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BANGLADESH

Selected Issues

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Approved by the Asia and Pacific Department

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I. RECENT REFORMS IN THE ENERGY SECTOR IN BANGLADESH¹

A. Power Sector

Status

1. Power shortage has become one of the most important bottlenecks to economic development of Bangladesh. Per capita consumption of electric power in Bangladesh is extremely low compared to its neighbors. Power is available to only 15 percent of the total population of the country. The sector is also suffered considerably from low efficiency and huge system losses. In spite of the fact that installed generation capacity is about 30 percent greater than the peak demand, the Bangladesh Power Development Board (BPDB) cannot adequately maintain the power systems causing chronic load shedding due to serious financial constraints, high system losses and low efficiency. Through substantial progresses have been achieved in recent year, the combined systems losses and accounts receivable of BPDB and Dhaka Electric Supply Authority (DESA) remained as high as 33 percent and 9 months equivalent, respectively.

Reforms since 1994

2. In view of the poor performance, the government, with assistance from donors, had formulated comprehensive reforms in the power sector since 1994. New entities in generation and transmission, such as the Rural Power Company (RPC), the Power Grid Power Company of Bangladesh (PGCB), the Dhaka Electric Supply Company (DESC), the AES Haripur Power Company as well as the Meghnaghat Power Company (MPC) have been constituted. It is expected that over the next few years, these companies will own and operate a substantial part of the power sector's assets.

3. The government has also taken concrete steps to involve the private sector. The private power generation policy was approved in October 1996. Potential has been created to add 1400 MW of capacity over the next five years by the private sector on BOO basis. This is 45 percent of the current installed capacity of 3100 MW and 68 percent of the currently available capacity of about 2000 MW. Several public/private and private sector entities have been licensed to construct and operate power generating facilities. One of these, the Rural Power Company has already started the construction and its first unit is expected to be in commercial operation by March 1999. Others are four barge-mounted power stations totaling to about 400 MW, the independent power producer stations at Meghnaghat (450 MW) and Haripur (360 MW) and the 100 MW expansion at Baghabari. However, till date, only the Mymensingh project and two barge-mounted power stations at Khulna and Baghabari have reached financial close and are expected to be commissioned shortly.

¹Prepared by Min Tang, Asian Development Bank (AsDB).

4. As a first step toward unbundling of BPDB, PGCB has been created to own and operate entire transmission system in Bangladesh. This will essentially segregate generation and distribution activities of BPDB. PGCB will start taking over of transmission assets related to Meghnaghat BOO project by September 1998 and complete taking over of all transmission assets by June 1998.
5. In the distribution sub-sector, there is a new mix of entities. In 1996, DESC was established to gradually take over the distribution system from DESA. In the rural areas, the Palli Bidyut Samities (PBSs) own and operate the distribution systems. Whereas the performance of BPDB and DESA has not been good, the performance of several PBSs has been excellent.
6. Rationalization of tariffs is an integral part of the power sector reforms. Until September 1996, the weighted average national retail tariff for electricity was only about 60 percent of the long-run marginal cost. To address this problem the government implemented tariff adjustments based on a formula to compensate for variations in fuel cost and foreign exchange fluctuations semiannually (March and September) each year.
7. Two issues arise out of the present situation. First, there seems to be an over commitment of base-load generation capacity. With a base load to peak load ratio of about 46 percent, continued addition of base load capacity will be detrimental to the system. Second, the government has guaranteed conversion of foreign exchange under the several implementation agreements that have been signed or committed to be signed. The amount under guarantee represents a large portion of the country's total foreign exchange reserves.

Direction of new reforms

8. The following reforms in the power sector are needed in the near future:
 - (i) Functional segregation or "unbundling" of the sector into generation, transmission and distribution companies and establishing commercial relationships between such unbundled entities;
 - (ii) Establishment of an independent statutory regulatory authority to oversee licensing, tariffs, approval of long-range plans and regulatory functions. This will be done through a law amending the existing provisions for supply of electricity;
 - (iii) Continue private sector participation in the sector, in generation and distribution. In generation, care needs to be taken on the private sector participation based on a long-term least cost expansion program, and in consistence with the ability of the country to meet local and foreign currency commitment;
9. In distribution, there is a need to adopt a policy of corporatizing the successor distribution companies of BPDB and preparing one distribution company for areas other than

Dhaka for structured, solicited privatization either fully or through transfer of management control to a strategic investor;

10. The government should ensure the independence of the management of newly created power sector entities. They should function in accordance with the Companies Act 1994;

11. It is recognized that in the transition process there may be a need for a de facto "single" buyer to facilitate the transition to a competitive pool and to protect consumer interests. BPDB should play this role.

B. Gas Sector

Status

12. Natural gas is an important resource for the economic development of Bangladesh. The share of natural gas in the commercial energy consumed has grown from 35 percent in 1980 to about 70 percent in 1998. Gas supply has, however, not kept pace with demand due to lack of investment in the sector. Investments have been mostly funded under concessional loans from multilateral and bilateral agencies. In 1993, however, the government introduced a new Petroleum Policy to encourage private sector participation in gas exploration and production under Production Sharing Contracts (PSCs). This policy has been generally successful and the flow of gas from the first round of PSCs is expected shortly. The current gas shortages are expected to be overcome by the end of 1998. The government is at present negotiating contract awards under the second round of PSCs.

Supply and demand situation

13. Total proven recoverable gas reserves in Bangladesh are estimated at about 13 trillion cubic feet (TCF). So far, about 2.7 TCF have already been consumed. The international Oil Companies (IOCs) are optimistic about discovering appreciable gas reserves in the near future. This has led to heightened interest in exploration activities in Bangladesh.

14. Preliminary estimation indicates that by the end of 1998 daily gas supply potential will be 30 percent higher than the demand. This gas supply surplus will be maintained up to the end of 2000, if there is no additional production capacity. Thereafter the surplus will gradually reduce over the next three years to zero by 2003. However, additional development gas wells in the public sector fields as well as the second round of PSCs may increase the supply substantially.

Major sector issues

15. Performance of the Public Sector Though the various public gas companies are incorporated under the Company Act and they are supposed to be independent, in reality they enjoy very limited operational or financial autonomy. Meanwhile, since they operate under the veil of state ownership and are insulated from real commercial or market risks, overall capacity in terms of management skills and financial viability remains weak. This situation is further aggravated by the high system losses and large outstanding receivables. Losses in the distribution system, for example, are as high as 26 percent. The high distribution losses are unsustainable and negatively impact the financial position of the public oil companies and overall revenue of the sector.

16. Gas Tariff. At present gas prices are set for different consumer groups and are kept uniform throughout the country despite variances in the costs of supply. The current average consumer price of Tk 54 per Mcf, set in 1994, is far below the long run marginal cost of Tk 73.8 per Mcf. To attract private sector involvement, the cost of gas should be increasingly linked to the international fuel oil prices. The consumer prices need to be revised and restructured so that there is transparency of prices at different stages in the supply chain and to enable cost changes to be passed on to the consumers.

17. Gas Utilization and Conservation Policy. As a result of the private sector's activity under the first round of PSCs, there are already indications that the country's own needs will be met for the foreseeable future. The IOCs are generally upbeat about the prospects of discovering and establishing additional gas reserves that could justify gas exports. A clear picture of the gas reserves will emerge in the next three to four years after additional drillings in present concession areas and the new areas to be awarded under round two. The government therefore needs to develop a gas utilization and conservation policy that addresses the best economic use of this resource.

18. Foreign Exchange for Servicing Private Sector Investments. The repatriation of the IOCs' entitlements, under the current and future PSCs for cost recovery and profit sharing, will create a huge demand on the foreign currency resources. While increase of gas availability could boost economic growth and exports, the demand on the foreign currency could be much earlier than the export earnings materialize. Concern has been expressed that the foreign currency required to service the private sector investment would create pressure on the foreign currency reserve of the country. Detailed assessment needs to be made on the foreign exchange impacts resulting from private sector investments in both gas and power sectors.

Direction of new reforms

19. The gas sector is poised to make a major contribution to the development of Bangladesh. There are real prospects that the gas reserves may become the driving force in the economic development of the country by closing the energy supply demand gap and by providing huge foreign exchange earnings. It also offers a unique opportunity for attracting foreign direct investment thus freeing scarce concessional and public sector funds for investment in social sectors and other sectors which cannot attract funds.

20. With deepening of reforms, the gas sector should be fully unbundled and the main entities will be a set of exploration/production companies largely in the private sector in the next few years. An integrated gas transport system—portions of which could be privately owned—and privatized gas distribution utilities will also be established. Distribution companies will be commercialized and privatized. The following major reforms need to be implemented:

- (i) The Gas Law needs to be drafted and approved and second round PSCs need to be concluded;
- (ii) Gas transmission should be flexible and be open to both public and private sectors and operate on all open access bases. Towards this end government should issue its policy on private sector participation;
- (iii) The high distribution losses should be addressed by (1) immediate institution of administrative and legal actions to reduce losses and recover dues from the users and (2) bringing in private sector participation;
- (iv) The gas tariff should be revised without any further delay by at least 30 percent on average with unbundling of well-head price, transmission charge and distribution margin. The structure of the tariff should be reconsidered based on the cost of supply to each consumer category independent of the ownership category of the consumers;
- (v) In order to reduce the pressure on foreign currency required to service the private sector investment and to maximize the economic benefits of the gas reserves, the government needs to put in place a gas utilization policy and plan to enable the gas producers to sell their gas and make a reasonable return on their investment;
- (vi) The import and distribution of LPG should be liberalized and deregulated. Private sector investors should be allowed to import bottles and distribute LPG without any restriction.

II. FISCAL SUSTAINABILITY IN BANGLADESH¹

A. Fiscal Situation in Bangladesh

21. Since the late 1980s, Bangladesh has shown modest improvements in its *overall economic performance*, although there have been ups and downs.² Up to FY 1993/94, price inflation has declined to the low single-digit level and the external accounts have strengthened, although output growth rates were largely stagnant at 4 percent levels. These improvements were mainly owing to a reform program, supported by an ESAF arrangement. Prudent macroeconomic policies were pursued, and comprehensive reform measures in the area of financial, fiscal, and external sectors were taken. However, economic performance during the mid-1990s deteriorated, with stagnant growth, increased inflation and a widened external imbalance. No major reform efforts were made in this period, thereby inhibiting the economy from attaining its full growth potential. Economic performance has been somewhat encouraging in recent years, with higher growth and reduced external pressures. However, the macroeconomic situation remains fragile, including increased inflationary pressures and slow pace of structural reforms. Moreover, the current structural problems in areas of banking sector and state-owned enterprises (SOE) are likely to cast a large burden on the economy.

22. During the recent period, *the fiscal position* has been managed prudently.³ Higher revenues, which more than offset the increase in expenditures, made the fiscal improvement possible. While total expenditure has risen by 2 percent of GDP since FY 1989/90, total revenue has increased by about 3 percent of GDP, on the average.⁴ As a result, the overall deficit of the government was reduced from 6 percent in 1989/90 to 4.2 percent in 1997/98, except for a temporary deterioration in FY 1994/95, when fiscal policy was expansionary (Chart 1). The reduction of the budget deficit reduced the recourse to the domestic financing, helping underpin macroeconomic stability. The primary deficit, which excludes the interest payments and grants from the overall deficit, has been maintained at about 1.5 percent of GDP in recent years. The gap between the overall and primary deficit has also remained unchanged recently, since a decreasing trend in grants relative to GDP has been roughly offset by an increase in interest payments.

23. The revenue structure of Bangladesh has been weak, and characterized by high and uneven import tariffs, various excise taxes and narrowly-based corporate and personal

¹Prepared by J. Yoon (FAD).

²The time span of this analysis is from 1989/90.

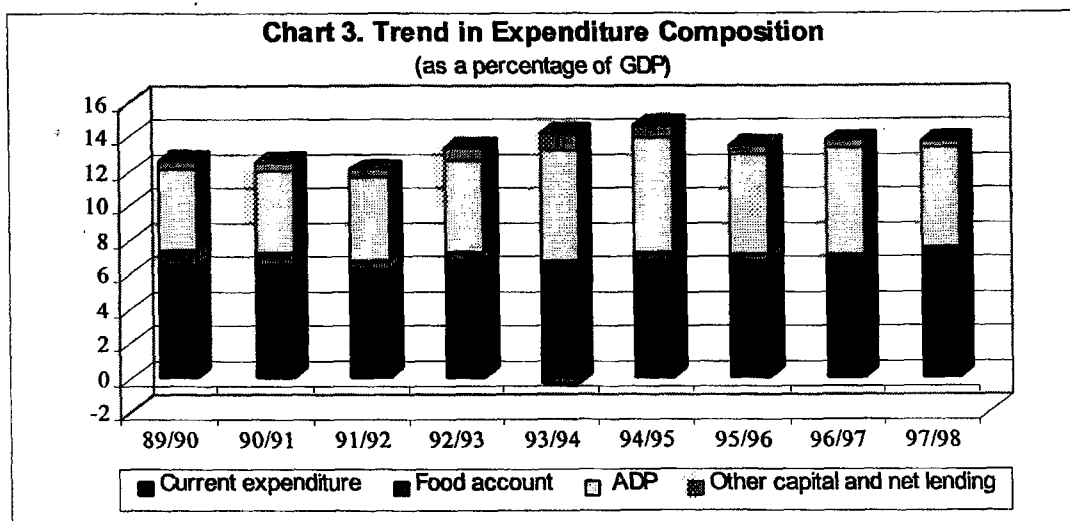
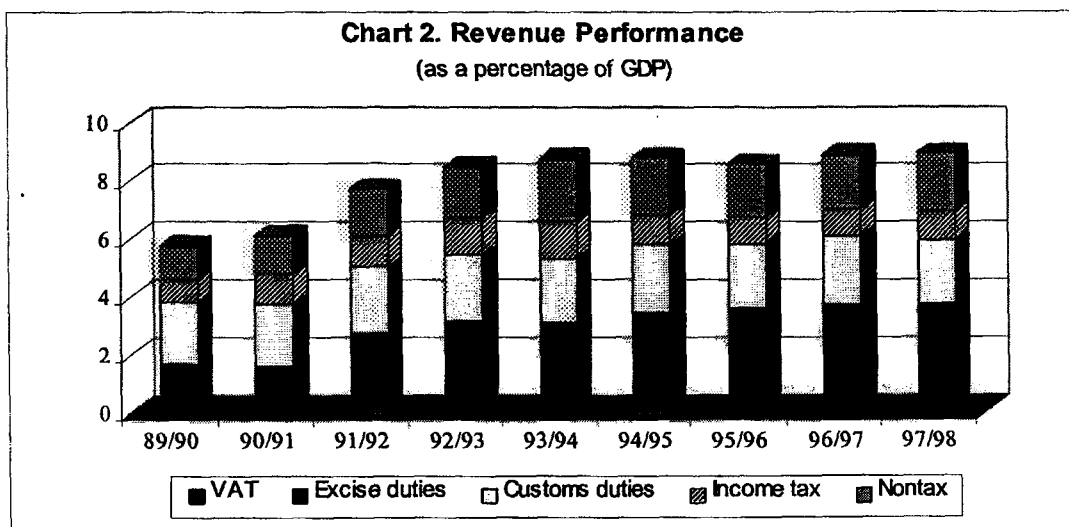
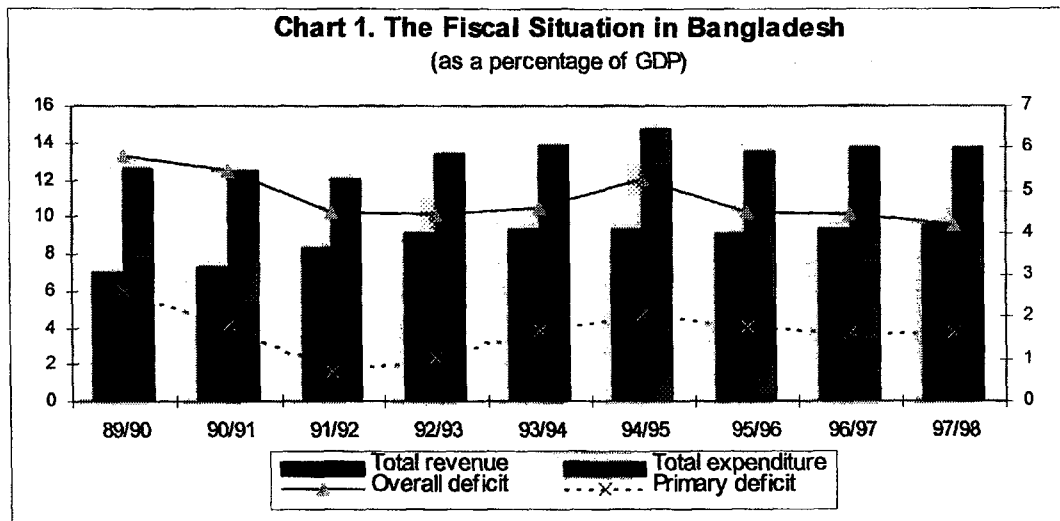
³Due to data availability, this analysis focusses on the fiscal position of the central government rather than the consolidated fiscal position of the public sector.

