures under the adjustment program. However, the authorities had decided to contain other components of current expenditures, thereby reducing the impact of the wage increases.

The ratio of domestic savings to GDP was very low in Bangladesh and was related basically to the low level of domestic savings in the public sector, the staff representative pointed out. The staff was in agreement with the authorities that there was a need to raise the tax to GDP ratio and to widen domestically based taxes. Moreover, Bangladesh needed to lower current expenditures in the area of subsidies and to improve the financial position of the public sector enterprises so that those enterprises could repay interest on their government loans and transfer profits and dividends to the Government. The Government could then make more resources available for annual development programs. Even with steps of the magnitude taken by the authorities during the current year, the ratio of revenue to GDP would remain substantially below the average for developing countries and below the average for some countries in Asia. The tax to GDP ratio was also low because the agricultural sector was relatively lightly taxed in Bangladesh, in line with the government policy to encourage the domestic production of foodgrains and to achieve self-sufficiency in food production. The World Bank was working with the Bangladesh authorities to increase domestic resource mobilization in the agricultural sector, and if those efforts materialized, a modest improvement in the tax to GDP ratio should occur.

With respect to the question on the marginal income tax rates, the staff representative said that the initial income tax rate in Bangladesh was 10 percent, rising progressively to 50 percent. The measures introduced during the current year had lowered the income tax rate, but the objective was to bring more taxpayers into the tax net and to encourage taxpayers to make a full declaration of their income, as had been done in 1982/83 with positive results. The staff had learned that the lower tax rate had already resulted in better tax compliance, and thus a net positive impact of the order of about Tk 280 million in additional income tax revenues was expected.

The overdue loan problem was of concern to creditors and was affecting the financial flows into Bangladesh in a very substantive way, the staff representative went on. The observation that there were economic reasons for overdue loans was correct, but in the case of Bangladesh an institutional factor had made the problem more serious than in other countries. In the wake of natural disasters and calamities, the Government had extended credits, especially agricultural credits, which were usually given in small amounts to too many farmers; most of the farmers were not sure whether the credits were disaster relief, subsidization to enhance agricultural production, or loans that had to be repaid. Consequently, the Government had mounted an educational campaign, reinforced by improved collection measures, such as protecting loan collectors, strengthening the courts as they prosecuted defaulters, and instituting an information system on defaulters in Bangladesh Bank. Moreover, the authorities had instructed banks to reduce lending progressively in the areas where there was no improvement in loan recovery. Such actions were commendable but would take time to show results. Nonetheless, it was helpful that the authorities could discuss the problem openly with their international aid donors.

The automatic promotion system had been abolished, which was a welcome step, the staff representative mentioned. For example, in 1984/85, the automatic promotion system had cost Tk 60 million, while the increment had accounted for Tk 40 million and the cost of living increase, Tk 1.240 billion. The new system stressed efficiency and ability as prerequisites for promotions of government employees. It might be possible for the authorities to lower current expenditures, the staff representative noted, but they would need to be careful about how far they went in lowering expenditures so as not to affect basic services or the maintenance of completed projects. There was scope for additional lowering of subsidies, but the authorities should place their emphasis mostly on resource mobilization rather than on expenditure cuts, because the tax ratio was very low and there were other sectors of the economy that could usefully be taxed.

It was true, as Mr. Polak had suggested, that tight fiscal policies would affect growth, the staff representative stated. However, it was important to keep in mind that 50 percent of GDP was generated in the agricultural sector and that a good rate of agricultural growth was expected in the current year because of a bountiful harvest.

Unfortunately, technical problems precluded the production of a chart showing the real effect of the exchange rate in the secondary market, because no complete breakdown existed of trade weights or of those transactions conducted in the secondary market by trade partners, the staff representative commented. However, he hoped that it would be possible to produce such a chart in the future.

