International Monetary Fund

Bangladesh and the IMF

Press Release:
IMF Executive Board Completes Third Review Under Bangladesh's PRGF Arrangement and Approves Disbursement Under the Trade Integration Mechanism
June 29, 2005

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Bangladesh: Letter of Intent and Memorandum of Economic and Financial Policies

May 26, 2005

The following item is a Letter of Intent of the government of Bangladesh, which describes the policies that Bangladesh intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Bangladesh, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Dhaka, Bangladesh
May 26, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C., U.S.A.

Dear Mr. de Rato:

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 and faster poverty reduction. It will be further defined in the Poverty Reduction Strategy Paper (PRSP), which is being finalized.

Based on discussions for the third review under the PRGF arrangement with the Fund staff in October 2004 and February and April 2005, the attached Memorandum of Economic and Financial Policies (MEFP) assesses economic and policy performance so far under the arrangement, updates the macroeconomic framework, and discusses the financial policies and structural reform program for the remainder of FY05 and first half of FY06, supplementing our MEFP dated July 8, 2004. The proposed performance criteria for the remainder of the year are set forth in Tables 2 and 3 of the MEFP and the next review is proposed for completion as specified in paragraph 32 of the MEFP. All prior actions referenced in Table 4 of the MEFP for the completion of the third review have been implemented.

All quantitative performance criteria for end-September 2004 were observed. However, the structural performance criterion on making the LTU for VAT operational (end-September 2004) was not observed. We have taken corrective actions, and the LTU for VAT became functional in October 2004. On this basis, and in view of the policies set out in the attached memorandum, including the strengthening of tax administration and the determined reform of the NCBs, the Government requests a waiver for the nonobservance of the structural performance criterion and the completion of the third review. In light of the delay in completing the third review, the Government also requests that the arrangement be extended until end-December 2006 and the disbursements be rephased accordingly.

We have removed the restriction on advance payment for imports effective December 2004. We have also reviewed the only remaining restriction under Fund jurisdiction pertaining to the convertibility and transferability of funds from nonresident taka accounts. Given the near-term outlook of the balance of payments, we think this is not the appropriate time to remove this restriction. However, we expect to remove this restriction by end-June 2006.

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 April 2005–June 2006

May 26, 2005

I. Introduction

1. The government has made significant progress in implementing the reform strategy adopted in June 2003 to move Bangladesh to a higher growth path and faster poverty reduction. This strategy is being supported by a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) and further articulated in the Poverty Reduction Strategy Paper (PRSP), which is being finalized. This memorandum assesses economic performance during the first two years under the PRGF arrangement, updates the medium-term policy framework, and lays out the objectives and policies that the government intends to pursue in the remainder of FY05 and the first half of FY06, supplementing our Memorandum of Economic and Financial Policies (MEFP) dated July 8, 2004.

II. Performance Under the Program

2. Bangladesh's economy continues to expand. Real GDP grew by 5½ percent in FY04 (ending June), while industrial production rebounded by 12 percent (MEFP Table 1). The economy has benefited from a healthy expansion in the construction, manufacturing, and service sectors, as well as a strong recovery in exports. Inflation was under control at 5.8 percent in FY04.

3. The floods in July have had devastating effects on the economy. Total losses to assets and output are estimated (by the World Bank and AsDB) to reach Tk 127 billion ($2.2 billion, or 3¾ percent of GDP), with the largest impact stemming from damage to crops, housing, and infrastructure. The overall situation worsened after the September floods (though on a smaller scale) and subsequent heavy rains in October. Inflation, particularly on food-related items, rose during the Ramadan season in October–November. The government took steps to reallocate domestic resources for urgent agricultural relief, reconstruction of housing and infrastructure, and restoring water and power supplies and other basic facilities in the affected areas. While floodwaters had receded since October and intensified efforts were made to replant the crops, the overall yield of the main crops remained substantially below the levels of the previous years. To support the reconstruction efforts, the government has mobilized external donor assistance of $420 million ($200 million from the World Bank, $185 million from the AsDB, and $35 million from DFID) to be disbursed during FY05–07.

4. Macroeconomic management has been broadly on course. The quantitative performance criteria for end-September 2004 were met (MEFP Table 2). The overall budget deficit was contained to 3.2 percent of GDP, about 1 percentage point below the revised budget. Total spending was 1.4 percent of GDP lower than budgeted, on account of lower-

than-projected recurrent and development expenditures. However, tax revenue collections by the National Board of Revenue (NBR) fell short of the revised budget (by an estimated 0.3 percentage point of GDP), with NBR revenue growing by 10 percent (on a 12-month basis) at end-June 2004 compared with a revised budget target of 14 percent. The shortfall reflected initial delays in the implementation of tax administrative reforms and weaknesses in collection enforcement. Fiscal management continues to be prudent in July–March of FY05, but the NBR revenue performance remained weak, falling short of our quarterly revenue targets (estimated by 0.3 percent of GDP).