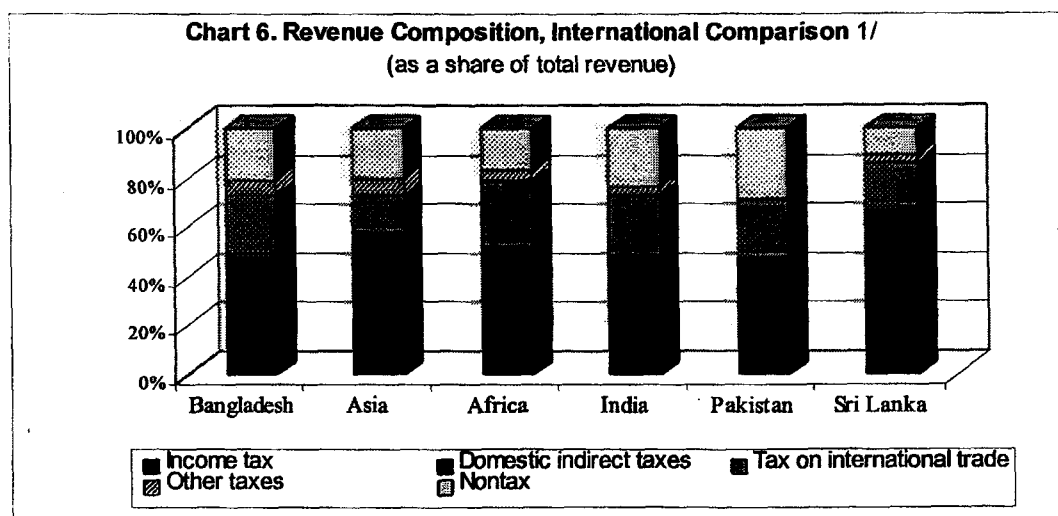
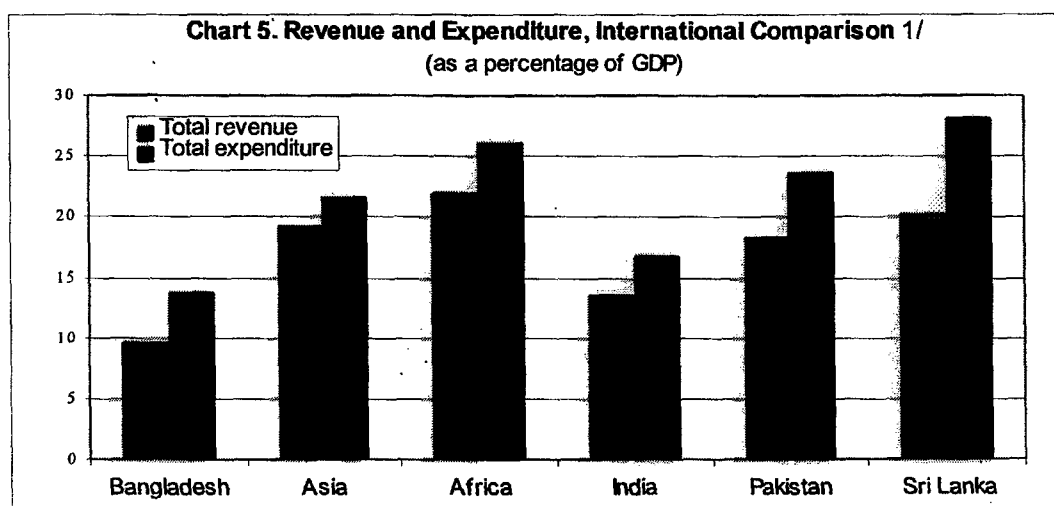
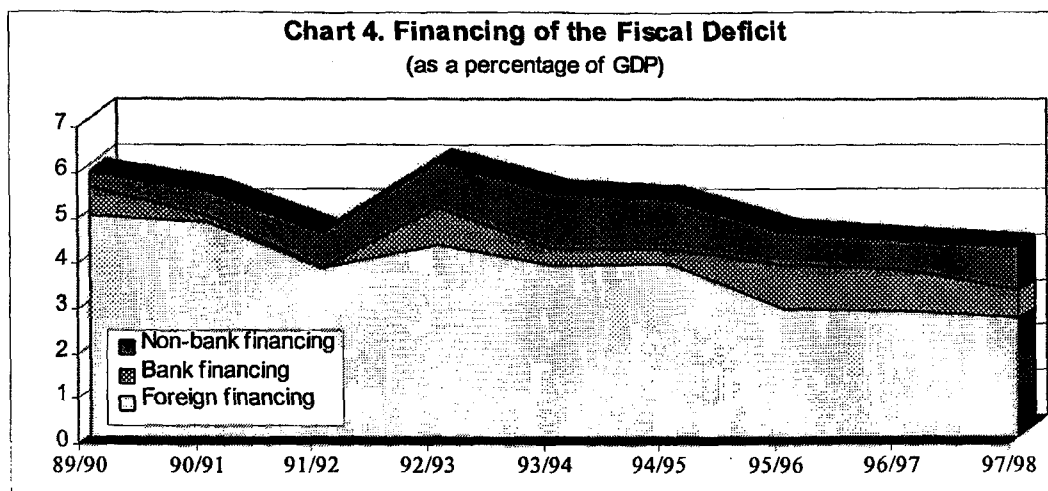
⁴The revised GDP series is used to calculate revenue- and expenditure-to-GDP ratios.

income tax. **Total revenue**, until the late 1990s, was less than 6 percent of GDP, with half of the tax revenue accounted for by customs duties (Chart 2). The tax base was significantly eroded by numerous preferences and exemptions. The major revenue reforms took place in 1991, when the VAT was introduced. The VAT, initially applying to manufacturing and import stages, has expanded its coverage through removal of exemptions. Although several sectors, including power and textiles, are still out of its net, the introduction of VAT increased the revenue by about 2 percent of GDP, and, together with supplementary duties and excises, accounted for almost a half of the total tax revenue (about 7 percent of GDP). As regards customs duties, notwithstanding the continuous lowering of the tariff rates, such duties have remained at more than 2 percent of GDP. Income tax collections, however, have been stagnant at less than 1 percent of GDP, which reflected excessive tax holidays and a poorly structured system of depreciation allowances. Although the total revenue-to-GDP ratio had increased after the reform, it has been stagnant at the level of less than 10 percent since 1993/94, which put Bangladesh as one of the lowest revenue performance countries.

24. **Total expenditure** of the central government has modestly increased from 12 percent of GDP in the late 1980s to 13.7 percent in FY 1997/98, except for FY 1994/95, when it reached more than 14 percent (Chart 3). Two major expenditure components are current expenditure and the Annual Development Program (ADP). Current expenditure averaged about 7 percent of GDP, although it has increased modestly in recent years due to the increase in pay and subsidies. Payments for goods and services including pay and allowances have accounted for about two-thirds of the total current spending. Interest rate payments have been small, reflecting the concessional nature of foreign loans, although they have increased recently due to higher nonbank financing and higher domestic interest rates. ADP expenditures, which are a major vehicle for public investment in Bangladesh, had increased in the early 1990s to 7 percent of GDP by FY 1994/95. However, it declined to 6 percent to GDP by FY 1997/98, due to implementation difficulties as well as prioritization of the investment projects. Foreign grants and concessional loans have continued to play a major role in financing ADP, while domestic financing has become also important in recent years. Other expenditures, including the food account deficit and non-ADP capital spending, took a small portion of expenditure, averaging about 0.5 percent of GDP.

25. **Financing of the overall government deficit** has been mostly through foreign grants (mainly food and commodity aid) and highly concessional foreign borrowing in the form of project aid. Foreign financing, which accounted for more than 80 percent of the total financing in the early 1990s, has shown a declining trend in recent years (Chart 4). On the other hand, domestic financing has increased recently, reaching 40 percent in 1997/98. Among domestic financing, the portion of nonbank financing has increased, reflecting issuance of high interest-bearing saving instruments. Bank financing, mostly borrowing from the Bangladesh Bank, has maintained at a quite low level, contributing to alleviate inflationary pressures.





Source: Data provided by the Bangladesh authorities, and IMF, the *Government Finance Statistics* 1/ FY 1997/98 data are used for Bangladesh, while the average of the available data during 1990-95 is used for other countries.

26. The reduction of the budget deficit and a large portion of concessional foreign financing contributed to lower the government debt burden (foreign debts, on which real interest rates are negative, accounted for more than 70 percent of the total debt). The government debt-to-GDP ratio has fallen from 55 percent in the early 1990s to 50 percent in 1997/98. However, an increasing share of costly domestic financing and the potential budgetary cost, especially related to the structural problems in the banking sector and SOEs, are likely to put pressures on the debt burden.

27. *International comparison* confirms that the fiscal situation in Bangladesh is very weak, especially in revenue efforts, compared to neighboring and other developing countries (Chart 5). The revenue-to-GDP ratio of Bangladesh is lower than that of the non-OECD African and Asian countries as well as that in the neighboring countries. Such a low level of revenue mobilization puts a constraint on expenditures, which have also been low compared to other countries. In terms of revenue composition, the domestic indirect taxes including VAT account for a relatively large portion of the total revenue, while the portion accounted by income taxation remains small (Chart 6). The poor revenue performance of Bangladesh reflects extensive tax exemptions and generalized tax incentives, weak tax administration, and the sizable underground economy which erode the tax base. It needs to be tackled in order to finance the resource needs to attain a sustained growth and to alleviate poverty.

28. Notwithstanding the weak fiscal position of Bangladesh, the budget deficit has so far been financed without raising the debt burden significantly. As regards *future prospects*, however, whether Bangladesh could maintain the current fiscal stance while keeping its sustainability is uncertain. Regarding expenditure, the potential costs related to the structural problems in the banking sector and SOEs could increase the fiscal burden substantially. Budgetary outlays on infrastructure and social expenditures such as education also need to be increased in order to sustain growth and reduce the poverty, that still afflicts nearly a half of the population. Moreover, the declining trend in concessional foreign financing and the rising share of domestic financing with higher interest rates are more likely to aggravate the fiscal situation. Revenue performance would also remain at the current level without rigorous reform efforts, and might not be enough to meet the resource requirement. In this context, we need to assess the fiscal sustainability of Bangladesh under various scenarios, and examine how much fiscal reform is required to keep the fiscal stance sustainable.

B. How to Measure Fiscal Sustainability

29. The public sector deficit and the burden of the public debt have important macroeconomic implications. Besides crowding out private investment, the public sector deficit might result in persistent inflation through monetisation of the deficit and/or vicious spirals of debt and deficit. An important issue regarding fiscal policy is the sustainability of fiscal position, which attempts to answer the question of whether the current fiscal position is sustained without exploding or imploding debt.

30. Assessing the sustainability of the fiscal policy is a complex and judgemental exercise, depending critically on assumptions concerning the future path of a number of macroeconomic variables. Assessments of fiscal sustainability attempt to examine the magnitude of medium- or long-run inconsistencies in fiscal policy and to measure the size of the fiscal adjustment needed to achieve stabilization of the base year public sector debt to GDP ratio. Most measures of fiscal sustainability, based on the accounting approach to public sector solvency, are derived from the following intertemporal budget constraint⁵.

$$\frac{D^p}{Py} + i \cdot \frac{D}{Py} + i^* \cdot \frac{ED^*}{Py} = \frac{\dot{M}}{Py} + \frac{\dot{D}}{Py} + \frac{ED^*}{Py} \quad (1)$$

where D^p is the primary deficit of the government (excluding grants); P is the GDP deflator; y is real GDP; i and i^* are the domestic and foreign nominal interest rates; D and D^* are the stock of domestic and foreign public debt; E is the nominal exchange rate (domestic currency units of foreign exchange); M is base money stock; and dots indicate time derivatives. The above budget constraint equates the above-the-line deficit (the sum of the primary deficit and interest payments) to below-the-line financing sources (the change in monetary and nonmonetary public debt holdings).

Simple manipulation of equation (1) permits derivation of the ratio of the primary deficit to GDP as:

$$d^p = \dot{m} + (\pi + g) \cdot m + \dot{d} + (g - r) \cdot d + \dot{d}^* + (g - r^* - c) \cdot d^* \quad (2)$$

where the lowercase variables, d^p , d , d^* , and m are defined as the ratios of D^p , D , D^* , and M to GDP at current prices; π is the domestic inflation rate; g is real GDP growth; r and r^* are the domestic and foreign real interest rates; c is the rate of real exchange rate depreciation. Equation (2) states that the primary deficit of the public sector, as a share of GDP, is constrained not to exceed the sum of the following financing sources: (i) seigniorage revenue comprising the inflation tax on the monetary base and growth-induced increase in money demand; (ii) the excess of real GDP growth over the real interest rate (adjusted for real exchange rate depreciation for foreign interest rate) multiplied by both the domestic and foreign debt stock; and (iii) increases in the stock of domestic and foreign debt.

31. One widely used measure of fiscal sustainability is to compare actual primary deficits and sustainable primary deficit levels. The sustainable primary deficit (sd^p) is computed by holding constant the ratios of public debt and money to output, which is given as follows:

⁵For comprehensive discussions of the fiscal sustainability, see Easterly and others (1994) and Horne (1991).

$$sd^P = s + (g-r) \cdot d + (g-r^* - c) \cdot d^* \quad (3)$$

where s is seigniorage revenue ($s = (\pi+g) \cdot m$). That is, the sustainable deficit level is defined as the deficit level that could be financed without adding to the debt burden and without resorting to monetary financing. If actual primary deficits are greater than the sustainable levels, then debt to GDP ratio would continue to rise, resulting in unstable debt dynamics. This measure of fiscal sustainability, based on the accounting approach, has several shortcomings, including the arbitrariness of the initial debt level and ignorance of different macroeconomic effects of change in public expenditure composition and varying tax regimes.⁶ However, it not only allows a determination of the range of sustainable deficits under various scenarios of economic growth, inflation, and domestic and foreign interest rates, but it also provides a tractable framework for examining the consistency between macroeconomic policy objectives and the size of the public sector deficit.

32. Alternative fiscal sustainability measures, suggested in other studies, include constant net worth deficit, primary gap and medium-term tax gap. *The constant networth deficit*, suggested by Buiter (1985), is defined as the difference between the present discounted value of the primary fiscal balance and public sector net worth, both in terms of ratios to GDP. A fiscal position is considered as sustainable if the present discounted value of the primary deficit is smaller than public sector net worth. *The primary gap*, suggested by Blanchard (1990), is defined as the difference between the primary surplus that stabilizes the outstanding public debt to GDP ratio and the current primary balance.⁷ *The medium-term tax gap*, suggested also by Blanchard (1990), equals the difference between the tax ratio, consistent with a stabilized initial public debt to GDP, and the current tax ratio. It measures the required adjustment in the tax ratio needed to stabilize the outstanding public debt to GDP ratio. These measures have advantages in that they are relatively simple, model-free, and based on a restricted information set. While they provide a useful tool for cross-country comparisons, they inevitably ignore the interrelation of macro variables, and are very sensitive to changes in parameters such as interest rates.

33. In this analysis, we rely on the fiscal sustainability measure suggested in Equation (3), which is based on a larger information set regarding the prospects of macroeconomic variables.

⁶See Horne (1991) and World Bank (1997) for the detailed discussion on limitation of the sustainability measures based on the accounting approach.

⁷The primary gap is conceptually equivalent to the difference between the sustainable primary deficit and the actual deficit, but relies on a few restricted variables.

C. Fiscal Sustainability in Bangladesh

Medium-term macroeconomic prospects

34. The analysis of fiscal sustainability is conducted under the two alternative scenarios, a no reform scenario and an adjustment (reform) scenario, which provide developments of the major macroeconomic parameters for the calculation of the fiscal sustainability measure.¹ Before turning to description of each scenario, the following caveats have to be kept in mind.

35. The fiscal sustainability analysis, as mentioned above, is to see whether the *underlying* fiscal balance is sound enough to cover debt-service burdens without increasing debt-to-GDP ratio. In order to better reflect the future paths of the public sector deficit and its debt dynamics, the fiscal position of the public sector (rather than the central government) as well as potential fiscal costs needs to be incorporated. In the case of Bangladesh, however, information on the consolidated fiscal balance of the public sector is not available.² In this study, we focus on the central government balance, while also attempting to take into account the potential fiscal costs related to the structural problems of the banking sector and SOEs.

36. As regards potential fiscal burdens which would fall on to the government, the following costs need to be considered. First, restructuring of the banking sector, including the potential costs of recapitalization and other possible costs such as purchases of nonperforming loans need to be considered. Nonperforming loans of Nationalized Commercial Banks (NCBs) as well as Private Domestic Banks (PDBs) are estimated at around 50 percent of the portfolio. Recapitalization of the banks to keep the capital adequacy ratio in line with the international standard alone would cost about 6 percent of GDP. Retrenchment of the workers would also add a further cost of 0.5 percent of GDP (World Bank estimates (1998)). Second, reform costs of the SOE sector, including potential debt assumption, writing-off of debt to the government, and the retrenchment of workers would increase the fiscal burdens. Assuming government absorption of about one-third of SOEs debt in the industrial sector (141 SOEs, denoted Category III)³, the fiscal cost could be 1.7 percent of GDP, and its retrenchment cost could add a further 0.5 percent of GDP. Inclusion of other SOEs (Category I and II) could add an additional cost of 1 to 2 percent of GDP. Third, in order to attain sustained growth and to reduce poverty, budgetary outlays in

¹The two scenarios are exactly the same as projected in the recent Article IV Staff Report (SM/98/232).

²The main shortcomings of the government finance data of Bangladesh include an incomplete coverage of government transactions, a lack of frequency and timeliness in data compilation and a lack of reconciliation of data among different sources.

³For the underlying assumptions, see Table 1.

the physical infrastructure and social expenditures such as education and public health will need to be increased. The overall reform costs are difficult to estimate more precisely, as they will depend on the coverage, the speed and the modalities of the reforms. Aside from the budgetary outlays in infrastructure and education, the staff's rough estimates put the structural reform costs at 10 percent of GDP in total over the medium term.

37. An important issue to note is how to treat the reform costs in the sustainability analysis. It depends on many factors including the nature of expenditure and the way through such assistance is provided. For instance, in case where reform costs are of a once and for all nature, it is appropriate to consider only the interest component, which would better reflect the underlying fiscal position. On the other hand, when the fiscal burdens due to the reforms are more likely to continue, the reform cost itself needs to be reflected in the primary balance, since it affected the underlying fiscal balance. In the case of Bangladesh, the banking sector and SOE reform costs, which are estimated to be about 10 percent of GDP, are more of a temporary nature. However, other potential fiscal costs including investment in physical infrastructure and social spending, as illustrated above, are needed to increase in order to achieve high growth and to alleviate poverty. To better reflect the underlying fiscal balance,

Table 1. Budgetary Cost of the Banking Sector and SOE Reforms

	Reform cost 1/		Underlying assumptions
Banking sector reform	114.2	6.4	
Bank recapitalization	105.0	5.9	100 percent provisioning for all classified loans as of June 1997, and bank recapitalization up to international standards.
(NCBs)	(71.0)	(4.0)	
(PDBs)	(34.0)	(1.9)	
Retrenchment cost	9.2	0.5	30 percent of overstaffing for NCBs and BB, and average severance pay of Tk 446,000.
SOEs reform	67.2	4.1	
SOE debt assumption	51.2	3.1	Assumption of inter-corporation liability and other liabilities for Category III, and a half of other liabilities for Category I and II.
(Category III)	(27.2)	(1.7)	
(Category I and II)	(24.0)	(1.4)	
Retrenchment cost	16.0	1.0	50 percent overstaffing and average severance pay of Tk 135,000 for the Category III workers. 2/
(Category III)	(8.8)	(0.5)	
(Category I and II)	(7.2)	(0.4)	25 percent overstaffing and average severance pay of Tk 223,000 for the Category I and II.
Total	181.4	10.5	

1/ Figures in the left column are in billions of Taka and the right in percent of GDP. The banking sector cost is as of June 1997, and the cost for SOEs is as of June 1996. Figures in percent of GDP are calculated using the corresponding nominal GDP (the 1996/97 GDP for the banking sector and the 1995/96 GDP for the SOEs).

2/ The number of the Category III workers is assumed to be a half of the total SOE workers.

we spread out the banking sector and SOE reform costs over the next five years, and expect that a similar magnitude of expenditure continues after FY 2003/04.⁴

38. Returning the medium-term prospects, *the adjustment scenario* assumes that the comprehensive structural reforms, in such areas as in the banking sector and SOEs as well as on the revenue side, take place. The adjustment scenario envisages high growth under price stability. GDP growth rates are expected to rise from 5.6 percent in 1997/98 to 7 percent by 2002/03, while price inflation is stabilized into 4 percent levels. High growth is made possible due to a rapid increase in investment, together with broad efficiency gain which the structural reforms would bring. The reform costs to tackle the structural problems in the banking sector and SOEs are estimated to be 10 percent of GDP, as indicated above. Higher public saving, which is vital to meet the resource needs, is attained primarily through higher revenue. Revenue reform is assumed to bring a revenue gain of 2.5 percent of GDP over the medium term. The overall government deficit, including the reform costs, rises initially to 5.6 percent of GDP, but declines gradually to 4 percent levels as a higher revenue is attained. The foreign financing of the deficit is expected to decline from 2.6 percent in 1997/98 to 1.9 percent of GDP in FY 2002/03, while the share of domestic financing become larger (2.3 percent of GDP in FY 2002/03). Interest rates (on government bonds) are projected to remain at 11 percent, which are broadly in line with the nominal GDP growth. The rate of real exchange rate depreciation is expected to be zero.

