

Bangladesh PRSP Forum Economic Update

Recent Developments and Future Perspectives

The World Bank Office, Dhaka

November 2005



Document of the World Bank

GOVERNMENT FISCAL YEAR

July 1 – June 30

CURRENCY EQUIVALENTS

Currency Unit = Bangladesh Taka (Tk.)

US\$1 = Tk. 66.1 (October 23, 2005)

ABBREVIATIONS

ACC	Anti-Corruption Commission	MDG	Millennium Development Goal
ADB	Asian Development Bank	MFA	Multi-Fibre Arrangement
ADP	Annual Development Program	MoF	Ministry of Finance
ATC	Agreement on Textiles & Clothing	MOU	Memorandum of Understanding
BAC	Bangladesh Anti-corruption Commission	MTEF	Medium-Term Expenditure Framework
BPC	Bangladesh Petroleum Corporation	NBFI	Non Bank Financial Institution
BTRC	Bangladesh Telecommunication Regulatory Commission	NBR	National Board of Revenue
BTTB	Bangladesh Telegraph and Telephone Board	NCB	Nationalized Commercial Bank
C&AG	Comptroller and Auditor General	NGO	Non-Government Organization
CAO	Chief Accounting Officer	NPL	Non-Performing Loan
CGA	Controller General of Accounts	NTRCA	Registration and Certification Authority
DFID	Department for International Development	PEDP-II	Primary Education Development Project
CRR	Cash Reserve Ratio	POL	Petroleum, Oil, Lubrication
ERC	Energy Regulatory Commission	PPR	Public Procurement Regulations
FMRP	Financial Management Reform Program	PRGF	Poverty Reduction and Growth Facility
GDP	Gross Domestic Product	QR	Quantitative Restriction
HNP	Health, Nutrition and Population	REB	Rural Electrification Board
HNPS	Health, Nutrition and Population Sector Program	RHD	Road and Highways Department
IAS	International Accounting Standards	RMG	Ready-Made Garments
ICT	Information and Communication Technologies	ROSC	Report on Observance of Standards and Codes
IMF	International Monetary Fund	SEF	Small Enterprise Fund
LTU	Large Taxpayer Unit	SLR	Statutory Liquidity Requirements
PRSP	Interim Poverty Reduction Strategy Paper	SME	Small and Medium Enterprise
		SOE	State Own Enterprise
		VAT	Value-Added Tax
		VAW	Violence Against Women
		VRS	Voluntary Retirement

This report was prepared for the PRSP Implementation Forum (November 15-17), in Dhaka, Bangladesh. It covers recent macroeconomic developments and draws on recent and ongoing World Bank research and analysis undertaken in the areas of Governance, Finance and Trade, Public Administration, Infrastructure and Human Development.

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I. THE COUNTRY CONTEXT

Bangladesh: Some impressive and sustained socio-economic trends – which outperform many South Asian and other developing countries.

1. *Faster economic growth has helped Bangladesh to reduce the poverty rate by about 1 percentage point per year since 1990.* Poverty fell from 60 percent in 1990 to 50 percent in 2000. Independent for just 33 years, Bangladesh has achieved a positive development record in the face of extremely weak initial conditions, virulent and often times violent politics, fragile institutions and poor governance, frequent large-scale destruction by extreme weather conditions, and the negative global image generated by these. The advent of democracy in the early 1990s was accompanied by a quickening in the pace of economic reforms with greater macroeconomic stability, a trend towards trade openness, and economic deregulation. Growth in GDP per head has increased from 1 percent during the 1970s to over 3 percent since the early 1990s: per capita growth has moved to an even higher trajectory of 4 percent since FY03. Growth has also been remarkably stable: Bangladesh is among the handful of countries that have sustained positive per-capita growth in each year since the early 1990s¹. This performance has been underpinned by rising agricultural and non-farm rural output and a rapid expansion in export of ready made garments (RMG)².

2. *Progress on social measures has been encouraging.* Primary enrollment for both genders is near universal, and the secondary enrollment rate has more than doubled since independence. Bangladesh has already met the Millennium Development Goal (MDG) on gender parity in school enrollment at secondary and primary levels. The child mortality rate has halved, and life expectancy has increased by more than 15 years. The decline in infant and child mortality rates, from 140 and 95 respectively in 1972 to about 60 and 30 in 2000, was among the fastest in the developing world. If present trends continue, Bangladesh and Maldives will be the only South Asian countries to achieve their MDGs of reducing infant and child mortality. A decline in the total fertility rate from 6.3 children in 1975 to 3.3, reduced population growth to 1.5 percent a year by the mid-1990s. Fertility has since declined further to 2.9 in 2003, again at a much faster pace than most. Although Bangladesh has often started from a low baseline, it has achieved some impressive results both in terms of the rate of progress and actual development outcomes (Table 1). Bangladesh outperforms its neighbors in Region and other low income countries by a considerable margin in many social/developmental areas.