5. The monetary policy stance has been accommodative in the first three quarters of FY05. Reserve money growth reached 11.2 percent at end-March and credit to the private sector accelerated to 19.5 percent, mainly for agricultural lending and imports of food and capital goods. Broad money also grew 15.4 percent at end-March. To contain the inflationary risks posed from increases in imported food prices and high credit growth, Bangladesh Bank (BB) raised the Cash Reserve Requirement, effective March 1, 2005, by a half percentage point (to 4.5 percent) and also increased the one-month and three-month treasury bill rates by 1 percentage point since early March, to 6.6 percent and 6.7 percent, respectively. However, the net sales of treasury securities to commercial banks have remained broadly constant, with many banks holding treasury securities only up to the SLR limit. Furthermore, BB has actively used the repo and reverse-repo facilities to enhance daily monetary operations.

6. Exports remained robust through October 2004, registering a monthly average of $720 million during July–October 2004 ($600 million in the same period of FY04), driven mainly by the ready-made garments (RMG). However, imports were even stronger. Despite continued strong remittance inflows, the external current account went into deficit in September 2004. Overall, gross official reserves rose to $3 billion (covering three months of imports) at end-September (from $2.5 billion at end-June 2003). The effective exchange rate depreciated by 2 percent and 5 percent in real and nominal terms, respectively, between September 2003 and September 2004. However, export earnings have moderated since November 2004 (a monthly average of $644 million during November 2004–February 2005), particularly for woven garments, while imports continued to rise strongly. Oil imports exceeded the original target by about $370 million at end-March 2005, reflecting higher international oil prices. In addition, the government increased the import targets for rice and wheat by about $200 million to bridge the projected shortfall in domestic production owing to the devastating floods in last July.

7. The exchange market has come under pressure since early 2005. To ease the pressure, BB injected $148 million of foreign exchange to the market through February while allowing the taka to depreciate (by about 5 percent). However, demand for imports remained strong, particularly for capital machinery and raw materials, reflecting in part investment and structural repositioning of the RMG sector and expansion of the industries in anticipation of the expiration of some existing tax holidays at end-June 2005. The current account deficit rose significantly in the third quarter of FY05, and the reserve cushion built in NIR was used to mitigate the impact of the external oil price shock. Accordingly, the end-March indicative target for NIR has been adjusted for higher-than-expected oil imports.

8. Good headway has been made on the fiscal structural reform agenda, although tax administration efforts have yet to translate into revenue gains. On income tax administration, the newly expanded Large Taxpayer Unit (LTU) for income tax and the Central Intelligence Cell (CIC) are in full operation after initial delays. Effective September 1, 2004, the LTU for income tax was expanded to cover 11 withholding taxes. To improve the compliance of taxpayers, a system of universal self-assessment for LTU income taxpayers and higher penalties for late and nonfiling have been introduced. At the same time, the audit program is being strengthened and expanded. All NBR departments are making increased use of information gathered by the CIC to reduce tax evasion. To discourage taxpayers from delaying payment of income tax by filing appeals to the tribunal, they are now required to pay 15 percent of the difference between the contested amount and the admitted tax liability before the court filing. Moreover, to expedite disposal of court cases, two benches in the High Court have been selected to devote exclusively to tax matters. We have also expanded the LTU system to cover domestic VAT and steps were taken by end-December 2004 to transfer files to ensure minimum coverage of 50 percent of total domestic VAT collection by NBR, covering at least the 100 largest VAT filers, and to conduct joint audits for income tax and VAT LTUs to improve tax compliance.

9. The VAT Act and the rules have been amended to improve enforcement. Nationwide inspections in the retail sector to enforce compliance with VAT have also been launched. In addition, the VAT net has been expanded to include more services and VAT enforcement for products at import and domestic stages has been strengthened. In the area of customs administration, the bonded warehouse system has been revamped, although the bank guarantee requirements for imports for domestic consumption have been stayed by the High Court. Adequate records are required at the premises of the bonded warehouses to allow spot inspection. We have also stepped up our efforts to train inspectors.

10. With respect to NCB reform, good progress has been made in strengthening bank management. The management team for Agrani started its operation in October 2004 and is now finalizing its report on management restructuring and operational improvement. The management support team in Sonali Bank has submitted at end-March its recommendations on operational and management improvements. The retendering of the contract for the Janata Bank management team has been completed and the contract was signed in May. The financial advisors at Rupali Bank have provided strong support to the government to bring Rupali to the point of divestment. An Information Memorandum (IM) was issued by the Privatization Commission on May 12. The Memoranda of Understanding (MOUs) have been strengthened for all four NCBs and good progress has been achieved under them, with the exception of cash recoveries from the largest defaulters. However, in the aftermath of the flood, the overall lending limit of 5 percent is likely to be exceeded (but to no more than 7 percent) to ensure adequate support for agricultural sector reconstruction.