39. Under *no reform scenario*, on the other hand, neither reforms in the banking sector and SOEs sector nor revenue reform takes place. The structural problems prevalent in the economy threaten macroeconomic stability, with adverse implications for investment and growth. Real GDP growth is expected to be lowered gradually to 4 percent levels over the medium term, while price inflation remains at 7 percent. As the potential cost of the banking sector and SOEs materializes without revenue reforms, the overall government deficit worsens into more than 6 percent of GDP in FY 2002/03, most of which is financed by domestic financing. Interest rates are expected to rise by about 2 percent to 13 percent level, reflecting inflationary pressures and inefficient financial intermediation. Medium-term macroeconomic prospects under each scenario are summarized in Table 2.

⁴The currently projected ADP spending, 6 to 7 percent of GDP, is quite low to sustain 7 percent growth. Under the current incremental capital output ratio, further public investment of at least 1 to 2 percent of GDP is likely to be needed to keep high growth. Expenditures to alleviate poverty, such as on education and health, also need to be increased.

Table 2. Medium-Term Macroeconomic Prospects Under Each Scenario

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
(Adjustment scenario)							
Real GDP growth	5.9	5.6	6.0	6.5	6.5	7.0	7.0
Inflation	2.6	7.0	5.0	4.0	4.0	4.0	4.0
Overall deficit 1/	4.4	4.2	5.6	5.1	4.5	4.2	4.2
(o/w reform costs)	(-)	(-)	(2.0)	(2.0)	(2.0)	(2.0)	(2.0)
Domestic financing	1.5	1.6	3.0	2.6	2.2	2.3	2.3
Foreign financing	2.9	2.6	2.6	2.5	2.3	1.9	1.9
Total government debt 1/	48.7	50.0	51.1	50.1	48.7	47.0	45.7
Domestic debt	12.4	12.9	14.7	15.8	16.5	16.9	17.5
Foreign debt	36.3	37.1	36.5	34.3	32.2	30.1	28.1
Interest rate 2/	11.0	11.0	11.0	11.0	11.0	11.0	11.0
(No reform scenario)							
Real GDP growth			5.0	4.5	4.5	4.0	4.0
Inflation			7.0	7.0	7.0	7.0	7.0
Overall deficit 1/			4.3	4.6	5.0	5.5	6.1
(o/w structural costs)	-	-	(-)	(0.2)	(0.4)	(0.6)	(0.8)
Domestic financing			1.8	2.3	3.0	3.7	4.5
Foreign financing			2.5	2.3	2.0	1.8	1.6
Total government debt 1/			49.4	48.0	47.3	47.4	48.2
Domestic debt			13.3	14.2	15.7	17.8	20.5
Foreign debt			36.1	33.8	31.6	29.6	27.7
Interest rate 2/			13.0	13.5	13.5	14.0	14.0

1/ In percent of GDP.

2/ It represents interest rates for government bonds. It is more likely to be higher than the projected, considering the large issuance of government bonds.

Fiscal sustainability in Bangladesh⁵

40. The fiscal sustainability in Bangladesh is assessed by comparing the actual primary deficit and the sustainable primary deficit in Equation (3), which is as follows:

$$fs = d^p - sd^p = d^p - (g-r) \cdot d - (g-r^*-c) \cdot d^* \quad (4)$$

⁵For a related issue of external viability of Bangladesh, see "External Evaluation of the ESAF (1998)," pp 39-44.

where fs is a sustainability measure, of which positive sign indicates that the primary deficit exceeds the sustainable level, resulting in increases in the debt-to-GDP ratio. Note that the seigniorage component (s) is absent in the equation, since most of the Bangladesh Bank's profit is already reflected in the actual deficit (d^p) by its transfer to the government.⁶

41. The fiscal sustainability measure has been calculated by plugging medium-term projection of key macroeconomic variables, shown in Table 2, into Equation (4). The results of the sustainability analysis are reported in Table 3. As shown in the table, the fiscal position of Bangladesh has been sustainable so far, owing to several factors. First, the interest rates on foreign financing have been very low due to the highly concessional nature. Second, foreign debt, with negative real interest rates, accounted for more than 70 percent of the total debt. These two factors made the effective interest rates on the government debt very low. Third, the fiscal improvement, although moderate, together with higher growth improved the fiscal sustainability.

42. Fiscal sustainability over the medium term is found to depend critically on the scenario envisaged. Chart 7 compares the sustainability under various scenarios, in which the difference between the projected primary deficits and the sustainable levels, in percent of GDP, is plotted. Under the scenario that no reform takes place, the fiscal position is quite sustainable in the initial stage. However, as the potential burden of the banking sector and SOEs materializes, the fiscal position becomes unsustainable. By FY 2002/03, the actual primary deficit exceeds the sustainable level by about 1 percent of GDP, and the fiscal position is expected to deteriorate further after FY 2003/04. Low growth, increase of the fiscal burdens due to the structural problems, and greater domestic financing with higher interest rates are the underlying factors which aggravate the fiscal situation.

43. On the other hand, under the adjustment scenario where the revenue reform as well as the banking sector and SOE reforms takes place, the fiscal stance turns out to be sustainable with a fair margin. For the initial stage of the reform where the revenue increase is small relative to the reform cost, the projected primary deficit exceeds the sustainable level. As the revenue efforts become stronger, however, the fiscal position begins to improve, and the sustainability is quite well maintained by a margin of 1 to 2 percent of GDP in FY 2002/03 when the reforms are to be finalized. The adjustment scenario without the revenue reform is also drawn in Chart 7 to see what would happen without the revenue reform. Despite the higher growth, the fiscal sustainability is threatened, as the projected primary deficit exceeds the sustainable level by 1 percent of GDP in FY 2002/03. It underscores the importance of

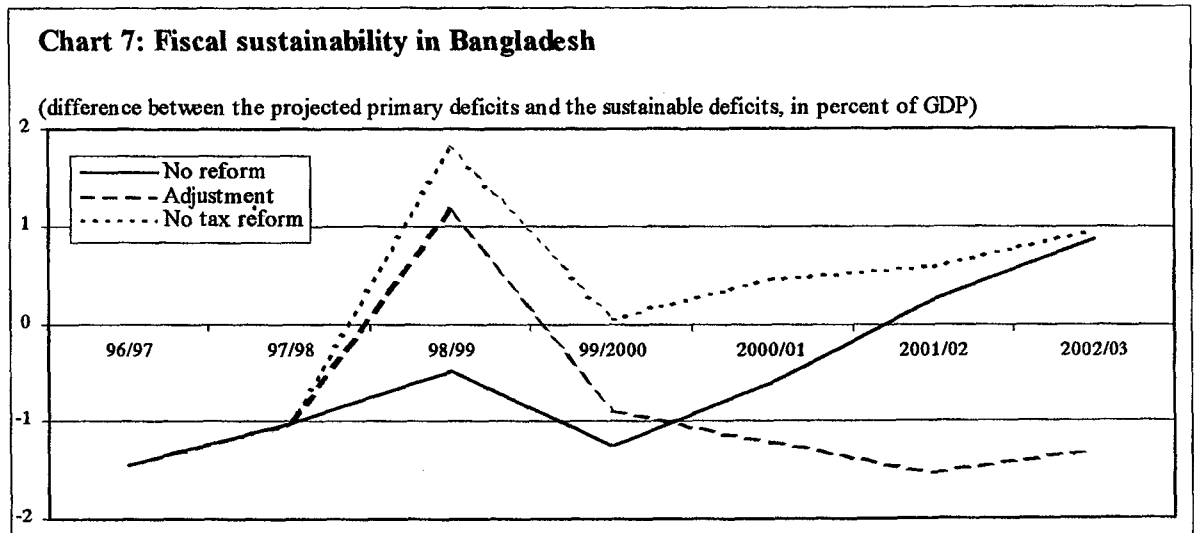
⁶The net profit of the Bangladesh Bank has been, on the average, 0.4 percent of GDP over the past three years, and more than 85 percent of the net profit has transferred into the central government as a nontax revenue. The rest of profit has also been appropriated for the quasi-fiscal activities such as transfers to various government funds. For seigniorage and the transfer of central bank profits, see Baltensperger and Jordan (1998).

the proposed revenue reforms to absorb the potential costs, without which the structural reforms could be constrained by a lack of fiscal resources.

Table 3: Bangladesh: Summary of the Fiscal Sustainability Analysis

	1996/97	1997/98	1998/99	Fiscal years			2002/03	average
				99/2000	2000/01	2001/02	(1998/99-	2002/03)
	(In percent of GDP)							
(1) No reform scenario								
Sustainable primary deficit	3.10	2.63	2.02	3.12	2.87	2.39	2.11	2.50
Actual primary deficit	1.65	1.62	1.54	1.86	2.26	2.63	2.98	2.26
fiscal sustainability (<i>fs</i>)	-1.45	-1.01	-0.48	-1.26	-0.61	0.25	0.87	-0.25
(2) Adjustment scenario								
Sustainable primary deficit	3.10	2.63	1.60	3.01	2.80	2.83	2.62	2.57
Actual primary deficit	1.65	1.62	2.75	2.13	1.60	1.29	1.33	1.82
fiscal sustainability (<i>fs</i>)	-1.45	-1.01	1.15	-0.88	-1.20	-1.54	-1.29	-1.13
(3) Sensitivity analysis of fiscal sustainability 1/								
No revenue reform	-1.45	-1.01	1.78	0.06	0.45	0.59	0.96	0.77
(difference from (2))	-	-	0.63	0.94	1.65	2.13	2.26	1.52
Lower growth	-1.45	-1.01	1.66	-0.38	-0.71	-1.07	-0.84	-0.27
(difference from (2))	-	-	0.51	0.50	0.49	0.47	0.46	0.49
Higher reform cost	-1.45	-1.01	2.12	0.10	-0.21	-0.56	-0.32	0.23
(difference from (2))	-	-	0.97	0.98	0.99	0.98	0.98	0.98
Real depreciation	-1.45	-1.01	1.88	-0.19	-0.56	-0.94	-0.73	-0.11
(difference from (2))	-	-	0.73	0.69	0.64	0.60	0.56	0.64
Lower aid	-1.45	-1.01	1.36	-0.65	-0.97	-1.31	-1.07	-0.52
(difference from (2))	-	-	0.21	0.23	0.23	0.23	0.23	0.23
Higher interest rate	-1.45	-1.01	1.15	-0.83	-1.11	-1.41	-1.13	-0.66
(difference from (2))	-	-	0.00	0.05	0.09	0.13	0.17	0.09

1/ The figures indicate *fs* in the Equation (4).



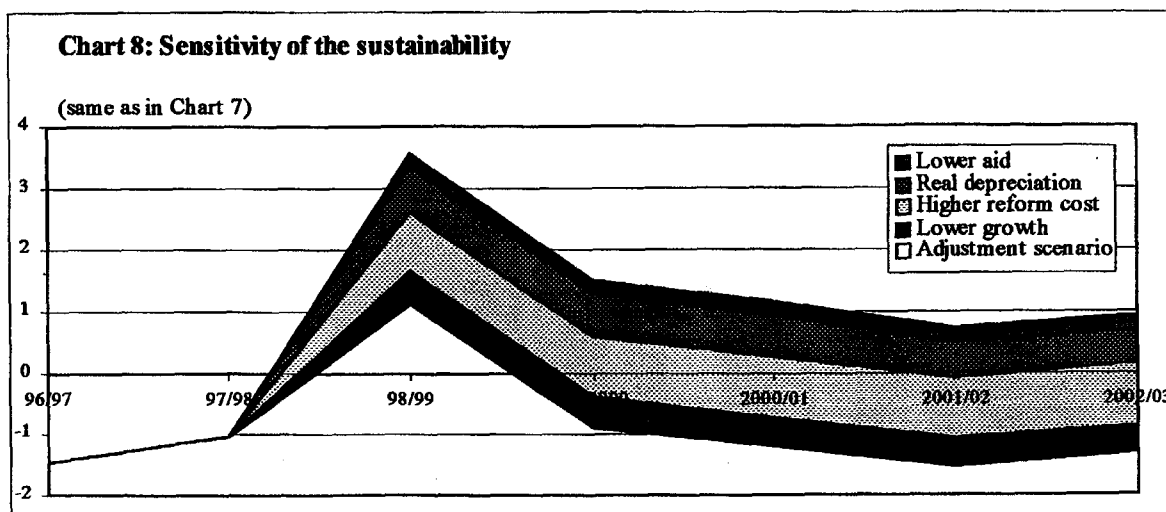
Sensitivity analysis of the fiscal sustainability

44. The medium-term fiscal sustainability depends on the projected paths of major macroeconomic variables. However, the macroeconomic prospects are subject to change with, indeed even without, exogenous shocks to the economy. Considering the potential risks related to this kind of analysis, we assess fiscal sustainability under various assumptions on the macroeconomic variables, including a lower growth, a higher reform cost, further real depreciation of the exchange rate, lower aid, and higher interest rates.⁷ The results of the sensitivity analysis, conducted under the adjustment scenario, are reported in Table 3, and its cumulative effect is drawn in Chart 8.

45. The sensitivity analysis shows that there remains a substantial risk while the sustainability margin (1 to 2 percent of GDP) under the adjustment scenario could absorb an individual shock. Under a lower growth assumption by one percentage point (6 percent growth over the medium term), the sustainability measure turned out to deteriorate by about 0.5 percent of GDP. A higher reform cost, by 1 percent of GDP each for the next five years, significantly

⁷Most of assumptions represent downside risks. While there might be factors which would positively affect the fiscal position, such as a lower reform cost due to better recovery of non-performing loans, they are not as likely as the downside risks.

threatened sustainability.⁸ Further real depreciation of the exchange rate by 2 percent,⁹ which raises the debt service burden, aggravated the sustainability measure by about 0.6 percent of GDP. Lower aid, which is assumed to be constant at the FY 1997/98 level in absolute terms, and a higher interest rate by 2 percentage points (changed from 11 percent to 13 percent) also aggravated the sustainability by 0.1 to 0.2 percent of GDP. The results, which are cumulatively drawn in Chart 8, indicate that how essential is the proposed revenue reform in order to keep the fiscal sustainability under various risks.



D. Conclusion

46. This paper assessed the fiscal position of Bangladesh and examined its fiscal sustainability using a simple measure based on the debt dynamics. While Bangladesh has so far maintained its sustainability mainly due to the large portion of foreign financing with highly concessional interest rates, the potential fiscal burdens related to the structural problems in the banking sector and SOEs might threaten the sustainability. Stronger revenue efforts, which would raise the revenue to GDP ratio by a total of 2½ percentage points of GDP over the medium term, are

⁸Further reform cost of 5 percent of GDP might not be very unrealistic, considering the following: (i) the reform cost becomes much larger when the reform is delayed (a World Bank (1998) estimated that the fiscal burden of the bank sector reform, when delayed 5 years, becomes roughly doubled); (ii) other potential reform costs such as further government assumption of foreign debt of SOEs, might materialize, increasing fiscal burdens; (iii) actual reform costs might be greater than initial estimates, as in the other countries (financial sector restructuring costs of Indonesia and Thailand are found to be more than double compared to the estimate in the original program. The interest cost of financial sector restructuring was revised from 0.5 percent in the initial program to 1.6 percent of GDP later for Indonesia, and 1.1 percent to 2.7 percent of GDP for Thailand).

⁹2 percent real depreciation is chosen, considering that the real exchange rate of taka has been depreciated by 2.1 percent, on the yearly average, during FY 1990/91~1997/98.

likely to be essential in absorbing the structural reform costs and also keeping the fiscal sustainability under possible downside risks.

47. The results of this analysis need to be interpreted with a caution. First, the sustainability measure, employed in the analysis, provides only one of several possible perspectives on the soundness of public finances. For example, it assesses the sustainability from the perspective of borrowers rather than creditors, and a fiscal position is sustainable only when the creditors are willing to finance it. Second, any sustainability measure critically relies on the status of the consolidated fiscal position and the potential fiscal burdens. In this context, significant improvements in government finance data are indispensable to better assess the fiscal position and its sustainability. Also, further studies regarding the magnitude of the structural reform costs related to the banking sector and SOEs would help improve the quality of the analysis.

III. BANKING SYSTEM PROBLEMS AND REFORM IN BANGLADESH¹

48. The banking sector in Bangladesh has experienced severe problems for more than a decade. This chapter establishes the extent of bank soundness problems based on quantitative indicators of financial distress. In its analysis it regards the bank soundness problems as symptoms that reflect the underlying weaknesses in the banks and in their surrounding environment such as the regulatory framework and the legal and judiciary system. It analyzes these weaknesses and identifies key areas where reforms are needed. The chapter is structured as follows: Section A gives an overview of the financial system; Section B looks at financial indicators of bank soundness problems; Section C analyzes the underlying weaknesses that cause the financial problems; Section D discusses key issues related to severe banking distress; Section E gives an overview of recent reforms; and Section F suggests future reforms.

A. Background

Overview of the financial system

49. The banking sector dominates the financial system in Bangladesh, accounting at end-1997 for 96 percent of the system's total assets. Overall, the size of the financial sector relative to GDP remains somewhat smaller than in other countries in the region (Table 1).

50. The banking institutions in Bangladesh comprise the central bank—the Bangladesh Bank (BB)—four nationalized commercial banks (NCBs), four government-owned specialized development banks, 18 private domestic banks (PDBs), and 12 foreign banks. The NCBs dominate the commercial banking sector accounting for about two-third of its assets, although the share has been declining over the last decade reflecting the impact of some financial sector reforms, including the privatization of two NCBs. The specialized banks, created with special mandates to address the financial needs of clients in the agricultural and industrial sectors and used as a means of granting subsidies to these sectors, have been experiencing especially serious structural problems in recent years. While their deposit-taking is relatively small (5 percent of all bank deposits), they provide 17 percent of all bank advances, financed by large borrowings from the central bank. The foreign banks with a stable share of about 7 percent of bank assets in recent years are active principally in international transactions.

Macroeconomic environment for the financial sector in recent years

51. As seen in Table 2, the overall macro economy has on balance provided a relatively stable and favorable environment for financial sector development in recent years. Real GDP

¹Prepared by P. Wade (APD).

Table 1. Regional comparison of indicators on financial sector, saving and investment.

