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Economic Adjustment Programs - Bangladesh

BANGLADESH

Structural Adjustment Facility--Policy Framework Paper, 1986/87-1988/89

Prepared by the staffs of the Fund and the World Bank

In consultation with the Bangladesh authorities

April 7, 1986

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I. Introduction

1. Bangladesh is a country with a very high population density, limited natural resources, and widespread poverty. Annual per capita income was only about \$130 in 1984/85. ^{1/} A high rate of population growth (2.6% per annum) acts as a major constraint on economic and social development. Agriculture is the mainstay of the economy, accounting for about 50 percent of GDP and 75 percent of employment and exports. The ability to grow sufficient foodgrain has been the highest priority since independence. Although considerable success has been achieved in this regard the country continues to require annual foodgrain imports of about 11 percent of total consumption.

2. Growth in the agricultural sector has contributed to employment and exports. However, it has not been sufficient to fully absorb the rapidly growing labor force or to generate adequate foreign exchange earnings. Rapid growth in industry, which accounts for about 12 percent of GDP, and expansion in labor-intensive exports have therefore become important development policy objectives. However, the labor force in Bangladesh is largely unskilled and lacks the human capital requirements in education, health, and nutrition, necessary for this transition. The adult literacy rate is only about 26 percent and public expenditure on education is among the lowest in the world. Other key constraints on industrial development include a weak infrastructure (power, transport), inefficient public enterprises, inadequate incentives for

^{1/} Fiscal year ending June 30.

efficient private sector investment, and a weak financial intermediation system.

3. The economy is also characterized by very low savings, which in part reflects the low level of incomes, and by a large structural payments gap. National savings are about 5 percent of GDP and finance only a very small part of investment, which has averaged about 16 percent of GDP in recent years. Export earnings cover less than 30 percent of the import bill, with raw jute and jute goods still accounting for 55-60 percent of total merchandise exports. The deficit in the goods and services account of about 15 percent of GDP is financed by workers' remittances, which rose rapidly to more than 5 percent of GDP in 1983/84 before declining markedly to 3.5 percent of GDP in 1984/85, and by foreign assistance equivalent to about 10 percent of GDP. The capacity to finance imports can be severely affected by external factors (e.g., falling jute prices, declining remittances) that are largely beyond the control of the Government. The effect of such adverse factors on the economy is amplified by the heavy dependence of budgetary resources on imports. Inadequate growth in domestic resources also seriously constrains the financing of key public investments, and operations and maintenance of existing assets. Even though most development projects are largely aid-financed, the shortage of local currency resources, compounded by weaknesses in public administration, have tended to impede project implementation in Bangladesh.

II. Recent Developments

4. Despite the country's structural constraints indicated above, and repeated disruptions caused by natural disasters, Bangladesh has made significant progress in several areas during the late 1970s and early 1980s. In particular, policies towards agricultural, industrial, and export sectors have been strengthened, and the economy grew by about 4 percent per annum during the Second Five Year Plan period, 1980/81-1984/85. Foodgrain production growth averaged 3.5 percent per annum during the Plan period, faster than in the previous five years, and significantly above the rate of population growth. Such growth was achieved despite adverse weather, especially the severe flooding in 1984/85. Industrial output rebounded strongly in 1983/84 and 1984/85 averaging more than 6 percent per annum growth after the stagnation evident in the early 1980s, and has been led by efficient import substitution, and export oriented labor-intensive activities (e.g., ship-breaking and garments). Growth of nontraditional exports (items other than jute, tea, and leather) has averaged about 20 percent annually in real terms during the past five years. Development of domestic commercial energy supplies, especially natural gas, has increased rapidly in recent years, enabling relatively high growth in the power and fertilizer sectors and significant import substitution of petroleum products.

5. The improvements in economic performance can be attributed for the most part to a wide range of policy reforms undertaken in recent years. In foodgrain and agricultural production, key policy improvements have been the increased emphasis on the private sector in the distribution of inputs

(fertilizers, irrigation equipment), elimination or reduction in subsidies (fertilizer, irrigation equipment), increased outlays for other agricultural development activities, and the rapid spread of high yield variety seeds (HYV), fertilizers and irrigation equipment. In industrial development, under the Government's New Industrial Policy (NIP), initiated in 1982, key policy improvements have included an enhanced role for the private sector through large scale denationalization of public enterprises, liberalization of imports by significantly broadening the scope of the relatively free secondary foreign exchange market, and some liberalization of investment sanctions and controls. The result has been stepped up private investment in labor-intensive and efficient import-substitution and export-based activities. In export development, the main policy improvements have included more effective exchange rate policies and export incentives, improvements in export policy administration through liberalized imports, efficient duty-drawback systems (bonded warehouse system), and improved access to export financing. The result has been an important breakthrough, particularly in garments exports, which were practically non-existent prior to 1982/83, and have risen to over \$100 million or 12 percent of total exports in 1984/85. Bangladesh's garments exports have been affected by quotas of importing countries, which could reduce the prospects for future expansion in these exports. Recently, however, an agreement has been signed with the United States which will allow improved access for Bangladeshi garment exports to the U.S. market for the next two years.

