

Bangladesh: First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria—Staff Report; Staff Supplement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Bangladesh

In the context of the first review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for waiver of performance criteria, the following documents have been released and are included in this package:

- the staff report for the first review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for waiver of performance criteria, prepared by a staff team of the IMF, following discussions that ended on **October 30, 2003**, with the officials of Bangladesh on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on December 22, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of **January 8, 2004** updating information on recent developments.
- a press release summarizing the **views of the Executive Board as expressed during its January 9, 2004 discussion** of the staff report that completed the request and review.
- a statement by the Executive Director for Bangladesh.

The document(s) listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Bangladesh*
Memorandum of Economic and Financial Policies by the authorities of Bangladesh*

*May also be included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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BANGLADESH

**First Review Under the Three-Year Arrangement
Under the Poverty Reduction and Growth Facility
and Request for Waiver of Performance Criteria**

Prepared by the Asia and Pacific Department

(In consultation with other departments)

Approved by Steven Dunaway and Anthony Boote

December 22, 2003

- Discussions for the first review under the three-year Poverty Reduction and Growth Facility arrangement were held in Dhaka during September 6–12 and October 18–30, 2003. The staff team comprised Ms. Puckahtikom (Head), Ms. Liu, and Messrs. Heenan (all APD), Ha (FAD), and Mlachila (PDR); and Ms. Sirihorachai (Admin. Assistant, APD). The mission was assisted by Mr. Verhoeven, the Resident Representative, and worked closely with the World Bank's resident mission. Mr. Gauba (OED) participated in some policy discussions.
- The mission met with Finance and Planning Minister Rahman, Finance Secretary Khan, Bangladesh Bank Governor Ahmed, other senior officials, and civil society and donor representatives.
- The PRGF arrangement for SDR 347 million (65 percent of quota) was approved on June 20, 2003, together with the conclusion of the 2003 Article IV consultation. This is the first PRGF arrangement for Bangladesh since an ESAF was completed in 1993. To boost growth, the program is centered on four structural areas: fiscal reform for a sustained revenue effort and a shift in spending toward infrastructure and human capital; reform of the nationalized commercial banks to curtail nonperforming loans and lower the cost of funds; reform of the state-owned enterprises to ensure fiscal sustainability and renewed investment in infrastructure; and exchange and trade reform to reduce external vulnerability. Tackling economic governance issues associated with these reforms was considered key.
- The authorities intend to publish the staff report, LOI, and MEFP.
- The principal authors of this report are Chanpen Puckahtikom and Olin Liu, with inputs from other team members.

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EXECUTIVE SUMMARY

Satisfactory progress has been made so far under the first-year Poverty Reduction and Growth Facility (PRGF), and the program is on track. Economic performance has strengthened further, with a pickup in growth, manageable inflation, and a better-than-expected external position. Implementation of the FY03 budget was prudent, keeping the deficit below target, and monetary policy was tight through June 2003, making for a smooth transition to the floating of the exchange rate. The budget for FY04 is accommodative in line with the program and is so far on course, as is the monetary program. All indicative targets and quantitative performance criteria have been met to date.

The programmed structural measures in tax administration and for the nationalized commercial banks (NCBs) have also advanced, although with some delays relative to the structural benchmarks and performance criteria for the first review. Following initial slippages, adequate progress has more recently been made, and the process is now on course for securing new management/management support or privatizing the four NCBs in 2004. On tax administration, the bonded warehouse system has been strengthened, the Large Taxpayer Unit (LTU) for income tax is now in place, and the Central Intelligence Unit (CIU) is also being set up.

The reform agenda under the PRGF arrangement is aimed at turning this progress into faster and lasting growth, through improving the investment climate and governance and protecting macroeconomic stability. The priorities over the next twelve months are:

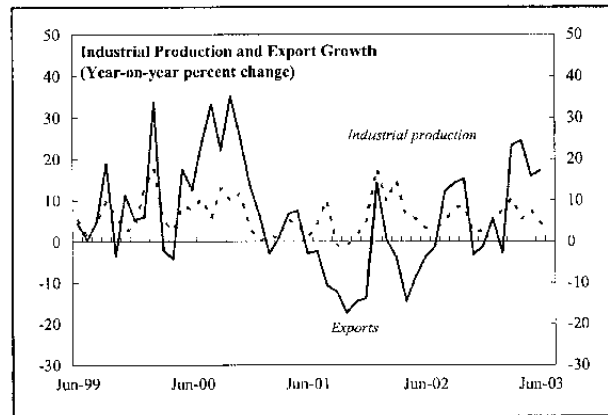
- **A cautious shift in macroeconomic policies** to support growth, primarily through:
 - (i) meeting the revenue target and ensuring the budgeted increase in spending for infrastructure (especially power) and social sector as envisaged in the FY04 budget; and
 - (ii) easing monetary conditions by lowering interest rates and making them more flexible, notably through linking rates on National Savings Certificates (NSCs) to market rates.
- **Further steps to reform tax administration,** by making the LTU and the CIU fully effective, expanding the scope of the large taxpayer system to cover VAT for FY05, and initiating steps to modernize the National Board of Revenue (NBR).
- **Keeping to the timetables for strengthening management of/privatizing the NCBs,** with closer monitoring, and defining bank-by-bank resolution strategies by April 2004, to be followed by detailed action plans by November 2004.
- **Tackling governance,** through the above structural measures and early and effective functioning of an Independent Anti-Corruption Commission.

The key risks to the program center on the structural areas, deriving from weak governance in a fragile political environment and administrative constraints. Close monitoring and technical assistance will remain essential.

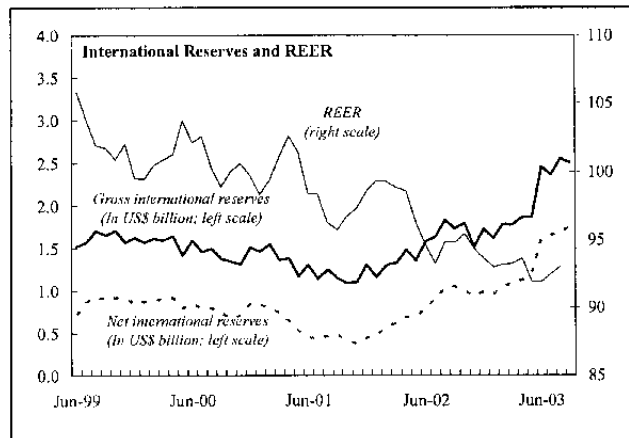
I. PERFORMANCE UNDER THE FIRST-YEAR PRGF

1. In the attached letter dated December 18, 2003 and the Memorandum of Economic and Financial Policies (MEFP, Attachment I), the Government of Bangladesh outlines the progress that has been made under the program, and requests completion of the first review under the PRGF arrangement and waiver for the nonobservance of structural performance criteria (MEFP ¶12 and ¶17).

2. Macroeconomic performance has improved markedly, and all indicative targets and quantitative performance criteria for end-June and end-September were met (Tables 1–2, Figure 1, and MEFP Table 2). Economic recovery is taking hold, driven by a rebound in external demand and domestic activity. Real GDP growth accelerated to 5.3 percent in FY03 (ending June), on the strength of exports, industrial production, and agriculture. Inflation was contained under 5 percent by September 2003 as programmed, despite increases in food and administered prices.



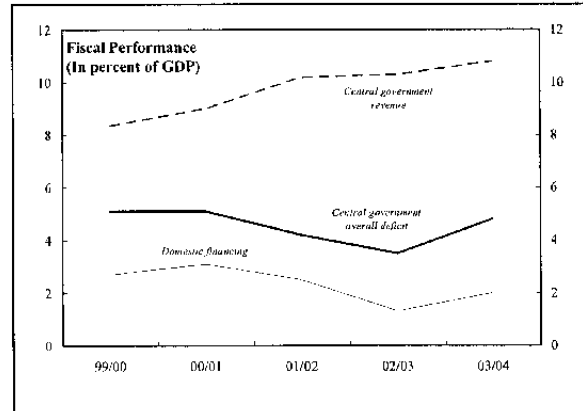
3. The external position has strengthened more than expected, reflecting gains in competitiveness and rising external demand (Table 3 and Figure 2). Exports grew by 9½ percent in FY03 (against a projected 2 percent) and kept this pace through the first four months of FY04. This reflected a turn-around in the ready-made garment (RMG) sector, and buoyancy in knitwear and seafood. Remittances also remain strong, rising to \$3 billion in FY03, and they amounted to \$1 billion in the first four months of FY04. Imports increased by 13 percent in FY03 and rose by 15 percent (year-on-year) in the first four months of FY04. Despite this pickup in import growth, the current account balance has remained relatively strong and financeable. With higher aid inflows and program loan disbursements, official reserves rose markedly to \$2.4 billion (three months of imports) by end-November 2003, well above the program target.



4. Prudent macroeconomic policies have contributed to this favorable outcome. The budget deficit for FY03 was cut to 3.5 percent of GDP, below the target of 4.2 percent, on account of strong revenue performance (particularly the VAT and customs duty) and

expenditure discipline (Table 4 and Figure 3). As a result, domestic financing was halved to 1.3 percent of GDP.

5. **The FY04 budget targets a wider deficit, a further revenue effort, and a reordering of spending priorities.** A larger deficit of 4.8 percent of GDP has been judged appropriate, given the spending need in critical sectors that is expected to be financed by concessional external sources; domestic financing is capped at 2 percent of GDP. The targeted revenue effort of 0.5 percent of GDP is to come from a set of

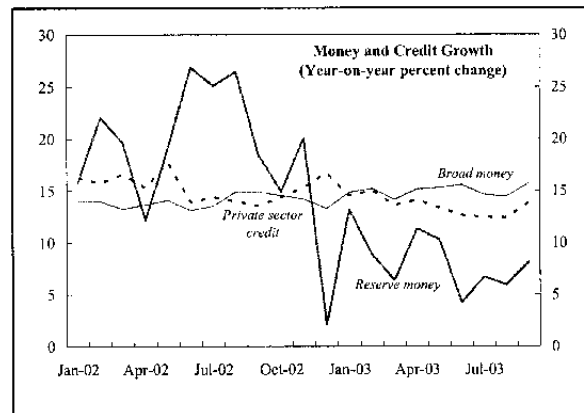


measures including collection of tax arrears, an extension of the VAT net to cover additional services, a broadening of the income tax net, and a strengthening in tax administration. The latter includes revamping the bonded warehouse system, modernizing the LTU, and setting up a CIU. On the expenditure side, priorities are to be shifted to infrastructure and social sectors, with an increase of 1 percentage point of GDP in pro-poor spending, mainly education and rural development projects.

6. **Budget execution overall was on course in the first quarter of FY04.** Total revenue grew by an estimated 15 percent, largely on account of nontax revenue, while expenditure remained under control. Thus, domestic financing for the budget was kept below the program ceiling for end-September. However, tax revenue collection by the NBR was below target, due to shortfalls in import-related receipts. These shortfalls reflect in part a sharp decline in sugar imports, which are subject to the highest tariff rates, and labor action in customs administration protesting corruption charges against them.

7. **Monetary policy was tightened as programmed in the second half of FY03 to smooth the transition to the floating of the exchange rate** (Tables 5–6 and Figure 4).

Reserve money growth slowed to 4 percent and treasury bill rates were raised by 1½ percentage points (from the first half of FY03). As the economic environment became more favorable, Bangladesh Bank (BB) shifted to an easing stance beginning in the first quarter of FY04. Key actions included cutting treasury bill rates by 3 percentage points and the bank rate by 1 percentage point, improving interbank market functioning and competition, and reducing the Statutory Liquidity Requirement (SLR) ratio from 20 percent to 16 percent. In addition, NCB deposit rates were reduced by 1 percentage point. As a result, bank lending rates have started to fall.



8. **Exchange market conditions have been steady since the currency was floated at end-May 2003.** The taka has been broadly stable and BB's interventions have only been to build up reserves in line with program objectives. With the weakness of the U.S. dollar, the taka has depreciated by 7.3 percent in nominal effective terms, and by 2 percent in real effective terms since June 2002. Moreover, external debt management was prudent, with no contracting of nonconcessional debt in the first quarter of FY04.

9. **Structural measures on the margin requirements for imports and on the LTU for income tax were implemented with brief delays.** The authorities are seeking a waiver of these two structural performance criteria (MEFP Table 3). To further reduce distortions, the remaining margin requirements for the opening of letters of credit on 55 import items were removed effective December 2 (an end-November structural performance criterion). After a slow start, good progress has been made more recently in modernizing and expanding the LTU (an end-September performance criterion) and in making the CIU fully operational. Specifically, over 1,000 large taxpayers—covering about 35 percent of the income tax base—have been selected based on objective and transparent criteria that were published in early November. They comprise the largest companies, and include all banks and nonbank financial institutions, telephone and satellite TV companies, and company directors. The transfer of tax files has begun, and staffing and logistical arrangements have been made. In the case of the CIU, the revised organization chart agreed with the Fund staff has been approved, and the process of selecting 1,000 taxpayers (based on compliance record) covering all major taxes and making other logistical arrangements is under way. In addition, the structural benchmark for revamping the bonded warehouse system has been broadly met, given the measures introduced with the budget, although imports of packaging materials are being exempted from required bank guarantees and part of the budgeted measures is being contested in the High Court.¹

10. **Moreover, BB has made good progress on elements of NCB reform, although the benchmarks relating to the strengthening of bank management have slipped.** The special audits for each bank are under way and are to be completed by year-end. Moreover, bank performance under the Memoranda of Understanding (MOUs) agreed between the NCBs and BB has been satisfactory so far, with the NCBs adhering to lending restrictions and reducing operating costs. BB is intensifying its monitoring of these banks under the MOUs. However, the structural benchmark for contracting new professional management for Agrani by October 2003 was not observed, and the benchmark for contracting management support for Sonali and Janata for the second review by end-December is now unlikely to be met. The process for securing new management/management support lagged initially, owing to the longer time needed to build consensus for reform, and some formalities concerning the procurement requirements associated with the World Bank financing of the consulting contracts.

¹Pending the final court decision, such imports are subject to 100 percent bank guarantee on import duties and VAT.

11. **Progress has been uneven on state-owned enterprise (SOE) reform on account of rising political resistance.** On the positive side, automatic pricing formulas adopted under the World Bank's Development Support Credit (DSC) are being implemented for electricity, gas, and petroleum products, in a phased approach toward cost recovery and reducing subsidies. However, closure of manufacturing SOEs has slowed, owing to labor action, despite the offer of severance packages for affected workers.

II. REPORT ON THE DISCUSSIONS

A. Outlook and Risks

12. **The macroeconomic prospects for FY04 remain favorable, with upside potential from a brighter external outlook.** With the global recovery, strong remittances, and the buildup in reserves, risks on the external front have diminished in the near term. Economic growth is thus expected to remain broad-based, and further boosted by accommodative fiscal and monetary policies. Accordingly, projections in the original macroeconomic framework for real GDP growth to rise to 5.5 percent and inflation to stay at 4.5 percent should be achieved. External reserves are targeted to continue rising, though at a more moderate pace.

13. **However, considerable risks on the external front remain over the medium term.** Bangladesh is particularly vulnerable to the phasing out of Multifiber Agreement (MFA) quotas at end-2004, given its heavy dependence on protected markets for RMG exports (Box 1). While the impact on net export earnings may be muted, the total impact on output and jobs could be larger, given the economy's overall dependence on RMG. These risks have heightened the need for export diversification and for urgent improvement in the investment climate to boost growth and productivity.

14. **Noting the positive economic performance so far, the authorities reaffirmed their commitment to macroeconomic prudence and a deepening of structural reform,** as set out in their three-year PRGF strategy (IMF Country Report No. 03/205). However, in Bangladesh's fractious political environment, they also pointed to the need to give due account to socio-political factors in the sequencing and timing of sensitive measures. Indeed, there have been nationwide shutdowns (hartals) to protest price hikes of essentials and the law and order situation. Moreover, after two years of reform that have resulted in significant job losses, the authorities believed that more visible gains in investment and jobs are now critical for the reform program to remain politically viable.

B. Fiscal Policy and Reforms

15. **For FY04, while the overall budget stance is appropriately accommodative, the authorities agreed that achieving the revenue target is essential.** NBR tax collection has been steadily rising, by 10.2 percent through the first four months (from the same period last year), but this increase still falls short of the target of a 15 percent increase for the year. Thus, efforts are being made to register more taxpayers and to strengthen tax assessment. In addition, the implementation of tax administration measures in the program is being stepped up. The authorities expect these steps to soon begin to help improve collection. Nonetheless,

it was agreed that if shortfalls persist, additional revenue measures would need to be introduced in early 2004 (MEFP ¶11). In addition, to help ensure that the deficit target is met, quarterly expenditure ceilings (which are back-loaded) are being strictly adhered to.