	1993	1994	1995	1996	1997
(In percent of GDP)					
Broad money					
Bangladesh	26.3	27.5	27.8	28.2	28.6
India	52.6	53.9	52.4	54.6	57.5
Nepal	35.0	36.9	37.8	37.6	37.7
Pakistan	44.4	44.7	43.8	43.7	44.0
Sri Lanka	36.1	37.0	38.9	37.6	37.2
Indonesia	43.2	45.4	48.4	52.4	57.0
Malaysia	127.1	127.9	131.5	142.4	144.3
Philippines	32.6	35.9	39.9	40.2	43.4
Singapore	87.1	86.8	84.5	85.6	86.3
Thailand	79.1	77.9	79.0	81.0	78.1
National saving					
Bangladesh	19.7	19.8	19.0	19.5	20.5
India	21.4	22.5	24.9	24.5	22.5
Nepal	15.5	13.9	10.1	12.0	12.8
Pakistan	13.6	15.8	14.5	12.0	11.3
Sri Lanka	20.2	19.1	19.5	19.0	21.4
Indonesia	31.6	29.3	29.0	28.8	29.8
Malaysia	33.0	32.7	33.5	36.6	38.0
Philippines	18.4	19.4	17.8	19.5	21.7
Singapore	45.1	48.9	50.5	51.0	52.7
Thailand	34.9	34.7	33.6	33.7	32.9
Investment					
Bangladesh	19.0	19.6	20.4	20.8	20.9
India	22.2	23.5	26.5	25.7	24.0
Nepal	21.1	21.7	22.9	22.8	24.3
Pakistan	20.7	19.4	18.4	18.8	17.5
Sri Lanka	25.6	27.0	25.7	24.2	24.4
Indonesia	33.2	31.1	31.9	32.1	31.6
Malaysia	37.8	40.4	43.5	41.5	42.8
Philippines	24.0	24.1	22.2	24.2	25.0
Singapore	37.9	32.8	33.7	35.3	37.4
Thailand	39.9	40.3	41.6	41.7	35.0

Source: WEO Reporting System, IMF.

growth has been fairly high (average 5.2 percent) and rising over the period, and exports and workers' remittances from abroad have grown rapidly. This has boosted banking sector liquidity through a steady increase in deposits which have grown faster than nominal GDP. Inflation has been relatively low and the exchange rate fairly stable. Fiscal deficits have been manageable, averaging 4½ percent of GDP, and in general prudence has limited the part of deficit financing coming from the banking system. So far the net impact on the Bangladeshi economy of the current Asian financial crisis has in fact been mildly positive.²

Table 2. Bangladesh: Overview of the Macro-Financial System, 1993/94–1997/98

	1993/94	1994/95	1995/96	1996/97	1997/98
Real GDP growth (percent change)	3.8	5.5	5.0	5.9	5.6
Inflation (percent change)	3.3	8.9	6.6	2.6	7.0
Budget Deficit/GDP (percent)	-4.6	-5.3	-4.5	-4.4	-4.2
M2/GDP (percent)	27.1	27.9	27.7	28.5	28.6
Deposit Growth (percent change)	11.6	15.0	8.2	10.5	10.0
Credit Growth (percent change)	3.0	23.2	20.4	13.2	11.3
Credit to private sector (percent change)	5.1	23.6	22.6	13.7	10.1
Private Credit/Total Credit (percent)	71.6	71.8	73.1	73.4	72.7

Early problems of banking distress

52. Severe banking problems are not a recent phenomenon in Bangladesh, having prevailed for more than a decade in the state-owned banks but by the early 1990s, also in the private domestic banks. The need for overhaul in the banking sector was recognized in the late 1980s leading to implementation of the World Bank supported financial sector reform program (FSRP) from 1989 to 1995. Related policy measures for the financial sector were also important components of an ESAF supported program in the early 1990s. Key reform areas in the FSRP were: interest rate liberalization; abolition of sectorally directed lending; abolition of sectoral refinancing from the central bank; new private sector entry; improving financial management in the state banks; and strengthening banking supervision, supported by technical assistance. Considerable progress was made in moving away from the previous system of direct controls in the banking system as well as in revising loan classification and provisioning criteria, the legal provisions and procedures for enforcing loan recovery, and improving the availability of credit risk information. Notwithstanding this, the commercial banks have remained in severe distress.

²See SM/98/232 for a discussion of the impact of the financial crisis in East Asian countries on the Bangladesh economy.

B. Bank Soundness in Recent Years

53. An assessment of bank soundness looks at the banks' solvency or capital adequacy, the quality of their assets or loan portfolio which is their revenue generating base and the banks' liquidity. This section discusses these factors using selected quantitative indicators such as the share of overdue or nonperforming loans (NPLs) in total bank loans, the adequacy of provisioning against loan losses and capital adequacy.

54. It is shown that by most measures Bangladesh's banking system is unsound and that there has been little improvement in the banking system in recent years. Bank capital and provisioning are highly inadequate in almost all domestic banks; asset quality is very poor and the management and operating environment is unsatisfactory. The high levels of classified loans necessarily adversely affect the banks' earnings and cash flow, and raise concerns about liquidity if deposit growth were to slow down. However, so far liquidity appears sufficient. There has been no sign of withdrawal of funds that could have come from confidence loss. In light of the public knowledge of the distress in the PDBs, this leads one to conclude that the public is applying the assumption of government support for the NCBs also for the PDBs.

55. Given that the foreign banks are generally sound, the analysis focuses in particular on the domestic banks which account for 94 percent of the banking system and in which the problems are concentrated. The main focus is on the NCBs and PDBs and in general excludes the specialized banks whose main funding is not through deposit-taking but rather from government institutions. The empirical data are provided by the BB and are based on the authorities' classification and prudential standards when not specifically indicated otherwise.

Nonperforming loans and provisioning shortfalls

56. The loan classification and loss provisioning criteria in Bangladesh are less rigorous than the international "best practice" standards. However, the gap in these standards as well as those for capital adequacy has been progressively narrowed since 1995 when a revised phased schedule for tightening the classification criteria reaching full international standards by January 1999, was introduced. In 1997, loans were classified as "substandard" when overdue for 9 to below 24 months (international standard: 4-6 months), "doubtful" for 24 to below 36 months (international standard: 7-12 months), and "bad" for 36 months or more (international standard: 13 months or more). The provisioning requirements were for unclassified loans: 1 percent; substandard: 10 percent; doubtful: 50 percent; and bad loans: 100 percent. Only the provision for substandard loans differed from international standards at 20 percent.

57. **The share of nonperforming loans is very high and has been rising over the last two years.** The classified loans ratio for domestic commercial banks increased from 34 to 35 percent in 1995-1997, reflecting a steady rise in the NPL ratio of NCBs to 37 percent

Table 3. Bangladesh: Summary performance indicators in the banking system, 1994 - 1997

	Dec. 1994	Dec. 1995	Dec. 1996	Dec. 1997
	(In percent)			
Classified loans by group of bank 1/	34.8	32.0	31.5	32.7
Domestic banks	36.3	33.9	33.3	34.8
Nationalized commercial banks	32.1	31.0	32.6	36.6
Private domestic banks	44.5	39.4	34.8	31.4
Foreign banks	8.8	5.4	4.7	3.4
<i>Memorandum item: Specialized development banks</i>	...	...	50.9	65.7
Classified loan ratios by debtor 1/				
Public sector	...	24.6	41.3	32.4
Private sector	...	33.1	30.3	32.8
Distribution of classified loans by debtor 2/	...	100.0	100.0	100.0
Public sector	...	9.3	14.7	12.1
Private sector	...	90.7	85.3	87.9
Total classified loans by category 1/ 3/	34.8	32.0	31.5	32.7
Substandard 2/	19.2	13.1	13.4	10.6
Doubtful 2/	17.6	12.4	12.3	15.7
Bad 2/	58.6	69.8	74.3	73.8
Loan market shares 1/	100.0	100.0	100.0	100.0
Domestic banks	94.6	93.6	93.7	93.4
Nationalized commercial banks	62.7	61.9	62.1	61.5
Private domestic banks	32.0	31.7	31.6	31.9
Foreign banks	5.4	6.4	6.3	6.6
Total adjusted classified loans by sector 4/	31.4	25.6	24.8	25.7
Domestic banks	32.8	27.2	26.4	27.5
Nationalized commercial banks	26.5	25.3	26.6	29.9
Private domestic banks	44.2	31.3	26.0	23.0
Foreign banks	8.8	3.5	3.1	1.9
<i>Memorandum item: Specialized development banks</i>	...	...	28.9	55.2
Actual capital in percent of required capital	...	...	80.5	91.8
Domestic commercial banks	...	...	73.5	87.8
Nationalized commercial banks	...	...	69.6	82.9
Private domestic banks	...	...	81.9	98.7
Foreign banks	...	...	180.7	173.4
Actual provisioning in percent of required provisioning	60.3	48.3	53.9	48.6
Domestic banks	59.4	47.0	52.8	47.4
Nationalized commercial banks	67.0	47.2	50.0	45.2
Private domestic banks	45.8	46.6	58.3	52.2
Foreign banks	103.2	112.5	122.4	137.5
Shortfall in capital-cum-provisions in percent of requirement	...	...	36.3	35.5
Domestic banks	...	...	40.1	39.8
Nationalized commercial banks	...	...	43.1	42.8
Private domestic banks	...	...	34.0	33.2
Foreign banks	...	...	-64.2	-65.7
<i>Memorandum item: Specialized development banks</i>	...	...	16.7	16.6
Actual capital adjusted for provisioning shortfall, bn taka	2.4	-4.4	-0.3	-1.7
Domestic banks	0.9	-7.1	-4.3	-7.0
Nationalized commercial banks	3.3	-4.4	-4.0	-6.5
Private domestic banks	-2.4	-2.7	-0.3	-0.5
Foreign banks	1.4	2.7	4.0	5.3
Borrowing from Bangladesh Bank, bn taka				
Nationalized commercial banks	1.5	0.9	1.3	2.2
Private domestic banks	2.3	1.4	2.0	1.6
Foreign banks	0.1	0.0	0.0	0.0
<i>Memorandum item: Specialized development banks</i>	22.4	27.5	33.7	36.3

1/ In percent of total loans.

2/ In percent of classified loans.

3/ Includes overdue agriculture short-term loans of 4.6 and 4.8 percent of all classified loans in 1994 and 1995, respectively.

4/ Adjusted to exclude interest suspense and in percent of total loans excluding interest suspense.

Table 4. Bangladesh: Commercial Bank Loan Classification and Provisioning, 1994-1997

	1994 Dec.	1995 Dec.	1996 Dec.	1997 Dec.
(In billions of taka)				
Total commercial bank loans 1/	262.9	310.3	351.0	395.8
Domestic banks	248.8	290.5	328.8	369.6
Nationalized commercial banks	164.7	192.1	217.9	243.5
Private domestic banks	84.0	98.5	110.9	126.1
Foreign banks	14.1	19.8	22.2	26.2
Total including specialized banks	...	...	435.0	462.3
Specialized development banks 2/	...	...	84.0	66.5
by debtor:				
Public sector	...	37.5	39.4	48.4
Private sector	...	272.7	311.6	347.4
Total adjusted commercial bank loans 4/	249.7	283.5	319.8	358.3
Domestic banks	235.6	264.1	298.0	332.5
Nationalized commercial banks	152.1	177.3	200.3	220.2
Private domestic banks	83.5	86.8	97.7	112.3
Foreign banks	14.1	19.4	21.8	25.8
Total including specialized banks	...	...	377.8	409.2
Specialized development banks	...	...	58.0	50.9
Total classified loans by sector 3/	91.6	99.4	110.5	129.6
Domestic banks	90.3	98.4	109.5	128.7
Nationalized commercial banks	52.9	59.5	70.9	89.1
Private domestic banks	37.4	38.8	38.6	39.6
Foreign banks	1.2	1.1	1.0	0.9
Total including specialized banks	...	...	153.3	173.3
Specialized development banks	...	...	42.8	43.7
Classified loans by debtor				
Public sector	...	9.2	16.3	15.7
Private sector	...	90.2	94.3	113.9
Total classified loans by category 3/	91.6	99.4	110.5	129.6
Substandard 5/	17.6	13.0	14.8	13.7
Doubtful 5/	16.1	12.3	13.6	20.3
Bad 5/	53.7	69.4	82.2	95.6
Memorandum item: interest suspense	13.1	26.8	31.2	37.5
Total adjusted classified loans by sector 4/	78.4	72.6	79.4	92.1
Domestic banks	77.2	71.9	78.7	91.6
Nationalized commercial banks	40.2	44.8	53.3	65.8
Private domestic banks	36.9	27.2	25.4	25.8
Foreign banks	1.2	0.7	0.7	0.5
Total including specialized banks	...	...	96.1	120.2
Specialized development banks	...	...	16.7	28.1
Required provision	40.7	48.0	51.7	60.3
Domestic banks	39.8	47.2	50.9	59.5
Nationalized commercial banks	25.5	30.9	33.6	40.6
Private domestic banks	14.4	16.3	17.3	18.9
Foreign banks	0.8	0.8	0.8	0.8
Total including specialized banks	...	...	68.1	76.4
Specialized development banks	...	...	16.4	16.1
Actual provision	24.5	23.2	27.9	29.3
Domestic banks	23.7	22.2	26.8	28.2
Nationalized commercial banks	17.1	14.6	16.8	18.4
Private domestic banks	6.6	7.6	10.1	9.9
Foreign banks	0.8	0.9	1.0	1.1
Total including specialized banks	...	...	42.0	43.4
Specialized development banks	...	...	14.1	14.1
Provision shortfall	16.2	24.8	23.8	31.0
Domestic banks	16.2	25.0	24.0	31.3
Nationalized commercial banks	8.4	16.3	16.8	22.2
Private domestic banks	7.8	8.7	7.2	9.0
Foreign banks	0.0	-0.1	-0.2	-0.3
Total including specialized banks	...	...	26.2	33.0
Specialized development banks	...	...	2.3	2.0

1/ Excluding staff loans and including agriculture loans (both short-term and medium/long-term). Excludes specialized bank loans. Includes interest suspense, as per authorities' reporting.

2/ Includes BSB, BKB, RAKUB and BSRS, although BSRS data are incomplete. BASIC is classified here as a private commercial bank.

3/ Including classified agriculture short-term loans.

4/ Adjusted to exclude interest suspense.

5/ For 1994 and 1995, excludes overdue agriculture short-term loans. Includes interest suspense, which is not allocated between categories, in official figures.

whereas the PDBs reduced their NPL ratio to 31 percent (Table 3). These ratios as reported by the BB are very high by international comparison. Furthermore, they understate the NPL problem when measured by the more rigorous international standards. Based on June 1997 data (from local audits) and consistent with international classification standards, the World Bank has made preliminary estimates of NPL ratios in the range of 50 percent for all domestic commercial banks. Comparable data from other countries in Asia and Latin America with severe banking distress show average NPL ratios of 20 percent before a banking crisis with the highest NPL ratio being 35 percent. Preliminary NPL estimates from recent international audits of the four NCBs show similar magnitudes which are also expected for the PDBs. Furthermore, NPLs were particularly pervasive in the specialized development banks where the ratio as reported by BB exceeded 65 percent and was rising. Even after excluding the interest suspense, the classified loans ratio for all domestic commercial banks remained high by international comparison—at 25-25½ percent in 1995-1997—and worsened for the NCBs. However, to some extent the increase in the measured NPL ratios in the NCBs in 1995-1997 could reflect the gradual tightening of classification requirements. The sharp increase in loans classified as bad could also partly reflect this.

58. **The concentration of defaulting individual borrowers is very high.** At end-1997, 88 percent of the NPLs were to the private sector and within this group the NPLs were extremely concentrated. In the NCBs the top 20 private sector defaulters (1 percent of their borrowers) accounted for 21 percent of their NPLs in September 1997, and 95 percent of the loans of these defaulters were overdue. The NPLs of the PDBs were even more heavily concentrated: The banks' top 20 private sector defaulters (3 percent of their borrowers) accounted for 47 percent of the NPLs, and 83 percent of their loans were overdue.

59. **A very high proportion of the classified loans is bad with only a low likelihood of recovery.** The expected loan losses are tentatively estimated at about 6 percent of GDP, assuming 80 percent loss on the NPLs. This reflects the large extent of bad loans.

60. **Domestic banks are seriously deficient in loan loss provisions and their provisioning deficiency has been worsening.** Their provisioning shortfalls rose in 1997 to 52½ percent of required provisions (Table 3). These data show that while in recent years the provisioning regulations have progressively approached and are now close to international standards, they are in practice not followed by domestic banks. Since the loan classification standards (which are the basis for calculating required provisions) are less stringent than international practice, estimates based on the latter would show larger provisioning shortfalls.

Capital adequacy

61. **Domestic banks have effectively remained insolvent in recent years with continued deterioration in the NCBs but with modest improvement in the PDBs.** The strained capital position of the NCBs has continued in spite of a substantial recapitalization

Table 5. Bangladesh: Capital Adequacy, 1994-1997

	1994 1/ Dec.	1995 1/ Dec.	1996 Dec.	1997 Dec.
(In billions of taka)				
Total bank assets	344.7	397.1	1919.2	1872.3
Domestic commercial banks	311.9	353.1	1725.4	1670.6
Nationalized commercial banks	219.2	245.9	1491.9	1449.4
Private domestic banks	92.7	107.2	233.5	221.3
Foreign banks	14.0	20.5	60.1	82.5
Specialized development banks	18.8	23.5	133.7	119.1
Risk weighted assets 2/	...	...	434.8	463.3
Domestic commercial banks	...	...	326.8	339.8
Nationalized commercial banks	...	...	229.8	237.0
Private domestic banks	...	...	97.0	102.8
Foreign banks	...	...	21.4	30.3
Specialized development banks	...	...	86.6	93.2
Required capital 2/	...	...	35.9	38.0
Domestic commercial banks	...	...	26.9	27.6
Nationalized commercial banks	...	...	18.4	19.0
Private domestic banks	...	...	8.5	8.7
Foreign banks	...	...	2.1	2.9
Specialized development banks	...	...	7.0	7.5
Actual capital	24.1	26.8	28.9	34.9
Domestic commercial banks	17.1	17.9	19.7	24.3
Nationalized commercial banks	11.7	11.9	12.8	15.7
Private domestic banks	5.4	6.0	6.9	8.6
Foreign banks	1.4	2.6	3.8	5.0
Specialized development banks	5.6	6.3	5.4	5.6
Capital surplus (-) or shortfall (+)	...	...	7.0	3.1
Domestic commercial banks	...	...	7.1	3.4
Nationalized commercial banks	...	...	5.6	3.2
Private domestic banks	...	...	1.5	0.1
Foreign banks	...	...	-1.7	-2.1
Specialized development banks	...	...	1.6	1.9
Provisioning surplus (-) or shortfall (+), bn taka	16.2	24.9	26.2	33.0
Domestic banks	16.2	25.0	24.0	31.3
Nationalized commercial banks	8.4	16.3	16.8	22.2
Private domestic banks	7.8	8.7	7.2	9.0
Foreign banks	0.0	-0.1	-0.2	-0.3
Specialized development banks	...	...	2.3	2.0
Shortfall (+) in capital-cum-provisions, bn taka	18.0	28.2	33.2	36.1
Domestic banks	18.4	29.3	31.1	34.6
Nationalized commercial banks	9.8	19.2	22.4	25.5
Private national banks	8.6	10.1	8.7	9.2
Foreign banks	-0.4	-1.1	-1.9	-2.4
Specialized development banks	...	...	3.9	3.9
(In percent)				
Capital adequacy ratio (CAR)	...	...	6.7	7.5
Domestic commercial banks	...	...	6.0	7.1
Nationalized commercial banks	...	...	5.6	6.6
Private domestic banks	...	...	7.2	8.3
Foreign banks	...	...	17.8	16.7
Specialized development banks	...	...	6.2	6.0
Actual capital in percent of required capital	...	...	80.5	91.8
Domestic commercial banks	...	...	73.5	87.8
Nationalized commercial banks	...	...	69.6	82.9
Private domestic banks	...	...	81.9	98.7
Foreign banks	...	...	180.7	173.4
Specialized development banks	...	...	77.4	74.5

1/ In 1994 and 1995, capital adequacy was defined as 6 percent of bank demand and time deposits, with a minimum capital of Tk 200 million. Bank "assets" reported here are therefore equal to deposits and are lower than a normal definition of total assets (and liabilities) by excluding paid-up capital, reserves and retained earnings.