Formidable challenges remain, notably on governance issues

3. *Despite sustained progress, a formidable development agenda remains given the low starting base.* Almost half the population is still under the poverty line, and over half the country is functionally illiterate. Although Bangladesh has the lowest child malnutrition and maternal mortality among its South Asian peers, these rates for the region are the highest in the developing world outside of Sub-Saharan Africa. The proportion of births attended by a doctor or skilled midwife is less than 1.5 percent for the poorest households, compared with 22 percent for the richest: this equity gap is one of the highest in the world. Despite expanded access to education,

¹ Bangladesh's growth volatility is the lowest in a sample of 151 countries for which at least 15 annual observations were available. See World Bank, *Bangladesh Development Policy Review*, December 14, 2003. Report No. 26154-BD, pp. 7-8.

² Binayak Sen, "Operationalizing Pro-Poor Growth - A Country Case Study of Bangladesh", A joint initiative of AFD, BMZ, DFID, GTZ, KfW Development Bank and the World Bank, October 2004.

poor quality pervades the system and completion rates are very low: less than 10 percent of grade 1 pupils complete grade 12.

Table 1 : Selected World Development Indicators

Country	Decrease in child mortality 1990-2000 (%)	Maternal mortality ratio (per 000 women)	Decrease in fertility rates 1990-2003 (%)	Increased Access to primary education 1990-2000 (%)	Child immunization rates for DPT (%)	Proportion of women employed in labor force (%)
Bangladesh	-52	380	- 29	59	85	68
India	-29	540	- 24	4	70	45
Pakistan	*	500	- 22	*	67	39
Nepal	-29	740	- 23	19	78	58

Source: *World Development Indicators*, World Bank, 2005.

* No data available

4. ***Bangladesh continues to face huge problems, in a number of important aspects of governance, which hamper development.*** In particular, the law and order situation is weak and corruption is widespread. There has been steady erosion in the quality of the civil service and the Government's capacity to deliver essential services is further constrained by highly centralized political and administrative systems. Capturing this, recent cross-country governance indicators developed at the World Bank show Bangladesh to be a poor performer on four important measures of governance: control of corruption, political stability, regulatory quality, and rule of law (see box 1).³ Perceptions of a weak governance environment have adversely affected Bangladesh's global image, severely hurting prospects for long-term foreign capital inflows. It is imperative that the Government address these issues if the country is to improve its growth and development prospects. There are several positive features already in place that the country can build on. Bangladesh is a new democracy with its fourth consecutive general elections due by early 2007. Voters have twice voted out the incumbent party, thus giving clear signals to the government to be more responsive to the needs of the electorate. An activist Supreme Court has played its role in promoting checks and balances. A vigorous and rich civil society and a relatively free press have contributed to holding governments accountable.

Small, incremental reforms support positive outcomes

5. ***The Government is beginning to implement a broad-based reform program to tackle governance issues,*** with donor support. Reforms in core governance areas such as public administration, tax administration, procurement, and financial management will have long-term benefits, as will the recently established Anti-Corruption Commission, once it is fully effective. Related sectoral reforms have sought to strengthen governance in banking, health, education, and state-owned enterprises (SOEs), and energy. The activities of the public sector banks, previously a huge source of corruption through directed credit, have been curtailed through tighter MOUs. The culture of non-payment to energy companies has been another root of systemic corruption. Recent successful efforts to reduce the stock of arrears to power companies and improved collection of current bills have addressed this partially. These are important incremental steps in what is necessarily a long-term, complex, and daunting agenda.

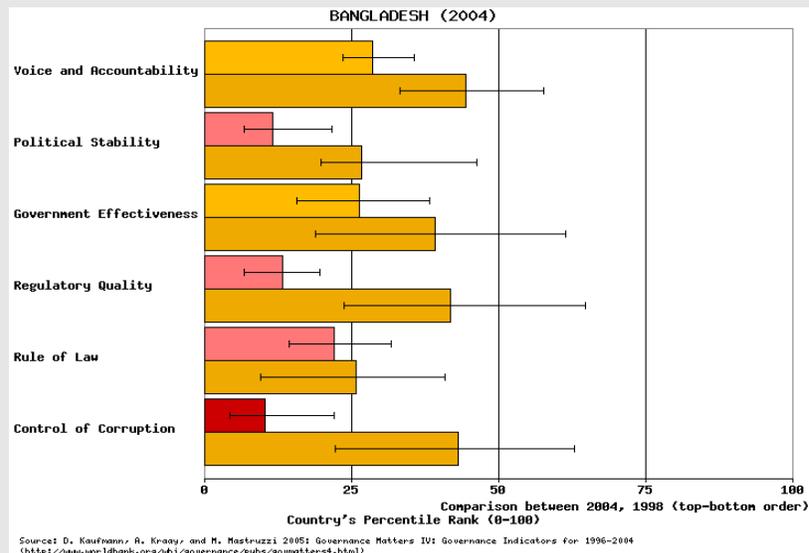
³ External perceptions-based indices, also rank Bangladesh quite low on corruption comparisons. Most notably, Transparency International, the Berlin based private corruption rating agency, has placed Bangladesh last in its cross-country corruption rankings five years in a row.