16. **Looking ahead, meeting the PRGF medium-term revenue target of raising tax collections by 1½ percent of GDP over three years will hinge on substantial further improvements in tax administration** (Box 2 and MEFP ¶13). Modernizing the LTU and setting up the CIU should facilitate the expansion of the audit program, envisaged for March 2004. The mission noted that, to meaningfully strengthen tax collection, the authorities will need to ensure the effective functioning of the new LTU against resistance by vested interests. Strong efforts will also be needed to expand the LTU system to cover withholding tax and VAT for FY05. In addition, while these steps are significant, more fundamental reforms of tax administration are needed since the problems in this area are basic and deep-rooted. Consideration should therefore be given to further measures, including a modernization of the NBR, drawing on the recent recommendations of FAD technical assistance. The authorities agreed with this priority, noting the envisaged reduction in trade taxes in FY05, and have asked for World Bank assistance in collaboration with the Fund. Further improvements in tax policy, including rationalization of supplemental duties, should also be considered.

17. **At this early stage of the fiscal year, the authorities saw no compelling case for revising the deficit target on account of the overperformance of last year's budget.** The staff agreed that if external financing on concessional terms becomes available as projected, urgent spending needs in priority sectors should be met, especially since upgrading infrastructure is vital for private investment. At the same time, in view of the programmed substantial increase in spending and underlying governance issues, the authorities undertook to ensure that funds released from the budget are timely and used for their intended purposes (MEFP ¶14). In particular, attention is being given to improving project selection and execution, and strengthening the tracking and transparency of spending; three tracking studies are being undertaken in the education and health sectors. They also intend to take timely decision with respect to meeting policy conditions for project funding.

18. **In this context, reforming the power sector is being given renewed impetus, to allow its upgrading and to resolve its arrears.** Rigorous implementation of the energy pricing formulas will be important,² which will be reinforced by the upcoming creation of an Energy Regulatory Commission. Most critically, given serious shortages of electricity, the authorities are giving priority to defining a financial and operational restructuring framework

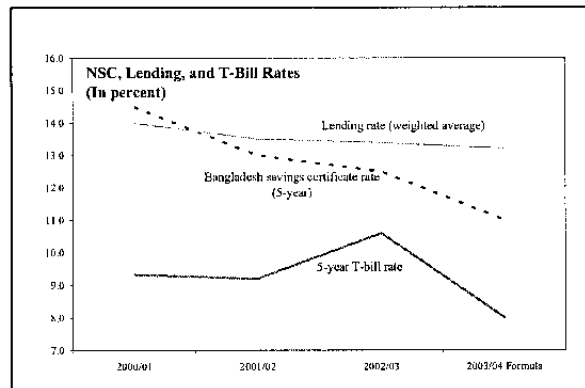
²Under these formulas, gas prices will be reviewed monthly and adjusted if the benchmark international price moves 10 percent away from the baseline; petroleum product prices are to be realigned every six months, unless the monthly review indicates an international price variation of over 5 percent from the baseline, in which case the adjustment will be immediate.

for urban electricity distribution systems, in collaboration with the World Bank and the Asian Development Bank (AsDB) (MEFP ¶123). The need is critical for the Dhaka Electricity Supply Authority (DESA), where the problems of system losses and billing and collection are the most serious and whose arrears (1½ percent of GDP) account for the bulk of inter-SOE arrears. With recent price adjustments, arrears are being curbed, and the authorities are considering options for improving billing and collection. Tentative staff estimates indicate that resolving SOE arrears overall could cost up to 4 percent of GDP over three years but would be consistent with fiscal sustainability (Box 4, IMF Country Report No. 03/205).

19. **With respect to manufacturing SOEs**, the authorities are focusing on containing budgetary costs associated with their operations, given that SOE closure has been slowed by public opposition. These SOEs are now subject to constraints on budget support and to performance targets, and workers are being encouraged to take voluntary separation with severance packages. In order to achieve the authorities' goal of substantially downsizing the manufacturing SOEs by FY06, the momentum of closure/privatization of these SOEs will need to be stepped in the near future.

C. Monetary and External Policies

20. **BB has taken timely steps to ease monetary conditions through lowering interest rates to stimulate investment and growth.** This shift is warranted by the favorable inflation outlook, the stable exchange market, and reserves development. The mission thus endorsed BB's market-based actions to lower rates. In addition, relatively high interest rates on NSCs have held up bank deposit rates as well as the cost of budget financing. To address these concerns, rates on new NSC issues are soon to be reduced under an agreed automatic formula that links NSC rates to yields on comparable government securities. Adjustments under this formula are expected semi-annually.



21. **The monetary program has been revised to reflect the better-than-expected external performance and the easier monetary policy stance** (MEFP Table 2). The target for accumulation of net international reserves has been raised, with gross reserves projected to reach \$2.9 billion for end-FY04, some \$300 million above the original program. Reserve money growth is being kept at 10 percent in FY04, but growth in broad money is now projected at 14 percent, reflecting higher demand for private sector credit. In addition, within the original limit on domestic financing, nonbank financing has been raised to reflect the greater NSC demand to date.

22. **The authorities are committed to limiting interventions in the exchange market only to counter disorderly conditions and to build reserves.** LEG/MFD technical

assistance has also been provided recently to, inter alia, review issues relating to the phasing out of two remaining exchange restrictions subject to Fund jurisdiction (i.e., with respect to nonresident taka accounts and the advance payments for imports of goods and services).

23. **External debt management will continue to be cautious.** The authorities intend to minimize nonconcessional debt, and to first seek funding for infrastructure from concessional sources, especially from IDA. The staff has suggested improving the monitoring of new government external borrowing that is in the process of being contracted.

D. Reform of the Nationalized Commercial Banks

24. **The authorities stressed their commitment to stepping up the pace of NCB reform and strengthening its monitoring** (MEFP ¶19). Performance under MOUs with these banks will remain closely tracked, to curb their lending and the flows of new bad loans. Based on early experience, the timetables for NCB management/privatization have been revised, in consultation with the World Bank and Fund staff, to take fuller account of the capacity constraints in pursuing this process for four banks in parallel, and the greater-than-anticipated complexity of the legal and administrative requirements.

25. **The revised timetables are on track**, and the initial goals of improving bank management are likely to be achieved in the next year. The key steps ahead of the review completion include:

- For new management for Agrani, the request for proposal has been issued, technical evaluation of bids has been completed, and the winning bid has been approved by Cabinet.
- For Sonali and Janata, the requests for proposal for the management support contracts have been issued to allow technical evaluation of bids to begin before year-end.
- For Rupali, technical evaluation of bids for a sales adviser on its privatization has been completed.

26. **With these measures**, the structural benchmark for contracting new professional management for Agrani is being moved to January 2004, and for signing contracts for management support for Sonali and Janata to May 2004. A new benchmark is also being set to bring Rupali to the point of sale by December 2004. In addition, in view of the substantial work that lies ahead, the mission endorsed the authorities' intention to set up a monitoring cell, with World Bank assistance (under an Enterprise Growth and Bank Modernization project), to support the current Working Group on NCB reform (comprising senior officials from the Ministry of Finance and BB).

27. **Moreover, the authorities were encouraged to begin active consideration of the wide range of issues and options involved in defining bank-by-bank resolution strategies**, in consultation with the World Bank and Fund staff. Such strategies are to be defined by end-April 2004 (a structural performance criterion for the second review). It was

also agreed that detailed action plans for implementation of these strategies should be drawn up by end-November 2004.

III. OTHER ISSUES

28. **With respect to the safeguards assessment, BB is working to bring its accounts in line with international accounting standards (IAS),** with MFD technical assistance. An audit of BB financial statements for FY03 has been completed as envisaged, conducted by a local firm in compliance with international auditing standards and signed off by an international accounting firm. However, while the statements reflect some improvements, they still fall materially short of IAS, thus requiring further action. The authorities are committed to implementing the other critical recommendations of the safeguards assessment.

29. **Work has been initiated to complete the full PRSP by end-2004.** An interministerial steering committee, with oversight by the National Poverty Council chaired by the Prime Minister, has been set up to carry this work forward, although the timetable is quite tight. The mission stressed the importance of ensuring more effective consultations with stakeholders (including parliamentarians), a sharper prioritization of policies based on their impact on poverty and job creation, and a fuller costing and integration of pro-poor programs into the medium-term expenditure framework.

30. **The overall poverty and social impact of the reform program should be positive over the medium term.** This would be expected to arise from higher growth with job creation, and larger and more pro-poor budget spending, including improved quality of public services. The near-term adverse impact in terms of job losses from SOE and NCB reforms would be eased by retrenchment schemes that are now in place or being developed in the case of the NCBs. A more comprehensive assessment of the poverty and social impact is expected to be undertaken in the context of the full PRSP.

31. **Progress is being made in addressing governance issues,** including through reform of tax administration and the NCBs, a more liberal exchange system, and greater transparency in budget spending outlined above. To further curb corruption, the authorities noted the recent adoption of new government procurement guidelines which have been designed to curtail the scope for abuses in this key area. Moreover, consultation is well advanced on a draft bill to set up an Independent Anti-Corruption Commission (IACC), with technical assistance from USAID and the AsDB. Parliament is expected to pass this bill in its first session of 2004. An early and effective functioning of the IACC is an important element of the authorities' effort to combat corruption, and could help to improve international perceptions regarding corruption in Bangladesh. Making the IACC operational and defining a time-bound national anti-corruption action plan are among the issues for the upcoming DSC II discussions.

32. **On program monitoring,** the performance criteria and indicative targets through December 2004 are summarized in MEFP Table 2. Structural conditionality has been extended to the remainder of 2004 in fiscal and NCB reforms, in line with the approach taken

for the first-year PRGF (MEFP Table 3, Box 6, IMF Country Report No. 03/205). To contain risks to program implementation especially with respect to tax administration, close monitoring—including through quarterly reviews by staff—will be continued, as well as technical assistance to strengthen administrative capacity. In addition, the monitoring of structural policies will continue to be coordinated with DSC II.

IV. STAFF APPRAISAL

33. **The authorities' policies have succeeded in strengthening economic performance under the program.** Macroeconomic discipline has been maintained and the structural agenda is moving ahead, despite political tensions and initial slippages. Growth has picked up, inflation is in check, and the external sector has improved more than expected. The first-year program is on track and all quantitative targets and performance criteria were observed. On the structural side, there were initial but modest delays with respect to steps in tax administration and NCB reform that are subject to one structural performance criterion and benchmarks, respectively, but these slippages have now been redressed. As for the other structural performance criterion, the delay in removing the margin requirements on the opening of letters of credit for imports was negligible.

34. **Turning this progress into faster and lasting growth will, however, require deeper reform to improve the investment climate and credible action to strengthen governance.** The authorities' policy package for the next year is designed to meet these difficult challenges, including potential shocks associated with the phase-out of the MFA quotas. Determined implementation will be needed to realize tangible results that can help to build domestic support for reform. In particular, governance issues will need to be decisively tackled. In this regard, the effective execution of the programmed measures to strengthen tax administration and NCB reform, as well as the recent steps to liberalize the exchange system, should all help to improve governance. In addition, the newly adopted government procurement guidelines should be helpful. Looking ahead, and more generally, an early and effective functioning of the IACC will also be critical to improving investor sentiment.

35. **Given the manageable financial situation, the recent shift in the stance of macroeconomic policies to better support growth is timely.** With inflation under control and a stable exchange market, easier monetary conditions through lower interest rates are providing the appropriate stimulus. Recent market-based actions by BB to bring down lending rates, including the reduction in the SLR, were well-timed. Given the relatively high real rates due to structural rigidities, further strengthening interbank and broadening government securities markets can also be helpful. In addition, the staff welcomes the planned adjustment in NSC rates under an automatic formula to align them with market rates, to contain the cost of domestic financing for the budget, as well as to make interest rates more flexible.

36. **Aimed at bolstering growth and reducing poverty, the targeted increase in the FY04 budget for infrastructure and social spending is well considered.** This would be consistent with fiscal sustainability given the prospective external support on concessional terms. However, achieving these spending goals will require better public expenditure

management, timely decision on meeting policy conditions for project financing, and closer tracking and greater transparency of spending.

37. **Proper emphasis is being given to achieving the FY04 revenue target, but looking ahead, more fundamental improvements in NBR tax administration should be a priority.** To protect the revenue target this year, the authorities are taking actions to ensure timely functioning of the LTU and the CIU, but they will also need to make every effort to ensure their effectiveness. In addition, if shortfalls in tax collection persist, additional measures will be needed in the revised budget at midyear. To attain the program's medium-term revenue target, the coverage of the LTU system will also need to be expanded in FY05. The staff also encourages the authorities to undertake fundamental reforms of tax administration, including modernizing the NBR, particularly in view of the envisaged reduction in trade taxes in the FY05 budget.

38. **With respect to the NCBs, the process for strengthening bank management is being put on track and under close monitoring.** Following teething problems, the time-tables have been revised to factor in the requirements for advancing this process across four banks at the same time, and a critical mass of actions have now been taken to stay on course. The authorities will need to closely monitor this process to ensure progress, as well to continue to track performance of these banks against memoranda of understanding with Bangladesh Bank. Looking ahead, the staff encourages the authorities to give active consideration to the resolution options, so as to be in a position to define bank-by-bank strategies by April 2004.

39. **Early attention is being given to stepping up the reform of the power sector, to improve growth prospects and protect fiscal sustainability.** In particular, the authorities are encouraged to work with the World Bank and the AsDB to define a framework for turning around the financial and operational performance of the urban electricity distribution systems, especially DESA. With respect to manufacturing SOEs, the pace of reform has been slowed by public opposition. In light of this, even greater attention will need to be paid to curtailing budget support to loss-making enterprises. The momentum for closure/privatization of these SOEs will also need to be resumed as soon as is practicable if the authorities' medium-term targets in this area are to be met.

40. **Efforts to prepare the full PRSP are under way to complete work on target at end-2004.** There is need to ensure that pro-poor programs are prioritized and fully integrated into a medium-term expenditure framework. The consultative process could also be extended to include broader segments of civil society and parliamentarians.

41. **Risks to program implementation remain considerable in the structural areas but are judged manageable.** They derive from resistance of vested interests in a fragile political environment and from weak administrative capacity. To mitigate these risks, close monitoring, including through quarterly staff reviews, and technical assistance should be continued.

42. **Bangladesh's record under the program so far is positive overall and going forward, the MEFP sets out a credible and coherent agenda.** The authorities have reaffirmed their commitment to stay the course and are making efforts to forge domestic support for reform. Given the strength of the program, and that the initial slippage in tax administration has now been redressed and the delay in phasing out the margin requirements on imports was negligible, the staff recommends approval of the requested waiver for the nonobservance of structural performance criteria and completion of the first review.

Box 1. Bangladesh: Potential Impact of Removal of Multifiber Agreement Quotas

All textile and clothing quotas under the Multifiber Agreement (MFA) are to be phased out over the period 1995–05. However, due to the limited progress to date, many of the most restrictive quotas remain to be removed at the end of 2004, indicating the potential for countries to face a large shock at the beginning of 2005 (see “Market Access for Developing Country Exports,” Selected Issues (www.imf.org)).

Bangladesh is highly vulnerable to the quota removal as almost all its ready-made garments (RMG) exports are to protected markets (the European Union and the United States), and because RMG exports account for three-fourths of its export earnings. Bangladesh is reasonably competitive, given its low labor cost, and it has an established position in the low end, high volume market segments, as well as in knitwear. However, it will face stiff competition in some other product categories when quotas are removed.

The impact of the potential loss of market share post MFA could be significant for Bangladesh. For example, a 25 percent fall in RMG exports could directly reduce net export earnings by about \$750 million per year (1½ percent of GDP). The direct impact on the balance of payments would be contained by the corresponding reduction in RMG-related imports. However, the overall adverse impact of such a decline on output and jobs could be substantial, because a large share of the manufacturing and service sectors is RMG-dependent. Moreover, RMG-related jobs account for nearly one-half of the formal labor force and are held mainly by women.

To remain competitive in the RMG sector and to diversify the economy over time, Bangladesh faces a number of competitive challenges, most notably in the low productivity of its labor force, inadequate infrastructure, poor law and order, and weak governance. A recent World Bank study on the investment climate in Bangladesh concludes that:

- **Defective and insufficient infrastructure poses some of the most severe obstacles** to firms operating in Bangladesh, with lack of reliable electricity a key constraint.
- **Corruption is pervasive and costly, and is ranked by firms as a severe obstacle to business.** Excessive regulations often lead to extortion and bribery. Transparency International ranked Bangladesh last for a third successive year in its Corruption Perceptions Index published in October 2003.
- **High levels of nonperforming loans keep bank lending rates high.**

The reform program under the PRGF arrangement contains policy elements that address these key deficiencies.