11. The weak performance of the energy sector SOEs is due mainly to the Bangladesh Petroleum Corporation (BPC) and the Dhaka Electricity Supply Authority (DESA). BPC incurred significant losses in the last two years due to sharp increases in world oil prices. To reduce the losses of energy sector SOEs and improve their financial viability over the

medium term, the government adjusted prices of kerosene by 17 percent in June 2004, and increased prices for diesel and gasoline by 15 percent in December 2004, and gas price by 2.3 percent in early January 2005, in line with the agreement under the World Bank's DSC. DESA continues to incur significant financial losses stemming from poor bill collections and heavy system losses. This has led to a further accumulation of DESA's arrears to other SOEs (to a cumulative 1¾ percent of GDP at end-December 2004). Under the World Bank's DSC III, we are now working on reducing DESA's arrears using a combination of loan restructuring and write-offs.

III. Macroeconomic Framework and Policies

12. We remain committed to the reform strategy of private sector-led growth and poverty reduction, as outlined in our PRSP, which is being finalized. The National Steering Committee, which was formed to lead this effort, circulated the draft PRSP for comments in January. Consultations were held at the regional and national levels and with the donor community. Attention is placed on: (i) prioritizing near-term policies in key sectors and anti-poverty programs; (ii) incorporating the costing of the proposed sectoral projects into the medium-term budgetary framework; (iii) improving the monitoring and evaluation mechanism of social development; and (iv) initiating a poverty and social impact assessment (PSIA) of the reform strategy.

13. We have updated the medium-term macroeconomic framework to incorporate the impact of external and domestic shocks. Growth prospects have deteriorated in the wake of the devastating floods in July that submerged about half of the country's districts and affected some 25 percent of the population. Preliminary indications suggest that last year's floods were as devastating as the 1998 floods, which resulted in a decline in real GDP growth of an estimated ½ percent and a significant pickup in inflation.

14. A further challenge is posed by the impact of the phaseout of Multifiber Arrangement (MFA) quotas at end-2004. On the upside, there are indications of fresh investment in the sector and we have retained some competitive edge in the European Union and Canadian markets, given the duty-free access to these markets, as well as some advantage in competing for the high-volume, low-margin segment of the world garment market. On the downside, however, with intensified competition, Bangladesh is likely to face increasing pressures from lower prices, and further loss of market share in the United States. Funding and operational constraints for upgrading infrastructure, particularly for improvement in port operations, remain a major problem.

15. Consequently, real growth for FY05 has been revised downward to 5.2 percent, while the inflation target has been revised to 6.5 percent. The monetary program has also been adjusted to accommodate increased lending to the agricultural sector for post-flood recovery. The external current account deficit is projected to deteriorate to about 2 percent of GDP, and the end-June 2005 target for NIR has been reduced by $300 million in light of higher payments for oil imports. The overall budget deficit for FY05 is projected to increase to 4.4 percent of GDP, including domestic and external flood rehabilitation efforts, while

maintaining domestic financing of the budget as programmed. Public spending on human capital and infrastructure will remain strong, to be met by revenue efforts and external support mainly on concessional terms including donor funds for rehabilitation. With prudent debt management, these projections suggest that the ratios of external debt to GDP and the net present value of debt to exports should remain within comfortable zones over the medium term.

A. Fiscal Policy

16. Our fiscal strategy remains to protect fiscal sustainability while supporting growth and poverty reduction. To this end, we are making strong revenue efforts by expanding the tax base and improving tax administration. We remain fully committed to pursuing a revenue effort of ½ percent of GDP in FY06. This revenue effort is vital for the budget to adequately support human capital, physical infrastructure, and anti-poverty programs without threatening debt sustainability over the medium term. To ensure the needed improvement in revenue, we will convert the quarterly revenue targets for NBR taxes to indicative indicative targets under the program: a cumulative collection of Tk 73 billion by end-September 2005, Tk 154 billion by end-December 2005, Tk 244 billion by end-March 2006, and Tk 356 billion by end-June 2006.

17. Strengthening tax administration will continue to remain a top priority. We will give particular attention to strengthening the near-term effectiveness of the LTU system. To this end, efforts will be made immediately to expedite cases pending at the High Court. In the FY06 budget, we will further strengthen the income tax LTU through defining a turnover threshold above which taxpayers will be included in the LTU. We will also ensure that the LTUs are staffed with sufficiently skilled collection enforcement officers. In addition, an independent audit unit, headed by an advisor with the rank and status of a member reporting directly to the chairman, will be created in the NBR to enhance enforcement and audit operations. The establishment of this unit will constitute a structural performance criterion (end-November 2005) for the completion of the fourth review (MEFP Table 3). Moreover, sustained efforts will be made to identify tax evaders through information gathered by the CIC, and standard and transparent procedures, including notifying delinquent taxpayers and imposing penalties for late payments, will also be put in place. Finally, while we recognize that it may not be possible to address low civil service pay in NBR, we intend to establish performance-based incentives for LTU staff. The VAT LTU staff will continue to be guided by the existing operational manual. However, with the technical assistance of the incoming DFID team, a new operational manual will be put in place by end 2005.