6. *In the area of economic management, the Government has maintained macroeconomic stability and pushed forward the structural reform agenda despite a difficult political environment.* Trade-related quantitative restrictions were virtually eliminated while holding the line on average tariff protection. Unification of the capital and recurrent budgets was initiated and policy orientation of expenditure allocations strengthened on a pilot basis in four ministries. This is now being extended to another six ministries. Public administration reforms were further deepened with increased emphasis on merit in promotions, creation of a Career Planning and Training Wing in the Establishment Ministry, and limiting new hiring in non-essential posts. The Central Bank’s oversight of the banking sector was strengthened, one nationalized commercial bank (NCB) was brought to the point of sale, and management support teams hired for the other 3 NCBs. State-owned manufacturing enterprises reduced their losses by 12 percent in FY05, and power utilities substantially improved their financial positions.

Box 1 : A Mixed Record of Governance

Bangladesh scores poorly in all six governance indicators for 2004 produced by the World Bank Institute. These survey and perception based indicators are used to measure performance in six main dimensions of governance: *voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption.* The indicators, which cover some 209 countries, show that Bangladesh’s percentile ranking in 2004, for four of the six indicators was in the lowest quartile, while for two others it was in the second lowest quartile. Thus for *political stability*, Bangladesh’s percentile ranking was 11.7, for *regulatory capacity* it was 13.3, for *rule of law* it was 22.2 and for *control of corruption* it was 10.3.

Bangladesh did somewhat better on *government effectiveness* (26.4) and *voice and accountability* (28.6). Bangladesh’s performance is poor relative to other low income countries in *political stability, regulatory quality and control of corruption*, while it does better than low income countries in *voice and accountability and rule of law.*



A comparison of the point estimates for these indicators over time suggests that Bangladesh’s performance may have worsened on all six indicators between 1998 and 2004.

However, because of large, though declining, margins of error, there is not enough evidence to conclude that Bangladesh’s Governance have become better or worse, except in the case of *Regulatory Quality*, where it is possible to say at a 90% confidence interval that there was a perceived decline. We can also say with some certainty that for three of the six indicators (*political stability, regulatory quality and control of corruption*), Bangladesh’s governance ratings are low, i.e. in the bottom quartile of all countries measured.

Source: World Bank Institute

7. *These efforts have produced relatively favorable development outcomes.* Per-capita GDP growth has averaged 4 percent over FY03-05, the highest 3-year average since independence. In FY05, GDP growth remained above 5 percent even though floods caused widespread damage, while monetary, fiscal, and external sector targets stayed within the medium-term macro framework agreed with the IMF despite severe exogenous pressures arising from severe floods in 2004 and sharp increases in global commodity prices. Although the latest poverty data are still being collected, proxy indicators suggest that good progress on poverty reduction and social development has continued in recent years. Many MDGs are also on track for being met (Box 2).

Box 2 : Is Bangladesh on track to meet the MDGs in 2015?

Bangladesh has made remarkable progress on several MDGs --such as gender parity, consumption poverty and child mortality. Several other MDGs are within reach but will require special attention and concerted effort. Finally, some MDGs will challenge the country for some time (Annex 1, Table 5). Thus, a mixed picture is emerging for Bangladesh, as suggested by two recent MDG assessments, *Millennium Development Goals: Bangladesh Progress Report* (GoB and UN, 2005) and *Attaining the MDGs in Bangladesh* (World Bank, 2005).

- **Bangladesh has already attained the goals relating to reaching gender parity in schooling opportunities, and universal primary education.** Bangladesh is the only country in South Asia other than Sri Lanka to have achieved parity in male and female enrollments not just at the primary level but also at the secondary level. This is an impressive achievement for a country that is one of the poorest countries in the world, with a per capita GDP just over \$400.
- **Attainment of two other MDGs – reduction of consumption-poverty and under-five mortality – is also feasible with a combination of interventions, including sector-specific interventions** (such as expanding immunization coverage and reducing pupil-teacher ratios), economic growth, improved coverage of infrastructure, and social safety-net programs.
- **Attainment of the child malnutrition-related MDG as well as the education MDGs relating to universal net primary enrollment and primary completion remains challenging.** In the case of child malnutrition, the projections suggest that Bangladesh could come very close to – within 5 percentage points of – the MDG of having no more than 34% of its children underweight. It is still unclear whether Bangladesh is likely to achieve rates of net primary enrollment and primary completion exceeding 83-86% by 2015.
- **Maternal mortality goal will also be difficult to achieve.** Bangladesh has the lowest maternal mortality in South Asia, but South Asia’s indicators are among the worst in the world. The maternal mortality rate was in the range of 320 to 400 per thousand live births in 2001. For Bangladesh to meet the target for maternal mortality, this figure must be reduced to 143 per thousand live births, which will require the inducement of major behavioral changes in mothers, far greater access to quality reproductive health services, and a generally improved socio-economic situation.
- **Bangladesh had nearly achieved the safe water goal, with 97% of the population having access to pathogen-free waters. Arsenic contamination presented a second round of challenges, with access to pathogen- and arsenic-free water now roughly 80 percent in urban areas and 70 percent in rural areas.** The Government’s “total sanitation” program has been a real success in rural areas, with very high coverage, but an emerging set of challenges to MDG attainment is driven partly by urbanization, as only 14 percent of slum dwellers in metropolitan areas have access to sealed latrines – yet the urban population is projected to nearly double to 50 million people by 2015.
- **Reversing the trend of deforestation and increasing energy efficiency, therefore, weigh heavily on the MDG agenda of ensuring environmental sustainability.** The financial and institutional resources necessary to accomplish these objectives, however, pose significant challenges to attainment of this MDG.