Box 2. Bangladesh: Tax Administration

Bangladesh has the lowest tax to GDP ratios in the region despite comparable statutory tax rates, reflecting poor tax compliance and weak tax administration, as well as a relatively small formal sector and a comparatively large informal rural sector. Revenue performance has improved in recent years, owing to incremental modernization efforts, with donor and World Bank support. These efforts have been most notable in customs administration, especially in the installation of the ASYCUDA++ computer system in the Customs Department, and in income tax and VAT, primarily through registration of additional taxpayers and adoption of the post-auditing program.

However, the structure and culture of the revenue administration by the National Board of Revenue (NBR) have not undergone fundamental changes since its establishment 30 years ago. A recent FAD technical assistance mission found that the NBR is not organized along functional lines and that its operations suffer from deep-seated problems. These include notably the lack of coordination and information sharing among major tax departments, weak audit capacity, poor taxpayer services, and lack of computerization. To meet the revenue target over the medium term, modernization and reform of the NBR would be essential. Recent FAD recommendations include the following key elements:

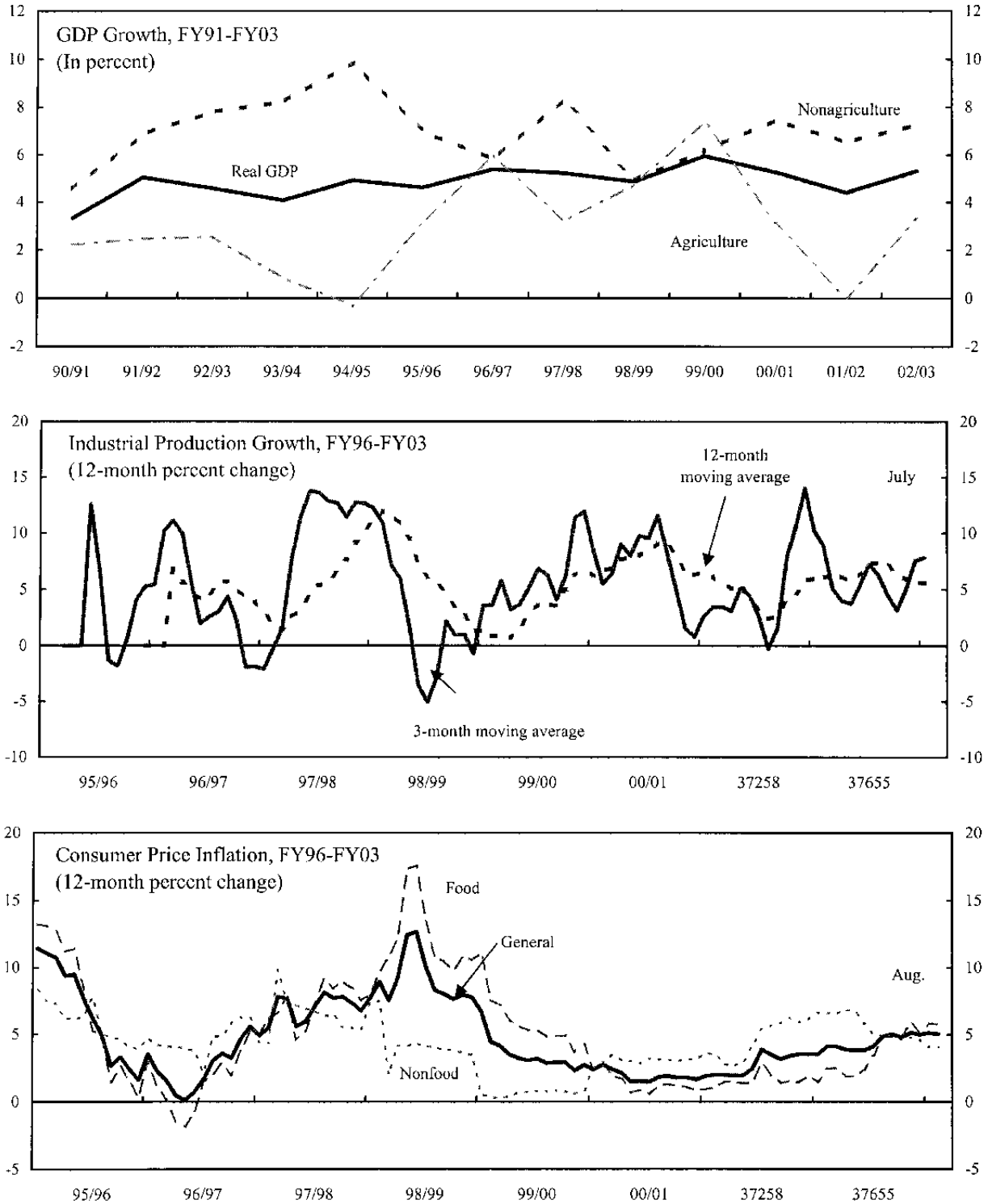
- Reorganize the NBR along functional lines to permit clear lines of accountability, streamline functions, and develop appropriate expertise;
- Expand the LTU to cover VAT for large taxpayers;
- Adopt a true self-assessment system, first in the LTU;
- Establish a risk-based auditing system supported by third party information, and targeting scarce resources at the taxpayers most likely to be defaulting; and
- Use modern technology, particularly an integrated computer system to handle the processing (assessment and collection), audit case selection, and the principal management information needs for all taxes that are administered by the NBR.

Central Government Tax Revenue in South Asian Countries, 2001/02
(In percent of GDP)

	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Tax	7.4	8.3	9.6	12.1	15.0
Income tax	1.4	3.2	2.2	3.8	2.5
VAT or sales tax	3.9	...	2.8	5.7	6.7
Excise taxes	0.1	3.2	0.9	1.3	3.3
Trade taxes	2.0	1.9	3.2	1.3	2.1
Other taxes	0.1	...	0.4	0.0	0.4
Memorandum items:					
Standard VAT rates	15	...	10	15	12.5
Corporate tax rates	35	35	...	45.2	35

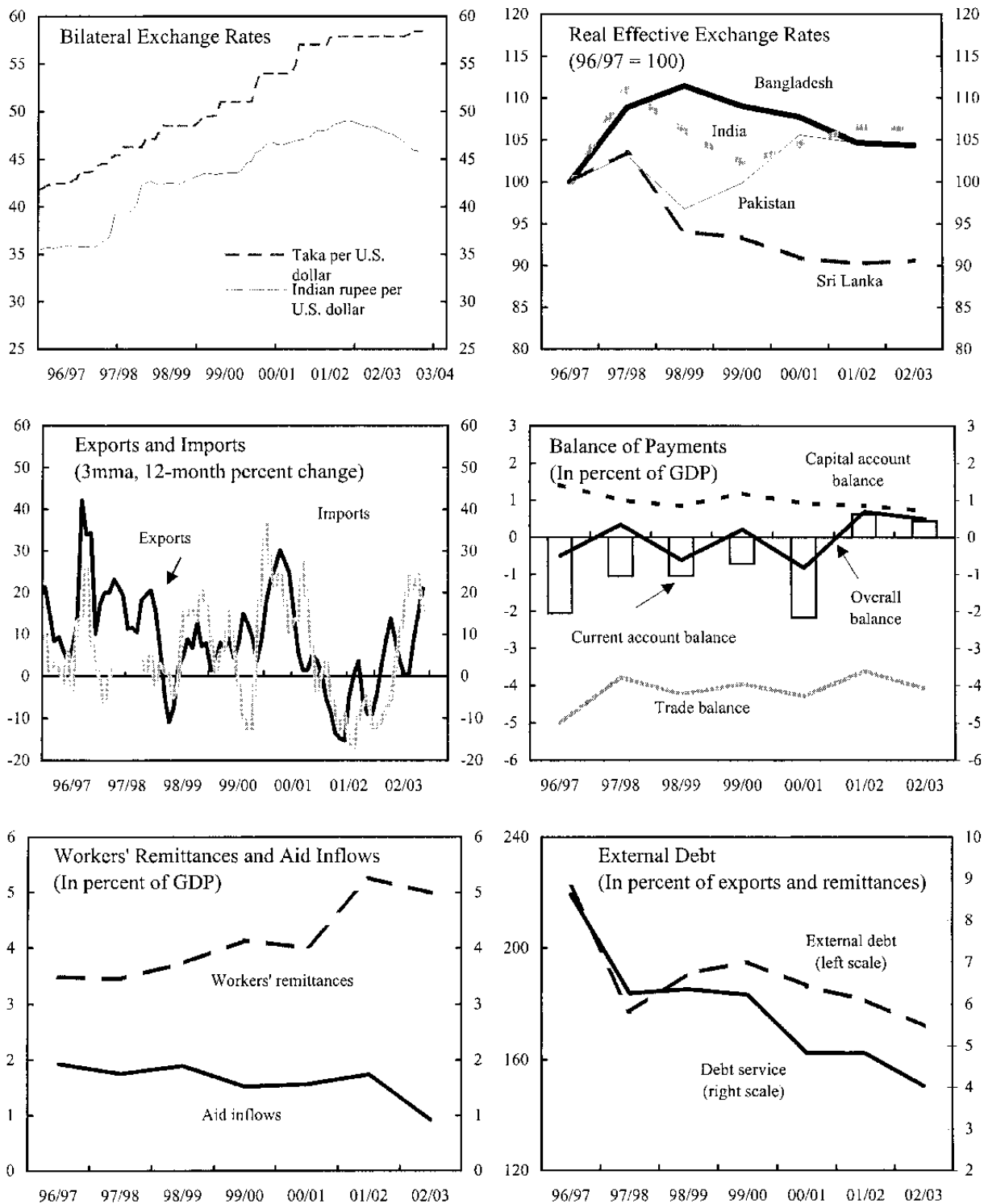
Source: IMF staff reports.

Figure 1. Bangladesh: Real Sector Indicators, FY91-03



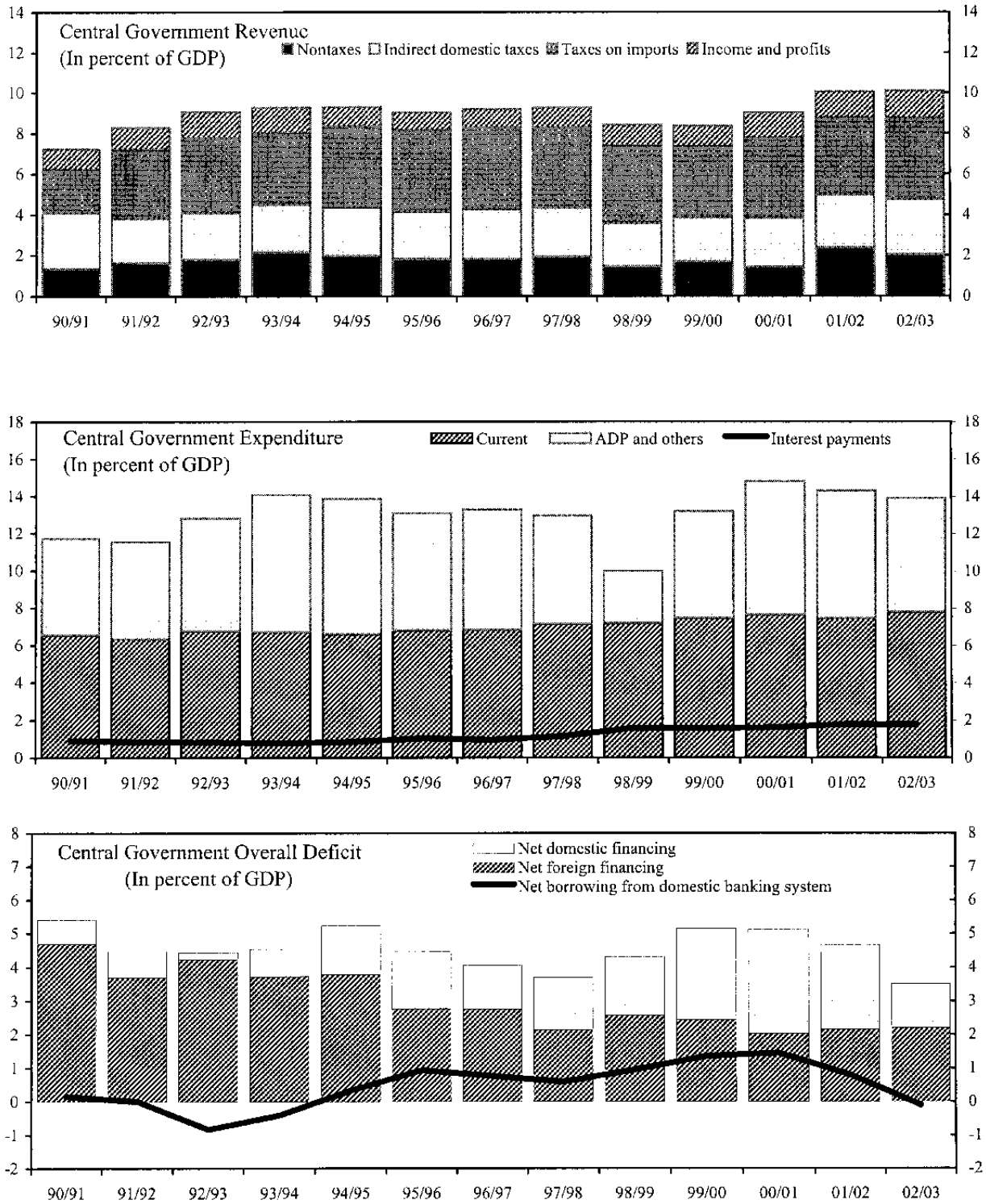
Sources: Data provided by the Bangladesh authorities; and Fund staff estimates and projections.

Figure 2. Bangladesh: External Sector Indicators, FY97-03



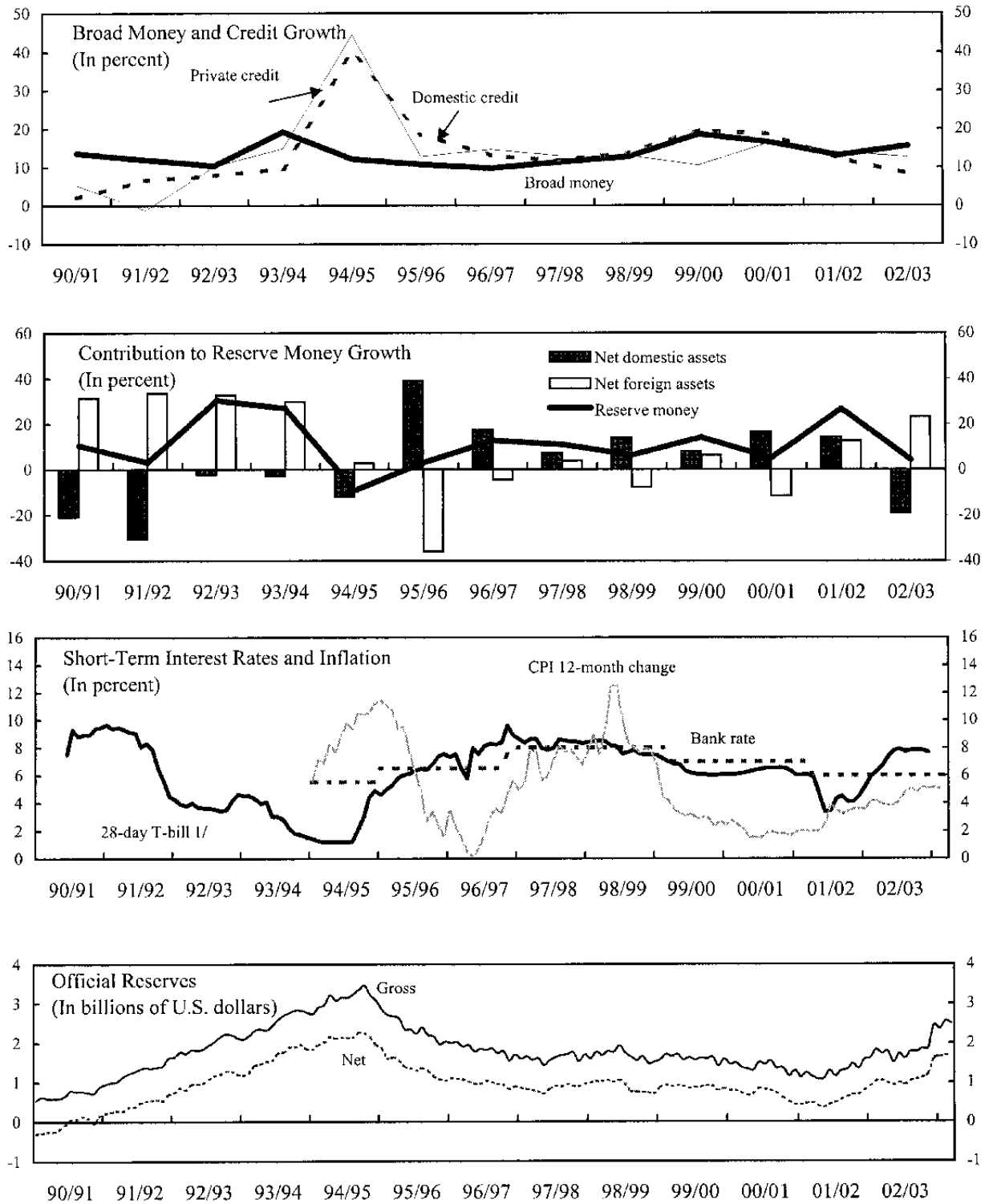
Sources: Data provided by the Bangladesh authorities; IMF, Information Notices System, *International Financial Statistics*; and Fund staff estimates and projections.