Responding to the question relating to the impact of the surcharge on interest rates on domestic savings, the staff representative pointed out that the surcharge was relatively small. A 10 percent interest rate would be reduced to an effective rate of 9.6 percent and, given the circumstances of Bangladesh, should not lead to a fall in savings. The surcharge had been introduced to compensate for the loss of revenue as a result of the withdrawal of the proposal to levy specific income taxes at source on interest income, with the objective of identifying taxpayers who maintained large deposits in banks and received large incomes so as to include them in the tax net. Given the difficulties associated with that proposal, the surcharge had been adopted instead. The authorities had already stated their willingness to adjust interest rates, if necessary, and the staff and the authorities would be monitoring the situation.

Unlike Mr. Goos, who had suggested that the monetary program might be too liberal, the staff representative said that he thought that given the rapid monetary expansion of recent years, the projected growth in money was consistent with nominal GDP growth. The special needs of the jute industry had required the Government to provide about Tk 1.5 billion to finance buffer stocks of raw jute in order to prevent jute prices from declining even further, but aside from that, the monetary program was tight. One of its main features was the sharp decline in private sector credit from about 40 percent to about 18 percent in the current year. Moreover, net credit to the Government by the banking system was dropping considerably.

The role of the World Bank had been referred to in several sections of the staff reports, and a breakdown of World Bank involvement in the various sectors of the economy and the role of the import program credits in the development of Bangladesh was given in the Annex to SM/85/264, the staff representative stated. The thirteenth import program credit, in the amount of $200 million, was currently under negotiation, and might be submitted for approval by the Bank by the end of December 1985. Although such credits may continue, it seemed that in the future, the World Bank would be placing more emphasis on loans to attack structural weaknesses sector by sector. Future program-type credits would probably be focused more on the development of the industrial sector in Bangladesh.

The projected moderate increase in the rate of inflation from about 11 percent to 12 percent was mostly due to the impact of wage increases and exchange rate actions, the staff representative recalled. Most of those inflationary pressures had been absorbed by the economy, so that if the Government continued its adjustment efforts and kept close to the projected targets for current and development expenditures, the staff would not project any acceleration in the rate of inflation in the coming months. In fact, the data for the first three or four months of the current year showed that inflation had risen slightly, to just below 12 percent, but that was in line with staff projections.

It was true, as Ms. Bush had suggested, that development expenditures had borne the brunt of the adjustment in the past two years, the staff representative acknowledged. The proposed program allowed for a small real increase in development expenditures and, if that materialized, it would represent a great improvement in the authorities' ability to utilize project aid and to overcome difficulties in project implementation. The projected increase in current expenditure had to be viewed in the context of the wage increase, which accounted for about 30 percent of the total increase in the current fiscal year.

A question had been asked about whether the relatively low share of corporate revenue in total tax receipts might be strengthened, the staff representative recalled. Most corporate revenue came from the public sector corporations, which were not taxed but they transferred dividends to the Government. Private sector corporations were not very profitable, despite the denationalization of some of the textile mills and jute mills. In an effort to give the private sector a more prominent role in the economy, the authorities had exempted most of the private sector corporations, in the initial stages of operation, from income tax and from taxes and customs duties on imported inputs. It was expected, however, that when the privately held corporations improved financially, their tax contributions would increase.

For the 1986/87 program, the authorities were committed to take further measures to improve domestic resource mobilization and to pursue a tighter current expenditure policy, the staff representative said. However, it was very difficult for them to set precise targets for 1986/87, given their heavy dependence on the projected flows of project and commodity aid, which greatly influenced the development program. The authorities had an overall commitment to continue tight monetary policies, even though they were currently unable to set precise figures for future programs. There should also be an improvement in the tax to GDP ratio relative to its present position. Those were the broad outlines for the spring 1986 negotiations by the staff and the authorities for the 1986/87 program.