6. In addition to generally sound development strategies in key sectors, the Government has recently taken important steps to improve short-term economic management. In the two-year period 1983/84-1984/85, there was an extremely rapid growth in money supply and private sector credit, accompanied by a rapid deterioration in credit recoveries in agriculture, industry and other sectors. These developments contributed to an acceleration in inflation and increased pressures on the balance of payments. Since the latter part of 1985, successful measures have been taken to curb money supply growth and to moderate the growth in domestic credit. Measures were also taken to improve credit recoveries, although this remains an urgent problem. These factors, as well as the recovery in food production, have resulted in a moderation in domestic inflation from over 12 percent in 1984/85 to about 10 percent in 1985/86. The balance of payments situation deteriorated sharply in 1984/85 because of a large recovery in import demand, including the need for large foodgrain imports as a result of the flood damage to foodgrain crops, and a marked decline in workers' remittances. In view of this, as well as an appreciation of the real effective exchange rate, the Government took steps during February-December 1985 to stabilize the balance of payments by depreciating the taka and by slowing down money supply expansion. These stabilization measures are being supported by a Standby Arrangement with the IMF in the amount of SDRs 180 million covering the period December 1985 to June 1987. As a result of these stabilization measures, the situation has improved in 1985/86 with a reduction of the current account deficit to approximately 7 percent of GDP from over 8 percent in 1984/85. Cautious

public finance policies have also been adopted in recent years. The 1985/86 budget included efforts to raise additional revenues (increased natural gas excise taxes, power tariffs, and fertilizer prices) equivalent to about 0.4 percent of GDP; however, the increase in revenues will largely be offset by significantly higher public sector salaries. Public investment expenditures will remain largely unchanged in real terms in 1985/86, compared with 1984/85.

7. However, progress has been less satisfactory in several key areas: improvements in the financial system, domestic resource mobilization, project implementation, and public investment and expenditures planning, including that for operations and maintenance of existing public investments. The most immediate problem in the financial sector is the unacceptably low level of recoveries, which has undermined the efficiency and viability of the financial system. Agricultural credit recoveries deteriorated to only 38 percent in 1984/85 as the volume of lending was expanded extremely rapidly between 1982/83 and 1984/85. The problems in industrial finance are more severe and past efforts of the development finance institutions to recover arrears and restructure their portfolio have shown little real progress. Underlying these difficulties are systematic distortions in the financial sector--inadequate appraisal and supervision, and an inordinate degree of Government intervention. Public domestic resource mobilization efforts have slackened after the measures taken by the Government in 1982/83, and there remain significant opportunities to increase and diversify sources of revenue. In addition collections of revenue by the Government and public sector agencies

and enterprises remain very weak. Although disbursement rates 1/ of externally aided projects have improved to about 16 percent in 1984/85 from 15 percent in 1982/83, they still remain well below the rates of above 20 percent achieved between 1977/78-1981/82. This was due partly to domestic financial resource constraints, and partly to the lack of improvements in project implementation capacity necessary to keep pace with the growth in project aid commitments. Finally, the shortage of adequate domestic resources, the bias towards new investments, and the absence of cost recovery efforts have contributed to the very low expenditures on operations and maintenance (O & M) of existing assets, and to their serious deterioration. Budgetary management in general has also tended to suffer from an overestimation of resource availability and a limited one-year time horizon in fiscal planning. Significant improvements in the medium-term are necessary in all these areas in order to augment the availability of scarce resources in the economy and improve the efficiency of resource utilization.