Figure 3. Bangladesh: Fiscal Sector Indicators, FY91-03



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

Figure 4. Bangladesh: Monetary Sector Indicators, FY91-04



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

1/ Bangladesh Bank bill rates until 1998.

Table 1. Bangladesh: Key Social Indicators, 1970–01

	1970–75	1980–85	1995–01 1/	Low-income 2/
Population				
Total population, midyear (millions)	75.6	97.1	133.3	2,505.9
Growth rate (percent annual average for period)	2.6	2.6	1.7	1.9
Urban population (percent of population)	9.9	17.5	25.6	30.8
Total fertility rate (births per woman)	6.6	5.3	3.0	3.5
Poverty (percent of population)				
National headcount index	...	...	33.7	...
Urban	...	...	19.1	...
Rural	...	...	37.4	...
Income				
GNI per capita (in U.S. dollars)	200	200	360	430
Income/consumption distribution				
Gini index (percent of income or consumption)	...	25.9	31.8	...
Lowest quintile	...	9.7	9.0	...
Highest quintile	...	35.8	41.3	...
Social indicators				
Public expenditure (percent of GDP)				
Health	...	...	1.4	1.1
Education	0.8	1.4	2.5	2.8
Net primary school enrollment rate (percent of age group) 3/				
Total	50	56	89	...
Male	66	65	88	...
Female	33	47	90	...
Access to an improved water source (percent of population)				
Total	...	...	97	76
Urban	...	...	99	90
Rural	...	...	97	70
Immunization rate (percent under 12 months)				
Measles	...	1	76	60
DPT	...	2	83	61
Child malnutrition (percent under 5 years)				
	...	68	48	...
Life expectancy at birth (years)				
Total	46	52	62	59
Male	47	52	61	58
Female	45	51	62	60
Mortality				
Infant (per 1,000 live births)	137	113	51	80
Under 5 (per 1,000 live births)	222	175	77	121
Adult (15–59) (per 1,000 population)				
Male	473	383	262	312
Female	486	388	252	256
Maternal (per 100,000 live births)	...	...	600	...

Source: 2002 *World Development Indicators*, World Bank.

1/ Latest available single year data.

2/ Countries with 2001 gross national income (GNI) per capita of \$745 or less, calculated using the World Bank Atlas method.

3/ Net enrollment ratios exceeding 100 indicate discrepancies between the estimates of school-age population and reported enrollment data.

Table 2. Bangladesh: Key Economic Indicators, FY02–08 1/

	2001/02	2002/03		2003/04	2004/05	2005/06	2006/07	2007/08
		Prog.	Prel.			Prog.		
National income and prices (percent change)								
Real GDP	4.4	5.2	5.3	5.5	6.0	6.5	6.5	6.5
GDP deflator	2.7	4.8	4.4	4.0	4.0	4.0	4.0	4.0
CPI inflation (annual average) 2/	2.8	5.2	4.4	4.5	4.0	4.0	4.0	4.0
Central government operations (percent of GDP) 3/								
Total revenue	10.2	10.4	10.4	10.8	11.3	11.8	12.1	12.2
Tax	7.7	8.3	8.3	8.7	9.2	9.7	9.9	10.0
Nontax	2.4	2.0	2.1	2.1	2.1	2.1	2.2	2.2
Total expenditure	14.8	14.5	13.9	15.6	16.1	16.4	16.4	16.2
Current expenditure	8.0	8.4	7.8	8.4	8.5	8.5	8.5	8.5
<i>Of which</i> : Interest payments	1.8	2.0	1.8	2.0	2.1	2.0	2.0	2.0
Annual Development Program	5.6	5.8	5.3	6.1	6.5	6.9	7.0	6.9
Extraordinary expenditures	0.0	0.4	0.4	0.5	0.5	0.5	0.3	0.2
Other expenditures 4/	1.2	-0.1	0.4	0.6	0.6	0.5	0.5	0.5
Overall balance (excluding grants)	-4.7	-4.2	-3.5	-4.8	-4.7	-4.5	-4.3	-4.1
Primary balance	-2.9	-2.2	-1.7	-2.8	-2.7	-2.5	-2.3	-2.1
Financing (net)	4.7	4.2	3.5	4.8	4.7	4.5	4.3	4.1
Domestic	2.6	1.9	1.3	2.0	1.9	1.9	1.9	1.9
External	2.1	2.3	2.2	2.8	2.8	2.6	2.3	2.1
Total central government debt (percent of GDP)	53.2	51.7	51.7	52.2	51.1	50.5	49.8	48.9
Money and credit (end of year; percent change)								
Net domestic assets	11.9	10.6	12.2	14.2	14.8	13.5	13.1	13.1
Private sector credit	13.9	11.4	12.6	15.6	15.5	13.5	13.1	13.1
Broad money (M2)	13.1	12.5	15.6	14.1	14.5	14.0	12.8	12.8
Money velocity	2.8	2.7	2.6	2.5	2.4	2.4	2.3	2.3
Balance of payments (in billions of U.S. dollars) 5/								
Exports, f.o.b.	5.9	6.1	6.5	7.0	7.4	7.9	8.6	9.4
(Annual percent change)	-7.6	2.1	9.5	7.2	6.2	7.5	8.3	8.7
Imports, f.o.b.	7.7	8.2	8.7	10.1	10.5	11.0	11.7	12.4
(Annual percent change)	-8.7	6.8	13.0	15.7	4.0	5.5	5.8	6.0
Gross official reserves (in billions of U.S. dollars)	1.6	2.1	2.5	2.8	3.2	3.7	3.9	4.2
In months of imports of goods and nonfactor services	1.8	2.6	2.9	2.9	2.9	3.1	3.2	3.3
Memorandum item:								
Nominal GDP (in billions of taka)	2,732	2,996	3,005	3,294	3,629	4,019	4,452	4,931

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

1/ Fiscal year begins July 1.

2/ CPI has recently been rebased using FY96 weights.

3/ Starting FY02, central government fiscal positions are presented on a gross basis.

4/ Consists of other capital, net lending, and food accounts (including check float and discrepancy).

5/ Balance of payments is presented on the basis of BPM5. For FY04, export and import projections are based on the growth rates in the original program.

Table 3. Bangladesh: Balance of Payments, FY2002-08 1/

(In millions of U.S. dollars, unless otherwise indicated)

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
		Prel.	Rev. Proj.		Proj.		
Trade balance	-1,768	-2,207	-3,109	-3,082	-3,107	-3,088	-3,038
Exports (f.o.b)	5,929	6,492	6,959	7,389	7,940	8,600	9,351
Imports (f.o.b)	-7,697	-8,699	-10,068	-10,471	-11,047	-11,688	-12,389
Services	-500	-688	-981	-1,049	-1,062	-1,134	-1,246
Receipts	864	887	882	904	950	996	1,043
Payments	-1,364	-1,575	-1,863	-1,953	-2,012	-2,129	-2,288
Income	-321	-195	-230	-307	-326	-345	-364
Receipts	50	64	70	73	77	81	84
Payments	-371	-259	-300	-380	-403	-425	-449
Transfers	2,826	3,418	3,677	3,681	3,744	3,812	3,845
Official current transfers 2/	69	60	85	53	54	55	56
Private transfers	2,757	3,358	3,592	3,628	3,690	3,757	3,789
<i>Of which: Workers' remittances</i>	2,501	3,062	3,292	3,325	3,382	3,443	3,472
Current account balance	237	328	-643	-756	-751	-754	-803
Capital and financial account balance	446	577	393	449	479	426	391
Capital account	410	392	405	349	356	363	369
Capital transfers	410	392	405	349	356	363	369
Financial account	36	185	-12	100	123	63	22
Foreign direct investment	65	92	60	52	55	58	60
Portfolio investment	-6	2	2	0	0	0	0
Net aid flows	541	634	651	710	704	686	686
Aid disbursements 3/	963	1,070	1,147	1,164	1,188	1,210	1,231
Debt amortization	-422	-436	-496	-454	-484	-524	-545
Other long-term loans (net)	-42	-20	-25	0	0	0	0
Other short-term loans (net)	20	143	0	0	0	0	0
Other assets (net)	-52	-81	-107	-99	-96	-101	-98
Trade credits (net)	-482	-656	-544	-512	-490	-530	-576
Commercial banks (net)	-9	71	-50	-50	-50	-50	-50
Errors and omissions	-354	-94	0	0	0	0	0
Overall balance	329	811	-250	-307	-272	-328	-412
Financing items	-329	-811	-270	-300	-310	-254	-296
Bangladesh Bank	-329	-811	-270	-300	-310	-254	-296
Assets (- increase)	-276	-871	-394	-395	-420	-267	-308
Liabilities 4/	-53	60	124	95	110	13	12
Financing gap 5/	0	0	520	607	582	582	708
Memorandum items:							
Current account balance (percent of GDP)	0.5	0.6	-1.2	-1.3	-1.1	-1.0	-1.0
Export growth rate (percent)	-7.6	9.5	7.2	6.2	7.5	8.3	8.7
Import growth rate (percent)	-8.7	13.0	15.7	4.0	5.5	5.8	6.0
Gross official reserves (US\$ million) 6/	1,582	2,454	2,848	3,243	3,663	3,930	4,238
(In months of imports of goods and services)	1.8	2.9	2.9	2.9	3.1	3.2	3.3
Net international reserves (US\$ million)	792	1,604	1,874	2,174	2,484	2,738	3,034
Medium and long-term external public debt (US\$ million)	16,276	17,023	18,164	19,481	20,767	22,035	23,429
(In percent of GDP)	34.4	32.9	32.9	32.4	31.6	30.7	29.8
(To exports of goods, nonfactor services and private transfers)	170.4	158.5	158.9	164.4	166.1	166.6	167.6
Debt-service ratio 7/	6.1	5.5	5.7	5.5	5.5	5.5	5.4
Nominal GDP (US\$ million)	47,303	51,744	55,287	60,063	65,734	71,876	78,594

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

1/ Fiscal year begins July 1. Following an STA technical assistance mission in August 2002, presentation of the data has been modified to comply with the fifth edition of the balance of payments manual.

2/ Excludes official capital grants.

3/ Loans only.

4/ Includes Asian Clearing Union balances.

5/ The financing gap for 2003/04 is fully financed (see Table 9).

6/ Gross foreign reserves of Bangladesh Bank, including resident foreign currency deposits.

7/ In percent of current earnings defined as the sum of exports of goods, nonfactor services, and private transfers.

Table 4. Bangladesh: Central Government Operations, FY02–08 1/

	2001/02	2002/03		2003/04	2004/05	2005/06 Proj.	2006/07	2007/08
		Prog.	Prel.					
(In billions of taka)								
Total revenue	276.8	310.5	310.8	356.9	410.6	475.9	537.3	601.0
Tax revenue	210.3	249.5	248.4	286.6	333.9	390.3	441.7	494.4
NBR taxes	199.2	237.5	237.7	273.4	319.4	374.2	423.8	474.7
Non-NBR taxes	11.1	12.0	10.7	13.2	14.6	16.1	17.8	19.7
Nontax revenue	66.5	61.0	62.4	70.3	76.6	85.6	95.6	106.6
Total expenditure	389.9	435.0	417.4	515.4	582.9	657.7	728.6	800.9
Current expenditure	218.2	252.5	234.6	278.3	306.3	339.6	379.3	421.6
Pay and allowances	68.8	72.9	71.4	80.7	81.4	90.1	99.8	110.6
Goods and services	33.2	43.7	42.2	47.8	52.5	59.7	69.1	80.0
Interest payments	49.3	59.0	53.4	65.6	75.0	81.0	88.6	96.1
Subsidies and transfers	58.4	61.7	64.1	64.7	76.0	85.0	95.5	105.8
Block allocations	8.4	15.2	3.6	19.5	21.4	23.7	26.3	29.1
Food account surplus(-)/deficit(+)	2.1	-0.5	0.1	3.5	2.5	2.5	2.5	2.5
Annual Development Program (ADP)	152.3	173.0	159.3	200.0	237.1	275.7	311.1	342.6
Non-ADP capital and net lending	17.2	9.4	11.2	18.7	17.0	18.4	23.4	24.9
Structural adjustment expenditures	0.0	11.6	12.2	14.9	20.0	21.4	12.4	9.4
Cheque float plus discrepancy	13.8	-11.0	-1.7	0.0	0.0	0.0	0.0	0.0
Overall balance (excluding grants)	-126.9	-124.5	-105.0	-158.5	-172.3	-181.8	-191.4	-199.9
Net financing	126.9	124.5	105.0	158.5	172.3	181.8	191.4	199.9
External	58.1	68.0	64.8	92.5	101.0	102.7	105.3	105.0
Domestic	68.1	55.9	39.6	65.0	68.8	76.2	84.4	93.5
Bank	21.7	17.9	-3.5	20.0	29.0	32.1	35.5	39.4
Nonbank	46.4	38.0	43.1	45.0	39.8	44.1	48.9	54.1
Privatization receipts	0.6	0.7	0.6	1.0	2.5	2.9	1.7	1.5
(In percent of GDP)								
Total revenue	10.1	10.4	10.3	10.8	11.3	11.8	12.1	12.2
Tax revenue	7.7	8.3	8.3	8.7	9.2	9.7	9.9	10.0
NBR taxes	7.3	7.9	7.9	8.3	8.8	9.3	9.5	9.6
Non-NBR taxes	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Nontax revenue	2.4	2.0	2.1	2.1	2.1	2.1	2.1	2.2
Total expenditure	14.3	14.5	13.9	15.6	16.1	16.4	16.4	16.2
Current expenditure	8.0	8.4	7.8	8.4	8.4	8.5	8.5	8.5
Pay and allowances	2.5	2.4	2.4	2.4	2.2	2.2	2.2	2.2
Goods and services	1.2	1.5	1.4	1.5	1.4	1.5	1.6	1.6
Interest payments	1.8	2.0	1.8	2.0	2.1	2.0	2.0	1.9
Subsidies and transfers	2.1	2.1	2.1	2.0	2.1	2.1	2.1	2.1
Block allocations	0.3	0.5	0.1	0.6	0.6	0.6	0.6	0.6
Food account surplus(-)/deficit(+)	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1
ADP	5.6	5.8	5.3	6.1	6.5	6.9	7.0	6.9
Non-ADP capital and net lending	0.6	0.3	0.4	0.6	0.5	0.5	0.5	0.5
Structural adjustment expenditures	0.0	0.4	0.4	0.5	0.6	0.5	0.3	0.2
Cheque float plus discrepancy	0.5	-0.4	-0.1	0.0	0.0	0.0	0.0	0.0
Overall balance (excluding grants)	-4.6	-4.2	-3.5	-4.8	-4.7	-4.5	-4.3	-4.1
Net financing	4.6	4.2	3.5	4.8	4.7	4.5	4.3	4.1
External financing (net)	2.1	2.3	2.2	2.8	2.8	2.6	2.4	2.1
Domestic financing	2.5	1.9	1.3	2.0	1.9	1.9	1.9	1.9
Bank	0.8	0.6	-0.1	0.6	0.8	0.8	0.8	0.8
Nonbank	1.7	1.3	1.4	1.4	1.1	1.1	1.1	1.1
Privatization receipts	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0
Memorandum item:								
Nominal GDP (in billions of taka)	2,732	2,996	3,005	3,294	3,629	4,019	4,452	4,931

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

1/ Fiscal year ends June 30.