The public enterprise sector in Bangladesh had developed after the country's independence when many major textile and jute mills had been nationalized, the staff representative from the Asian Department recalled. Although most of the public enterprises played a major role in providing employment and producing exports, they were unfortunately not very profitable. The authorities had been trying to increase their efficiency in order to improve their financial health. The authorities had established a committee in the Ministry of Finance to explore ways and means of either improving their efficiency or denationalizing them. However, that would be a long process, because it was not easy to denationalize financially weak enterprises. In addition, the public enterprises had been asked to adjust their prices to reflect actual increases in costs. Originally, the price adjustments were to cover only increases in costs of imported inputs, but they currently covered all increases, whether owing to wage increases or to increases in the cost of imported or domestically procured inputs. The authorities were also thinking of examining the outstanding debt of some of the enterprises to determine whether any of it could be written off or capitalized. Finally, the Government had issued instructions to the public enterprises to make sure that they paid the interest due on their loans from the Government, stating that if they did not pay, they risked having the interest due deducted from their budget. With the tight credit ceilings that had been imposed on those enterprises, it was expected that the enterprises would have to implement strong measures--through pricing mechanisms, or perhaps through increased efficiency--to strengthen their financial positions. In view of the importance of the issue to Bangladesh, it would be a topic for detailed discussion during the next Fund mission.

The staff representative from the Exchange and Trade Relations Department commented that when the May 1985 cyclone damage had occurred, the authorities and the staff were already engaged in discussions of the use of Fund resources. For that reason, the authorities had not requested any additional access to emergency assistance.

The staff representative from the World Bank indicated that the Fund staff had accurately portrayed the views of the World Bank on the question of the substantial salary increase that had taken place earlier in the fiscal year. In 1983, the World Bank resident office in Bangladesh had conducted a review, in consultation with other members of the aid group in Bangladesh; low salaries had been identified as a major problem of motivation in the civil service. There had been a substantial erosion in real salaries over the years since independence because the Government had not increased salaries enough to keep up with inflation, although civil servants did have other nonmonetary benefits that had been taken into account. Thus, prima facie, there was a justification for a substantial increase if only as a catching-up operation. In addition, the poor salary levels had led many government employees to seek alternative forms of remuneration; some were employed in two jobs, were seeking consulting jobs outside government, or were trying to go on overseas assignments. Thus, although the aid group and the World Bank had recognized the problem, Bank staff had cautioned in a 1984 economic memorandum that the civil service wage increases should be selective, perhaps focusing on performance of the high-level employees of public corporations who were managing multimillion dollar enterprises. The question of whether the Government should consider a phased increase was also raised, but it was important to remember that to be effective, the increases had to be significant.

Bangladesh had been the beneficiary of some 12 import program credits, almost on an annual basis since its independence, the staff representative commented. In assessing their significance, it needed to be borne in mind that they had represented about one third of IDA's total commitments to Bangladesh since its independence, and therefore in themselves constituted an important resource for imports. Equally important, however, were the policy objectives of the programs that had been attached to those import program credits. In the early years after independence, they had been largely geared to rehabilitation efforts. In the late 1970s, the emphasis had shifted to the industrial sector: funds had been supplied for rehabilitation, policies had been tied to the import programs related to improving of the textile and jute industries, and part of the resources had been made available for raw materials and spare parts for those industries. During the past three or four years, the focus had changed again, to resource management, largely in response to the international crisis of 1981 and 1982, where resources had become even more constrained. The World Bank had reached understandings with the Government on reducing the size and improving the management of the Annual Development Program. Bangladesh had far too many projects in the program, so the resources had been spread very thin over a large number of projects that were taking a long time to complete, instead of having been focused on priority projects. Management improvements had been effected, with authority having been delegated from the Central Government to independent agencies of the Government, and greater authority having been given to project managers in the matter of expenditures.