18. We are cognizant that improving revenue performance will depend on bringing additional taxpayers into the tax net, to expand the VAT net to cover more services, and to step up nationwide inspections in the retail sector to enforce compliance with VAT. To this end, most of the existing tax holidays will be allowed to lapse at end-June 2005 and a significant reduction in tax exemptions will be introduced in the FY06 budget. Furthermore, to augment customs collection, we will further strengthen the pre-shipment inspection (PSI), customs valuation process, and the post-clearance audit, with World Bank assistance. We

will also continue to monitor the functioning of the bonded warehouse system. In this regard, we will make further efforts to ensure that inspectors are well trained.

19. Over the medium term, our efforts will focus on the modernization of the NBR along functional lines. With assistance from the World Bank, a strategic plan is being developed and needed technical assistance projects will be approved by the Planning Commission. The plan will include steps for a more rigorous self-assessment system, a risk-based auditing system supported by third-party information, and the use of modern technology, particularly an integrated computer system for handling assessment, audit case selection, and collection. An improved board structure will be critical to enhance the NBR management. By end-December 2005, key personnel will be appointed to facilitate work on tax administration reform, including a tax expert to advise on key aspects of the NBR modernization project, supported by a human resources advisor, an audit advisor, and an IT manager.

20. On the expenditure side, we will ensure that pro-growth and pro-poor spending is given priority, and public sector wages are contained. We have stepped up our efforts to strengthen expenditure management by improving project selection and execution under the ADP, drawing on the recommendations of the fiscal ROSC for Bangladesh. The financial management reform program (FMRP) is assisting in putting in place a medium-term budget framework in four key line ministries. Broad expenditure parameters for the next two years for these four ministries will be presented in the FY06 budget. The government plans to roll out this exercise to more line ministries for preparation of the FY07 budget. The recent floods have necessitated some reallocation of spending from both the revenue and ADP budget towards rehabilitation efforts. The government will continue to undertake an expenditure review to improve public expenditure management with enhanced fiscal transparency and accountability, in consultation with relevant development partners. Meanwhile, we have streamlined the project approval process in consultation with our development partners; implemented new procurement regulations; delegated more financial authority to the line ministries; and required line ministries to strengthen their own project monitoring capacity.

21. The recent proposal by the National Pay Commission on wage increases for the civil service has been reviewed by a committee headed by the Cabinet Secretary. To safeguard macroeconomic stability, the overall increase in the government wage bill will be phased in over three years, totaling about Tk 40 billion (Tk 8 billion in FY05, Tk 16 billion in FY06, and Tk 16 billion in FY07). An official public announcement regarding this wage increase was made on May 16 (a prior action for the completion of the third review; MEFP Table 4). The increased spending on wages will be partly offset by cuts in nonpriority spending to preserve pro-poor expenditures. Moreover, starting in FY06, the government will combine attrition with a selective hiring freeze to reduce employment while eliminating unnecessary and redundant posts. To ensure medium-term fiscal sustainability, we will work with the World Bank on a plan for civil service reform in the context of the EMTAP, aimed at (i) rationalizing government employment; (ii) decompressing the pay scale; (iii) establishing a systematic and transparent performance evaluation procedure for merit-based salary increases and promotion; and (iv) introducing a tighter link between pay and performance.

Keeping up with the regional trend in pension reform, we will initiate the reform of the public pension system.

22. Reform of the energy sector SOEs is key to improving their financial performance and reducing infrastructure bottlenecks to growth. In coordination with the World Bank in the context of the DSCs, we are monitoring oil market developments closely. In view of the substantial and continued price surge in the world oil market since the beginning of FY05, we recognize that further price adjustments are needed for kerosene, diesel, and gas. However, in light of the price increases in early 2005 and the emerging inflationary impact of the floods, further adjustments will need to be made gradually while taking into account social considerations. Nonetheless, we are committed to contain BPC losses through further price adjustments in the first half of FY06. The government is working closely with the World Bank (in the context of DSC III) and the AsDB to formulate a restructuring plan for the energy sector, focusing on improving both the operational and financial performance of the energy SOEs. As agreed with the World Bank and AsDB, the Energy Regulatory Commission (ERC) will be fully operational by June 2005. The government is working closely with DESA and municipal authorities to improve electricity collections and further reduce electricity payment arrears.

B. Monetary and External Sector Policies

23. A cautious monetary policy stance is essential in the next few months to restore stability in the money and exchange markets while supporting economic growth. Bangladesh Bank will continue to actively employ indirect monetary instruments for conducting monetary policy. Interest rates on treasury securities will rise in the next few months to contain domestic demand, subject to due caution against excessive fluctuation. Given the adverse impact on food prices from the floods, and the rise in international oil and commodity prices, there has been a buildup in inflationary pressures. In addition, export growth has been modest since November 2004, while import growth accelerated. Against this adverse background, we are committed to manage these pressures in a market-based manner. In light of developments in the first three quarters of FY05 and in view of the need to contain liquidity, we have revised the end-June targets for private sector credit growth and broad money to 15 percent and 14 percent, respectively.