Table 5. Bangladesh: Central Bank Balance Sheet, June 2001-December 2004

	FY01	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03		Sep-03		Dec-03	Mar-04	Jun-04	Sep-04	Dec-04
			Actual			Prog.	Actual	Prog.	Actual		Revised program			
	(End of period; in billions of taka)													
Net international reserves 1/	25	46	61	57	64	78	94	75	103	104	104	109	114	118
Net international reserves 2/	...	48	...	...	64	80	89	75	96	97	97	103	107	111
Net domestic assets 1/	137	160	136	146	143	136	121	143	110	120	124	126	119	127
Net domestic assets 2/	...	158	...	...	142	135	125	143	116	127	130	133	126	134
Net credit to central government	92	108	69	75	75	69	62	72	36	54	58	62	51	60
Credit to other nonfinancial public sector	2	1	1	1	1	1	1	1	1	1	1	1	1	1
Credit to deposit money banks	44	47	48	48	49	48	48	48	50	48	48	48	48	48
Other items, net 1/	0	3	17	22	18	19	9	22	23	17	16	15	19	18
Reserve money	162	206	196	203	206	215	214	218	212	224	227	236	233	245
Currency	128	139	140	147	150	158	153	160	152	161	164	170	166	175
Reserves	34	67	56	56	56	57	61	58	60	63	63	66	67	70
	(Change since start of financial year; in billions of taka)													
Net international reserves 1/	-18	20	15	11	18	32	48	-3	9	10	10	16	4	9
Net domestic assets 1/	25	23	-24	-14	-17	-23	-39	6	-11	0	3	6	-7	1
Net domestic assets 2/	...	...	...	...	-16	-23	-33	6	-9	2	6	9	-7	1
Net credit to central government	28	16	-39	-33	-33	-39	-46	3	-27	-8	-4	0	-11	-2
Credit to other nonfinancial public sector	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Credit to deposit money banks	1	4	1	1	1	1	1	0	2	0	0	0	0	0
Other items, net	-3	4	14	19	14	16	6	3	14	8	7	6	4	3
Reserve money	8	44	-9	-2	0	9	9	4	-2	10	13	22	-3	9
Currency	16	10	1	8	11	19	15	2	14	8	10	17	-4	5
Reserves	-8	33	-10	-11	-11	-10	-6	1	-1	2	2	5	1	5
Memorandum items:														
Reserve money (year-on-year percent change)	5.0	26.8	18.5	2.1	6.4	4.3	4.2	11.1	8.1	10.2	10.2	10.1	9.9	9.6
Net international reserves (in millions of U.S. dollars) 1/	447	792	1,048	988	1,099	1,349	1,604	1,299	1,756	1,774	1,774	1,874	1,949	2,024
Flow since start of fiscal year (in millions of U.S. dollars) 1/	-401	165	256	195	306	336	811	-50	153	171	171	271	75	150
Net international reserves (in millions of U.S. dollars) 2/	...	824	...	...	1,102	1,381	1,546	1,299	1,658	1,671	1,671	1,771	1,846	1,921
Flow since start of fiscal year (in millions of U.S. dollars) 2/	...	...	...	...	278	557	722	-50	112	125	125	225	75	150
Required domestic cash reserves (in millions of taka)	4	37	38	40	40	41	41	42	43	44	44	47	48	50
Excess domestic cash reserves (in millions of taka)	30	30	19	16	16	16	20	16	17	19	19	19	19	20

Sources: Data provided by the Bangladeshi authorities; and Fund staff estimates and projections.

1/ Calculated from monetary data using end-of-period exchange rates.

2/ Calculated using program exchange rates.

Table 6. Bangladesh: Monetary Program, June 2001-December 2004

	FY01	Jun-02	Sep-02	Dec-02	Mar-03	Jun-03		Sep-03		Dec-03	Mar-04	Jun-04	Sep-04	Dec-04
			Actual			Prog.	Actual	Prog.	Actual		Revised program			
	(End of period; in billions of taka)													
Net foreign assets	76	96	110	101	107	124	140	123	149	151	150	159	164	169
Net domestic assets	796	891	906	967	959	985	1,000	1,013	1,027	1,072	1,085	1,142	1,167	1,229
Domestic credit	846	957	966	1,031	1,030	1,059	1,034	1,089	1,055	1,111	1,135	1,180	1,208	1,272
Net credit to central government	162	184	184	189	183	202	173	213	172	176	186	194	205	207
Credit to other nonfinancial public sector	56	59	55	63	57	61	55	62	55	55	55	55	55	55
Credit to private sector	628	715	727	780	790	797	806	814	828	880	894	931	949	1,011
Other items, net 1/	-50	-67	-60	-64	-71	-74	-34	-76	-28	-39	-50	-38	-41	-43
Broad money (M2)	872	986	1,016	1,069	1,066	1,110	1,140	1,135	1,176	1,223	1,235	1,301	1,331	1,399
	(Change since start of fiscal year; in billions of taka)													
Net foreign assets	-9	20	14	6	12	29	45	-1	9	11	10	19	5	11
Net domestic assets	134	95	16	77	68	95	109	27	27	73	85	142	25	88
Domestic credit	135	112	9	74	73	102	76	29	21	77	101	146	28	93
Net credit to central government	37	22	0	5	-1	18	-11	11	-1	3	13	20	11	13
Credit to other nonfinancial public sector	11	3	-4	4	-2	2	-3	1	0	0	0	0	0	0
Credit to private sector	88	87	12	64	75	82	90	17	22	74	88	126	17	80
Other items, net	-2	-17	7	3	-4	-7	33	-2	6	-5	-16	-4	-3	-5
Broad money (M2)	124	114	30	83	80	124	154	26	36	83	95	161	31	98
	(Year-on-year percent change)													
Net foreign assets	-11.1	25.8	55.8	39.4	32.3	30.2	46.8	12.1	35.9	48.7	40.0	13.3	10.1	12.4
Net domestic assets	20.2	11.9	11.3	11.1	12.4	10.6	12.2	11.7	13.3	10.8	13.1	14.2	13.7	14.7
Domestic credit	19.0	13.2	10.3	12.7	11.9	10.6	8.0	12.7	9.2	7.8	10.2	14.1	14.5	14.5
Net credit to central government	29.4	13.4	1.4	-1.2	6.4	9.7	-5.8	15.5	-6.6	-6.8	1.7	11.8	18.9	17.3
Credit to other nonfinancial public sector	23.5	4.8	2.3	12.9	6.9	4.2	-5.7	13.6	0.5	-11.9	-2.8	-0.4	0.2	-0.4
Credit to private sector	16.3	13.9	13.5	16.7	13.6	11.4	12.6	11.9	13.9	12.9	13.1	15.6	14.6	14.9
Other items, net	3.5	34.2	-2.9	45.5	5.0	10.6	-48.7	26.9	-52.6	-38.8	-29.5	10.8	44.5	10.2
Broad money (M2)	16.6	13.1	14.9	13.3	14.1	12.5	15.6	11.8	15.7	14.4	15.8	14.1	13.2	14.4
	(In billions of taka)													
Memorandum items:														
Broad money multiplier	5.37	4.79	5.17	5.26	5.17	5.17	5.32	5.21	5.54	5.46	5.44	5.51	5.71	5.70
Broad money velocity	2.91	2.77	2.75	2.68	2.75	2.70	2.64	2.70	2.62	2.57	2.61	2.53	2.54	2.47
Net domestic financing of central government (since beginning of FY)	79	69	13	27	35	56	38	20	15	31	50	65	21	33
Bank	37	22	0	5	-1	18	-11	11	-1	3	13	20	11	13
Nonbank	42	47	13	22	36	38	48	9	16	28	37	45	10	20

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

1/ The large change in other items, net in June 2003, was due in part to writeoffs by commercial banks of longstanding nonperforming loans, in response to changes in regulatory guidelines by Bangladesh Bank.

Table 7. Bangladesh: Schedule of Disbursements Under the PRGF Arrangement

Amount	Available Date	Conditions for Disbursement
SDR 49.5 million (9.3 percent of quota)	June 25, 2003	Observance of the end-March 2003 quantitative benchmarks, implementation of prior actions, and Board approval of arrangement.
SDR 49.5 million (9.3 percent of quota)	December 15, 2003	Observance of the end-September 2003 performance criteria and structural performance criteria for end-September and end-November 2003 and completion of the first review.
SDR 49.5 million (9.3 percent of quota)	June 15, 2004	Observance of the end-March 2004 performance criteria and structural performance criteria for end-December 2003 and end-April 2004 and completion of the second review.
SDR 49.5 million (9.3 percent of quota)	December 15, 2004	Observance of the end-September 2004 performance criteria and structural performance criteria for end-September 2004 and end-November 2004 and completion of the third review.
SDR 49.5 million (9.3 percent of quota)	June 15, 2005	Observance of the end-March 2005 performance criteria and completion of the fourth review.
SDR 49.5 million (9.3 percent of quota)	December 15, 2005	Observance of the end-September 2005 performance criteria and completion of the fifth review.
SDR 49.5 million (9.3 percent of quota)	June 15, 2006	Observance of the end-March 2006 performance criteria and completion of the sixth review.

Table 8. Bangladesh: External Financing Requirements, FY03-08

(In millions of U.S. dollars)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Total financing requirements	1,465	2,135	2,172	2,180	2,212	2,368
Gross financing requirements	593	1,741	1,777	1,761	1,945	2,060
Current account deficit	-328	643	756	751	754	803
MLT debt amortization	436	496	454	484	524	545
Trade credits (net)	494	544	512	490	530	576
UFR (abstracting from expected Fund financing)	35	25	0	0	0	0
Other Bangladesh Bank liabilities (net)	-25	-148	-95	-110	-13	-12
Other long-term loans (net)	20	25	0	0	0	0
Other short-term loans and assets (net)	-62	107	99	96	101	98
DMBs foreign exchange assets (net)	-71	50	50	50	50	50
Errors and omissions	94	0	0	0	0	0
Buildup in gross reserves (+, increase in assets)	872	394	395	420	267	308
Resources	1,094	1,614	1,565	1,598	1,630	1,660
Aid disbursements	1,000	1,552	1,513	1,544	1,573	1,600
Foreign direct and portfolio investment	94	62	52	55	58	60
Financing gap						
Without expected Fund financing	371	656	741	717	582	708
With expected Fund financing	300	520	607	582	582	708
Identified program financing	300	520	520	520	500	500
Loans	300	450	500	500	500	500
World Bank	300	400	400	400	400	400
Asian Development Bank	0	50	100	100	100	100
Grants	0	70	20	20	0	0
United Kingdom	0	20	20	20	0	0
Others	0	50	0	0	0	0
Residual financing gap	0	0	87	62	82	208
Memorandum item:						
Gross official reserves	2,454	2,848	3,243	3,663	3,930	4,238

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

Table 9. Bangladesh: Projected Fund Transactions Under the PRGF, FY03–08

(In millions of SDRs)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Total use of Fund resources (UFR) outstanding	74.0	148.5	247.5	346.5	346.5	346.5
SBA	24.5	0.0	0.0	0.0	0.0	0.0
PRGF	49.5	148.5	247.5	346.5	346.5	346.5
PRGF						
Disbursements	49.5	99.0	99.0	99.0	0.0	0.0
Debt service	0.0	0.5	1.0	1.6	2.0	2.0
Repayments	0.0	0.0	0.0	0.0	0.0	0.0
Charges	0.0	0.5	1.0	1.6	2.0	2.0
Total debt service to the Fund	61.0	26.0	1.8	2.4	2.8	2.8
SBA	51.6	24.8	0.0	0.0	0.0	0.0
Repurchases	49.1	24.5	0.0	0.0	0.0	0.0
Charges	2.5	0.2	0.0	0.0	0.0	0.0
PRGF	8.6	0.5	1.0	1.6	2.0	2.0
Principle	8.6	0.0	0.0	0.0	0.0	0.0
Interest	0.0	0.5	1.0	1.6	2.0	2.0
Other SDR charges	0.8	0.8	0.8	0.8	0.8	0.8
Memorandum items:						
Total UFR as a percentage of quota	13.9	27.8	46.4	65.0	65.0	65.0
Total UFR as a percentage of GDP	0.2	0.4	0.5	0.7	0.6	0.6
Debt service as a percentage of exports of goods and services	1.2	0.5	0.0	0.0	0.0	0.0

Bangladesh: Fund Relations
(As of October 31, 2003)

I. **Membership Status:** Joined August 17, 1972; accepted the obligations under Article VIII, Sections 2, 3, and 4 on April 11, 1994.

II. General Resources Account:	<u>SDR million</u>	<u>Percent Quota</u>
Quota	533.30	100.00
Fund holdings of currency	533.30	100.00
Reserve position in Fund	0.19	0.03
III. SDR Department:	<u>SDR million</u>	<u>Percent Allocation</u>
Net cumulative allocation	47.12	100.00
Holdings	2.79	5.91
IV. Outstanding Purchases and Loans:	<u>SDR million</u>	<u>Percent Quota</u>
PRGF arrangements	49.50	9.28

V. **Financial Arrangements:**

Type	Approval date	Expiration date	Amount approved (SDR million)	Amount drawn (SDR million)
PRGF	6/20/03	6/20/06	347.00	49.50
ESAF	8/10/90	9/13/93	345.00	345.00
SAF	2/06/87	2/05/90	201.25	201.25

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2003	2004	2005	2006	2007
Principal	0.00	0.00	0.00	0.00	0.00
Charges/interest	<u>0.30</u>	<u>0.94</u>	<u>0.94</u>	<u>0.94</u>	<u>0.94</u>
Total	0.30	0.94	0.94	0.94	0.94

VII. **Safeguards Assessment**

The Safeguards Assessment Report issued in August 2002 concluded that the accounting, financial reporting, auditing, and control systems, as well as the legal framework, of Bangladesh Bank (BB) suffered from widespread vulnerabilities. Its risk assessments ranged from medium-high to high. The report recommended, inter alia, that: (i) BB's financial statements for FY02 be restated in accordance with International Accounting Standards (IAS) and audited in compliance with International Standards on Auditing (ISA) by an

international firm, possibly in collaboration with a local firm; (ii) the BB board should adopt IAS as BB's accounting framework beginning with FY03, and ISA should be established as the auditing standard; (iii) the statistical classification of accounting data should be regularly validated and the data to be reported to the Fund under a future arrangement should be regularly reconciled against BB's accounts and audited financial statements; and (iv) the reserve management functions should be adequately segregated between the dealing room and middle and back offices, and an appropriate reporting mechanism for reserves management established. BB has since made progress in addressing those weaknesses. IAS has been adopted as its accounting framework, its FY03 accounts were audited by a local auditing firm and signed off by an international accounting firm, and reserve management functions have been separated into front and back offices.

VIII. Exchange Arrangement

Exchange regime. Until May 31, 2003, the taka was fixed to the U.S. dollar, but was periodically adjusted. It was devalued on three occasions during 2000–02, when the trading band for BB's transactions was correspondingly widened or raised. From January 2002 until May 30, 2003, the official band for the taka remained unchanged at Tk 57.4–58.4 per U.S. dollar. Authorized dealer (AD) banks set their own buying and selling rates for the U.S. dollar and other currencies generally within the band until October 2002. From November 2002, however, AD banks have set rates outside the band. Effective May 31, 2003, BB no longer announced a trading band for its foreign exchange transactions, thereby allowing the taka to float.

Exchange restrictions. In December 2000, BB introduced margin requirements on letters of credit for most commercial imports, which constitutes an exchange restriction subject to Fund jurisdiction under Article VIII, Section 2(e). In the period to January 2003, the scope and level of margin requirements were adjusted on four occasions. In October 2003, the margin requirements on 55 items were reduced from 100 percent to 50 percent and all margin requirements were removed effective December 2, 2003.

In August 2002, limits on the availability of foreign exchange for travel, medical, and educational expenses, as well as other services, were removed.

At the last Article IV consultation (June 2003), the Executive Board approved the maintenance by Bangladesh of margin requirements for the opening of letters of credit for the import of goods until November 30, 2003, and also approved the maintenance of restrictions on the convertibility and transferability of proceeds of current international transactions in nonresident taka accounts until the conclusion of the second review under the PRGF arrangement or June 30, 2004, whichever is sooner.

IX. Article IV Consultation

The next Article IV consultation will be held subject to the provisions of the decision on consultation cycles approved on July 15, 2002. The last Article IV consultation was held over two missions in January and April 2003, and was concluded on June 20, 2003 (IMF Country Report NO. 03/205).

X. Technical Assistance During 2002–03

2002

- January: MFD/LEG mission advised on operational steps to facilitate the adoption of a more flexible exchange rate regime.
- February: An external legal expert advised on amendments to the Bangladesh Bank Order to strengthen the independence of BB.
- April: MFD consultant provided recommendations for the establishment of a repo market.
- May: A pre-FSAP mission advised on banking sector reform, followed by a full FSAP mission in October.
- May–November: MFD peripatetic adviser assisted in foreign exchange operations and liquidity management.
- August: FAD team conducted a fiscal ROSC, and STA conducted a multisector technical assistance mission.
- October: MFD mission provided assistance in implementing the Safeguards recommendations.