The second important focus of the import program in the past three years had been on the agricultural sector, the staff representative from the World Bank said. Emphasis had been placed on the supply of minor irrigation equipment, given the importance of foodgrain production, and policies had been implemented to shift the importation and distribution of most of the minor irrigation equipment to the private sector, which had been working well. Despite the vicissitudes of the weather, Bangladesh had managed to attain record agricultural production during the past three or four years, which could be attributed in part to the improved irrigation in use in the dry season. In addition, the fertilizer distribution had been largely moved out of public sector hands into those of the private sector, with good results. Moreover, progress had been made in persuading the authorities to reduce the fertilizer subsidy. The food distribution system had encouraged open market operations, and there had been a reduction of the foodgrain subsidy.

Mr. Sengupta commented that the financial and nonfinancial public enterprises were likely to make an aggregate profit in 1985/86 of Tk 44.7 billion, after paying taxes, dividends, and interest. The five major enterprises experiencing difficulty were in areas where quick improvement was very difficult, but the Bangladesh authorities were very conscious of the need for improvement, both in terms of pricing of products and increasing productivity. The policy of privatization was being pursued, but because those units were not generally profit making, it might be difficult to transfer them to the private sector.

As Mr. Polak had suggested, the current year's rate of growth was almost entirely due to an increase in agricultural growth; in fact, data as of October 1985 showed that the growth might exceed 4.5 percent, instead of 4.2 percent, Mr. Sengupta said. Moreover, the growth rate might be even higher because imports, which had been depressed in the first quarter for balance of payments reasons, were expected to pick up, helping to accelerate industrial growth. Nonetheless, while the rate of growth in the current year might be much higher than expected, the projections for the medium-term rate of growth were likely to be accurate.

In the budget for 1985/86, the rates of personal income tax had been restructured and reduced, Mr. Sengupta continued. The procedure of tax calculation had also been simplified, and the top marginal rate of income tax had been lowered from 60 percent to 50 percent. More important, however, was that the tax payable was not to exceed one third of the amount by which the total income of a taxpayer exceeded Tk 30,000, or about $1,000; thus, the marginal tax had been reduced substantially. Although the causal connection might not be easily established, it was interesting to note that as of October 10, 1985, the last date for filing returns for the assessment year 1985/86, self-assessment returns had increased 107 percent, compared with the previous year, with a threefold increase in the returns from individuals with revenues greater than Tk 50,000; and individuals filing new assessments had increased by almost 100 percent. Therefore, it did not appear that the reduction of tax rates would lower tax revenue.

Since the general level of civil service wages and salaries was very low, it was important to provide a general salary increase, Mr. Sengupta considered. It was very difficult for the administration to discriminate between groups because the administrative structure depended on the cooperation of all the employees. To contain expenditures, however, the authorities had made substantial cuts in other areas, particularly contingent expenditures, and they had also prohibited any new hiring. Thus, the salary and wage increases, which were considered a major element in enhancing the productivity of the whole system, could be contained within the total budgetary expenditure.

The Bangladesh authorities had been clearly entitled to come to the Fund for emergency relief, Mr. Sengupta recalled, but they had chosen instead to pursue the stand-by arrangement discussions, in the expectation that the stand-by arrangement would be effective much earlier than had actually been the case. The authorities had also introduced in their 1985/86 budget most of the policy measures that the Fund had recommended, and those measures would yield results.

Some of the issues that had been raised had implications that extended beyond the specific case of Bangladesh, Mr. Sengupta mentioned. For example, the low rate of savings in Bangladesh was an example of a major structural constraint for a country whose per capita income was among the lowest in the world. In such an economy, the rate of savings could not improve overnight but would have to rise gradually as a part of the process of adjustment in which the country was engaged. The World Bank had been playing a major role in that process in Bangladesh. Usually, a country's ability to increase tax revenues would also be affected by income distribution, but that was not a problem in Bangladesh.