III. Framework for a Three-Year Adjustment Program:

Objectives and Policy Priorities, 1986/87-1988/89

8. Sustained economic growth, with financial stability, is essential if a gradual improvement in the present extremely low standard of living in Bangladesh is to be realized. The Government has proposed a target of 5.4

1/ The rate is the amount of project aid disbursements during a fiscal year expressed as a percentage of the undisbursed project balance at the beginning of the same fiscal year.

percent per annum growth in GDP between 1985/86-1989/90 in its recent published Third Five Year Plan. However, the Government recognizes that this target, although desirable, may not be fully achieved. External resource availability is likely to remain quite constrained over the next few years; sharply lower jute export prices, lower workers' remittance and substantial repayments of past food loans and Fund repurchases are expected to outweigh the gains from lower oil prices. In addition, there will be constraints on the availability of concessional aid, and the growth in domestic resources will also be limited by the narrow revenue base, the heavy dependence of import related taxes, and the highly subsistence character of the economy. A high rate of foodgrain production growth will contribute importantly to increased employment and incomes and reduce the dependence on commercial imports, but there are limits on the rate at which agricultural inputs can be expanded. Finally, a range of reforms will need to be undertaken in order to achieve export-led growth and increased employment in the non-agricultural sectors of the economy.

9. A structural adjustment program (1986/87-1988/89) would seek to achieve improvement in real per capita incomes through a 4-5 percent per annum growth in GDP, while ensuring a sustainable current account deficit of about 7.5% of GDP. The high current account deficits of recent years (10.7% average for the Second Five Year Plan, 1980/81-1984/85) have been financed by mainly net aid disbursements (9.9% of GDP), but have also required net borrowing at commercial rates (1.0% of GDP). However net aid disbursements as a percent of GDP over the next three years are expected to fall by about

1.5 percentage points, even with improved disbursement performance from the pipeline. And further borrowing at commercial rates is not desirable; indeed net disbursements from these sources should be negative in the coming three year period as Bangladesh repays food loans and fulfills repurchase obligations to the IMF. A current account deficit higher than 7.5% of GDP for the next three years would be justifiable and sustainable only if concessional aid disbursements were to improve significantly (paragraph 22) so that the additional resources would be used for priority investments and the increased deficits would not be at the cost of inappropriate commercial term borrowing.

10. In addition to stabilizing the external balance and encouraging growth over the next three years, policy reforms would also lay the foundation for faster economic development in the future. The priorities of the program are: to increase foodgrain production and strengthen the operation of the public food distribution system; to expand and diversify exports through flexible exchange rate management and trade and industrial policy reforms; to ensure adequate growth in private savings and investment through financial sector policy reforms; to increase public domestic resource mobilization; and to improve the level and quality of public development expenditures. In some of these areas the framework of policies and programs are in place. In others, further work will be initiated by the Government in 1986/87. External assistance in support of such an adjustment program will be important, and the aid requirements in support of such a program are outlined in the concluding section of this paper.

IV. Structural Adjustment Policies

Foodgrain Production and the Food Distribution System

11. Growth in foodgrain production of about 3.5-4.0 percent per annum will need to be achieved to increase per capita food consumption and nutrition, and ensure food security. However, the achievement of this rate of growth will depend on continued rapid expansion in irrigation facilities for the dry-season crops through an increased role for the private sector, improvement in the performance of public sector agencies, and the strengthening of medium-term credit policies. Increased emphasis will also need to be given to the growth potential for the monsoon season crops through greater use of HYVs, fertilizers, and supplementary irrigation. Effective output price support policies will be maintained while the needs (e.g. access to inputs, credit, and markets) of small farmers will be specifically addressed through a revitalization of the cooperative system. Despite relatively rapid growth in foodgrain production, annual imports equivalent to 10 percent of total consumption would still be necessary, mostly financed by food aid. A large part of such aid (about 70 percent in 1988/89 as compared to 50 percent in 1984/85) would be targetted toward the rural poor and other vulnerable group programs. Foodgrain subsidies to other, better-off groups in the public distribution system would be eliminated.

Export Promotion and the External Balance

12. The authorities would implement appropriate exchange and trade and industrial policies designed to promote private sector investment, increase industrial output and employment and promote exports. The improvements in trade and industrial policies initiated under the NIP framework will be considerably strengthened to ensure rapid growth in nontraditional exports, and to promote efficient import substitution. A flexible exchange rate policy will be the primary instrument in promoting such activities. The jute sector will require close attention and assistance with a view to improving its competitiveness vis-a-vis synthetics in a difficult world export market. Growth in nontraditional exports will also be supported by a strengthened duty drawback system and expanded bonded warehouse facilities to ensure free-trade status of exporters, and improved access to export financing and guarantees. Further efforts to improve resource allocation would include liberalization of quantitative restrictions and tariffs and the elimination or reduction of investment sanctions and controls.