24. Further steps are being taken to improve the functioning of the interbank and treasury bill markets, including strengthening the primary dealer system, deepening the secondary market for treasury securities, and developing liquidity forecasting. In particular, BB will prepare the ground to move to a volume-based auction, reactivate the primary dealer system, and work closely with them to define the rules and obligations and a minimum announced auction amount to be purchased by primary dealers. Higher rates on treasury securities will stimulate demand for deepening the treasury market and ensure adequate flows for domestic nonbank financing of the budget. Transaction fees by banks for selling NSCs were modified in late 2004 to provide adequate compensation to encourage banks to transact in NSCs. The NSC sales picked up significantly in January. Further improvement will include modifying

the investment guidelines for insurance companies and provident/pension funds to encourage them to invest in government bonds.

25. We are committed to the floating exchange rate regime, and will confine interventions to countering disorderly conditions and building reserves to a more comfortable level. Against the background of recent pressures in the foreign exchange market, we will closely review the operation of the floating exchange rate system with technical assistance from the IMF to ensure that it is working effectively and smoothly, and that the taka exchange rates are market based. We are planning to facilitate forward and swap transactions by further easing the requirement that forward sales of authorized dealers be fully matched by their forward purchases. We removed the restriction on advance payment for imports in December 2004. We have also reviewed the only remaining restriction under Fund jurisdiction pertaining to the convertibility and transferability of funds from nonresident taka accounts. Given the near-term outlook of the balance of payments and recent developments in the exchange market, we think this is not the appropriate time to remove this restriction. However, we expect to remove this restriction by end-June 2006, with due attention given to having regulatory safeguards to prevent illegal transactions and limit the scope for capital outflows.

26. BB is committed to intensifying regulatory oversight of the banking system. We have recently issued new risk management guidelines for commercial banks and are now requiring banks to conduct systems audits. To improve corporate governance, BB is restricting the number of directors at banks and limiting them to two terms of no more than six years each. We are also improving on-site and off-site supervisory capacity and have significantly improved the data reporting requirements of commercial banks. BB will use its improved supervisory capacity to ensure that the NCBs meet all prudential regulations, including on net open limits.

27. In the face of the phaseout of the MFA quotas, we are adopting measures to reduce anti-export bias and improve the investment climate. In particular, we have removed restrictions on FDI in the RMG sector outside the EPZs, and steps are being taken to address infrastructural bottlenecks, particularly to upgrade the capacity of the Chittagong port, with the assistance of the AsDB. At the same time, we are seeking duty-free access for RMG exports to the U.S. market, together with the other LDCs that are facing similar pressure from the removal of quotas. We have reduced the number of regulatory stages involved in the import for and export of RMG and plan to replace all remaining quantitative restrictions by tariffs by end-June 2005, in the context of DSC III, except those on grounds of health, national security, religion, and environmental protection.

C. Reforming the Nationalized Commercial Banks

28. We have adopted action plans to operationalize bank-by-bank resolution strategies for the NCBs (Annex I), a structural performance criterion for end-November. Under these strategies, three NCBs (Rupali, Agrani, and Janata) will be brought to the point of divestment in full or in part in sequence during 2005–07. With respect to Rupali's divestment, we issued

the Information Memorandum (IM) to the public on May 12 (a prior action for the completion of the third review). Safeguarding the integrity of the divestment process is an overriding concern given the governance issues in the NCBs and their poor financial condition. Accordingly, we have reconstituted the board of directors of Rupali, conducted IAS special audits, and worked out a combination of methods for recapitalization through government bonds and loans to the government from Rupali, based on the statutory audit at end-December 2004 and the HVC IAS audit at end-September 2004 (MEFD Annex I-Attachment). In addition, the government will assume liabilities for existing pensioners and for the accrued rights of current employees up to the point of transaction. The majority shareholder will have management control over all aspects of the bank's operations, including on HR policies and pay scale.

29. With respect to the other three NCBs, we are committed to a timetable to bring Agrani to the point of divestment by end-June 2006. The Board will be reconstituted to meet BB's fit and proper test by end-June 2005, the contract for the financial advisors, which will be drafted broadly along the same lines as for Rupali Bank, will be signed by mid-December 2005, and the bank will be corporatized by end-December 2005. For Janata, we will ensure that the contract for the management support team will be signed by end-June and the team in place by end-August. The government will provide timely response to the management support team in Sonali on its proposal for management and operational improvements. This strategy entails restricting its commercial lending operations and stepping up NPL recoveries in the context of an enhanced MOU; corporatizing the bank and reconstituting its board of directors; and leveling the playing field by ensuring free entry into areas where Sonali has a dominant position. To facilitate the broader NCB reform effort, the government will make legislative modifications as needed, including granting BB required regulatory authorities over the NCBs.

D. Other Issues

30. Progress has been made to address the recommendations under the safeguards assessment. A full audit of BB's financial statements for FY04 has been completed, in accordance with international auditing standards, and the audited financial statements, including the audit opinion, have been published. Qualifications in the accounts expressed by the BB's auditors in previous years have been resolved. Monetary data reported to the Fund have been reconciled against BB's audited financial statements and reviewed by the external auditors as part of this annual audit. Furthermore, as part of its medium-term effort to build capacity in BB, technical assistance from the IMF has been provided to strengthen foreign reserve management, adopt and implement a plan for strengthening internal audit functions, and upgrade accounting skills and standards. The government has appointed in April 2005 auditors to prepare BB's FY05 audit in accordance with international financial reporting standards.