The major problems of Bangladesh were structural--a high growth rate of population, a low rate of savings, and dependence on exports of one or two items, Mr. Sengupta stated. Some of its export products were not price elastic, so that exchange rate adjustments did not always help. Moreover, the country had to import a substantial amount of foodgrain and energy. Over a period of time, the authorities had been adopting the policies that were considered the most appropriate for an economy facing such structural constraints. As Mr. Polak had said, it was the willingness of the authorities to adopt those policies that should be given the maximum weight in approving a Fund-supported program. The Fund staff had identified several problems, and the authorities were taking appropriate measures to solve them. For example, the real effective exchange rate had come down below the reference point of 1983 as a result of a sustained series of devaluations. The Bangladesh authorities were on track with their macroeconomic policies, but the assistance that Bangladesh required would have to come from long-term lending institutions, mainly the World Bank and bilateral donors. Linked with that issue was the question of the cost of credit. The Fund's credit was expensive; as Mr. Goos had pointed out, Bangladesh would have to use the Fund's resources in order to be able to clear its obligations to the Fund. In such cases--where the country deserved assistance and was following appropriate policies but was not able to afford the high cost of borrowing from the Fund, it was essential to consider providing the country with Trust Fund reflows or other concessional assistance.

Mr. Finaish recalled that the staff had said that emergency assistance had not been discussed after the May 1985 cyclone because at the time of the disaster the staff was already engaged with the authorities in negotiations to use the Fund's resources in a stand-by arrangement. That answer implied that there was no difference between use of the Fund's resources and use of emergency resources from the Fund. The key difference was that the purpose of emergency assistance was to provide quick money to help a country recuperate from a natural disaster. There was no reason for the staff not to have discussed the question with the authorities.

The Chairman replied that the cyclone had indeed caused heavy losses of human lives, but the impact on the economy had been less harsh than might have been expected because the major crops of Bangladesh had already been harvested and because the cyclone had been concentrated on a relatively small area. A Fund mission had visited Bangladesh in May-June 1985; the staff had informed the authorities of the possibility of an emergency assistance and had even requested the authorities to provide data and estimates of the economic loss and the impact on the balance of payments. The authorities had decided not to request such emergency assistance as they had felt that more effective support would be provided under the then-proposed stand-by arrangement. Unfortunately, lengthy negotiations had ensued on the stand-by arrangement.

The Chairman made the following summing up:

> Executive Directors were in broad agreement with the views expressed in the staff report for the 1985 Article IV consultation with Bangladesh and supported its request for a stand-by arrangement. Directors underscored the structural weaknesses of the Bangladesh economy and its vulnerability to external shocks such as the heavy floods and severe cyclone that had struck the

country in 1984/85. The floods had necessitated large foodgrain imports which, together with the sharp decline in workers' remittances, had contributed to the deterioration in the current external balance and in the reserves position. Noting also the country's vulnerability to fluctuations in the terms of trade, Directors indicated that Bangladesh would be able to overcome the fundamental weaknesses of its external position in the longer run only in the context of the diversification and expansion of its productive and export base.

Directors considered that a broad-based adjustment program with emphasis on the mobilization of domestic resources was appropriate in the circumstances of Bangladesh. They welcomed the 1985/86 fiscal package that included revenue measures, reductions in subsidies, and price adjustments, and they endorsed the authorities' intention to phase out the fertilizer subsidy. The implementation of the fiscal package should strengthen the financial position of the public sector and improve the efficiency of resource allocation.

However, a number of Directors expressed some concern regarding the size of--but perhaps more, the lack of differentiation according to skill in--the recent wage increases in the public sector. Moreover, the overall public sector deficit, as a ratio of GDP, was scheduled to remain uncomfortably high while the average tax ratio was relatively low in terms of GDP. In addition, several Directors observed that the weak financial position of some public sector enterprises was one of the basic reasons for the unduly low domestic savings ratio and the continued dependence of investment on external sources of finance.