2/ For 1994 and 1995, official data are not applicable as required capital was derived from a different base and methodology from 1996 onwards.

Table 6. Bangladesh: Overdue Loans, 1995 - 1997 1/

	Dec. 1995	Dec. 1996	Dec. 1997
Domestic commercial banks			
Overdue loans in percent of total loans			
Public sector loans	36.8	41.9	34.9
Private sector loans	34.4	38.8	36.7
Total overdue	34.7	39.1	36.4
Nationalized commercial banks			
Overdue loans in percent of total loans			
Public sector loans	32.5	38.1	32.0
Private sector loans	32.7	40.2	40.4
Total overdue	32.7	39.8	38.9
Private domestic banks			
Overdue loans in percent of total loans			
Public sector loans	70.7	75.0	65.9
Private sector loans	37.6	36.4	30.4
Total overdue	39.2	37.8	31.6
Domestic commercial banks			
Distribution of overdue loans			
Public sector loans	14.1	12.6	12.6
Private sector loans	85.9	87.4	87.4
Total overdue	100.0	100.0	100.0
Nationalized commercial banks			
Distribution of overdue loans			
Public sector loans	17.3	15.1	14.9
Private sector loans	82.7	84.9	85.1
Total overdue	100.0	100.0	100.0
Private domestic banks			
Distribution of overdue loans			
Public sector loans	8.4	7.2	7.0
Private sector loans	91.6	92.8	93.0
Total overdue	100.0	100.0	100.0

1/ BB's definition of overdue loans differs somewhat from its definition of classified loans. The amounts are somewhat higher under the definition of overdue but track each other closely under the two definitions.

Table 7. Bangladesh: Outstanding and Overdue Loans By Economic Sector, 1994 - 1997 1/

Economic Sector	Dec. 1994		Dec. 1995		Dec. 1996		Dec. 1997	
	Overdue	Sector's share of total overdue	Overdue	Sector's share of total overdue	Overdue	Sector's share of total overdue	Overdue	Sector's share of total overdue
	(In percent)							
Agriculture	67.7	27.4	69.1	27.4	73.8	25.0	71.5	23.4
Large and medium Industry	44.0	17.8	43.7	17.3	36.5	13.7	38.0	15.6
Commercial Credit	35.3	41.0	33.4	43.2	36.9	47.5	34.8	49.3
Others	31.2	13.8	24.4	12.1	30.7	13.7	30.1	11.6
Total	41.4	100.0	38.7	100.0	40.8	100.0	39.3	100.0

1/ Defined by BB as a loan where a contractual debt service payment is at least one day overdue.

by the government in the early 1990s (Tk 62 billion or 5 percent of GDP). This was done without fundamental restructuring and hence improvement of their operations.

62. Since 1996, banks have been required to hold (core plus supplementary) capital equivalent to 8 percent of risk-weighted assets, with a minimum capital requirement of Tk 200 million; previously, banks were required to hold 6 percent of total demand and time liabilities (excluding interbank deposits) in paid-up capital and reserves. The current regulations are close to the Basle standard which also requires 8 percent of risk-weighted assets but more stringent weighting and classification of the various asset types. Estimates of domestic banks' actual capital adjusted for provisioning shortfalls show that NCBs and PDBs effectively have remained insolvent (i.e., with negative adjusted capital) since 1995 (Table 3) and that their capital position adjusted for provisioning shortfalls has continued to deteriorate slowly. While these data as reported from BB clearly show the need for a substantial recapitalization of these banks, the true extent of the shortfalls is better estimated based on international standards given the less rigorous auditing and regulatory requirements used in Bangladesh. Such estimates have been made by the World Bank based on June 1997 data.

63. **The potential recapitalization cost of the banks in order to bring capital adequacy and provisions to international standards is estimated at about 6 percent of GDP.** The recapitalization cost was estimated by the World Bank at Tk 71 billion in the case of the NCBs and Tk 34 billion in the case of the PDBs. These estimates are made by measuring capital and provisions against the Basle standard. However, one should note that this standard was designed with the G-10 industrial countries in mind with far more developed financial systems than Bangladesh. In the case of the latter, prudence would advocate aiming over time at an even higher capital requirement in percent of risk weighted assets.

Bank liquidity

64. **The steady growth in deposits, helped by a favorable macroeconomic environment, has provided sufficient liquidity for domestic banks in recent years.** The banks have in general complied with the relatively stringent liquidity reserve requirements which are: five percent of deposits must be held as cash reserves with the central bank and the equivalent of a further 15 percent of deposits must be held as qualifying "secure" assets (either cash or government securities). Consequently, loans are limited to around three-quarters of bank deposits for most deposit money banks. Recourse to central bank credit increased in 1997 but was in general not necessary to meet the liquidity reserve requirements. However, liquidity of the NCBs as a group has at times been very close to the required minimum levels, possibly indicating more pressing liquidity needs for some individual banks.

C. Underlying Reasons for the Bank Soundness Problems

65. Having established the severity of banking distress in Bangladesh, this section identifies the factors that have caused the financial problems and points out areas where reform is needed.

66. The roots of the banking sector problems in Bangladesh go back several decades. Following independence in 1971, the banking sector was nationalized and remained largely government-owned and controlled until the mid-1980s when some liberalization began to occur. The high degree of direct state control in banking activities resulted in nationalized banks not maintaining truly commercial banking practices and skills as well as in inadequate banking supervision. Bank loans were disbursed mainly to the publicly-directed sectors without proper commercial consideration, the internal control and account systems of the banks were weak, and the quality of bank assets was not evaluated on strict accounting principles. In these circumstances, NPLs in the banking system rose dramatically.

67. The persistence of the banking soundness problems stems from the lack of political will so far to address squarely their root causes rather than the weaknesses in the regulatory and supervisory system which have been progressively reduced over time. The government seems to have been deterred by the perceived political and economic strength of key stakeholders (including major defaulters) and, if weak banks were closed, fear of possibly triggering a run on the banks and losing public support.

68. The factors behind the banking sector's problems can be addressed in terms of the three key elements of a sound banking system: (a) the regulatory and supervisory system; (b) bank management and corporate governance; and (c) the legal and court system.

Problems and weaknesses in the regulatory and supervisory system

69. **The central bank, Bangladesh Bank, is constrained by lack of authority and autonomy regarding enforcement of regulatory standards, automatic lending to government and directed lending to priority sectors.** While a number of prudential regulations such as loan classification, provisioning requirements and capital adequacy are now coming close to international standards, the key problem is weak and inadequate enforcement of these regulations. This is illustrated by the emergence of severe banking soundness problems in the PDBs following their rapid entry and credit expansion. This took place without adequate and timely strengthening of bank supervision capacity, of the legal and regulatory framework and of the enforcement of prudential standards. Other areas of weakness are the lack of transparency, the accounting base as well as the prudential regulations on credit exposure to individual borrowers and their enforcement.

70. In reality almost two thirds of the banking system (the NCBs) are not fully under the regulatory oversight and hence the legal authority of the BB. While being monitored by the

Ministry of Finance, the NCBs are subject to priorities set by the government that may differ from prudential concerns. Furthermore, the BB lacks functional focus, its financial conditions are weak and the staff's professional skills are inadequate. This partly reflects the effect of strong and militant unions interfering in personnel, recruitment and promotion decisions.

71. An additional problem area is the deposit insurance system which BB administers. This insurance system is grossly under funded compared to its legal obligation of coverage. This implies a substantial contingent fiscal liability or similarly, quasi fiscal costs associated with BB bailing out banks in the event of a liquidity crisis.

Problems and weaknesses in bank management

72. **Common to all domestic commercial banks is weak corporate governance.** There is a general lack of transparency and accountability and disclosure standards are inadequate. There has been no effective and transparent process for holding the incumbents responsible for their performance. The important role of independent bank auditors for good governance has been neglected, and the accounting base, wanting in transparency and credibility, is not fully adequate to ensure that the actual classification of loans reflects the true quality of the assets. Furthermore, concentration of NPLs on individual borrowers is very high, reflecting the banks' lack of a prudent credit policy.

Nature of problems in the nationalized commercial banks (NCBs)

73. **The government through the Ministry of Finance interferes implicitly and explicitly in the internal management and operational matters of the NCBs.** Political interference is seen in the selection of Directors to their Boards; the composition of their management teams; and in their loan portfolios. The latter reflects political pressure for lending to SOEs—even long-time defaulting ones—or preferred sectors such as agriculture with extraordinarily high NPL ratios. As a result, these banks are vulnerable to their lending exposure in agriculture (Table 7). Nevertheless, a large share of the loan portfolio of poor quality is to the rest of the private sector. This partly reflects lack of competent bank staff which has led to poor assessment of credit risk, poor project selection and lack of assistance on corporate debt workouts. The banks' professional competence and operational efficiency have been impaired by strong and militant unions who are increasingly politicized and who interfere in management and personnel decisions. The NCBs are over staffed and the number of branches is excessive as reflected in a number of branches running losses for many years. Another problem for these banks is that the government on several occasions has announced loan amnesties to various categories of private sector borrowers without reimbursement to the affected banks in a transparent manner. Beyond their direct impact on the banks these actions have also undermined the financial discipline in the banking sector.

Nature of problems in the private domestic banks (PDBs)

74. **Weak governance and lack of firm supervision are key issues in the case of the PDBs.** The financial strength of these banks has been severely weakened by insider lending, fraud and negligence, including involvement by directors, managers and owners. This has not been sufficiently deterred by the regulatory, supervisory and legal system although seven PDBs are now under enhanced monitoring by the BB. They have signed Memoranda of Undertaking with the BB which require certain corrective measures. However, there have been no punitive measures for non compliance. The NPLs to borrowers with genuine financial problems reflect to some extent the rapid credit expansion after deregulation.

75. **The NPLs of the PDBs are excessively concentrated in a small number of big private borrowers; and the concentration has worsened in recent years.** This reflects poor risk management and breach of regulations on individual lending limits.

76. Part of the current NPL problems of the PDBs is a carryover from the 1980s. Out of the currently 18 PDBs, three were previously NCBs that were partly or fully privatized in the 1980s without recapitalizing for the bad public sector debt, leaving a weak capital base.

Legal framework and court system

77. The third weak element in the banking system is the legislation affecting the financial system as well as the court system. The legal framework and the court system are not adequate to guarantee their disciplinary function; i.e., enforcing lenders' recourse on borrowers including SOEs: (i) Effective measures cannot be implemented in a timely manner. The court process for default cases is long and protracted with opportunities for defaulters to take advantage of loopholes in the laws or to successfully block banks' suits in court. As a result a very low share of cases under litigation is being settled. (ii) Over recent years, a number of laws have been identified as needing strengthening to enhance BB enforcement power as well as to close existing loopholes and strengthen the position of creditors. The authorities have been making progress in this area recently.

D. Issues Arising from the Weaknesses in the Banking System

Costs

78. **As seen in many countries, severe banking sector distress has a negative impact on savings and investment.** The lower investment levels translate into a cost to the economy in the sense of lost economic growth that comes from (i) reducing available resources in the financial system, and (ii) misallocation of existing resources. The impact on savings and investment is reflected in the relatively low degree of financial intermediation (measured as the ratio of deposits to GDP) compared to other countries in the region (Table 1).

(i) Both savings and lending volumes have been depressed due to the high spread between bank lending and deposit interest rates (over 7 percentage points) as a result of the very high incidence of NPLs. Real lending rates have remained high (9–12 percent since 1990). The severity and persistence of banking distress may also have dampened the growth in bank deposits by weakening the public's confidence in the banking sector to some extent.

(ii) The quality of resource allocation is worse in a less efficient financial sector resulting in lower returns on investment. This aspect is reflected in the high NPL ratios, at least on defaulters with genuine economic problems. Regarding fraudulent defaulters, the loss to the Bangladeshi economy is somewhat less than that of the banks since some of the funds are invested in the domestic—probably mainly in the informal—economy or abroad.

79. The costs discussed here have already taken place but continue to accumulate in the absence of decisive reforms. The dampening effect of banking distress on investment and economic growth gives reason to question the authorities' expectations of high and accelerating rates of economic growth if fundamental reforms were not to be undertaken.

80. **The bank soundness problems have led to considerable contingent fiscal liabilities.** The state owned part of the banking sector has been running a substantial quasi-fiscal deficit by accumulating large losses on NPLs, eroding the banks' capital. To the extent that PDBs will not be allowed to fail, the government may have to support these banks as well in a liquidity crisis. In either case this implies the realization of considerable contingent fiscal liabilities since recapitalization will be necessary. Potential fiscal costs of a new round of recapitalization have kept increasing and they will continue to do so in the absence of decisive reforms addressing the root problems in the banking sector.

Stability of the system: liquidity risks

81. In light of the severity of banking sector problems in Bangladesh compared to other countries in the region where full blown financial sector crises have been triggered, it is natural to ask why this has not happened in Bangladesh. The answers are manifold.

82. As noted, over the last five years the macroeconomic environment has been favorable for the banking sector. Sustained and rapid increases in real GDP and exports have provided for a steady increase in deposits, absorbing fairly easily the liquidity drain from the NPLs.

83. Reflecting the closed capital account, foreign exchange exposure of banks and of corporate borrowers is much less than in the crisis affected countries. This gives more room for maneuver in a crisis since as a last resort, substantial liquidity injection to troubled banks would help to ride over the storm. Although this would affect inflation and the exchange rate, the exchange rate impact on corporations' (and banks') balance sheets would effectively be contained to a much larger extent than in the Asian crisis countries (Table 8). Also reflecting the relatively closed capital account, capital inflows and outflows have so far had limited

Table 8. Bangladesh: Vulnerability Indicators, 1992/93 - 1997/98
(in percent of GDP, unless otherwise indicated)

	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98
Official risk indicators 1/						
Share of nonperforming loans (as percent of total loans) 1/	...	...	34.8	32.0	31.5	32.8
Nationalized commercial banks	...	...	32.1	31.0	32.6	36.6
Domestic private banks	...	...	44.5	39.4	34.8	31.4
Risk-based capital asset ratio (capital over risk-weighted assets) 2/	...	...	...	...	6.7	7.5
Nationalized commercial banks	...	...	...	...	5.6	6.6
Domestic private banks	...	...	...	...	7.2	8.3
Specialized banks	...	...	...	...	1.6	1.9
Foreign banks	...	...	...	...	17.8	16.5
Financial sector risk indicators						
Public sector debt	80.4	87.1	83.2	74.8	74.1	75.0
Broad money (percent change, 12-months basis)	11.4	14.6	16.0	8.2	10.8	10.1
Private sector credit (percent change, 12 months basis)	11.3	5.1	26.7	19.2	12.1	13.0
Share of deposits in broad money	85.9	85.1	84.4	84.4	85.0	85.4
Share of foreign currency deposits in total deposits	...	...	...	...	0.7	0.9
Share of foreign exchange loans in total loans	--	--	--	--	--	--
Share of private credit collateralized by immovable property, plant, and machinery 3/	39.5	42.6	41.0	41.2	40.6	36.7
Share of housing and property development in private credit 3/	24.4	26.1	24.5	24.4	23.8	21.7
Credit to housing and property development in percent of GDP 3/	5.1	5.2	5.1	5.5	5.6	5.2
Market assessment indicators						
Stock market index (1986/87=100)	136	190	260	246	580	344
Share price index of financial institutions (1986/87=100)	147	162	190	221	352	236
External indicators						
Foreign currency exposure of commercial banks 4/	...	...	...	...	44	50
Gross official reserves (as percent of imports of goods and services)	45.3	56.8	45.5	26.1	21.9	21.4
Net official international reserves (as percent of broad money)	17.8	22.7	21.0	11.8	9.9	9.7
Short-term debt	0.6	0.5	0.5	0.5	0.4	0.4
Short-term debt (as percent of net official international reserves)	13.6	8.5	9.0	14.3	15.9	16.8

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

1/ Measured at the authorities' classification standards. Based on the more stringent international standards, nonperforming loan ratios would be higher.

2/ The ratios do not take into account loan loss provisioning shortfalls. Prior to 1995/96 capital adequacy was not defined in terms of risk-weighted assets and hence the data are not comparable for the earlier years.

3/ Based on quarterly survey of loans and advances of commercial banks.

4/ Foreign currency liabilities as percent of foreign currency assets.

impact on domestic asset prices with the exception of a short-lived boom and bust cycle on the stock exchange in 1996 driven by foreign portfolio investments. One has not seen the type of real estate asset price bubble as in the Asian crisis countries, reflecting the much lower bank lending to the real estate sector in Bangladesh (as a share of the total economy).

84. So far the public's confidence in the banks' ability to honor their deposit liabilities seems to have remained fairly intact. There have been only modest signs of "flight to quality", inter alia, shifting deposits from domestic banks to foreign banks (which may also reflect differences in perceived quality of services by the foreign banks) or switching to other assets. On the other hand, one should note the substantial unidentified net outflows in recent years classified under Errors and Omissions in the balance of payments. These are usually associated with heavy discounts of merchandise exports and payments for smuggled imports but could indicate to some extent circumvention of capital controls. The public complacency reflects the belief of an implicit government guarantee to bail out weak banks.

85. However, one should not ignore the possible downside risks which include slower economic growth or even a decline in real GDP. This could come from negative impulses from the external environment (exports and workers' remittances) or from setbacks in agricultural production, being vulnerable to inter alia floods. In addition, one cannot discard the possibility of some capital flight by circumventing restrictions on capital transactions.

SOE debt as part of the banks' NPL problems

86. Resolution of the comprehensive nexus of problems related to the banking distress requires restructuring in the corporate sector as well as in the banks. Restructuring of corporations' debt and operations is necessary both for private and public enterprises. The government can primarily deal with the public enterprises whose overdue loans at end-1997 amounted to 12½ percent and 15 percent of overdue loans of all domestic banks and NCBs, respectively. Resolving the SOEs' debt problems and strengthening banks' balance sheets requires a reduction in the current debt overhang. To be sustainable, the solution also needs to address adequately the ongoing flow problem. This implies reforming the SOEs, giving the NCBs autonomy with regard to decisions about lending to SOEs, and allowing the NCBs to take recourse to legal means to recover debts with the SOEs. The debt resolution for the SOEs should be dealt with in the process of restructuring the enterprises and preparing a selected group for privatization, in particular commercial SOEs. The Government expects to assume their long-term debt before privatization, thereby reducing banks' problem loans.

E. Recent Policy Measures

87. The government has made efforts in recent years, albeit at a gradualist pace, to resolve the problems in the banking sector but additional reforms are needed.