8. **Prospects of annual growth remaining around 5-6 percent over the next 2-3 years are good** as long as Bangladesh maintains macro stability and sustains past saving and investment rates and the current pace of economic reforms. As detailed in Chapter V, growth could accelerate to perhaps 7-8 percent if the Government scales up its efforts to reduce regulatory costs, address infrastructure constraints (especially ports and power), deepen and improve the efficiency of the financial sector, improve labor quality, and further lower trade barriers. Investment rates would need to rise substantially to a level unlikely to be covered by higher private savings alone: this will require fiscal prudence (cutting budget deficits, lowering SOE losses etc.), continued donor support, and significant increases in foreign capital inflows.

9. **The recently completed Poverty Reduction Strategy Paper (PRSP) recognizes these challenges and opportunities.** It lays out ambitious development goals, emphasizing the Government’s commitment to reforms. It provides a cohesive policy framework for implementing a pro-poor growth strategy and meeting the MDGs. Development Partners are fully supporting the PRSP and its implementation, at Government’s request.

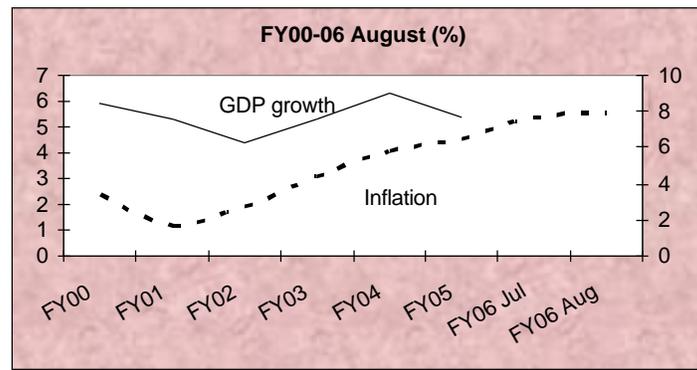
II. RECENT ECONOMIC DEVELOPMENTS⁴

Economic growth remains robust

10. **The Bangladesh economy grew in FY05 at a decent 5.4 percent**, compared with 5.8 percent growth in FY04 and 5.3 percent in FY03 (Figure 1). Growth was upheld in spite of several challenges over the past year including: the devastating floods in July-September 04, a sharp and sustained increase in international oil and commodity prices, the MFA-Phase out at the end of 2004, and an increasingly difficult political climate. There was a steady expansion in manufacturing, construction, and the services sector, which offset a weak performance in the agricultural sector.

11. On an expenditure basis, GDP expansion in FY2005 was driven by a strong growth in private consumption, exports and worker’s remittances, the government’s flood rehabilitation measures, including credit expansion to agriculture and industry, and an increase in private investment, including foreign direct investments. Private investment has increased from 17.8 percent of GDP in FY04 to 18.5 percent in FY05, while the domestic saving rate increased from 19.5 percent of GDP in FY04 to 20.2 percent in FY05. The rise in investment and saving rates are both positive factors for supporting future growth.

Figure 1 : Real GDP Growth & Annual Average Inflation



Source: National Accounts; Bangladesh Bureau of Statistics

⁴ This chapter draws upon several key documents including World Bank (2005) *Bangladesh Bi-Annual Brief, mimeo*, September 2005; ADB (2005) *Quarterly Economic Update – Bangladesh*, June 2005 and IMF (2005) *Staff Report for the 2005 Article IV Consultation*, June 2005.

Potential macroeconomic risks

12. ***Bangladesh faces several challenges for sustaining high rates of economic growth in both the short and medium term*** including galloping global oil prices, uncertain consequences of the MFA-phase out on the export competitiveness of the garment industry, political uncertainty in the run-up to the next elections due by January 2007, and weak governance.

13. ***Surging global petroleum prices*** in international markets pose major risks to Bangladesh's growth, macro-economic stability and external balances. High global petroleum prices are contributing to inflationary pressures, affect adversely the balance of payments and add to public borrowing to cover the losses from the Bangladesh Petroleum Corporation (BPC). During the last 12 months, domestic petroleum prices have risen only 30% compared with 86% for the price of international crude oil, with BPC losses likely to reach Tk 30 billion (455 million US dollars) again in FY06 (0.7 percent of GDP). Insufficient petroleum price adjustments are a major source of macroeconomic risk and have precluded giving a clear price signal to investors and energy users to improve resource allocation in this key sector. Continued price discrepancies will mean either further debt financing and/or expenditure cut backs with serious adverse implications for growth, inflation and poverty reduction. Moreover, if high world prices slow global economic growth, this could in turn depress demand for Bangladesh exports.