2003

- January and May: MFD missions advised on preparations for moving to a flexible exchange rate regime.
- March–September: MFD resident adviser assisted BB with liquidity forecasting and monetary and exchange operations.
- May: MFD mission assisted BB with nationalized commercial bank (NCB) reforms; a peripatetic adviser assisted BB with producing its FY03 accounts in accordance with IAS.
- August: MFD mission provided recommendations for reducing interest rates.
- August–September: FAD mission provided recommendations on tax administration.
- November: MFD mission provided recommendations for the resolution of NCBs and on the functioning of treasury bill markets. An STA mission on monetary and financial statistics and a joint LEG/MFD mission on exchange restrictions were conducted.

XI. Resident Representative

The resident representative office was established in 1972. The current Resident Representative, Mr. Marijn Verhoeven, took up the post in August 2001.

Bangladesh: Relations with the World Bank¹

The World Bank has an ambitious assistance program in Bangladesh covering a wide range of instruments including investment lending, advisory and analytical services, and policy dialogue on a broad range of macroeconomic and sectoral issues. This annex focuses on the Bank's activities in areas that are complementary to those of the Fund.

World Bank-Bangladesh relations and policy dialogue

Since taking office two years ago, the government has made progress on critical areas such as state-owned enterprises (SOEs), banking, energy, telecommunications, and economic governance. The Bank has been regularly interacting with the government team and has been providing inputs into the design and sequencing of reforms, as requested by the authorities.

To obtain inputs for the preparation of the country's Poverty Reduction Strategy, the government organized a series of national consultation workshops, including various government and nongovernmental organizations, members of civil society, and development partners. The Joint Staff Assessment, prepared by the Bank and the Fund and presented to their Boards on June 2003, concluded that the Interim PRSP constitutes an adequate framework for enhancing growth and poverty reduction. The government plans to complete the full PRSP by December 2004.

As part of its nonlending services, the Bank has completed key reports. These include, inter alia, the Public Expenditure Review and the Poverty Assessment, which were prepared jointly with the Asian Development Bank, and which provided inputs for the I-PRSP. In addition, an Investment Climate Survey (jointly with the Bangladesh Enterprise Institute) and a Country Framework for Private Provision of Infrastructure have been completed and shared with government officials. More recently, the Bank has completed the Development Policy Review and a review of trade policies in South Asia.

Restructuring SOEs. The Bank has engaged in an extensive dialogue with the authorities on SOE-related issues. A report entitled "Bangladesh: Review of Public Enterprise Performance and Strategy" (November 2002) was prepared by the Bank and widely discussed at a national seminar in Dhaka in December 2002. In response to a request from the authorities, the Bank has also provided technical assistance to the Privatization Commission and assisted it in the preparation of the government's new Privatization Policy, which has since been endorsed by Cabinet. Dialogue relating to SOEs in the energy sector has been particularly intensive and the Bank has provided detailed recommendations to the authorities in areas relating to pricing policy and the regulatory regime for energy and other utilities.

¹Prepared by Syed Nizamuddin, Aneeka Rahman, and Enrique Pantoja, Country Officer, World Bank, (202) 473-2516.

Restructuring the financial system. The Bank has been actively engaging the authorities in a dialogue on financial sector reform. Together with the Fund, the Bank co-managed the Financial Sector Assessment Program report that was prepared in October 2002. With IDA financing, the government is implementing a program to strengthen the Bangladesh Bank.

Trade liberalization. In response to requests from the authorities, the Bank has been regularly providing analytical support to the Ministry of Finance, the National Board of Revenue, the Bangladesh Tariff Commission, and the Ministry of Commerce. The Bank-supported Export Diversification Project has a component designed to build capacity within the Tariff Commission for tariff analysis and WTO-related negotiations. In addition, the Bank has regularly provided brief trade-related policy notes to the government as inputs into the annual budget preparation process.

Infrastructure development. Infrastructure development is needed in the country for economic growth in general, and private sector development in particular. In this context, the Bank is helping to prepare a power sector strategy, and plans to approve a Power Sector Reform TA this fiscal year which will include a project preparation facility.

Strengthening governance. The Bank has engaged the government in an active dialogue aimed at improving the investment climate by strengthening accountability and transparency. The Bank has prepared several analytical reports on the subject, including an Institutional and Governance Review, a Country Financial Accountability Assessment, a Country Procurement Assessment, and user surveys on the quality of service delivery. In addition, the Bank is providing technical assistance to the government for improving its procurement policies and practices.

The World Bank's Country Assistance Strategy

The FY01–FY03 country assistance strategy (CAS) for Bangladesh identified four main thrusts: (i) helping to build stronger institutions and governance across sectors; (ii) consolidating gains in human development; (iii) implementing an integrated approach to rural development; and (iv) accelerating and broadening private sector-led growth.

A CAS Progress Report was discussed by the Board on June 19, 2003. A new CAS is planned for FY2005, to ensure an adequate alignment of Bank assistance with the full PRSP. Details of the program for FY2004 and FY2005 are provided below.

The World Bank's Assistance Program

The Bank has been assisting Bangladesh since FY1973. As of October 31, 2003, the World Bank Group has approved \$10.6 billion for 196 projects (including one IBRD loan) to Bangladesh and the net commitment amount stood at \$1.3 billion. During FY2003, new commitments totaled \$554.2 million and disbursements totaled \$560.3 million (including \$300 million of adjustment lending). The Bank is currently supporting 25 projects in key sectors, including social development, rural development, energy and infrastructure, private

sector development, finance, and environment. These operations emphasize policy and institutional reforms in line with the CAS and CASPR objectives.

In FY2003 the Bank approved five IDA Credits. These included four investment projects, namely Social Investment Program (\$18.24 million); Rural Transport Improvement (\$190 million); BD Telecommunications TA (\$9.12 million); and Central Banking Strengthening (\$37 million); and one adjustment operation, the Development Support Credit (\$300 million). The latter marks a shift toward programmatic lending, and complements a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) approved by the IMF Board on June 20, 2003.

During FY2004, nine projects are scheduled to go to the Board. These projects² include, Water Management Improvement Project (\$80 million); Education Sector Development Support Credit (\$100 million); Enterprise Growth and Bank Modernization (\$250 million); Development Support Credit II (\$200 million); Economic Management TA (\$20 million); Power Sector Reform Support TA (\$13 million); Second Primary Education Development Project (\$150 million); Rural Water Supply (\$35 million) and Increasing Access to Education (\$80 million)

The projects currently planned for FY2005 delivery are: Road Sector Reform (\$200 million); HNP Sector Program II (\$250 million); Agriculture Technology Project (\$50 million); and possibly the first Poverty Reduction Support Credit (PRSC) (\$300 million). Bank financing is also under consideration for a possible power sector investment project.

As of July 31, 2003, IFC's held portfolio was \$156 million in 11 projects, of which \$120 million was on IFC's own account and \$36 million was in B-loans. Projects span sectors such as power, telecommunications, cement, gas, and financial markets. In FY2003, IFC committed \$12 million in a ceramic tile manufacturer and has approved investments pending commitment in rural power (Summit Power, \$7 million), a commercial bank (BRAC Bank, \$3 million), and a leasing company (ULC, \$5 million) IFC also syndicated a \$21 million loan for Khulna Power under its B-loan program in FY2003. In mid-2002, with the support of several bilateral donors, IFC started a regional SME technical assistance facility covering Bangladesh, Bhutan, Nepal, and north-east India. IFC has committed \$5 million to the facility for the duration of the initiative.

The Bank continues to be involved in providing technical and advisory assistance to the government in a number of areas, including banking, energy, privatization, taxation, tariff and trade policy, poverty monitoring and analysis, and financial management.

World Bank-Fund collaboration

The Bank and the Fund have been working closely in Bangladesh, particularly in areas related to macroeconomic management, financial sector, reform of state-owned enterprises, public expenditure management, and issues relating to financial accountability. Bank staff

²IDA Credit amounts are indicative.

routinely participate in Article IV missions and provide feedback, as requested, on the macroeconomic framework and other aspects of the Fund's macroeconomic dialogue with the authorities. The Bank co-managed the Financial Sector Assessment Program report and Fund staff were regularly consulted during the preparation of the Public Expenditure Review. The Bank has also collaborated with the Fund in several areas related to the Report on Observance of Standards and Codes (ROSC) and safeguards assessment.

Dialogue between the two institutions has intensified in recent years, especially in the context of the preparation of the country's poverty reduction strategy. In addition, Fund and Bank staff collaborated closely in preparing the Joint Staff Assessment of the I-PRSP, and in completing the complementary Development Support Credit and PRGF.

Dhaka, Bangladesh
December 18, 2003

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431, U.S.A.

Dear Mr. Köhler:

The Government of Bangladesh is committed to implementing the reform strategy set out in our Interim Poverty Reduction Strategy Paper (I-PRSP), endorsed by the IMF Executive Board together with the approval of the arrangement under the Poverty Reduction and Growth Facility (PRGF) in June 2003. This strategy is aimed at moving the economy onto a path of higher sustainable growth with job creation, and faster poverty reduction. It will be further defined in the Poverty Reduction Strategy Paper (PRSP) that is to be completed by end-2004.

Based on discussions for the first review under the PRGF arrangement with the Fund staff in September and October 2003, the attached Memorandum of Economic and Financial Policies (MEFP) assesses economic and policy performance through October 2003 under the arrangement, updates the macroeconomic framework, and discusses the financial policies and structural reform program through December 2004. It supplements the MEFP dated June 4, 2003.

All quantitative performance criteria for end-September 2003 were observed, and the structural performance criterion on the removal of margin requirements was also met with a negligible delay. However, the structural performance criterion with respect to modernizing and expanding the Large Taxpayer Unit to cover 1,000 income taxpayers was met with a brief delay. On this basis, and in view of the policies set out in the attached memorandum, including the strengthening of tax administration, the Government requests waivers for the nonobservance of these structural performance criteria and the completion of the first review.

The Government of Bangladesh will provide the Fund with such information as the Fund may request in connection with progress in implementing the economic and financial policies, and achieving the objectives of the program. The Government believes that the policies set out in the attached MEFP are adequate to achieve the objectives of the program, but it will take any further measures that may become appropriate for this purpose. The Government of Bangladesh will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

Sincerely yours,

/s/

M. Saifur Rahman
Minister for Finance and Planning
Ministry of Finance

Attachment

BANGLADESH

Memorandum of Economic and Financial Policies for October 2003–December 2004

December 18, 2003

I. INTRODUCTION

1. Bangladesh's economic performance has strengthened over the past two years, with restoration of macroeconomic stability and a renewal of structural reforms. This allowed us to increasingly shift the policy focus to boosting growth and reducing poverty in a sustainable fashion. Thus, the government launched in June 2003 a comprehensive reform program based on a poverty reduction and growth strategy as set out in our Interim Poverty Reduction Strategy (I-PRSP). This memorandum reviews progress that has been achieved so far and lays out the objectives and macroeconomic and structural policies during the period through December 2004, supplementing our Memorandum of Economic and Financial Policies (MEFP) dated June 4, 2003.

2. We have begun preparation for a full PRSP, and aim to complete it by end-2004. An interministerial Poverty Steering Committee has been set up to follow a two-staged approach—a review of implementation of the I-PRSP and then detailed thematic studies of the key issues for poverty reduction. Furthermore, pro-poor programs will be more sharply prioritized, and more fully costed into a medium-term expenditure framework. In order to help solidify domestic support for reform, we intend to strengthen the consultation process, to include broader segments of civil society and parliamentarians.

II. RECENT PERFORMANCE UNDER THE FIRST-YEAR PRGF

3. Recent economic performance continues to be positive. The recovery that began in early FY03 (ending June) has been bolstered by a pick up in external demand and domestic activity. Real GDP growth for FY03 thus rose to an estimated 5.3 percent on the rebound of agriculture and industrial output (Table 1). For FY04, a further strengthening in economic performance is likely. At the same time, inflation remains manageable, at under 5 percent as of September.

4. The external position has strengthened more than expected. Exports climbed by 9½ percent in FY03, due to a turnaround in the ready-made garment (RMG) sector. This reflects gains in competitiveness and a recovery in external demand. Remittances also remain buoyant, so that in spite of strong import growth, the current account registered a surplus of 0.6 percent of GDP. With a substantial increase in external assistance, gross official reserves rose by about \$1 billion from June 2002 to \$2.4 billion (three months of imports) by end-November 2003, well above our target. The taka has remained broadly stable since the May 31 float, but depreciated in real effective terms by 2 percent since June 2002. Moreover, external debt management has been prudent, with tight monitoring of nonconcessional debt, keeping new borrowing well below the program ceiling.

5. Macroeconomic policies are on track, with overperformance in key targets for FY03, and all indicative targets and quantitative performance criteria for end-June and end-September were met (Table 2). Strong revenue performance and expenditure discipline helped to narrow the budget deficit to 3.5 percent of GDP, below the program target of 4.2 percent of GDP. Tax revenue rose by 0.6 percent of GDP, with increases in VAT and customs duty more than offsetting a shortfall in income tax. As a result, domestic financing was halved to 1.3 percent of GDP, against the program target of 2 percent of GDP.

6. The FY04 budget is in line with the program, and includes revenue efforts and a reordering of spending priorities. The budgeted deficit—up to 4.8 percent of GDP—is expected to be financed by more concessional financing to meet the urgent need for infrastructure and social spending. Total revenue is targeted to rise by 0.5 percent of GDP, on account of recovery of tax arrears, a broadening of the income tax and VAT net, and a strengthening in tax administration. Spending priorities are to be shifted to pro-growth and pro-poor areas, with an increase of about 1 percent of GDP in poverty reducing spending. Domestic financing is to be capped at 2 percent of GDP.

7. Monetary policy was tightened in the second half of FY03 to facilitate the transition to the float. Treasury bill rates were raised and reserve money rose by only 4 percent, below program. Nonetheless, private sector credit remained robust, growing by 13 percent in FY03 and the exchange rate has been stable. Given this favorable environment, Bangladesh Bank (BB) began to ease monetary conditions in the first quarter of FY04 to better support growth. Treasury bill rates were reduced by 3 percentage points during July–October, and deposit and lending rates have also started to decline.

8. On the structural front, progress has also been made (Table 3). In tax administration, steps have been taken to revamp the bonded warehouse system, and measures have been adopted to modernize and expand the Large Taxpayer Unit (LTU) (an end-September performance criterion) and are in train to establish a Central Intelligence Unit (CIU). Similarly, the key initial steps in nationalized commercial bank (NCB) reform are being taken in line with the program approach, albeit with slippages from some of the original timetables. In particular, the special audits of the four NCBs are now underway, to be completed as scheduled at end-2003. Performance under Memoranda of Understanding (MOUs) agreed with BB has also been satisfactory, with the NCBs adhering to their lending limits and reducing operating costs. However, the contracting of new management or management support for these banks lagged at first, due to the time needed for completing the formalities for Cabinet approval for the reform approach and some startup uncertainty about the World Bank's procurement requirements for its funding support. Finally, closure of NCB branches and loss-making state-owned enterprises (SOEs) in the manufacturing sector has slowed, particularly owing to strong labor union opposition.

III. MACROECONOMIC AND STRUCTURAL POLICIES FOR OCTOBER 2003–DECEMBER 2004

A. Macroeconomic Framework

9. The original macroeconomic framework for FY04 (for real GDP growth of 5.5 percent and inflation of 4.5 percent) remains attainable. Global recovery along with more accommodative fiscal and monetary policies bring these targets within reach, with some upside potential. Both export and import growth should remain robust, and the shift of the current account into a deficit of 1.2 percent of GDP is expected to be covered by additional concessional financing. Although the pace of reserve accumulation has tapered off, the external outlook remains favorable. While keeping the prospects of external financing under close review, given the very good performance so far, we intend to further build up reserves to \$2.85 billion by end-FY04.

10. The main medium-term risk is the phase out of Multifiber Agreement (MFA) quotas at end-2004. Since Bangladesh is highly dependent on RMG exports, the adverse impact of quota removal on the external position, output, and employment could be substantial. In addition, risks to program implementation arise from uncertainties in the political environment and capacity constraints. To mitigate these risks, the program outlined below is geared toward creating a friendly climate for investment (domestic and foreign alike) so as to boost growth and create jobs. Moreover, flexible exchange and interest rate policies will help us to enhance competitiveness and better cope with external shocks.

B. Fiscal Policy and Reform

11. The fiscal program is broadly on course in the first quarter of FY04, reflecting good revenue collection and a backloading of discretionary expenditures. Total revenue rose by 15 percent year-on-year, but on account of nontax revenue, especially BB dividends. Lagging tax collection by the National Board of Revenue (NBR) is a matter of serious concern. NBR revenue in the first quarter rose by 9.4 percent, compared with the 15 percent annual target, mainly due to shortfalls in customs duty receipts. We expect tax revenue to grow faster in the remainder of the year, along with an acceleration in the registration of additional VAT and income taxpayers, and the phase in of the programmed revenue measures (see below). Nonetheless, we intend to track revenue performance closely and if shortfalls persist, we will take corrective actions in the context of a revised budget in February 2004.