88. With regard to the **regulatory framework**; the authorities have gradually brought the national standards for classification, loan loss provisioning and capital adequacy close to the international standards. This five year convergence process will be fully completed in January 1999. Efforts have been made to strengthen **bank supervision** of the weakest private banks, by inter alia establishing a separate "Problem Banks Department" in the BB and dedicating more resources to bank supervision. Seven PDBs with the most severe financial distress have been put under special surveillance as "problem banks", each with memoranda of undertaking containing specific, time bound improvement commitments, and central bank observers placed on their boards of directors. Supervision of the NCBs is being intensified with the current audits done by international accounting firms. The government has largely endorsed enhanced autonomy for the central bank but still with some caveats.

89. Some progress has been seen on addressing **corporate governance** of the banks: lending to SOEs in the jute and textile sectors was incorporated explicitly in the 1998/99 budget, and the BB has started to oppose politically directed lending for non-viable projects. The government's ability to issue instructions to banks has also been weakened.

90. With regard to the **legal framework**, debt recovery and bankruptcy laws have been enacted; the Banking Companies Act has been amended to enable the removal of bank directors in cases of defaults and insolvency; and amendments have been or are being drafted to laws covering the Bangladesh Bank, NBCs, transfer of property, deposit insurance, negotiable instruments, money loan courts and security of loans. In order to strengthen the **judicial system** and facilitate loan recoveries, two new bankruptcy courts and five financial loan courts have been established. Firm court action has been taken on some major defaulters.

91. The government launched a comprehensive **loan recovery** drive in 1997 resulting in some reduction in public sector NPLs. However, at the same time the extent of private sector NPLs worsened. The government has also started a debate in public on the banking sector problems, and has made public the names of notorious defaulters. It is building public awareness that could help muster sufficient political support for comprehensive reforms.

92. However, while these efforts go in the right direction, they have not resulted in any significant improvement in banks' balance sheets. Even in the favorable macroeconomic environment in recent years public banks in particular have failed to improve the quality of their assets. The pace of reform has not been commensurate with the severity of the situation and further reforms in a timely fashion are essential.

F. Areas for Attention in the Future

93. The authority and autonomy of **Bangladesh Bank** needs to be strengthened, including limiting the government's automatic access to central bank credit and halting central bank lending to specialized banks. BB's regulatory oversight and supervision should be enhanced further and its supervisory and regulatory mandate expanded to cover the NCBs fully. Its

professional skills should be strengthened by possibly establishing a salary structure separate from the general civil service. Also its capital base should be strengthened. Better monitoring of the commercial banks' soundness also requires a more credible and transparent accounting base and the enforcement of more stringent disclosure standards. The deposit insurance system, administered by BB, needs a substantial strengthening of funding and should be separated from the central bank as a separate entity.

94. **Reforms concerning the NCBs** would include shielding them from government interference, such as politically directed lending for non credit worthy projects, and making their Boards and management autonomous. A medium-term restructuring strategy should also include branch and staff rationalization, recapitalization and possibly privatization.

95. **Strengthening the PDBs** would require tougher enforcement and judicial action to address the problem of weak governance. The PDBs should be required to undertake audits by reputable international auditors since such an objective analysis would facilitate building political consensus on the restructuring strategy for these banks. Components of such a strategy could include: (i) keeping the pressure on the banks to rebuild their capital to the required levels, to meet classification and provisioning standards, and to undertake fundamental restructuring; (ii) introduce legislation to reduce the concentration of loans to individual parties and to eliminate insider lending; and (iii) remove directors and managers in case of defaults and insolvency.

96. Continued improvements should be made in **the legal framework and the court system** aiming at strengthening BB's regulatory and supervisory role, speeding up the court process, making loan recovery more effective and strengthening financial discipline.

G. Concluding Remarks

97. The current distress in the banking system in Bangladesh is a major impediment to more rapid and sustainable economic growth. Efforts in recent years to improve the situation have so far not resulted in any significant improvement in banks' balance sheets. The pace of reform has not been commensurate with the severity of the situation and further reforms in a timely fashion are essential. If no major reform initiatives are taken, the costs to the economy of an increasingly impaired financial system will continue to grow, and the prevailing situation will not be compatible with the authorities' expectations for raising economic growth rates over the medium term. However, the current syndrome of low efficiency and a heavy burden of bad loans in the banking system could possibly go on for sometime without triggering a liquidity crisis. On the other hand, there are risk factors that could put the system under severe liquidity strain, such as a deterioration in the external environment or slowdown in economic growth with subsequent dampening in deposit growth. In order to get onto a medium-term path of high and sustainable economic growth implementation of comprehensive structural reforms with a central role for financial sector reforms, is essential.

IV. EXPORT PERFORMANCE AND PROSPECTS¹

98. Significant progress was made in liberalizing the trade regime in Bangladesh since the late 1980s.² The number of quantitative restrictions (QRs) declined from 574 lines in 1989/90³ to 109 in 1993/94. By 1997/98, trade related QRs remained only on about 30 lines (or 12 groups) mainly on food and textiles to protect domestic industries. In line with the liberalization, the openness index of Bangladesh rose from 18 percent in mid-1980s to about 27 percent by mid-1990s (Table 1). Nevertheless, Bangladesh still remains one of the most closed economies in the Asian region.

99. Parallel to this development is the mixed success of the export sector. Although export performance improved over the last decade, it was accompanied by high export concentration in ready-made garments (RMG) and knitwear. By 1997/98, Bangladesh was heavily dependent on RMG and knitwear exports, which accounted for more than 73 percent of total exports (Table 2). Not only is Bangladesh now more vulnerable to shocks in the world garment industry, but also, it seems very likely that it would have to depend even more on the garment sector in the near future as progress in the non-garment export sector has been negligible so far. Such a prospect is worrisome as Bangladesh may face greater competition in garment exports from neighboring economies as they emerge from the recent crisis.

100. After a brief overview of export performance in Bangladesh, this note describes export promotion schemes, policies that created anti-export bias, factors that contributed to the increased concentration in the garment sector, and then, in light of these discussions, examines future prospects of export performance in Bangladesh and suggests policy responses.

A. Export Performance

101. With the adoption of Export-oriented growth strategy in the late 1980s, Bangladesh endeavored to increase its exports as well as diversify the export base. Some progress was made. Its exports as percent of GDP rose from less than 5 percent in mid-1980s to above 10 percent in mid-1990s (Table 3). Nevertheless, compared with other Asian countries, export performance has been weak and its exports as a percent of GDP still remain among the

¹Prepared by I. Lee (PDR).

²For progress under a program supported by the ESAF arrangement, see Appendix II, Trade Liberalization in IMF-Supported Programs, World Economic and Financial Surveys, IMF (1998).

³Tariff lines are at the four-digit level in the Harmonized System totaling 1,239.

Table 1. Cross-Country Comparison of Openness to Trade, 1975-1997 1/
(In percent)

	1975-77	1985-87	1995-97	Change
	A	B	C	C-A
Bangladesh	14.1	17.8	27.3	13.2
India	12.1	11.5	22.5	10.4
Indonesia	34.8	35.2	46.5	11.7
Korea	55.2	59.4	58.6	3.3
Malaysia	74.1	88.5	156.2	82.0
Philippines	37.9	34.1	65.3	27.4
Sri Lanka	29.2	52.8	69.1	39.9
Thailand	38.3	42.1	73.6	35.3
Asian NICs	93.0	102.0	113.6	20.7
World	28.0	28.3	35.5	7.5

Source: World Economic Outlook, IMF.

1/ Merchandise exports and imports divided by GDP.

Table 2: Bangladesh: Exports by Commodity, 1987/88-1997/98

	1987/88	1990/91	1993/94	1994/95	1995/96	1996/97	1997/98
(In millions of U.S. dollars)							
Raw jute	81	104	57	79	91	116	107
Jute goods (excl. carpets)	302	285	272	310	325	313	282
Tea	39	43	38	33	33	38	48
Leather and leather products	147	134	168	202	212	195	190
Frozen shrimps and fish	140	142	211	306	314	300	296
Ready-made garments	434	736	1,292	1,839	1,949	2,238	2,844
Knitwear and hosiery products	0	131	264	393	598	763	937
Naphtha, furnace oil and bitumen	12	32	16	14	11	16	11
Chemical Products (fertilizers)	38	36	51	91	95	104	91
Agricultural Products	20	22	0	0	26	0	0
Other exports	19	51	165	206	230	312	367
Total exports	1,231	1,718	2,534	3,473	3,882	4,418	5,172
of which: RMG & knitwear	434	867	1,556	2,232	2,547	3,001	3,781
Non-garment exports	797	851	978	1,241	1,335	1,417	1,391
(As percent of total)							
Total exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Raw jute	6.5	6.1	2.3	2.3	2.3	2.6	2.1
Jute goods (excl. carpets)	24.6	16.6	10.7	8.9	8.4	7.1	5.4
Tea	3.2	2.5	1.5	1.0	0.9	0.9	0.9
Leather and leather products	12.0	7.8	6.6	5.8	5.5	4.4	3.7
Frozen shrimp and fish	11.3	8.3	8.3	8.8	8.1	7.2	5.7
Ready-made garments	35.2	42.8	51.0	53.0	50.2	50.7	55.0
Knitwear and hosiery product	0.0	7.6	10.4	11.3	15.4	17.3	18.1
Naphtha, furnace oil and bitumen	1.0	1.9	0.6	0.4	0.3	0.4	0.2
Chemical Products (fertilizers)	3.1	2.1	2.0	2.6	2.4	2.4	1.8
Agricultural Products	1.6	1.3	0.0	0.0	0.7	0.0	0.0
Other exports 2/	1.6	3.0	6.5	5.9	5.9	7.1	7.1
Memorandum items:							
Garments (RMG + knitwear/hosiery)	35.2	50.5	61.4	64.3	65.6	67.9	73.1

Sources: Bangladesh Bank and Fund staff estimates.

Table 3. Cross-Country Comparison of Export Performance, 1975-1997

	1975-77	1985-87	1995-97	Change
	A	B	C	C-A
(As percent of world export)				
Bangladesh	0.04	0.05	0.08	0.04
India	0.57	0.47	0.63	0.06
Indonesia	0.88	0.79	0.97	0.09
Korea	0.77	1.66	2.51	1.74
Malaysia	0.52	0.73	1.44	0.93
Philippines	0.27	0.24	0.40	0.14
Sri Lanka	0.07	0.06	0.08	0.01
Thailand	0.29	0.43	1.07	0.78
Asian NICs	2.98	6.45	10.55	7.58
World	100.00	100.00	100.00	
(As percent of national GDP)				
Bangladesh	3.60	4.91	10.30	6.70
India	6.21	4.40	9.37	3.16
Indonesia	19.70	19.39	23.91	4.21
Korea	25.76	31.27	28.48	2.72
Malaysia	41.45	51.18	79.45	37.99
Philippines	15.35	16.17	26.14	10.79
Sri Lanka	15.88	20.69	29.39	13.50
Thailand	17.47	20.51	33.38	15.91
Asian NICs	43.80	54.39	56.29	12.49
World	14.11	14.18	17.88	3.77

Sources: World Economic Outlook, IMF.

lowest in the Asian countries. Its share of total world exports also remains very low, at 0.08 percent.

102. Export concentration was particularly severe with RMG exports contributing to 62 percent of cumulative export growth between 1988/89-1997/98 (Table 4). Taken together with exports of knitwear and hosiery products, the garment industry as a whole has contributed for more than 84 percent of cumulative growth in Bangladesh's exports. All traditional exports, such as raw jute and jute products, leather and leather products have remained stagnant in value terms during this period. As a result, RMG and knitwear in 1997/98 accounted for more than 72 percent of total exports, with raw jute and jute products and frozen shrimp and fish each accounting for only 8 percent of the total (Chart I).

B. Pro-Export Schemes

103. Streamlining the export regime started in the early 1970s with the introduction of the Duty Drawback Scheme. Since then, in an attempt to offset the anti-export bias created by the trade regime, the government established other export promotion schemes such as the Special Bonded Warehouses (SBWs) and the Export Promotion Bureau (EPB). However, these schemes have mainly benefitted the RMG sector to date and appear to have been successful for that sector.

Duty Drawback Scheme

104. The Duty Drawback Scheme was instituted as early as in 1970. In 1981, the Drawback at Flat Rate Scheme was introduced, by which refunds on duties and taxes were granted according to a preset schedule. In 1988, the Duty Exemption and Drawback Office (DEDO) was established to consolidate import-policy related and technical tasks on imports for export production. In 1988, DEDO was extended to cover also indirect exporters. Flat rates have been calculated on more than 700 items and are being updated, often taking the form of splitting existing rates to accommodate different product specifications. However, this scheme, which is used by direct and indirect exporters, has not been as successful as the duty suspension provided by the Special Bonded Warehouses.

Special Bonded Warehouses

105. The SBWs were established and monitored through the use of import and export passbooks and pre-tabulated input-output system (physical coefficients such as the fabric-garment conversion factor to check physical inventory of fabric which are calculated by the BGMEA, a private association of garment exporters). It allows exporters to import and stock inputs duty free. This scheme is used mainly by garment exporters. Until August 1993, SBWs were only available to 100 percent exporters in the garment industry using back-to-back L/Cs, and to suppliers of inputs (zippers and buttons) that sell 100 percent of their output to garment exporters. In August 1993, SBW status was extended to all 100 percent exporters and "deemed exporters." The National Board of Revenue, however, has resisted

Chart I. Bangladesh: Exports by Commodity

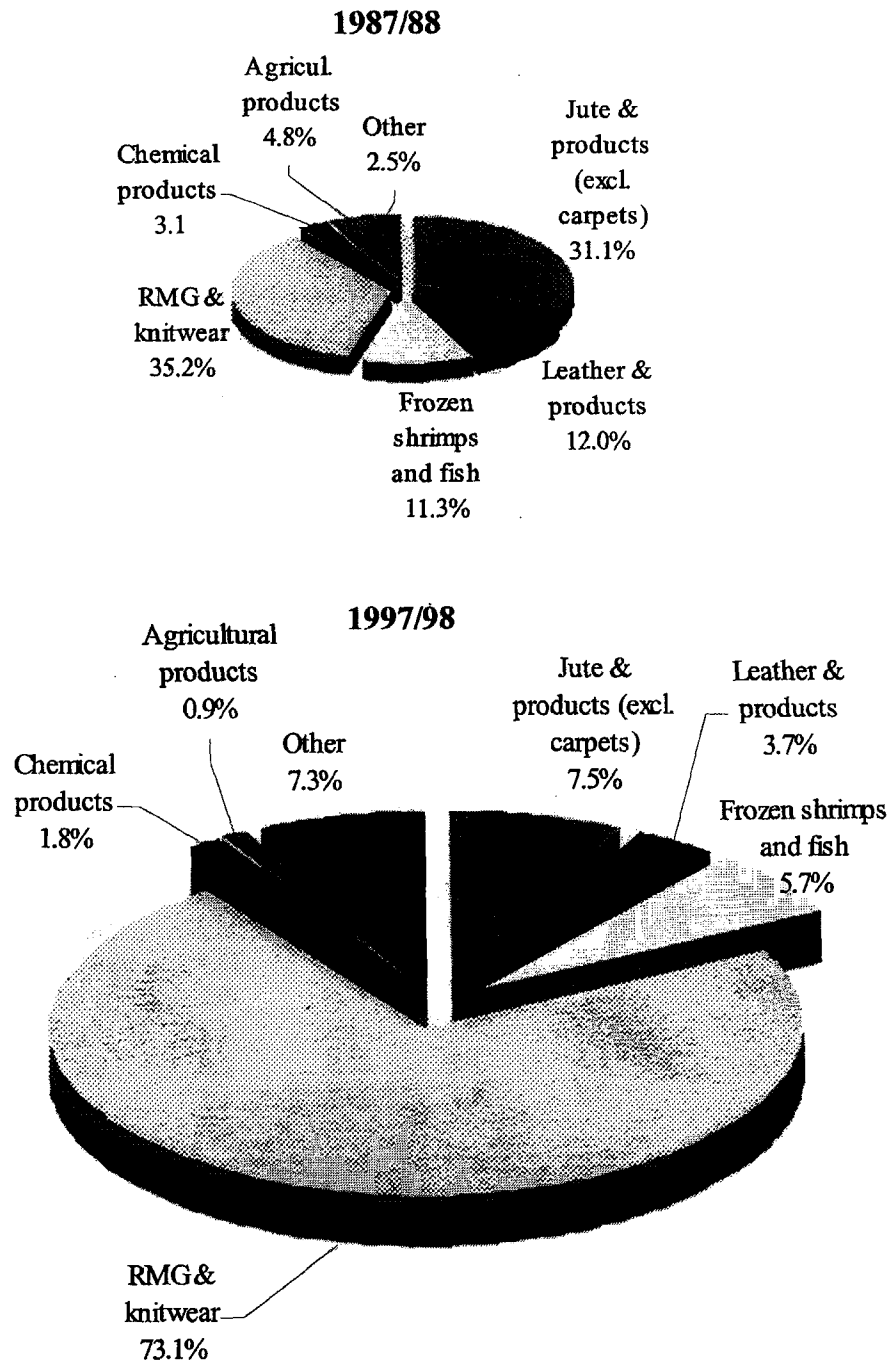


Table 4. Bangladesh: Contribution to Export Growth by Commodity, 1988/89-1997/98
(In millions of U.S. dollars)

	1988/89	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	Cumulative 1988/89-97/98
(Change as percent of previous year's total exports)								
Raw jute	1.4	-0.6	-0.7	0.9	0.3	0.7	-0.2	1.4
Jute goods (excl. carpets)	-1.8	-0.5	-0.5	1.5	0.4	-0.3	-0.7	-0.5
Tea	0.1	0.4	-0.1	-0.2	0.0	0.1	0.2	0.1
Leather and leather products	-0.8	0.2	0.9	1.3	0.3	-0.4	-0.1	2.2
Frozen shrimps and fish	0.1	1.9	1.9	3.8	0.2	-0.4	-0.1	6.6
Ready-made garments	3.0	8.9	2.1	21.6	3.2	7.4	13.7	98.1
Knitwear and hosiery products	0.0	4.3	2.5	5.1	5.9	4.2	3.9	34.0
Naphtha, furnace oil and bitumen	0.3	1.4	-0.9	-0.1	-0.1	0.1	-0.1	0.4
Chemical Products (fertilizers)	2.0	1.5	0.0	1.6	0.1	0.2	-0.3	2.1
Agricultural Products	0.1	0.4	-1.3	0.0	0.7	-0.7	0.0	-0.6
Other exports	0.1	1.6	2.5	1.6	0.7	2.1	1.2	13.3
Total exports	4.4	19.5	6.3	37.1	11.8	13.2	17.5	157.2
(Share of contribution to overall growth)								
Raw jute	30.6	-2.9	-11.5	2.3	2.9	4.9	-1.2	0.9
Jute goods (excl. carpets)	-41.2	-2.4	-8.0	4.1	3.6	-2.2	-4.1	-0.3
Tea	1.6	2.2	-2.0	-0.6	0.0	0.9	1.3	0.1
Leather and leather products	-18.6	0.9	13.4	3.6	2.4	-3.2	-0.7	1.4
Frozen shrimps and fish	3.2	9.7	29.9	10.2	1.9	-2.7	-0.6	4.2
Ready-made garments	67.9	45.4	33.9	58.3	26.8	56.2	78.2	62.4
Knitwear and hosiery products	0.0	22.1	39.5	13.7	50.1	32.1	22.4	21.7
Naphtha, furnace oil and bitumen	7.4	7.3	-13.9	-0.2	-0.8	1.1	-0.7	0.3
Chemical Products (fertilizers)	44.5	7.7	0.1	4.2	0.9	1.8	-1.7	1.3
Agricultural Products	1.8	1.9	-20.8	0.0	6.4	-5.1	0.0	-0.4
Other exports	2.8	8.2	39.3	4.3	5.8	16.1	7.0	8.4
Total exports	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources: Bangladesh Bank and Fund staff estimates.

promoting the use of SBWs mainly due to the lack of monitoring system to control non-garment SBW users. More recently, some leather, toy and jewelry exporters have started using the SBWs.