14. ***There remains some uncertainty regarding the impact of the Multi Fiber Agreement (MFA) phase-out on the country's garment exports.*** In the first few months since the MFA phase-out on January 1, 2005, exports of woven garments to the US grew rapidly up 21.5 percent during the first half of 2005 relative to the corresponding period for the previous year. However, exports to other markets, particularly the European Union, have performed less well. Although the export of knitwear has remained robust, the export of woven garments has slowed down considerably. The prices of some products have also dropped significantly as suppliers have come under pressure to become more competitive. Nevertheless, the restraints imposed on exports from China are likely to benefit Bangladesh in certain goods and markets, providing Bangladesh can overcome some of its current weaknesses. In order to profit, Bangladesh will need to address 3 key issues: its price competitiveness, lead time, and social compliance. First, Bangladesh's competitiveness has been hampered by the Government policies aimed at preserving export quotas for locally owned factories, which hampers the transmission of better technology and direct access to EU and US markets. Second, lead-time has become a critical determinant of competitiveness in a post-MFA world, yet Bangladesh manufacturers still has one of the longest lead-times amongst competing countries (over one month longer than major competitors) due to poor infrastructure and limited availability of local fabrics. Third, the garment industry has come under mounting foreign pressure to comply with international social standards following a series of recent incidents.

15. ***Private sector development remains the engine of growth.*** If Bangladesh is to finally realize its higher growth potential it will need to overcome some major bottlenecks. This will necessitate improving infrastructure (power, ports and roads), developing technology and basic skills, enabling public-private partnerships, supporting a vibrant SME sector, streamlining policies and bureaucratic red-tape and improving governance (particularly law and order and corruption). Bangladesh's challenges to stimulate greater growth and export competitiveness in a post-MFA world will be explored in greater detail in the final chapter.

Fiscal management continues to be prudent

16. *As in the previous two years, the overall fiscal stance has continued to be prudent.* The overall budget deficit is estimated at 3.5 percent of GDP, compared with 3.2 percent in FY04 and 3.4 percent in FY03 (Figure 2). This year's slightly larger deficit partly reflects the Government's flood relief efforts and slippages in revenue mobilization.

17. *Revenue collection yielded a lower outturn for FY05 than initially projected.* Although revenue collection from tax and non-tax revenues increased by 12.8 percent in FY05 (compared to 9 percent in FY04), it still fell short of the PGRF target of 0.2 percentage point of GDP, reflecting delays in the implementation of tax administration reforms at the National Board of Revenue (NBR) and lingering weaknesses in audit and collection enforcement.

18. *Total public expenditure was 2.8% lower than the original target.* Current expenditure was slightly above the budgeted level (by 3.5%) due to flood related expenditures. In contrast, the Annual Development Program (ADP) was lower by 6.8% due to slow project implementation and disbursement.

19. *The structure of deficit financing remains sound.* The more expensive domestic financing remains capped at 2 percent of GDP, with the rest coming from concessional foreign financing, including grants. The size of the quasi-fiscal deficit does remain, however, an area of concern. Rising oil import costs resulted in an increase in BPC losses from Tk 10 billion in FY04 by Tk 28 billion in FY 05 (or 150 million to 425 million US dollars), equal to 0.7 of GDP. Although external debt is relatively low – at about 33 percent of GDP and that too mostly on concessional terms – because export levels are even more modest, the country faces some medium-term liquidity risks: the net present value of future debt servicing obligations in relation to current exports ratio is large.

The FY06 Budget

20. *The FY06 budget, which became effective on July 1, 2005, reaffirms the Government's commitment to support the PRSP and economic growth.* In order to harness the country's productive potential, the budget focuses on the following building blocks: investments in social and physical infrastructure, private sector development and NGO partnerships, streamlined tax instruments and administration, employment generation for farm and non-farm sectors and SMEs, and social safety nets and targeted poverty reduction programs.

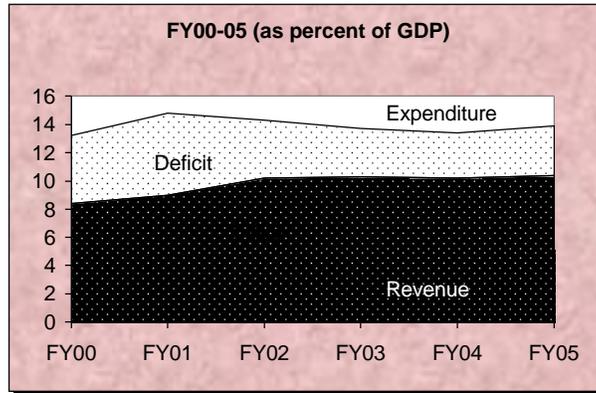
21. *Total public expenditure is expected to rise to 15.3 percent* of GDP in FY06, principally reflecting an increase in the ADP. The budget corresponds to the first year of PRSP implementation. The budget seeks to operationalize strategic elements of the PRSP including broad-based participation, good governance, improved service delivery. Key indicators for revenue and expenditure are broadly in line with the targets set out in the Medium Term Macroeconomic Framework (Figure 2).