12. To protect the program revenue target, we will ensure rigorous implementation of the following measures:

- On the LTU for income tax, the September performance criterion was met with a slight delay. Appropriate steps have been taken, and the LTU has begun to function. Over 1,000 large taxpayers—covering about 35 percent of the tax base—have been selected on objective and transparent criteria that have been published. They comprise all banks and nonbank financial institutions, telephone and satellite TV companies, enterprises with paid-up capital in the range of Tk 60–1,200 million, and company directors. The transfer of tax

files has begun from over 400 local tax offices, staffing and logistical arrangements are being made, and operational manuals have been finalized.

- On the CIU, the revised organization chart agreed with the Fund staff has been approved in early December, and 1,000 taxpayers covering all major taxes are being selected for monitoring on the basis of compliance records and risk assessment. Other preparatory work is being completed, and the CIU is expected to be fully operational by end-December (a performance criterion).
- As regard the bonded warehouse system, the December benchmark on revamping this system is expected to be met. All imports for domestic consumption and most imports for export production are now subject to bank guarantees of 100 percent and 25 percent, respectively, of import duties and VAT.

13. In FY05, revenue mobilization and improved efficiency of the tax system will remain critical. We are determined to make further efforts to strengthen tax administration, starting with plans to expand the LTU system in early FY05 to cover withholding tax and VAT; we will decide the appropriate coverage of relevant taxes by the second PRGF review in consultation with the Fund staff. Moreover, we will initiate efforts to modernize the NBR, drawing on recommendations of the recent FAD technical assistance and regional experiences, and in collaboration with the World Bank and other donors. In addition, we intend to rationalize the tax system by reducing trade taxes, including supplemental duties, in FY05 budget.

14. On expenditures, the agreed quarterly spending limits will continue to be observed. Moreover, steps are being taken to improve absorptive capacity in order to speed up project selection, preparation, and execution of the Annual Development Program (ADP), so as to ensure quality investment in infrastructure and social sectors. To this end and for transparency, we have recently approved procurement guidelines to expedite release of funds and improve governance. Moreover, we intend to take timely decisions on policy reforms and fast track preparation of key infrastructure projects with the support of donors. In addition, we will strengthen the system for monitoring and tracking public expenditure, to ensure achievement of budget priorities.

C. Monetary and External Policies

15. BB will take further steps to lower lending rates to promote investment, while standing ready to react to any emergence of inflation and keeping interest rates positive in real terms. Already, BB has strengthened bank competition by publishing market information, worked to improve the functioning of interbank money market, and developed a secondary market for government securities to better circulate surplus funds among banks. Moreover, the Statutory Liquidity Requirement (SLR) ratio was reduced from 20 percent to 16 percent in November. Additional steps will be taken to broaden and deepen the government securities market, including through gradually phasing in volume-based auctions and introduction of long-term treasury bonds, so as to reduce rate volatility and develop yield

benchmarks. In line with this overall easing stance, the monetary program has been revised and extended to cover the first half of FY05.

16. Reform of the National Savings Certificates (NSCs) scheme is vital, to contain the costs of financing the budget deficit as well as to make the interest rate structure more flexible and market-based. Consistent with this aim, and in view of the recent decline in other interest rates, we are making appropriate adjustments to interest rates on new issues of NSCs in line with market rates. In addition, we are taking steps to better enforce the limit on access by individuals to NSCs, and will consider affordable safety nets for the most vulnerable groups.

17. The floating exchange rate regime has increased the economy's resilience to shocks. We intend to avoid intervention in the exchange market except to smooth out disorderly market conditions, and to further build up reserves so as to reduce external vulnerability. On December 2, in order to eliminate distortions, we liberalized the exchange regime further by removing the remaining margin requirements for the opening of letters of credit on imports. We are receiving LEG/MFD technical assistance relating to the phasing out of exchange restrictions subject to Fund jurisdiction, i.e., with respect to the convertibility and transferability of proceeds of current transactions in nonresident taka accounts, and the advance payments for imports of goods and services.

18. We will continue to exercise caution in contracting suppliers' credits, and intend to stay below the ceiling for the contracting and guaranteeing of nonconcessional external debt. Funding for infrastructure will be sought first on concessional terms, especially from IDA. We will also enhance upstream monitoring and coordination of new loans in the process of being contracted.

D. Reform of the Nationalized Commercial Banks

19. The government remains committed to divesting the NCBs over the medium term, including by privatization in whole or in part. Our initial efforts are focused on curbing the flows of new bad loans and strengthening management of NCBs. For the remainder of FY04, the pace of NCB reform will be stepped up and monitoring intensified, for which a working group has been created. Accordingly, timetables for securing new management for Agrani, a sales advisor for Rupali, and management support for Sonali and Janata have been revised in consultation with World Bank and Fund staff. Over the last three months, implementation of the steps envisaged under these timetables has been on track.

20. Ahead of the completion of the first review, we expect to achieve the following: for Agrani, approval by the Cabinet's Purchase Committee of the winning bid by mid-December; for Sonali and Janata, issuance of the requests for proposal for the management support contracts and the convening of the pre-bid conference; and for Rupali, completion of technical evaluation of bids for a sales advisor. In addition, a monitoring cell under the working group will be established as soon as possible, with technical support from the World

Bank, to track performance under these contracts. Furthermore, we intend to bring Rupali to the point of sale by December 2004.

21. Looking forward, we have begun consideration of the options for comprehensive bank-by-bank resolution strategies, so as to be able to adopt such strategies by end-April 2004 as envisaged under the program. Following this, we intend to draw up action plans to operationalize these strategies by end-November 2004.

E. Other Issues

22. We continue to build upon the reform initiated in the energy sector, which is key to growth and fiscal sustainability. Automatic pricing framework for energy products has been adopted in collaboration with the World Bank, and initial price adjustments for power, gas, and petroleum products have been taken under the agreed framework. An investment/program loan for the power sector from AsDB has just been approved.

23. The government is attaching top priority to ramping up the reform of the power sector, so as to urgently upgrade the quality of services and expand the capacity of the sector. An Energy Regulatory Commission is being formed to be in place by early 2004. Furthermore, given the critical need to improve the financial performance of the urban electricity distribution systems, we are considering options for improving billing and collection. This is critical for the Dhaka Electricity Supply Authority (DESA), since DESA is responsible for over half of power distribution and 80 percent (1½ percent of GDP) of the stock of inter-SOE arrears. The restructuring of DESA is thus integral to the reform framework, and must be centered on the basic problems of heavy system losses and poor billing and collection. To advance this reform, we are securing a technical assistance credit from the World Bank to define a robust turnaround program for urban electricity distribution. This is expected to pave the way for a program for a financial and operational restructuring of DESA with donor support.

24. With respect to safeguards assessment, an audit of BB financial statements has been completed on international auditing standards by a local firm and signed by an international accounting firm. While these statements reflect improvements, they still fall short of international accounting standards. MFD technical assistance is being provided to follow up on further actions to address the identified weaknesses. We are committed to implementing the other critical recommendations of the safeguards assessment.

25. We are taking actions to fight corruption and to enhance the climate for investment. In particular, the draft law for establishing an Independent Anti-Corruption Commission (IACC) was submitted to parliament in July, is under broad consultation, and is planned for passage in the next parliament session in early 2004. Support is being provided by the USAID and the AsDB. Moreover, as noted above, the new procurement guidelines should help to curb corruption.

26. Understandings have been reached on quantitative performance criteria for end-March 2004, quantitative targets for end-June 2004, and indicative targets for the remainder

of 2004 (see Table 2). Furthermore, structural performance criteria and benchmarks have also been set to cover the remainder of 2004 on tax administration and NCB reforms (see Table 3). The second PRGF review will be completed by June 2004 to reach understandings for the second-year program, focusing on the formulation of FY05 budget, tax reform—drawing on the recommendations of FAD technical assistance noted above—and SOE and NCB reforms. To facilitate program implementation, we hope to continue receiving technical assistance from the Fund in monetary operations, banking and tax reforms, and statistics. In addition, the monitoring of structural policies will continue to be closely coordinated with the World Bank, especially in the context of the upcoming DSC II.

Attachments:

MEFP Table 1: Key Economic Indicators, FY00–04

MEFP Table 2: Quantitative Targets and Performance Criteria Under the PRGF,
June 2003–December 2004

MEFP Table 3: Structural Performance Criteria and Benchmarks Under the PRGF,
June 2003–December 2004

MEFP Table 1. Bangladesh: Key Economic Indicators, FY00-04 1/

	1999/00	2000/01	2001/02	2002/03		2003/04
				Prog.	Prel.	Prog.
National income and prices (percent change)						
Real GDP	5.9	5.3	4.4	5.2	5.3	5.5
GDP deflator	1.9	1.6	2.7	4.8	4.4	4.0
CPI inflation (annual average) 2/	2.8	1.9	2.8	5.2	4.4	4.5
Central government operations (percent of GDP) 3/						
Total revenue	8.4	9.0	10.2	10.4	10.3	10.8
Tax	6.7	7.6	7.7	8.3	8.3	8.7
Nontax	1.7	1.4	2.4	2.0	2.1	2.1
Total expenditure	13.5	14.1	14.8	14.5	13.9	15.6
Current expenditure	7.5	7.7	8.0	8.4	7.8	8.4
<i>Of which</i> : Interest payments	1.6	1.6	1.8	2.0	1.8	2.0
Annual Development Program	5.4	6.5	5.6	5.8	5.3	6.1
Extraordinary expenditures	0.0	0.0	0.0	0.4	0.4	0.5
Other expenditures 4/	0.6	-0.2	1.2	-0.1	0.4	0.6
Overall balance (excluding grants)	-5.1	-5.1	-4.7	-4.2	-3.5	-4.8
Primary balance	-3.6	-3.5	-2.9	-2.2	-1.7	-2.8
Financing (net)	5.1	5.1	4.7	4.2	3.5	4.8
Domestic	2.7	3.1	2.6	1.9	1.3	2.0
External	2.4	2.0	2.1	2.3	2.2	2.8
Total central government debt (percent of GDP)	47.9	50.8	53.2	51.7	51.7	52.2
Money and credit (end of year; percent change)						
Net domestic assets	16.9	20.2	11.9	10.6	12.2	14.2
Private sector credit	10.5	16.3	13.9	11.4	12.6	15.6
Broad money (M2)	18.6	16.6	13.1	12.5	15.6	14.1
Money velocity	3.2	2.9	2.8	2.7	2.6	2.5
Balance of payments (in millions of U.S. dollars) 5/						
Exports, f.o.b.	5,701	6,419	5,929	6,110	6,492	6,959
(Annual percent change)	7.9	12.6	-7.6	2.1	9.5	7.2
Imports, f.o.b.	-7,566	-8,430	-7,697	-8,224	-8,699	-10,068
(Annual percent change)	4.8	11.4	-8.7	6.8	13.0	15.7
Gross official reserves (in millions of U.S. dollars)						
In months of imports of goods and nonfactor services	1,596	1,306	1,582	2,100	2,454	2,848
	1.9	1.7	1.8	2.6	2.9	2.9
Memorandum item (in billions of taka):						
Nominal GDP	2,371	2,535	2,732	2,996	3,005	3,294

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

1/ Fiscal year begins July 1.

2/ CPI has recently been rebased using FY96 weights.

3/ Starting FY02, central government fiscal positions are presented on a gross basis.

4/ Consists of other capital, net lending, and food accounts (including check float and discrepancy).

5/ Balance of payments is presented on the basis of BPM5. For FY04, export and import projections are based on the growth rates in the original program.

MEFP Table 2. Bangladesh: Quantitative Targets and Performance Criteria Under the PRGF,
June 2003–December 2004 1/

(Cumulative flows, end of period) 2/

	Jun-03		Sep-03		Dec-03	Mar-04	Jun-04	Sep-04	Dec-04
	Indicative Targets	Actual	Performance Criteria	Actual	Indicative Targets	Performance Criteria	Indicative Targets		
(In billions of taka)									
Ceiling on net domestic assets of Bangladesh Bank	-23	-33	6	-9	2	6	9	-7	1
Ceiling on net domestic financing of central government	56	38	20	15	31	50	65	21	33
Ceiling on net central government bank borrowing	18	-11	11	-1	3	13	20	11	13
(In millions of U.S. dollars)									
Floor on cumulative increase of net international reserves of Bangladesh Bank	557	722	-50	112	125	125	225	75	150
Contracting or guaranteeing of short-term external debt by the central government	0	0	0	0	0	0	0	0	0
Contracting or guaranteeing of nonconcessional medium- and long-term external debt by the central government	150	50	100	0	150	200	250	100	150
<i>Of which</i> : External debt with an initial maturity of over one year and up to five years	0	0	0	0	0	0	0	0	0
Accumulation of external payments arrears (continuous performance criterion during the program period)	0	0	0	0	0	0	0	0	0

1/ The aggregates are defined in the Technical Memorandum of Understanding dated May 2003 (EBS/03/76).

2/ Cumulative flow since start of financial year beginning July 1.

MEFP Table 3. Bangladesh: Structural Performance Criteria and Benchmarks
Under the PRGF, June 2003–December 2004

Measures	Timing	Status
I. Structural Performance Criteria and Benchmarks for the First Review		
Contracts signed by MoF for audits of the four NCBs on international auditing and accounting standards	August 31, 2003	Completed
Modernize and expand the LTU to cover 1,000 income taxpayers 1/	September 30, 2003	Complied on November 29, 2003
Contract new professional management for Agrani Bank	October 31, 2003	Revised to January 31, 2004
Phase out margin requirements on the opening of letters of credit for imports 1/	November 30, 2003	Complied on December 2, 2003
II. Performance Criteria and Benchmarks for the Second Review		
Secure management support for Sonali and Janata banks	December 31, 2003	Revised to May 31, 2004
Make fully operational a CIU to monitor compliance of 1,000 large taxpayers 1/	December 31, 2003	
Complete revamping the bonded warehouse system, including requiring bank guarantees for all imports going through the system	December 31, 2003	
Expand the audit program to cover 1,000 large taxpayers	March 31, 2004	
Adopt resolution strategies for the four NCBs (in consultation with the Bank and Fund staff) 1/	April 30, 2004	
III. Performance Criteria and Benchmarks for the Third Review		
Expand the LTU system, to cover withholding income tax and VAT, and expand the current list of taxpayers; coverage of the relevant taxes will be defined by the second PRGF review 1/	September 30, 2004	
Agree on action plans with the managements of Sonali, Janata, and Agrani, covering the period to June 2006, to operationalize the resolution strategies for each bank 1/	November 30, 2004	
Bring Rupali Bank to point of sale by issuing an information memorandum to the public	December 31, 2004	

1/ Indicates structural performance criteria.

INTERNATIONAL MONETARY FUND

BANGLADESH

First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria

Supplementary Information

Prepared by the Asia and Pacific Department
(In consultation with other departments)

Approved by Steven Dunaway and Anthony R. Boote

January 8, 2004

I. INTRODUCTION

1. This supplement provides an update on economic developments and recent policy measures as envisaged under the PRGF arrangement based on information that has become available since the issuance of the staff report. Reflecting recent developments, the staff appraisal with respect to the interest rate adjustment for National Savings Certificates (NSCs) has been modified.

II. RECENT ECONOMIC DEVELOPMENTS AND POLICY IMPLEMENTATION

2. **Monetary policy remains prudent and quantitative targets for end-December are likely to be observed with significant margins.** While the 12-month reserve money growth was on a moderate upward trend during September–October (8 percent, y-o-y), reflecting in part an increase in NFA, growth in broad money was stable (15 percent, y-o-y) with a pickup in private sector credit. The external position has further improved with gross official reserves reaching \$2.6 billion at end-December (from \$2.4 billion at end-November). However, NBR revenue remains short of the program target in November, owing mainly to weak collections in customs duty.

3. **The authorities announced on December 31 that, effective January 1, 2004, interest rates on new issues of National Savings Certificates (NSCs) would be reduced** by 1½ percentage points to 11 percent and 10½ percent, respectively, for the 5-year savings certificate and the 3-year bonus certificate. This action is broadly consistent with the understandings under the PRGF (MEFP ¶16). However, interest rates on other government savings instruments (mainly postal savings deposits, amounting to 12 percent of the current stock of government savings instruments) were not adjusted. In addition, as a form of social protection, the authorities have exempted new NSC issues on a temporary basis from the ½ percentage point withholding tax on interest income to provide some protection to fixed

income holders of these instruments. The authorities agreed that this transitional arrangement will be reviewed with the staff by June 2004.

4. **With respect to tax administration, further efforts were made to modernize the Large Taxpayer Unit (LTU) and set up the Central Intelligence Unit (CIU) to monitor tax compliance.** File transfers from some 400 local offices to the LTU have nearly been completed and revenue collection from selected large taxpayers has started. The organizational chart for the CIU has been approved and significant progress has been made to recruit staff, make budget provisions, and allocate office space and equipment.