13. These improvements in efficiency would allow a continued economic growth consistent with a current account deficit of about 7.5 percent of GDP between 1986/87 and 1988/89. Gross external reserves would be maintained at a level of about 2 months of imports, compared to 1.6 months of imports between 1980/81-1984/85. Appropriate debt management policies that would serve to contain debt service obligations over the medium term will be

implemented. Toward this end, short- and medium-term borrowing on nonconcessional terms other than for food loans would be strictly limited. In addition to continued flexible exchange rate management, the Government will pursue the objective of unification of the exchange markets to improve resource allocation and provide better prices to traditional exports.

Financial Sector Policies and Private Savings

14. In the financial sector policies will be implemented to improve the efficiency of financial intermediation to ensure adequate growth in private savings and investment, and manage credit policy with a view to curbing inflation and easing pressure on the external balance. Recourse to net bank borrowing, by the public sector would be minimized, other than for financing foodgrain operations. The growth in credit to the private sector would take into account the need not to unduly constrain the productive sectors of the economy while ensuring improved credit recovery rates. The credit program would be consistent with the projected movements in net foreign assets of the banking system and the expected development in the demand for broad money. Over the period under consideration, the growth of broad money supply should be in line with the growth in nominal GDP. It will also be necessary to ensure that key interest rates would be positive in real terms--flexible interest rate policy would be pursued to promote domestic resource mobilization and an efficient allocation of resources. Financial sector policy reforms will be implemented to restore credit recovery in the agricultural sector to more viable levels (at least 65 percent by 1987/88), and firmly

support the development finance institution's efforts to recover arrears and restructure their portfolio. Strengthening of the legal framework to take effective action against defaulters, improved accounting and monitoring of overdue accounts, and stricter limits on central bank refinancing related to recovery performance will also be pursued. Beyond these measures, it will be necessary to undertake a review of the financial sector as a whole, and to identify broader policies necessary to promote efficient financial intermediation. This will also be crucial for generating additional private savings and investment. Such a review process will be initiated in 1986/87 and recommendations implemented thereafter.

Public Resource Mobilization

15. The major objective in regard to public resource mobilization is to improve the level of development-oriented expenditures while at the same time accomplishing a progressive reduction of the overall budget deficit as a proportion of GDP from its present level of about 7.5 percent. A higher budget deficit could be sustainable only insofar as the utilization of foreign aid increases significantly. Efforts should, therefore, be made to reduce subsidies and restrict the size of the Annual Development Program (ADP) in line with the expected inflow of foreign assistance and the availability of domestic nonbank resources. To further these objectives, policy measures in regard to revenue will aim at reduced dependence on the more volatile external trade taxes and concentrate on domestic-based taxes. Tax instruments will be reviewed to improve resource allocation and further

growth objectives. Tax administration and procedures will also be reviewed so that taxes are collected fully and on time. For this purpose, the Government will initiate in 1986/87 a review of tax administration and procedures, sources of additional revenues, and the effects on revenues of import tariff liberalization. Other resource mobilization efforts would include appropriate economic pricing of energy (natural gas, power), elimination of food subsidies, and cost-recovery in irrigation, transport, education, and health, and improved profitability of public enterprises through appropriate pricing policies. It will also be necessary to strengthen considerably the current inadequate collections performance in certain sectors (e.g. power, water, irrigation). In sum, the Government intends to increase domestic public revenues by at least 0.5 percent of GDP annually between 1986/87-1988/89.

16. As part of the effort to mobilize public sector resources, the financial and physical performance of public enterprises will be carefully reviewed. The major objectives in this area will be to adjust user charges so that they would adequately reflect production costs and a reasonable rate of return, to ensure the timely recovery of user charges and to explore possibilities for further reductions in production costs. The authorities will also review the economic viability and performance of public enterprises with a view toward adjusting the size of their operations, transfer to the private sector, or eventual closure. Public sector enterprises, which will continue to account for a large part of industry despite recent

disinvestment, will be given much greater operational freedom, and performance monitoring systems will be established.

17. These public resource mobilization efforts, taken together with the improvements in financial sector policies aimed at increasing the private savings rate, would be expected to significantly improve the overall savings rate in the economy by the end of the three-year program and beyond.

Public Expenditure Policies

18. Given the constraints of resource availability, emphasis will be directed toward an improvement in the quality of development expenditures: a higher level of operation and maintenance expenditure to ensure the adequate maintenance of existing assets, and to improve project implementation capacity to use more effectively available external assistance.