22. *Total revenue collection is expected to increase by over 20 percent* from the simplification of tax collection procedures, expanded tax coverage and efforts to enhance tax compliance. Specific measures have included increases in corporate tax for non-listed companies, taxes on apartment and brickfield, SIM cards and bringing some export sectors into the tax net. These measures alone are unlikely, however, to be sufficient to secure the 20.1 percent revenue growth (over FY05 collections) projected for FY06, since many existing tax holidays and exemptions have been retained. NBR tax revenue collection in the first quarter of FY05 was only 14.8 percent higher

relative to collections in the first quarter of FY04. Considering the likelihood of revenue shortfall, the government has initiated several austerity measures.

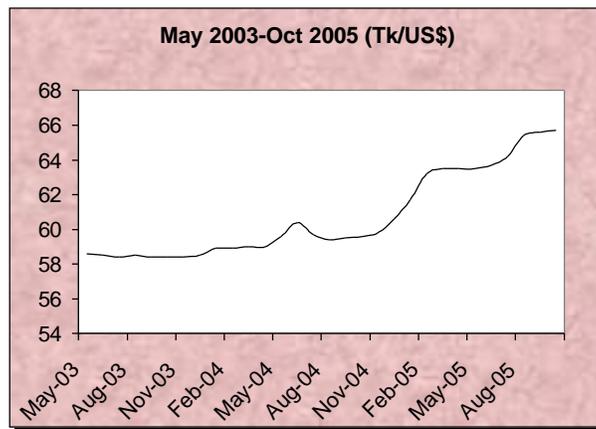
23. **FY06 budget endeavors to contain the fiscal deficit.** The overall deficit has been set at 4.4 percent; the primary deficit at 2.8 percent, with domestic financing remaining nearly unchanged at 2 percent. The mobilization of sufficient concessional external financing will be critical for the sustainability of the projected deficit.

Figure 2 : Revenue, Expenditure & Fiscal Deficit



Source: IMF data

Figure 3 : Average Monthly Interbank Rate



Source: Bangladesh Bank

Monetary expansion is consistent with growth and inflation targets thus far.

24. **Monetary policy has broadly supported growth and has remained reasonably successful in containing inflation and managing exchange market transactions.** Bangladesh Bank allowed interest rates to ease during 2004 to support credit growth to the private sector, in light of ample liquidity and a reduction in administered interest rates, e.g. on National Savings Certificates. However, the latter part of FY05 was a testing period for Bangladesh Bank partly due to pressures on the balance of payments and increases in inflation. The authorities will need to be vigilant and ready to counter any undue pressures promptly through action on interest rates and exchange rate flexibility, especially in the absence of a significant foreign exchange reserve cushion.

25. **Overall, monetary growth in FY05 increased to 16.9 percent**, compared with 13.7 percent in FY04. Domestic credit growth in FY05 increased to 17.3 percent, compared with 14.4 percent in FY04. The rise in domestic credit reflects 18.8 percent increase in credit to the public sector, compared with 15.3 percent in FY04. Credit to both the central government and SOEs increased significantly⁵. Private demand for credit was also strong due to a pick up in domestic manufacturing and service sector activities. Private sector credit growth increased to 17 percent in FY05, compared with 14.2 percent in FY04. Trade and working capital finance to the private sector increased by 16.6 percent and 36.2 percent respectively in FY05. The stock of outstanding term loans extended by banks and NBFIs increased by nearly 10 percent, reflecting rapid expansion of private investment demand, esp. in textiles and RMG, cement, pharmaceuticals, telecommunication and medical services. The monetary expansion was underpinned by sharp increase in reserve money growth from 8 percent in FY04 to 14.2 percent in FY05 due to increase in net credit to the government from Bangladesh Bank. The latter reflected temporary central bank financing of budget deficit.

26. **Banks have now come under pressure to increase deposit and lending interest rates**⁶, following the sharp monetary expansion accompanied by rising inflation, rapid import growth and declining foreign exchange reserves (Figure 3). With limited options available to the authorities to contain inflation and stem the decline in foreign exchange reserves, monetary tightening became unavoidable. (Figure 3) Bangladesh Bank has thus decided to increase the Statutory Liquidity Requirement (SLR) from 16 percent to 18 percent, including an increase in the Cash Reserve Ratio (CRR) from 4.5 percent to 5 percent, with effect from October 1, 2005. This tightening of the monetary policy was necessary, since an overly expansionary monetary stance poses serious risks for macroeconomic stability and rapid credit expansion could give rise to major credit quality problems later on.