31. Faster progress with efforts to improve governance are crucial for enhancing the investment climate. Reform measures in NCBs, tax administration, and trade reform bear directly on governance, and their firm implementation will have a lasting impact. Beyond these, the government is taking concerted actions to develop an anti-corruption strategy and

improve the law and order situation. Technical assistance in this area is being provided by the World Bank, the AsDB, and USAID.

32. In light of the delay in concluding the third review, the fourth, fifth, and sixth reviews under the PRGF arrangement will now be scheduled to take place by end-December 2005, end-June 2006, and mid-December 2006, respectively. The arrangement will therefore need to be extended until end-December 2006 and the disbursements under the arrangement rephased accordingly. With regard to program monitoring, quantitative performance criteria for end-September 2005 and indicative targets for end-December 2005 are being proposed. Key structural benchmarks and structural performance criteria for FY06 center on fiscal and NCB reforms. Technical assistance coordinated closely with the World Bank and DFID will remain essential to building capacity, especially in tax administration and NCB reform.

Attachments

Table 1.	Key Economic Indicators, FY2003–09
Table 2.	Quantitative Performance Criteria and Indicative Targets Under the PRGF Arrangement, June 2004–June 2006
Table 3.	Structural Performance Criteria and Benchmarks Under the PRGF Arrangement, 2005–06
Table 4.	Prior Actions for the Third Review Under the PRGF Arrangement
Annex I.	Operationalization of NCB Resolution Strategies
Annex I-Att.	Restructuring and Recapitalization of Rupali Bank
Annex II.	Addendum to the TMU

MEFP Table 1. Bangladesh: Key Economic Indicators, FY2003-09 1/

	2002/03	FY2003/04		FY2004/05	FY2005/06	FY2006/07	FY2007/08	FY2008/09
		Rev. Prog.	Act.	Projections				
National income and prices (percent change)								
Real GDP	5.3	5.5	5.5	5.2	6.0	6.0	6.5	6.5
GDP deflator	4.4	5.5	5.5	6.0	5.5	4.9	4.0	4.0
CPI inflation (annual average) 2/	4.4	5.9	5.8	6.5	6.0	5.0	4.0	4.0
Central government operations (percent of GDP)								
Total revenue	10.3	10.6	10.1	10.5	11.0	11.2	11.4	11.6
Tax	8.3	8.5	8.2	8.6	8.9	9.2	9.3	9.5
Nontax	2.0	2.1	1.9	1.9	2.0	2.0	2.1	2.1
Total expenditure	13.7	14.4	13.3	14.7	15.2	15.3	15.3	15.4
Current expenditure	8.1	8.2	7.7	8.6	8.4	8.6	8.7	8.7
Of which : Interest payments	1.9	1.7	1.6	1.8	1.6	1.7	1.7	1.7
Annual Development Program	5.4	5.4	5.0	5.3	5.7	5.7	5.7	5.7
Other expenditures 3/	0.2	0.8	0.6	0.8	1.1	1.0	0.9	1.0
Overall balance (excluding grants)	-3.4	-3.8	-3.2	-4.2	-4.2	-4.1	-3.9	-3.8
Primary balance	-1.5	-2.1	-1.6	-2.4	-2.6	-2.4	-2.2	-2.1
Financing (net)	3.4	3.8	3.2	4.2	4.2	4.1	3.9	3.8
Domestic	1.3	2.3	2.1	2.0	2.0	1.9	1.9	1.7
External	2.1	1.5	1.1	2.2	2.2	2.2	2.0	2.1
Total central government debt (percent of GDP)	51.0	50.3	48.3	47.9	48.3	47.9	47.1	46.2
Money and credit (end of year; percent change)								
Net domestic assets	12.2	11.8	13.4	14.8	13.5	13.8	13.5	13.1
Private sector	12.6	10.3	12.0	14.7	13.2	13.0	12.8	12.8
Broad money (M2)	15.6	11.9	13.8	14.2	12.8	13.1	13.0	13.0
Balance of payments (in billions of U.S. dollars) 4/								
Exports, f.o.b.	6.5	7.4	7.5	7.8	8.0	8.4	9.1	9.9
(Annual percent change)	9.5	13.3	15.8	4.1	2.0	5.1	7.9	9.0
Imports, f.o.b.	8.7	10.1	9.8	11.6	12.3	13.1	13.9	14.9
(Annual percent change)	13.0	15.8	13.0	18.0	6.2	6.0	6.6	7.1
Gross official reserves (in billions of U.S. dollars)	2.5	2.6	2.7	2.7	2.7	3.0	3.4	3.9
In months of imports of goods and nonfactor services	2.9	2.6	2.8	2.4	2.2	2.3	2.5	2.7
Memorandum item								
Nominal GDP (in billions of taka)	3,005	3,345	3,345	3,731	4,171	4,637	5,135	5,686

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/ Consists of other capital, net lending, and food accounts (including check float and discrepancy).
4/ Balance of payments is presented on the basis of BPM5.