5. **Reforms of the nationalized commercial banks are advancing according to schedule.** For Agrani, the winning bid for management contract is currently under final approval by the Prime Minister, and the new management team is expected to be in place by March 1 as envisaged. The evaluation of bids for management support contracts for Sonali and Janata is under way and is expected to be completed by end-January.

6. **Progress has also been made with respect to governance.** The authorities indicated that the Cabinet has recently modified the Independent Anti-Corruption Commission (IACC) bill to address certain issues raised by civil society, including on the selection of commission members. Under the bill, the IACC will be given financial independence similar to the High Court and also granted its own prosecutorial powers. The IACC bill is expected to be submitted to parliament in the session that starts on January 18. In addition, implementation of the procurement guidelines has started, which inter alia calls for compulsory external audit of all agencies that have procurement contracts that exceed Tk 100 million per year. Furthermore, the government is considering a proposal for a comprehensive reform of the National Board of Revenue, with technical support from the World Bank.

III. STAFF APPRAISAL

7. The last sentence of paragraph 35, with respect to the NSC rate adjustment, is modified as follows:

The staff welcomes the interest rate reductions on NSC instruments, as they represent a key step in the direction of increased interest rate flexibility. Another rate adjustment will be needed at mid-year, as envisaged under an automatic formula in the program, so as to further align NSC rates with market interest rates. However, it is regrettable that the rate adjustments were not extended to cover the full range of government savings instruments (particularly, the 3-year postal deposits). This gives rise to the risk of a significant shift from NSCs to postal deposits, undercutting the government's efforts to reduce its borrowing cost and to remove the distortion to the financial system created by the government paying above market interest rates on these instruments. Accordingly, the staff urges the authorities to adjust the rates on other government savings instruments without delay, and to apply the planned mid-year interest rate adjustments to all such instruments.



Press Release No. 04/3
FOR IMMEDIATE RELEASE
January 9, 2004

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes First Review of Bangladesh's PRGF Arrangement and Approves US\$74 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the first review of Bangladesh's economic performance under its three-year SDR 347 million (about US\$517 million) Poverty Reduction and Growth Facility (PRGF) arrangement, which was approved on June 20, 2003 (see [Press Release No. 03/92](#)). This decision entitles Bangladesh to the release of a further SDR 49.5 million (about US\$74 million) under the arrangement.

The Executive Board also approved Bangladesh's request for a waiver on the nonobservance of structural performance criteria in tax administration and in phasing out the margin requirements on imports. The initial slippage in tax administration has now been redressed, and the delay with respect to the margin requirements was negligible.

The Poverty Reduction and Growth Facility is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners, and articulated in a Poverty Reduction Strategy Paper (PRSP). This is intended to ensure that each PRGF-supported program is consistent with a comprehensive framework for macroeconomic, structural, and social policies, to foster growth and reduce poverty. PRGF loans carry an annual interest rate of 0.5 percent, and are repayable over 10 years with a 5 ½-year grace period on principal payments.

Following the Executive Board's discussion of Bangladesh, Shigemitsu Sugisaki, Deputy Managing Director and Acting Chairman, said:

“Bangladesh's economic performance has strengthened in the first year of implementation of the government's PRGF-supported economic program. Economic growth has picked up, inflation is in check, and the external position has improved more than expected. The program is on track. The key macroeconomic targets have been achieved to date, and reforms in tax administration and in the nationalized commercial banks are moving ahead after modest initial delays.

“The challenges ahead for Bangladesh are to turn this initial progress into faster and lasting growth with poverty reduction, and to prepare for the potential impact of the phase out of Multifiber Agreement quotas by end-2004. The authorities intend to meet these challenges with determined policy implementation, especially on the structural front, and a strong effort to

improve governance and the business climate. Critical policy measures envisaged are reforms in tax administration and the nationalized commercial banks, implementation of the recently adopted government procurement guidelines, and the establishment of an Independent Anti-Corruption Commission.

“The PRGF-supported program for fiscal year 2004 provides for a cautious easing of the stance of macroeconomic policies to better support growth, given the relatively stable financial environment. Bangladesh Bank has taken timely, market-based actions to lower interest rates, including a reduction in the Statutory Liquidity Requirement. Furthermore, the recent reduction in interest rates on National Savings Certificates represents a key step toward making the interest rate structure more flexible. It should help to put downward pressure on interest rates, and also contain the cost of borrowing for financing the budget.

“The budget for fiscal year 2004 targets increases in infrastructure and social spending, financed by external support on concessional terms. Realization of these spending goals will require improvements in public expenditure management and closer tracking and greater transparency of spending. On the revenue front, strong efforts to improve tax administration will be necessary to achieve the budgeted revenue target, in view of lagging revenue performance so far this year. Over the medium term, more fundamental reforms of tax administration, including modernizing the National Board of Revenue, will help underpin the program’s revenue target.

“A deepening of structural reforms is crucial to improve the prospects for investment and to maintain fiscal sustainability. Particularly important will be ongoing efforts to strengthen management of the four nationalized commercial banks and to define bank-by-bank resolution strategies by April 2004 as planned. Reform of the power sector and further progress in downsizing the manufacturing SOEs also will be important for improving growth prospects. Budget support to loss-making enterprises needs to be curtailed, and further efforts made to divest them as soon as feasible in order to achieve the authorities’ medium-term targets in this area.

“The authorities have started work on the full Poverty Reduction Strategy Paper (PRSP). The PRSP is expected to incorporate a comprehensive assessment of the poverty and social impact of reforms and to be prepared on the basis of broad consultations with civil society,” Mr. Sugisaki stated.

Statement by B. P. Misra, Executive Director for Bangladesh
January 9, 2004

1. At the outset, my authorities would like to express their appreciation to staff for a balanced report, and their constructive advice and hard work in the run up to the first review.
2. All indicative targets and quantitative performance criteria have been met, many with substantial over-performance. On the structural front, admittedly, the performance initially somewhat lagged but considerable momentum has been built up in recent months and most of the structural criteria and benchmarks have been met. Contracts were signed for the audit of the four Nationalized Commercial Banks (NCBs) and the final reports are expected soon. Large tax payer unit (LTU) has been modernized and expanded to cover 1000 large income taxpayers. In addition, the margin requirements on the opening of LOC for imports have been removed.
3. There has been substantial progress since October, 2003 with regard to the structural measures on the NCBs. The authorities are on track to contracting new management for the Agrani Bank and securing management support for Sonali and Janata banks, by the revised deadlines agreed in consultation with staff. The final evaluation for the appointment of a sales advisor for the privatization of the Rupali bank has been completed and it is expected to be brought to the point of sale by December 2004, as originally scheduled. Reform of the NCBs is a challenging area, given the realities of political economy. However, my authorities remain committed to divesting these banks, including by privatization, and devise bank by bank resolution strategies within the agreed timeframe. This progress should be seen against the substantial structural reforms implemented as prior actions before the commencement of this PRGF arrangement.
4. My authorities would like to reiterate their continued commitment to maintaining macroeconomic stability and implementing the agenda of reform measures outlined in the MEFP. Their strategy is centered on a significantly enhanced revenue performance to facilitate increased social and infrastructure related spending, without affecting fiscal balance, and easing monetary conditions and improving economic governance to spur private investment. The authorities are implementing the poverty reduction strategy set out in the I-PRSP aimed at moving the economy to a higher and sustainable growth path. This will be further defined in the PRSP which is expected to be completed by end-04. They sincerely value the financial and technical assistance that they have been receiving from the international community and look forward to continued support in their endeavor of achieving higher levels of growth and poverty reduction.

Recent economic developments

5. The authorities continued their pursuit of sound macroeconomic policies as evidenced from the performance in several key targets for FY 03. Real GDP growth maintained an upward trend and inflation was contained despite increases in food and administered prices. While tax revenues rose in line with the program objectives of 0.5 percent of GDP per year,

this coupled with expenditure restraint helped in keeping the fiscal deficit 0.7 percent below the program target and almost halving domestic financing to 1.3 percent of GDP, well below the program target of 2 percent. The authorities are implementing a number of measures to strengthen tax administration. A Large Taxpayer Unit has been set up in the Income Tax Department, covering 35 percent of the tax base and constituted on the basis of objective, transparent and published criteria. The income tax and VAT nets are being broadened, and actions are being taken to recover tax arrears. The authorities expect to achieve an increase of 0.5 percent of GDP in total tax revenue in FY 04. They are committed to raise pro-poor and pro-growth expenditure by a larger magnitude, about 1 percent of GDP. While steps are being taken for reorienting expenditure, this can only be a gradual process and will partly take care of the increased social sector and infrastructure related spending in FY 04. Consequently, fiscal deficit will widen to 4.8 percent with domestic financing capped at 2 percent of GDP. The increased expenditure is expected to be financed by more concessional financing.

6. Improved competitiveness contributed to a strong growth in the exports of RMG sector. This along with buoyant remittances and increased external assistance led to a more than expected strengthening of the external position. External debt management was prudent, and new non-concessional borrowing remained well below the program ceiling. The authorities practiced an active monetary policy, raising the treasury bill rates in the second half of FY 03 to facilitate a smooth transition to a floating exchange rate regime and subsequently easing the monetary stance to gradually steer the economy to a low interest rate environment, conducive to private investment and higher growth. Pending finalization of the resolution strategies for the four NCBs, measures to strengthen their performance are being successfully implemented. The special audit of these NCBs will be completed soon as per the Terms of Reference finalized in consultation with the World Bank. The NCBs have adhered to the MOUs with the Bangladesh Bank, remaining within the prescribed lending limits and reducing their operating costs. With action to contract management support now on track, the performance of these banks should improve significantly.

Structural reforms

7. The authorities have adopted a bold agenda of reforming the SOEs to reduce losses, by effecting improvements in their efficiencies, as well as by privatization. After a strong performance in FY 03, the momentum on this front has somewhat slowed. However, my authorities would like to emphasize the importance of taking into account the socio-economic factors for sequencing and timing the reform measures. Mobilizing consensus for structural changes is not an easy task, especially in an environment of significant job losses. My authorities believe that demonstrable gains in investment and jobs will have to be achieved to build the requisite popular support. Despite rising political opposition, however, the authorities remain fully committed to their structural reforms agenda, and a number of significant measures have been implemented. Following the closure/privatization of major manufacturing SOEs in FY 03, hard budget constraints and performance targets have been imposed and voluntary separations are being encouraged through severance packages. Sale of SOEs is now being implemented through the Privatization Commission and their liquidation, as appropriate, is being undertaken by the respective ministries.

8. The authorities realize that reforming the energy sector is especially crucial for ensuring fiscal viability as well as for removing bottlenecks to growth. Accordingly, they have adopted an automatic pricing framework for energy sector and initial price adjustments have been made in accordance with this. The power sector requires wide ranging reforms. The authorities are focusing on the quality of power, creating additional capacity, reducing heavy system losses, and improving billing and collection. An energy regulatory commission is being established shortly. Dhaka Electricity Supply Authority (DESA), which accounts for over half of power distribution and over 80 percent of the stock of inter SOE arrears, is of critical significance in this scheme of things. A technical assistance credit has therefore been secured from the World Bank to work out the reforms of the urban electricity distribution. Further, the authorities expect to utilize the recently approved loan from AsDB to revitalize the power sector.

Macroeconomic policy framework for 2004

9. Improved global outlook and accommodative fiscal and monetary policies should help achieve the target of increasing GDP growth to 5.5 percent in FY 04. Inflation is targeted to be contained at 4.5 percent. While external reserves have reached a more comfortable level, it is intended to achieve further accretion as a cushion against external shocks. The authorities are fully cognizant of the risks stemming from the scheduled phasing out of MFA quotas at the end-2004 and they expect to mitigate these risks by creating a more conducive climate for domestic and foreign investment by continued structural reforms and flexible exchange rate and interest rate policies. My authorities intend to benefit from greater regional economic integration by the way of South Asian Free Trade Area (SAFTA). The trend in the reduction of lending rate will reduce cost of borrowing and cause freeing of funds held in banks as long term deposits. It will also proactively impact on deepening the capital market and making cheaper capital available for investment.

10. The fiscal program has remained on track, helped by good overall revenue collection and back loading of discretionary expenditures. However, the authorities are conscious of the fact that the growth in tax revenue has not been in line with the program targets. This has been due to shortfalls mainly in customs duty receipts. Aware of the importance of achieving revenue targets for preserving fiscal balance while protecting the planned increase in priority expenditure, they are implementing a number of additional steps to remedy this situation. Progress in expanding the coverage of income tax and VAT has accelerated and the LTU and the CIU are intended to be fully utilized to boost revenue performance. With these, my authorities are optimistic about achieving a faster growth in the tax revenues in the remainder of the year. They will introduce additional revenue measures in early 2004, if shortfalls persist. Improved revenue performance is one of the central elements of this program and the authorities propose to carry forward the reforms in the areas of tax policy as well as tax administration. Trade taxes and supplemental duties will be rationalized and reduced beginning the FY 05 budget and the LTU concept will be further expanded to bring withholding tax and VAT under similar arrangements. Following up on the recommendations of FAD technical assistance and with World Bank assistance, the authorities will undertake modernization of NBR drawing upon international experiences

which they regard as relevant to their context. On expenditure, quarterly spending limits are being observed, steps have been taken to speed up project execution and strengthen tracking, and transparency is expected to improve following the implementation of new procurement guidelines.

11. Further steps are planned to continue the movement towards lower lending rates. At the same time, Bangladesh Bank will remain fully alert to the re-emergence of inflation and respond appropriately, in a timely manner. While the SLR was reduced by four percentage points in November 2003, publishing market information has strengthened bank competition and the secondary market for government securities has been developed, including through the recent introduction of long-term treasury bonds, facilitating better circulation of surplus funds. The government securities market will be further broadened and deepened by phasing in volume based auctions. This is expected to reduce rate volatility and develop yield benchmarks, in line with the overall easing stance. My authorities realize the importance of reforming the NSC scheme to contain the costs of financing the budget deficit and strengthen the overall trend for a transition to lower interest rates. Accordingly, they have recently reduced the rates on the new issues of NSCs to better align them with the market rates. In addition, administrative measures are proposed to enforce the limits on access by individuals to NSCs. However, it may be appreciated that these instruments represent the predominant investments for a substantial section of senior citizens, pensioners and low income vulnerable groups. Appropriate safety nets therefore have to be devised for those affected by the transition to a fully market based interest rate structure for NSCs. However, the authorities will like to reassure that such provisions will be restricted to the most vulnerable groups and the costs will be contained to affordable limits.

12. Monetary policy will be conducted consistent with the principles underlying a floating exchange rate regime, resorting to intervention only to contain volatility and to meet the objective of accretion to foreign exchange reserves. The authorities have continued to liberalize the exchange rate regime by removing the remaining margin requirements for opening L/Cs on imports. Regarding the remaining exchange restrictions on convertibility and transferability of current transactions in the nonresident taka accounts, the authorities plan to phase them out and they have received technical assistance from the Fund in this regard. They are committed to maintaining the prudent stance on contracting nonconcessional external debt. Funding for infrastructure projects will also first be sought on concessional terms. My authorities will continue their endeavor to bring the practices of the Bangladesh Bank up to the international accounting standards by following up on the recommendations of the safeguards assessment. The latest audit reflects improvements but a lot of work remains to be done and it is proposed to follow up on the identified weaknesses by utilizing MFD technical assistance.

13. My authorities are committed to improving governance and fighting corruption. The draft law for establishing the Independent Anti-Corruption Commission(IACC) has been submitted to parliament and is now under broad consultation. The Bill for enactment into law is expected to be tabled in the next parliamentary session. Besides, reforms in a host of key areas like tax administration, transparency and tracking in expenditure, liberalization of

exchange rate system and implementation of new procurement guidelines should help curb corruption.

Conclusion

14. In conclusion, the macroeconomic position has improved steadily since the beginning of this program and growth has picked up. While my authorities broadly agree with the staff assessment of the situation, the characterization of risks to the program as "resistance of vested interests in a fragile political environment and from weak administrative capacity" may be somewhat of an exaggeration. Bangladesh is a large, populous and vibrant democracy, managing transitions of elected governments in an orderly manner. The political environment is often fractious but this has not prevented the government of the day having the popular mandate from carrying out its policy agenda, and while there are capacity constraints, the fairly steadfast implementation of the current program is a testimony to resolute governance. That said, the authorities are fully cognizant of the risks underscored in the staff report and wish to reassure the Executive Board of their strong commitment to stay the course of sound macroeconomic policies, implement the reform agenda set out in the MEFP and continuously endeavor to improve governance. They value the advice of this Board and regard continued support of the international community as crucial to their pursuit of poverty reduction. I seek the support of my colleagues for today's proposed decisions.