Balance of payments experiences some pressure

27. **The external position strengthened in FY 2003-04, but pressures have emerged during the course of FY 2005.** Export performance started off robustly with 21.7% growth in July-September 2004 compared with the previous year. Export earnings have moderated, however, since November 2004, reflecting mainly a sharp decline in prices associated with the elimination of MFA quotas on January 1, 2005 (Figure 4). Nevertheless exports grew by 13.9 percent in FY05. There has been an overall steady rise in merchandise exports, particularly from knitwear garments which have grown explosively, and woven garments which have also performed well. Export growth was also significant in frozen food, raw jute, jute goods and chemical products. Remittances continued to steadily increase, growing by 14.2 percent in FY05 compared with 10 percent growth in FY04. Remittances increased by 28.7 percent in the first quarter of FY06 relative to the first quarter of FY05.

⁵ Credit to Government actually declined during July-May of FY05, as Government was repaying loans early, as its financing requirements were reduced with the ADP's underperformance. However, the situation was sharply reversed in June 2005, when credit to Government surged.

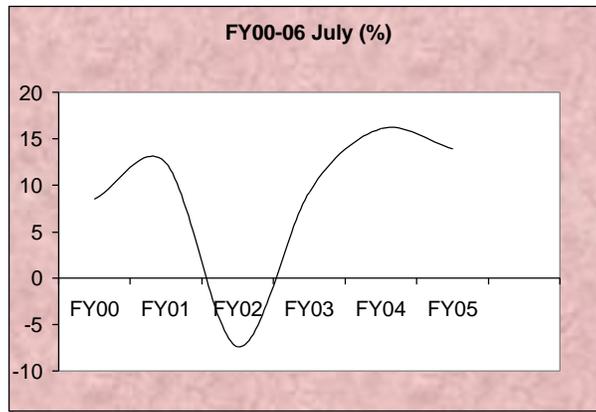
⁶ Bangladesh Bank conducted regular auctions of treasury bills with the yield on 28-day T-bills moving up from 4 percent in January 2005 to 6.7 percent in September. Repo rate and reverse repo rates moved upward in line with market conditions and call money rates stabilized at around 6 percent in June after displaying considerable volatility in April-May. With rising inflation, these rates are still negative in real terms. Commercial bank lending and deposit rates, however, have remained fixed at around 10.5 percent and 5.5 percent respectively.

28. **Import payments have grown even more rapidly than export earnings**, due to (i) higher oil and commodity prices, and (ii) a 20.6 percent increase in payments for merchandize imports. The import bill for crude and refined petroleum, food, and investment goods, including capital goods and industrial inputs, increased significantly (with the stronger demand for industrial inputs suggesting a pick up in industrial performance).

29. **As a result, the external current account had a deficit of \$562 million (0.9 percent of GDP)**, compared with \$176 million surplus in FY04. The current account deficit was ultimately offset by a sharp increase in the financial account surplus, coming from sizable increases in medium and long-term loans and foreign direct investment inflows. The overall balance of payments therefore enjoyed a surplus of \$76 million. Foreign exchange reserves increased to \$2.879 billion as of July 23 2005, equivalent to 2.7 months of imports, slightly below the PRGF's target of 3 months (Figure 5). Reserves remained stable at around this level through mid-October 2005.

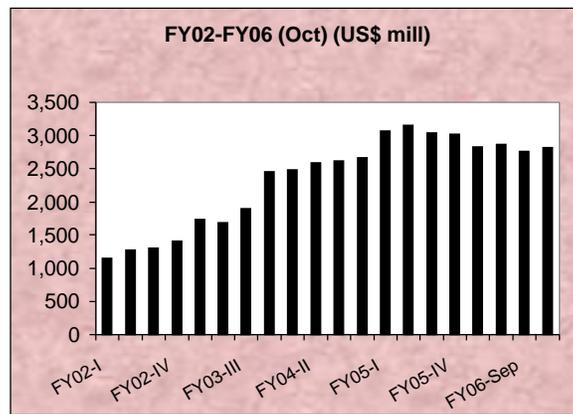
30. **The balance of payments is increasingly at risk from higher oil prices**. Bangladesh's oil import bill increased by 56.8 percent in FY05 relative to FY04. The proportion of crude and POL as a percentage of total imports has increased from 9.4% in FY04 to 12.2% in FY05. The incremental cost (around \$580 million) of oil imports put pressure on reserves and the exchange rate.

Figure 4 : Export Growth



Source: Export Promotions Bureau

Figure 5 : Gross Foreign Exchange Reserves



Source: Bangladesh Bank

Inflation continues to creep up

31. *The rising trend in inflation relates to both real sector and monetary developments.* The year-on-year inflation rate increased to 7.9 percent in August 2005, compared with 5.5 percent in August, 2004 and 7.3 percent in June, 2005. This is the first time since June 1999 that the inflation rate has crossed 7.5 percent. Unlike the trend in previous episodes when rising inflation was associated mainly with food inflation, both food and non-food inflation contributed to the increase in inflation this time. Direct inflationary effects of the oil price increase have been limited due to the incomplete pass-through of the administered retail price of petroleum products in the domestic market. However, increased international prices of imported goods combined with the depreciation of the exchange rate as well as poor aman crop fueled inflationary pressures. The expansionary monetary policy (mentioned above) also contributed to sustaining strong domestic demand, further reinforcing inflationary momentum. Interest rates may have to rise further if inflation does not moderate.