Directors agreed that the tight monetary and credit policies envisaged under the adjustment program were essential to contain inflationary pressures and to achieve the external targets. That policy stance was all the more necessary considering the unduly sharp monetary expansion experienced during the past three years. It was observed that the rapid accumulation of overdue loans had contributed to the growth in domestic credit and had impaired the effectiveness of monetary policy. Directors therefore stressed the importance of keeping domestic credit under tight control in order to encourage banks to intensify their efforts to achieve higher rates of loan recovery. In that connection, the measures taken by the authorities to reduce overdue bank loans--including the decision of Bangladesh Bank to link the refinancing of agricultural loans to improvements in loan recovery--were seen by Directors as a step in the right direction. Directors commended the authorities on maintaining positive real interest rates.

It was noted that the effective implementation of monetary policy was heavily dependent on accurate and complete monetary data and the authorities were therefore encouraged to sustain their efforts to improve the quality of those data.

Directors commended the authorities on implementing a flexible exchange rate policy and on liberalizing the trade and payments system, and welcomed their commitment to pursue those policies in the future. It was noted that the recent successive devaluations had resulted in a full reversal of the real appreciation of the taka that had occurred in the past two years. Directors noted with satisfaction the authorities' decision to significantly expand the scope of the secondary foreign exchange market and to allow the rate in that market to reflect market conditions. They welcomed the commitment of Bangladesh Bank not to effect sales of foreign exchange in the secondary market and to ensure that the official exchange rate was not at an excessive discount in relation to the rate prevailing in the secondary market. In that regard, the authorities were urged to adopt a timetable toward the unification of the exchange markets, and they were encouraged to further liberalize the trade and payments system as Bangladesh's external position improved.

Directors observed that although most of Bangladesh's external debt was of a concessional nature, the debt service burden had become considerable and was expected to remain relatively high in the next few years. They encouraged the authorities to continue the present cautious external debt policy and welcomed their commitment to avoid borrowing on nonconcessional terms except in cases of emergency.

Directors considered that the adjustment program, in support of which Bangladesh had requested a stand-by arrangement from the Fund, should help strengthen Bangladesh's external position and bring about a limited but necessary increase in gross international reserves. Directors were also of the view that it was essential for Bangladesh to continue its adjustment efforts over the medium term so as to achieve a sustainable balance of payments position and a satisfactory rate of economic growth. Directors emphasized that the achievement of these objectives would require that Bangladesh's exports not be hampered by protective measures in markets abroad, that generous concessional aid flows be stepped up, and that the World Bank and other development institutions continue to play a leading role in Bangladesh's development.

Directors also stressed the need to intensify domestic resource mobilization, to achieve fundamental improvements in the financial position of the public sector enterprises, to progressively raise the tax/GDP ratio, and to move toward domestically based taxes during the Third Five-Year Plan. The authorities were encouraged, with the active assistance of the World Bank, to take measures to overcome difficulties in project implementation, to ensure the adequate maintenance and efficient utilization of completed projects and to provide incentives for and pursue trade policies conducive to the growth of output and exports.

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

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Bangladesh's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 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 (9/23/85). The Fund welcomes the introduction of a negative list for imports and the movement of additional transactions to the secondary exchange market. 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.

Decision No. 8142-(85/173), adopted
December 2, 1985

Stand-By Arrangement

1. The Government of Bangladesh has requested a stand-by arrangement in the amount of SDR 180 million for the period from December 2, 1985 to June 30, 1987.

2. The Fund approves the stand-by arrangement set forth in EBS/85/251, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 8143-(85/173), adopted
December 2, 1985

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/85/172 (11/27/85) and EBM/85/173 (12/2/85).

2. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND GUIDANCE

The Executive Board approves the recommendation by the Committee on Liaison with the CONTRACTING PARTIES to the GATT with regard to the guidance statements for the Fund Representative attending the GATT meeting as set forth in EBD/85/300 (11/27/85).

Decision No. 8144-(85/173), adopted
November 29, 1985

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/85/286 (11/26/85) and EBAP/85/288 (11/27/85) and by Advisors to Executive Directors as set forth in EBAP/85/286 (11/26/85) is approved.

APPROVED: July 11, 1986

LEO VAN HOUTVEN
Secretary