Export Processing Zones (EPZs)

106. The EPZs were established (first in Chittagong in 1984) by the Bangladesh Export Processing Zone Authority (BEPZA) to attract foreign investments. Both foreign and local enterprises could set up factories exempt from customs duties and import restrictions. The second EPZ was set up in Dhaka in 1993. EPZ producers import raw materials, supplies and capital goods free of duty, retain foreign currency earnings, operate in a labor market free of unions, and are exempt from income tax for the first 10 years after opening (see Box 1). Products made in EPZs include garments, knitwear, textiles, metal products, electrical goods, footwear and leather, and sporting goods. A number of Hong Kong and Korean companies are based in the EPZs to produce fabrics that are sold to domestic manufactures of exportable garments as well as to other EPZ garment manufacturers. Total investment in Chittagong amounts to about \$150 million, representing 52 operating projects of which 31 are 100 percent foreign owned.

Box 1. Bangladesh: Taxes on Exporters

- ▣ **Corporate income tax:** Non-publicly traded companies—40 percent; publicly traded companies—35 percent.
- ▣ **Tax rebate:** Exporters have a tax rebate of 50 percent of the amount of income tax attributable to sales of nontraditional exports.
- ▣ **Tax holiday:** For undertakings set up before July 1995, tax holidays range from 5–12 years. Ten percent of the exempted income must be invested within 9 months of the end of the tax year in government bonds or securities. 30 percent of the exempted income must be invested within 2 years of the end of the exemption period in the same undertaking, in any new industrial undertaking, in stocks and shares of a public company, or in government bonds or securities. For undertakings set up after July 1, 1995, tax holidays range between 5-7 years. Same 30 percent rule applies.
- ▣ **Depreciation allowance:** Standard depreciation allowances are 10 percent for general buildings, and 20 percent for factory buildings.
- ▣ **Withholding of tax:** The rate for imports is 2.5 percent and 0.25 percent on exports.
- ▣ **Export duty:** Effective rates of export duty on all commodities are zero.
- ▣ **Value-added tax:** Tax on exports is zero-rated.

Export Promotion Bureau

107. The EPB was set up in 1978 to assist firms in identifying export markets by providing trade information and technical services. It has spent a large amount of its efforts monitoring the quotas on garments until this function was transferred to the BGMEA. The EPB now concentrates more on making arrangements for export fairs. It also provides a small amount of venture capital financing to exporters and sponsors display centers at foreign trade fairs.

Cash Incentive Scheme

108. The Bangladesh Bank administers a cash incentive scheme for the RMG sector that provides a limited amount of subsidies to garment exporters if the garments are manufactured by 100 percent local inputs, both locally manufactured using 100 percent local raw materials or duty-paid imported raw materials.

C. Anti-Export Bias and Constraints to Exports

109. Import substitution policies, which were established to foster and protect domestic industries, have created anti-export bias that was only partially offset by the various export promoting schemes. These policies include the high tariffs and various quantitative restrictions. In addition, export performance was constrained by lack of trade financing from the local banking system.

Tariffs

110. High tariff rates in the late 1980s resulted in significant protection of domestic industries. The unweighted average nominal protection rate in 1990/91 was 89 percent, and dispersion, measured by the coefficient of variation, was 59 percent. Trade liberalization in the 1990s led to a decline in the nominal effective protection rate to 25 percent in 1995/96, and the import weighted tariff rate to 21 percent. The dispersion increased in 1995/96 because the reduction of the average rate was achieved through the lowering of the low rates rather than high rates.

111. Consequently, the **effective protection rate (ERP)** for manufacturing as a whole was as high as 82 percent in 1992. High ERPs were found in textiles and engineering, and some consumer goods sub-sectors, all of which sell the bulk of their output to the domestic market (Table 5).

112. High output tariffs, coupled with low tariffs on inputs (as a result of export-promotion incentives) resulted in even higher protection. These were reflected in much higher domestic prices, e.g., output of public sector cotton mills were 51 percent higher than that of imported yarn of similar quality (40 count cotton yarn).

Table 5. Bangladesh: Effective Rate of Protection, 1992 and 1995 1/
(In percent)

	1992 ERPs	1995 ERPs	Change in ERPs	1992 Domestic Share	1992 Exports % of total	1995 Exports % of total
Tanning and Leather	127	41	-86	14	7.2	5.5
S & Engineering	86	123	37	97		
Textile	105	73	-32	92		
Jute	36	24	-12	29	14.7	10.7
Dyeing and Printing	91	66	-25	92		
Knitwear	0	64	64	56	5.9	15.4
Readymade Garments	222	48	-174	3	53.4	50.2
Fish and Seafood	34	12	-22	8	6.4	8.1
Medicine	-6	8	14	97		
Perfume and Toiletries	116	111	-5	82		
Food and Dairy	45	123	78	100		
Food Processing	139	72	-67	79		
Total	82	67	-15	57	100.0	100.0

Sources: Yilmaz, 1996, using data from ISS manufacturing survey, 1992/93; and Fund staff estimates.

1/ ERPs on domestic sales.

Quantitative restrictions

113. Restrictions on re-exports have hindered the development of entrepot trade. Re-exports were permitted as long as the value of exports exceeded certain floor on a mark up on the value of imports. In the Export Policy Order of 1997-2000, this mark up was reduced to 10 percent. Export bans remain on a few agricultural commodities (wheat, pulses, onion, jute, and sun-hemp seeds, prawns and shrimps (except frozen), whole bamboo and cane). There are restrictions on export of molasses, de-oiled rice bran, and wheat bran. Export bans are imposed on a group of manufactured goods, including ferrous and non-ferrous metals and their scrap, petroleum and petroleum products (except for naphtha and furnace oil), gur and sugar and wooden logs. Furthermore, export of samples valued more than \$1,500 requires permission from the government, export of nonperishable goods on consignment is banned, and exporters are allowed to retain 25 percent of export value in foreign currency.

114. The textile sector in Bangladesh enjoys a high level of protection through nontariff barriers, which has crowded out other potential industries, including export sectors. According to the estimates of the Bangladesh Tariff Commission, the cloth mill and handloom subsectors have the highest effective rates of protection (110 percent and 95 percent, respectively) of all the sectors. Although such protection has raised the profitability of the sector, it has not only rendered the textile industry inefficient and encouraged the smuggling of foreign textile imports, but also created anti-export bias. Most of the local textile production is for the domestic market.

115. Restrictions such as minimum local content requirements prevent exporters from deciding the most appropriate import contents on a case-by-case basis. For example, due to the 25 percent local content requirement for knitwear, exporters are forced to produce only acrylic sweaters since the production of wool sweaters would require imported inputs worth more than 75 percent.

Lack of access to trade financing and guaranteeing agency

116. A weak commercial banking system and foreign exchange scarcity have made foreign trade finance a difficult task in Bangladesh. In the mid-1990s, though exports accounted for almost one-third of industrial output, the export sector received only 9 percent of total industrial financing. The banking system is reluctant to lend to borrowers who lack enough collateral, which is the case for most exporters. Thus banks prefer to employ usance L/Cs for export financing, even if this practice results in exporters being squeezed out of markets due to reduced margins. Furthermore, there are interest rate ceilings (8-10 percent) on local currency export loans, as opposed to market-determined interest rates for other loans (11-14 percent). This has negatively affected exporters' access to local credit. Indirect exporters are forced to give inter-firm credits for their sales of indirect export items to direct exporters since they do not have the option of receiving sight or advance payments from direct exporters. This has been inconsistent with the government's policy of promoting backward linkages.

117. The RMG sector has been forced to use suppliers' credits for purchasing inputs for export production using a back-to-back usance L/C system. It required exporters of RMG to use suppliers' credit based on usance import L/Cs for purchasing inputs duty free using an SBW, and usance inland L/Cs (opened back-to-back based on the master export L/C) for purchasing inputs from domestic producers. These bills can be paid by the corresponding export receipts after the master export L/C negotiations. The extra cost of importing inputs under the current norm is estimated to be higher by 7-8 percent of total outstanding suppliers credits (difference between average imputed one turn-over interest costs of suppliers credit compared with EDF, and average bank fees of opening and accepting the one turn-over usance L/Cs compared with one turn-over sight L/Cs).

118. Pre-shipment export finance guarantees are provided by the Export Credit Guarantee Department of the Sadharan Bima Corporation (SBC). This agency has largely failed to ensure access to pre-shipment export finance for those exporters with confirmed L/Cs but insufficient collateral and track record. In practice, banks had difficulties in obtaining export credit guarantees and executing claims from SBC. Since commercial banks are reluctant to provide pre-shipment export finance based on L/Cs only, and collateral is heavily discounted and/or difficult to find for small and medium exporters, the absence of an effective export credit guarantee scheme has restricted the number of exporters who have access to pre-shipment financing.

D. Why the Garment Sector?

119. Although Bangladesh, with its abundant semi-skilled labor force, but limited capital, has a definite comparative advantage in garments and knitwear, export concentration in the RMG is unusually high (Table 6). In 1996/97, garments and knitwear exports accounted for more than 68 percent of total exports in Bangladesh, or equivalent to about 1.6 percent of the world total. This compares with Sri Lanka with 49 percent, Korea with 29 percent, and China with less than 8 percent of its total exports, even though it is the largest single exporter of garments with a world market share of 15.3 percent. Even in Korea, during the early 1970s where it also relied heavily on garment and textile exports, RMGs reached only about 45 percent of its total exports.

120. In addition to the almost exclusive use of the SBWs, there are various factors that could have pushed garments as the predominant export item relative to other products in Bangladesh. These include exogenous external factors, relative prices, and lack of foreign investments.

Table 6. Bangladesh: Export and Import of Clothing, 1992-96

	1992	1993	1994	1995	1996
(In millions of U.S. dollars)					
Exporters					
World	132,300	128,780	140,410	157,180	163,320
China	16,704	18,441	23,731	24,049	25,034
Hongkong	20,060	20,998	21,404	21,297	21,976
Korea	6,770	6,166	5,653	4,957	4,221
Thailand	3,767	4,179	4,508	5,008	4,030
India	3,099	2,970	3,701	4,110	...
Indonesia	3,164	3,502	3,206	3,376	3,591
Taipei	4,117	3,727	3,445	3,251	3,207
Bangladesh	1,183	1,445	1,556	2,232	2,547
Importers					
United States	32,951	35,605	38,643	41,367	43,317
EU (from outside the EU)	37,087	36,645	38,705	41,502	43,682
Japan	11,191	12,588	15,265	18,758	19,672
(Annual percent change)					
Exporters					
World	10.5	-2.7	9.0	11.9	3.9
China	31.4	10.4	28.7	1.3	4.1
Hongkong	14.1	4.7	1.9	-0.5	3.2
Korea	-7.3	-8.9	-8.3	-12.3	-14.8
Thailand	15.6	10.9	7.9	11.1	-19.5
India	10.7	-4.2	24.6	11.1	...
Indonesia	38.6	10.7	-8.5	5.3	6.4
Taipei	1.6	-9.5	-7.6	-5.6	-1.4
Bangladesh	37.7	22.1	7.7	43.4	14.1
Importers					
United States	10.5	8.1	8.5	7.0	4.7
EU (from outside the EU)	14.5	-1.2	5.6	7.2	5.3
Japan	13.2	12.5	21.3	22.9	4.9
(As percent of total)					
Exporters					
World	100.0	100.0	100.0	100.0	100.0
China	12.6	14.3	16.9	15.3	15.3
Hongkong	15.2	16.3	15.2	13.5	13.5
Korea	5.1	4.8	4.0	3.2	2.6
Thailand	2.8	3.2	3.2	3.2	2.5
India	2.3	2.3	2.6	2.6	...
Indonesia	2.4	2.7	2.3	2.1	2.2
Taipei	3.1	2.9	2.5	2.1	2.0
Bangladesh	0.9	1.1	1.1	1.4	1.6
Importers					
United States	24.9	27.6	27.5	26.3	26.5
EU (outside EU)	28.0	28.5	27.6	26.4	26.7
Japan	8.5	9.8	10.9	11.9	12.0

Source: Annual Report 1997 (Volume II), World Trade Organization; and Fund staff estimates.

Exogenous factors

121. World demand for garments since the late 1980s was strong, reaching on average about 7 percent. In particular, demands from the U.S. and the E.U., to which most of Bangladesh's RMGs are exported under the GSP and MFN status, have reached 8.2 percent and 7.5 percent, respectively during 1990-96 (Table 6). Such strong demand in the U.S. and the E.U. as well as the fact that existing producers have gradually moved into more up-scale products, have opened up new markets for Bangladesh products.

Unit export prices

122. During 1988/89-1997/98, Bangladesh export unit value (in U.S. dollars) increased on average by 5 percent per annum (Chart II). This was achieved by the large increase in knitwear and hosiery products and RMGs (8.2 percent and 5.9 percent, respectively). Unit prices of all other products were well below the average, with frozen shrimp at 2.2 percent and raw jute as low as 0.4 percent. The large price increases in U.S. dollar terms during a period of nominal depreciation raised the profit margin of the RMG and knitwear well beyond other sectors, except for highly protected industries such as textiles.

Exchange rate

123. The anti-export bias created by import substitution policies meant that the real exchange rate must be more appreciated than it would have been under a free trade environment. The export promotion schemes that were introduced to offset the anti-export bias have, however, benefitted largely the garment sector. Consequently, exports of RMG and knitwear performed well. The strong performance of the garment sector, coupled with the anti-export bias, has further strengthened the real exchange rate, with negative impact on the non-garment export sector.

Lack of foreign investments

124. Foreign investment in Bangladesh in percent of GDP is among the lowest in Asian countries. Cumulative foreign investment in Bangladesh during 1988-97 amounted to less than 0.5 percent of its GDP (Table 7). This compares with 52.9 percent for Vietnam, 31.8 percent for China, and 12.1 percent for Thailand during the same period. Foreign investments, especially foreign direct investments, could have played an important role in transferring technology and skills from a more advanced country to Bangladesh, providing scarce financial resources and information on potential markets for exports. Bangladesh's export sector was unfortunately sheltered from such positive external factors, and domestic investors would have found it easier to invest in RMG sectors where information on and access to foreign markets was well established and which requires only limited technology

Chart II. Bangladesh: Average Export Growth, 1988/89-1997/98

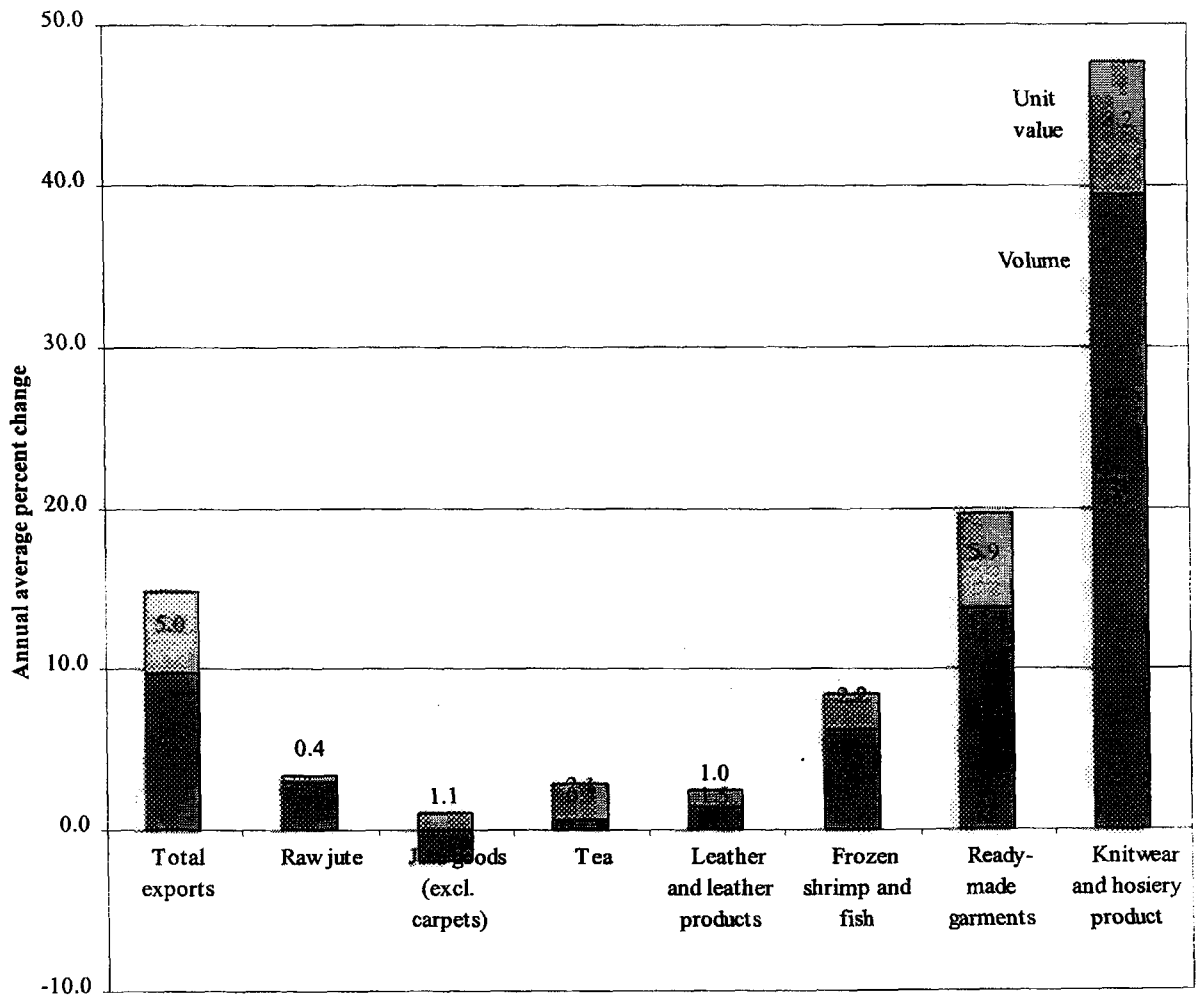


Table 7. Cross-Country Comparison of Foreign Investment and Exports, 1988-1997

	1988	1992	1993	1994	1995	1996	1997	1988-97
	(Foreign investment as percent of GDP)							(Cumulative)
Bangladesh	0.0	0.0	0.1	0.2	0.1	-0.2	0.1	0.4
China	0.9	2.6	4.5	6.2	5.1	4.8	4.8	31.8
India	0.1	0.1	0.2	0.4	0.6	0.7	0.8	3.1
Philippines	2.5	-0.6	0.5	1.5	-3.8	-0.9	1.6	4.5
Sri Lanka	0.6	1.2	2.1	1.6	0.1	0.7	0.7	8.4
Thailand	1.8	-0.8	1.3	1.0	1.3	1.4	2.1	12.1
Vietnam	0.0	3.3	7.3	10.5	11.2	7.5	7.6	52.9
	(Annual percent change of export values)							(Average)
Bangladesh	16.5	17.4	11.6	20.8	19.8	9.7	12.0	14.9
China	17.3	19.6	10.0	37.3	23.7	16.6	21.0	18.5
India	15.8	3.0	14.2	18.1	19.8	9.7	3.9	11.4
Philippines	35.3	14.9	10.2	-13.0	47.6	25.7	24.4	16.9
Sri Lanka	5.3	16.9	15.2	13.7	18.4	3.9	11.3	12.2
Thailand	39.3	16.8	19.8	18.3	26.4	1.7	1.1	18.5
Vietnam	-16.0	28.4	17.4	42.1	36.3	38.1	14.3	31.0

Source: World Economic Outlook, IMF.