MEFP Table 2. Bangladesh: Quantitative Targets and Performance Criteria Under the PRGF Arrangement, June 2004-June 2006 1/

(Cumulative flows, end of period) 2/

	Jun-04		Sept-04		Dec-04		Mar-05		Jun-05	Sept-05	Dec-05	Mar-06	Jun-06
	Indicative Targets		Performance Criteria		Indicative Targets		Indicative Targets		Indicative Targets	Proposed PCs	Proposed Indicative Targets		
	Target	Actual	Target	Actual	Target	Actual	Target	Actual					
(In billions of taka)													
Ceiling on net domestic assets of Bangladesh Bank 4/	12 3/	13	-7	-15	-5	-10	1	8 7/	29	2	11	19	27
Ceiling on net domestic financing of central government 4/	76 3/	60	4	-6	33	16	53	19	76	8	28	51	83
Ceiling on net central government bank borrowing 4/	31 3/	13	-5	-15	10	5	18	-3	36	-4	4	15	36
Taxes collected by National Bureau of Revenue 5/	...	...	...	...	...	...	...	...	...	73	154	244	356
(In millions of U.S. dollars)													
Floor on cumulative increase of net international reserves of Bangladesh Bank 4/	105	196 3/	200	331	220	358	200	237 7/	-25 8/	70	35	15	0
Contracting or guaranteeing of short-term external debt by the central government 6/	0	0	0	0	0	0	0	0	0	0	0	0	0
Contracting or guaranteeing of nonconcessional medium- and long-term debt by the central government 4/	250	8	100	8	150	8	200	8	250	100	150	200	250
Of which: External debt with an initial maturity of over one year and up to five years 6/	0	0	0	0	0	0	0	0	0	0	0	0	0
Accumulation of external payments arrears 6/	0	0	0	0	0	0	0	0	0	0	0	0	0

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

1/ The aggregates are defined in the Technical Memorandum of Understanding dated May 2003 (IMF Country Report No. 03/205).
2/ Cumulative flow since start of financial year beginning July 1.
3/ Including the bridge financing of Tk 16 billion for delay of the World Bank's DSCII and education loans (US$300 million) into July 2004.
4/ Performance criteria assessed on a periodic basis under the program period.
5/ Indicative targets assessed on a quarterly basis under the program period.
6/ Performance criteria assessed on a continuous basis under the program period.
7/ Corrected for shortfall in net open position of nationalized commercial banks.
8/ Relative to the actual NIR in June, 2004, representing an increase of $48 million relative to the June 2004 program target.

MEFP Table 3. Bangladesh: Structural Performance Criteria and Benchmarks Under the PRGF Arrangement

	Measures	Timing	Status
	I. Performance Criteria and Benchmarks for the Third Review		
1.	Expand the LTU system to cover withholding income tax and VAT, with a minimum coverage of 50 percent of total VAT collection by NBR, covering at least the 100 largest VAT filers 1/	September 30, 2004	Not Observed (met in October, 2004)
2.	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, with key benchmarks as specified in the TMU 1/	November 30, 2004	Observed
3.	Bring Rupali to point of sale by issuing an information memorandum to the public	December 31, 2004	Not Observed (met in May, 2005)
	II. Proposed Performance Criteria and Benchmarks for the Fourth Review		
1.	Establishment in the NBR of an independent audit unit headed by an advisor of the rank and status of a member reporting directly to the Chairman 1/	November 30, 2005	
2.	Reconstitution of Sonali Bank's Board of Directors to meet BB's fit and proper test for board membership, and ensuring that at least two board members have relevant banking experience.	December 15, 2005	
3.	Signature of final contract for appointment of financial advisor for Agrani Bank. 1/	December 15, 2005	

1/ Indicates structural performance criteria.

MEFP Table 4. Bangladesh: Prior Actions for the Third Review Under the PRGF Arrangement

	Prior Actions	Status
1.	Conducting joint audits for income tax and VAT LTUs.	Completed
2.	Transferring files to ensure minimum coverage of 50 percent of total VAT collection by NBR, covering at least the 100 largest VAT filers.	Completed
3.	Bring Rupali to point of sale by issuing an information memorandum to the public.	Completed
4.	Public announcement by the Ministry of Finance that the overall increase in the government wage bill and pensions will be phased in over three years with the maximum increase contained to no more than 15 percent per year.	Completed

Operationalization of NCB Resolution Strategies

1. To operationalize the NCB resolution strategies, a steering committee has been created comprised of the Finance Secretary, Bangladesh Bank Governor, and the Permanent Secretary of Law Ministry to oversee the Working Group and to take key decisions with regards to NCB restructuring and divestment.

2. An International Bank Restructuring Expert and a Local Banking Specialist with experience in banking will be appointed to assist the Working Group in monitoring the performance of the management teams in each of the four NCBs and to help operationalize the NCB strategies.