19. Following an extended period of relative neglect of operations and maintenance, the rate of return on incremental public expenditures is likely to be the highest during the next few years for outlays to improve the condition of existing infrastructure. The Government will, therefore, aim to significantly increase O & M expenditures in real terms, by about 10 percent per annum. Included in a higher level of maintenance expenditure is the need to achieve a better balance in manpower and other costs. This would, however, leave less resources for financing investment expenditures in the ADP. The growth of the ADP in real terms may not exceed a modest 4 percent per annum, and within the ADP allocation, about three quarters of projected

available resources are already committed to ongoing projects or others which were identified, evaluated and agreed with donors before July 1985. The scope for starting new projects will therefore be strictly limited. In this context, it will be important for the Government to undertake a careful review of priorities in resource allocation in the investment budget, and O & M, to ensure the maximum benefits to the economy from scarce public resources. Budgetary management would also benefit from a change to multi-year rolling budgetary plans, including the formulation of public investment and financing programs, which would allow a more realistic assessment of expected resources and hence feasible expenditures.

20. The major task in regard to the ADP would be to raise project disbursement rates. Bangladesh has a large pipeline of project aid commitments, totalling about \$4.0 billion in 1985/86. In view of this, the emphasis will be on improving project implementation. The Government has begun to address problems related to project implementation capacity, including cumbersome procurement procedures, delays in decision making and approval process, lack of delegation of authority, and restrictive guidelines. The Government will further streamline the review and approval process and procurement procedures in 1986/87. Part of the reason for slow project implementation is also the lack of adequate domestic resources. However, more efficient implementation of projects would help strengthen the case for increased commodity assistance, increased local cost financing, or both, to supplement the constrained availability of domestic resources for project implementation.

V. External Assistance Requirements, 1986/87-1988/89

21. Bangladesh has made heavy use of external assistance, with foreign aid disbursements accounting for about 40 percent of total Government resources, 50 percent of total investment, and close to 55 percent of import payments in recent years. Even under the most optimistic assumptions regarding the growth of exports and national savings, the country will continue to rely heavily on external assistance for the foreseeable future. However, while aid commitments increased substantially during the first ten years of independence through 1981/82, there has been no discernible upward trend since then: the average level for 1982/83 through 1985/86, in fact, has been 7.4 percent below the level in 1981/82 in real terms. The availability of highly concessional aid, especially from bilateral sources, is likely to remain constrained over the next few years (see paragraph 9).

22. In view of the country's continuing high dependence on aid for imports and domestic revenues, the achievement of a rate of growth in GDP averaging 4-5 percent per annum during the next three years will require gross concessional aid disbursements of at least \$1.65 billion per annum from an unchanged annual level of aid commitments in real terms. To achieve a rate of economic growth at the higher end of the projected range and maintain a safety cushion against unexpected shortfalls in foreign exchange earnings, it is essential that total aid commitments to Bangladesh should rise by about 1 percent per annum in real terms over the next three years. There is also a

need for a shift in the composition of external assistance in favor of commodity and program aid to directly finance imports of eligible goods and services not linked to specific projects. An increase in commodity and program aid to Bangladesh is particularly important in the adjustment program because (a) increased counterpart funds generated will be needed to facilitate a faster pace of project implementation; (b) together with an intensified domestic resource mobilization effort, the resources will also help support increased O & M expenditures; and (c) the foreign exchange provided will be essential to financing the flow of imports needed for a sustainable rate of economic growth.

23. Allowing for the availability of funds from the proposed IMF Structural Adjustment Facility, commodity aid commitments and disbursements would still need to rise by about 3 percent per annum in real terms between 1986/87-1988/89, from a level of about \$500 million in 1985/86.

24. New project aid commitments to Bangladesh, on the other hand do not need to rise in real terms because of the substantial pipeline. It is expected, therefore, that project aid commitments would be maintained in real terms; however, project disbursements are expected to increase by 8 percent per annum in real terms as a result of improved implementation. Bangladesh will continue to require substantial food aid to help bridge the gap between domestic production and effective demand and to provide for the food requirements for rural poor and other vulnerable group programs. Based on estimates of domestic foodgrain production, stock requirements and minimum nutrition

needs, food aid requirements will remain at about the average of 1983/84 and 1984/85 levels in real terms. It should be possible to accommodate a modest increase in total aid commitments of about 1 percent per annum as noted above, given the pressing needs of Bangladesh and provided that policy improvements outlined in this paper are successfully carried out.

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