E. Future Prospects

125. The present structure of exports in Bangladesh may not be sustainable in the medium term as it relies too heavily on the garment sector only. The prospect of the garment sector is uncertain due to the lower growth in the U.S. and the E.U. In addition, the value added component of the garment sector is estimated to be low, which implies smaller net contribution to the trade balance. On the other hand, there are no apparent substitutes for garments in sight.

The demand side

126. The Asian crisis is expected to have a spill over effect on the rest of the world resulting in lower growth in the U.S. and the E.U. In addition, greater competition from neighboring countries is expected. Exports of several Asian competitors in the garment industry were disrupted in 1997/98 due to the financial turmoil, losing their market share in the U.S. and the EU. Under a regained stable environment and with much devalued currencies, these countries' competitive edge could seriously undermine Bangladesh's garment export prospects, especially given the high substitutability of the garment products.

Erosion of preference margins

127. The conclusion of the Uruguay Round and the entry into force on January 1, 1995 of the World Trade Organization provides, inter alia, integration of trade in textiles and clothing into the framework of multilateral rules and disciplines.⁴ This could potentially erode preferential margins in the markets of industrial countries following tariff reductions on a most-favored-nation basis. Furthermore, after the MFA will be phased out by end-2004, Bangladesh will be openly competing with the rest of the world for its market share.

Relatively low value added

128. The rule of origin for accessing EU GSP schemes requires 3 stage value additions in the case of knit RMG, and a two-stage value addition for woven RMG. Currently, the industry imports more than 90 percent of its higher quality woven fabric and 60-65 percent of its knitwear fabric. Furthermore, there is a large difference in the quality between imported and domestically produced fabric which is of much lower quality. Only a few private mills in Bangladesh produce fabric whose quality is comparable to imported fabric. Over time, the lack of an efficient domestic supplier will put the RMG sector at a competitive disadvantage in the world market for garments. This has been made worse since the value added and world demand for RMG, produced with the higher quality woven fabrics, are much greater than that made with lower quality knitwear.

⁴See Chapter IV, Bangladesh - Selected Issues, July 24, 1996 (SM/96/193).

Small non-traditional export base

129. Except for the garment sector, most other traditional exports such as jute, leather and fertilizers, have contributed very little to export growth over the last decade. In addition, there is no apparent reason why these traditional exports should rebound in the near future. On the other hand, only slow progress was made in nurturing non-traditional exports such that there are no apparent substitutes for garments.

F. Policy Response

130. Against this background, there is an urgent need to support the growth of the non-traditional export sector, especially before Bangladesh faces open competition after the MFA is phased out in 2004. Support could include the following policy responses.

Reduce anti-export bias

131. The average tariff rate is still too high. Lower tariffs would not only reduce the anti-export bias, but also help Bangladesh establish backward linkages to the garment sector. Since domestic producers of intermediate inputs are at a competitive disadvantage vis-à-vis other country suppliers in so far as there is duty on imported components, RMG exporters have a strong incentive to use imported inputs (produced in countries with lower tariff rates) duty free.

Expand the use of the special bonded warehouses

132. To at least partly address the disincentive created by the mix of anti-export policies and export promoting schemes for the garment sector, the use of the SBWs should be expanded to include all export sectors. The administrative constraints could be reduced through computerization of the monitoring procedures.

Attract foreign direct investment

133. Attracting foreign direct investment is probably the fastest way Bangladesh could expand its export base into non-traditional and semi-skilled manufacturing industries. Foreign direct investment would also provide the needed financial capital. To do so, streamlining the regulatory environment and improving the infrastructure are essential. From an investor's point of view, a reliable work force (no frequent disruptions through strikes etc.) and a transparent regulatory environment may be of a greater value than a complex tax incentive in deciding where to invest as the former would reduce the risk premium. The near capacity uses of the current infrastructure, which led to frequent power outages, could limit new investments, and, hence, would need to be urgently addressed.

Improve access to domestic financing

134. Restrictions on export financing should be removed to allow exporters flexibility to borrow from domestic and foreign sources. This includes, in particular, the lifting of the back-to-back usance import L/C requirement for RMG in the medium term. In the short run, the interest rate ceiling on export loans should be abolished as it provides a disincentive for local banks to lend to exporters and potential exporters.

Provide effective information on markets abroad

135. The role of the EPB could be further strengthened toward information collection and data dissemination. Such strengthening of the role would most likely require restructuring of the EPB and retraining of the EPB staff. For local private producers, which are mostly small and medium sized operations, would be unable to conduct the needed research on foreign markets by themselves. The EPB could also more proactively assist local producers access into foreign markets by holding trade fairs as well as present Bangladesh products in foreign trade fairs and conventions.

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Revised National Accounts and Saving and Investment Rates

As a result of the Strengthening the National Accounts Project funded by AsDB, Bangladesh Bureau of Statistics revised the national accounts series (June 1998) for the period of 1989/90 to 1995/96. Under the new estimates, which have also been reviewed by staff of the Fund and the World Bank, the coverage and method of estimation of national accounts have been improved. The old estimates, based on 1984/85 benchmark, have suffered well known weaknesses, particularly significant underestimation of the value added of manufacturing and trade sectors, overestimation of the agricultural sector, and underestimation of private consumption. Aware of these weaknesses, Fund staff had in the past prepared own GDP estimates based on a 1989/90 benchmark. Given the significantly improved estimation of national accounts in the new series, the present staff report uses the official new GDP figures.

On the production side, the classification of industrial sectors in national accounts has been expanded. Under the revised series, GDP is classified into the 15 main industrial sectors, compared to 11 main industrial sectors in old estimates. The four new separate sectors in the new national accounts are fishing, hotels and restaurants, health, and education. In the previous classification, fishing was a sub-sector of the agricultural sector; the category of hotels and restaurants was incorporated in the miscellaneous and professional services sector; and health and education were included in the public administration and defense. The output coverage of the revised GDP estimates has also been improved. In the new series, GDP has been estimated on the basis of new data developed from the censuses, surveys, and studies conducted during 1988–1995. The improvement in output coverage together with price related effects have changed the sectoral contribution to GDP, particularly the contributions of the manufacturing, trade, and agricultural sectors. In the new GDP estimates for 1995/96, the contributions of the manufacturing and trade sectors to GDP are revised upward to 16.8 percent and 14.7 percent of GDP compared with 9.5 percent and 9.1 percent in the old estimates. The upward revision in the share of the manufacturing sector is mainly due to the upward revision in the contribution of large and medium scale industries to 12.3 percent, almost double the figure in the old series. As expected, the share of agriculture (excluding fishing) is revised downward to 19.5 percent, compared with 25.0 percent in the old estimates.

On the expenditure side, estimates of GDP have also been revised to some extent in respect of coverage and methodology. While in the old series private consumption was estimated as a residual, in the revised series private consumption is estimated directly based on Household Expenditure Survey (HES) data. HES 1989 and HES 1991/92 provide the basis for revised estimates of private consumption. Further revision of private consumption has also been made with the help of HES 1995/96. For the years for which HES data are not available, the private consumption estimates are derived by applying expenditure growth rates of various groups. On the investment expenditure estimates, the coverage of gross fixed capital formation both for the public and private sectors has been expanded. Compared to the old

estimates, both consumption and investment figures have been significantly revised upward. However, the resource balance figures in the new series are hardly different from the old estimates as well as the staff estimates, since the more reliable balance of payments data underlying all these estimates have not changed.

One important distinction between the new and the old series which should also be mentioned here is the introduction of the line item "statistical discrepancy." As private consumption is estimated directly, the statistical discrepancy item is included to bridge the gap between GDP figures derived from the expenditure side and GDP figures derived from the production side. In the old series, there is no difference between those GDP figures since private consumption is a residual; GDP derived from the production side deducted by investment and the resource balance.

The improvement in national accounts estimates revises significantly GDP values upward which was expected. In level terms, GDP estimates in revised series are about 30 percent higher than the old official estimates or 20 percent higher than the staff estimates (see table). In line with the upward revision in the GDP level, per capita income estimates are revised upward. For example, Bangladesh's per capita income in 1995/96 is US\$342 in the new series, compared to US\$273 in the old series. Although the GDP level has been revised significantly upward, the year-to-year rate of real output change has not been materially affected by the improved estimation.

The revised national account estimates have also altered Bangladesh's saving and investment rates significantly. The old estimates had suggested significant increases in Bangladesh's saving and investment rates between 1990/91 and 1995/96. In the new estimates, the saving and investment rates increase more gradually, but saving and investment were at much higher levels during the same period. For example, in 1995/96 the new series put saving and investment rates at 18.4 percent and 20.8 percent of GDP respectively, compared with 14.3 percent and 17.0 percent in the old series.

On the investment front, the difference between the old and the new series is largely due to an upward revision in the estimates for investment in the construction sector, which is consistent with the upward revision of construction value added. Approximately 80 percent of total investment is construction related, a ratio which has remained relatively stable during the past five years, with the private sector accounting for 60 percent and the public sector 20 percent. As a consequence, the role of private investment in total investment has become more important. The private sector investment has risen from 11.6 percent of GDP in 1989/90 to 14.3 percent in 1995/96, making the share of private investment in total investment increase from 61 percent to 69 percent. Over this same period, the public sector investment has declined from 7.3 percent to 6.4 percent of GDP.

On the savings front, the upward revision in national saving is mainly due to upward revision in domestic savings, in line with the upward revision of GDP with relatively unchanged nominal resource balance. In the new series, the domestic savings-to-GDP ratio

fluctuates around 12-14 percent of GDP during 1989/90 to 1995/96, compared to 3-8 percent of GDP in the old series. During the same period, the total amount of net factor income and net current transfers move around 6 percent of GDP, slightly down compared to old estimates which move around 7 percent, reflecting the higher GDP figures.

The new series has narrowed the gap of Bangladesh's saving and investment rates compared to other South Asia countries (see Chart).¹ In the old series, Bangladesh's saving and investment rates were significantly lower than the average saving and investment rates of other South Asian countries though they had increased significantly in recent years. The new saving series show that Bangladesh's saving rates have been considerably closer to the average of other South Asian countries but have increased only very gradually. The same conclusion applies to the new estimates of investment rates in Bangladesh.

¹For the purpose of comparison, grants are excluded from both Bangladesh's and other South Asian countries' national savings.

Bangladesh: GDP and Saving and Investment Balance, 1989/90-1995/96

	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
(In billions of taka)							
GDP							
New series	994.2	1,097.0	1,188.9	1,249.9	1,342.4	1,512.1	1,648.4
Old Series	737.6	834.4	906.5	948.1	1,030.4	1,170.3	1,301.6
Staff Estimates 1/	774.0	875.1	954.0	1,023.5	1,112.9	1,265.6	1,409.1
(In percent of GDP)							
New series							
Investment	18.9	18.7	18.8	18.9	19.0	20.0	20.8
Private	11.6	12.0	11.8	12.4	12.3	13.2	14.4
Public	7.3	6.7	7.0	6.5	6.7	6.8	6.4
Old Series							
Investment	12.8	11.5	12.1	14.3	15.4	16.6	17.0
Private	6.4	5.8	6.6	7.9	7.8	9.4	10.7
Public	6.4	5.7	5.5	6.4	7.6	7.2	6.3
New series							
Domestic Savings 2/	12.9	14.7	13.7	11.6	11.5	12.1	11.4
Net Factor Income	2.3	2.4	2.8	3.1	3.6	3.7	3.6
Net Current Transfers	2.5	2.7	2.9	2.6	2.1	2.4	1.7
Statistical Discrepancy 3/	1.5	1.6	-0.4	-2.3	-2.6	-1.5	-1.7
National Savings	16.2	18.2	19.9	19.6	19.9	19.6	18.4
Old Series							
Domestic Savings	2.7	4.1	5.8	7.0	7.5	8.2	7.5
Net Factor Income	3.0	3.2	3.7	4.1	4.7	4.8	4.6
Net Current Transfers	3.4	3.6	3.4	3.4	2.8	3.1	2.1
National Savings	9.2	10.9	13.0	14.4	14.9	16.1	14.3
Staff Estimates							
National Savings 2/	5.5	7.6	9.2	10.9	12.8	12.1	11.0

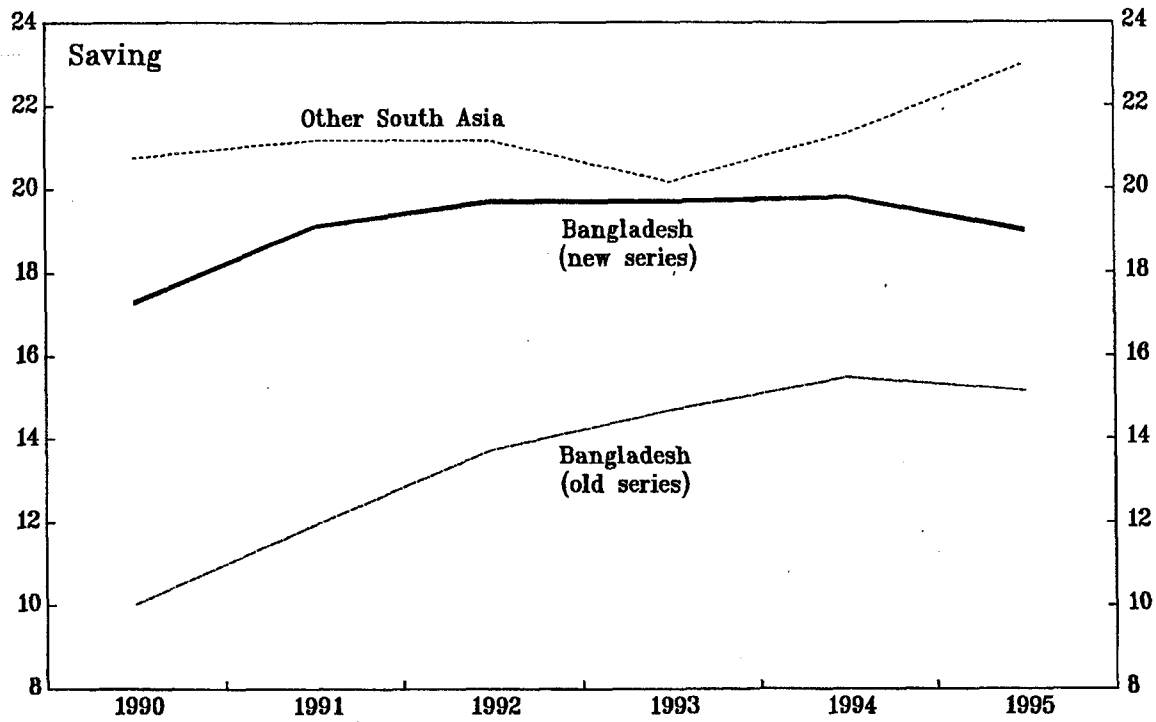
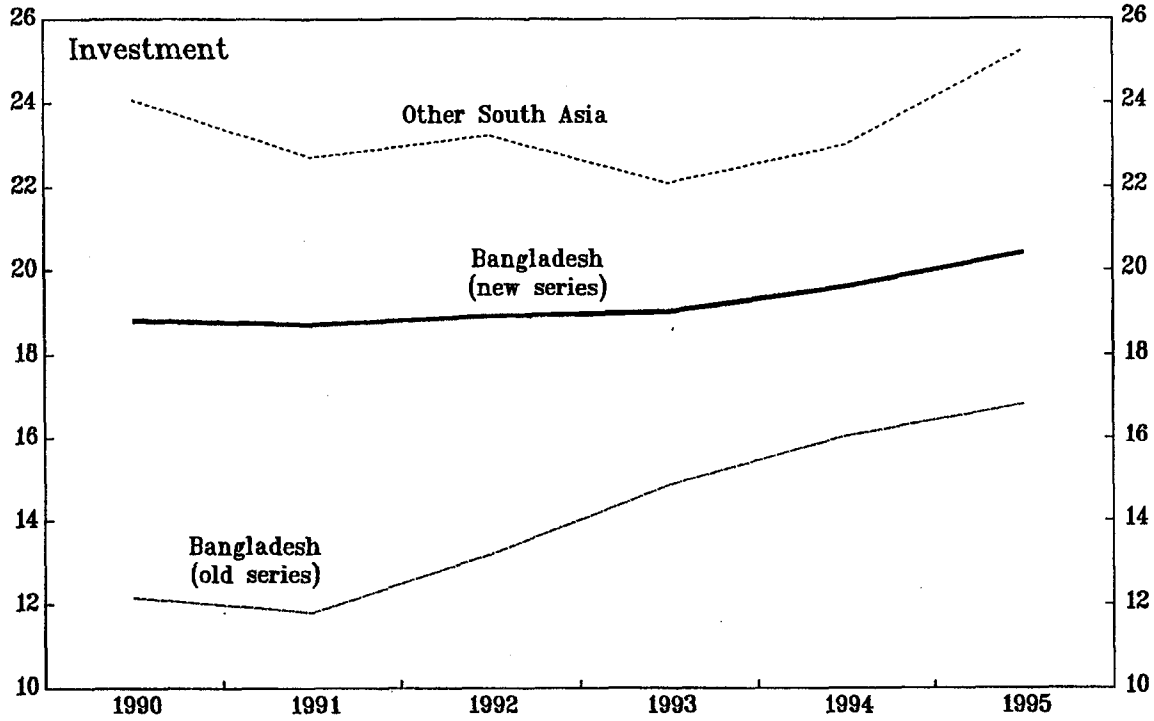
Sources: Bangladesh Bureau of Statistics; and Fund staff estimates.

1/ Staff estimates used in 1997 Article IV consultation report.

2/ Defined as GDP (from the expenditure side) minus consumption.

3/ BBS's new methodology with direct estimates of all expenditure categories leaves a statistical discrepancy to bridge the gap in GDP estimates from the production side and the expenditure side.

BANGLADESH
COMPARISON OF SAVING AND INVESTMENT RATES, 1990-95
(In percent of GDP)



Sources: Data provided by the Bangladesh authorities; and World Economic Outlook database.