I. Bank-by-bank Action Plans

A. Rupali Bank

3. The objective is to bring Rupali to the point of sale by end-May 2005 by issuing an information memorandum to the public. To achieve this objective, the following steps will be taken:

- Bringing Rupali's capital to zero level at point of divestment (Attachment to Annex I). Also, investors to be required to inject sufficient capital at the point of divestment to bring Rupali's capital up to CAR. The investors to take a majority stake in Rupali.

- Reconstituting Rupali's Board of Directors by applying BB's fit and proper test for board members, which among various other things precludes board members from serving more than two consecutive three-year terms.

- Specifying that strategic investors will be given full control over HR policy, with staff retrenchment facilitated by a VRS to be financed by the World Bank loan.

- Assuming liability for all pension obligations of Rupali Bank.

- No regulatory forbearance for capital adequacy.

- Freezing all new lending until the strategic investor has assumed full management control.

B. Agrani Bank

4. The objective is to bring Agrani to the point of divestment by end-June 2006 by issuing an information memorandum to the public. To achieve this objective, the following intermediate steps will be taken:

- A financial advisor will be appointed by mid-December 2005 to bring Agrani to the point of divestment.

- The board of directors will be reconstituted and BB's fit and proper test for board membership will be applied by end-December 2005, ensuring that at least two board members have relevant banking experience.

- The bank will be corporatized by end-December 2005.

- The existing Memorandum of Understanding will be extended beyond December 2005.

C. Janata Bank

5. The objective is to bring Janata to the point of divestment by end-June 2007 by issuing an information memorandum to the public. To achieve this objective, the following intermediate steps will be taken:

- The contract with the management support team will be signed by end-June 2005.

- The board of directors will be reconstituted and BB's fit and proper test for board membership will be applied by end-December 2005, ensuring that at least two board members have relevant banking experience.

- The bank will be corporatized by end-June 2006.

- The existing Memorandum of Understanding will be extended beyond December 2005.

- A financial advisor will be appointed by end-December 2006, to bring Janata to the point of divestment.

D. Sonali Bank

6. The objective is to contain Sonali's future losses by restricting the bank's lending activities and restructuring its operations to the point where a minority shareholding can be divested. To achieve this objective, the following intermediate steps will be taken:

- The board of directors will be reconstituted and BB's fit and proper test for board membership will be applied by mid-December 2005, ensuring that at least two board members have relevant banking experience.

- The existing Memorandum of Understanding will be extended beyond December 2005 and maintained until the time of divestment.

- The bank will be corporatized by end-December 2006.

RESTRUCTURING AND RECAPITALIZATION OF RUPALI BANK

As per the statutory audit at end-December 2004 and the HVC IAS audit at end-September 2004, the government will recapitalize Rupali by using a combination of government bonds and loans to the government from Rupali.

1. The government has agreed to convert all SOE NPLs as per HVC IAS audit, after deducting the actual provisions made for these loans, into a single loan and service it at appropriate treasury bill rates.

2. The government has agreed to cover upfront clearly defined government liabilities as per HVC IAS audit through a loan from Rupali to the government that includes: i) liabilities to Rupali stemming from loan forgiveness to private jute mills; ii) advanced tax payments made by Rupali that were not reimbursed by the government, and iii) other government liabilities.

3. The government has agreed to issue government bonds to meet: (i) the capital shortfall in the statutory accounts at end-December 2004, and (ii) the underprovisioning in private loans in the statutory accounts at end-December 2004.

4. Non-SOE loans and other liabilities beyond paragraph 3 above as per statutory audit are subject to further clarification, and provisioning as needed under BB regulatory requirements will be funded by the government.

ADDENDUM TO THE TECHNICAL MEMORANDUM OF UNDERSTANDING

The Technical Memorandum of Understanding (TMU) dated June 4, 2003 (EBS/03/76) will be modified as follows:

- Para. 1, page 80 will be replaced by:

1. For program purposes, any foreign asset, liability, or cash flow denominated in a currency other than the U.S. dollar shall be converted into U.S. dollars by applying the appropriate end-of-period exchange rate for March 31, 2005, as published in the Fund's *International Financial Statistics* (Table 1).

Table 1. Selected End-of-Period Exchange Rates

Taka per U.S. dollar	63.5220	Indian rupee per U.S. dollar	43.7550
SDR per U.S. dollar	1.5108	Pakistani rupee per U.S. dollar	59.1240
Australian dollar per U.S. dollar	1.2955	Swedish kroner per U.S. dollar	7.0526
British pound per U.S. dollar	0.5312	Japanese yen per U.S. dollar	107.3500
Canadian dollar per U.S. dollar	1.2096	Gold price in U.S. dollars per troy ounce (London PM fixed)	433.9000
Euro per U.S. dollar	0.7714		

Source: Fund's *International Financial Statistics.*

- The following additional paragraphs will be added at the end of page 81:

2. The NIR floor will be adjusted downward by $100 million (at end-March 2005 TMU rates) if the World Bank's education loan is not disbursed in the first quarter of FY06.