Overall macroeconomic status remains healthy, with latent pressures

32. *The overall picture that emerges is of a buoyant economy that, with rapidly rising oil prices, is creating pressure on imports and domestic credit.* Prudent demand management will be necessary to ensure sustainability of growth and continued macroeconomic stability. Monetary and exchange rate policies will need to be flexible. At the same time, efforts to raise domestic revenues must be a real priority. Bangladesh's budgetary revenue effort has been extremely low, less than 10% of GDP and with a very low number of taxpayers for a population of 136 million. This represents the serious governance challenges facing the National Board of Revenue. The low tax base in turn creates huge incentives for corruption by forcing the government to pay abysmally low salaries to civil servants that limit their ability to effectively exercise their functions, to under-fund operations and maintenance expenditures, and to force a rationing of essential public services and infrastructure, creating ever more opportunities for rent-seeking.

III. PROGRESS ON THE GOVERNANCE AGENDA

33. *Governance issues have rarely been far off stage in the recent years' dialogue between Government World Bank and other development partners.* Improved governance is essential for the success of Bangladesh's economic growth and poverty reduction strategy, and none of Bangladesh's major Development Partners is able to sustain support without squarely addressing the governance agenda. This section seeks to take stock of reforms undertaken to date in three critical areas of governance related reforms: (i) core governance functions; and a reduction in sectoral governance impediments to (ii) improving the investment climate, and (iii) empowering the poor. These three areas are critical to the PRSP and are the focus of the Government's November 15-17 2005 *PRSP Implementation Forum*. They are also the three pillars of the joint-country assistance strategy of the ADB, DFID, Japan and the World Bank.

34. An overview of the major reforms achieved in recent years is provided. Reforms in core governance areas such as public administration, tax administration, procurement, financial management will have long-term benefits, as will the Anti-Corruption Commission if it can be made fully effective. Parallel sectoral reforms have sought to strengthen governance in banking, health, education, energy and SOEs. The activities of the nationalized commercial banks (NCBs), previously a huge source of corruption through directed credit, have been curtailed. The culture of non-payment to energy companies has been addressed. Nonetheless, a huge unfulfilled agenda remains and we see no evidence of a comprehensive anti-corruption strategy backed by sustained political commitment. In the absence of an overarching strategy, progress is necessarily

incremental and opportunistic. Expectations should remain realistic and progress is hard to predict. Nonetheless, real progress can be and has been made, as demonstrated by the achievements listed in the table and described in more detail below.

35. Progress of reforms in core governance, improving investment climate and empowering the poor are discussed below and summarized in Table 2.

A. STRENGTHENING CORE GOVERNANCE

36. Improving core governance functions remains a critical challenge for Bangladesh and should be a high Government priority. The Government has undertaken some incremental steps towards reform in five core areas, with World Bank and other development partner support: (i) improving public expenditure and financial management; (ii) reforming public administration; (iii) strengthening revenue mobilization; (iv) establishing an independent Anti-Corruption Commission; and (v) reforming the civil justice system. Other, non-economic, core governance areas such as law and order and political governance, are equally critical in ensuring sustainability and improved efficacy of economic and social sector reforms.

Improving Transparency and Efficiency of Public Expenditure - Financial Management

37. The Government is strengthening public expenditure planning within a medium-term budgetary framework, as well as the essential financial management and accountability functions of accounting, auditing, expenditure tracking and procurement. Government has initiated institutional changes in budget planning by issuing new annual budget guidelines on a pilot basis that contain elements of more strategic budgeting practices, better fiscal discipline and better coordination of recurrent and capital budgets. These provided unified envelopes for recurrent and capital spending for three years ahead for four ministries in preparation of the FY06 budget. Previously, the revenue (recurrent spending) budget and the development (capital) budget, known as the Annual Development Program (ADP) in these four ministries, were prepared sequentially for each year, with little integration and largely in the absence of a strategic medium-term framework or policy orientation. The Government is extending the new system to 6 more ministries for the preparation of FY07 budget, covering nearly 50 percent of the total budget.

Table 2 : Reforms in Sector and Core Governance and their Impact

Source	Actions Taken	Impact
Sectoral		
Banking	Strengthened prudential regulations and banking supervision; enhanced competition; initiated privatization of NCBs.	§ Non-Performing Loan ratio fell from 27% to 18% in NCBs and from 16% to under 3% in private banks between FY98 and FY04 § NCB's share of total bank assets fell from 54% in FY98 to 40% in FY04
Power and Energy	<ul style="list-style-type: none"> • Tightened billing and collection in the power sector • Established Energy Regulatory Commission • Reduced power sector system losses through theft reduction and better maintenance 	<ul style="list-style-type: none"> • Between FY02 and FY04, systems loss in power sector fell from 30% to 24%, collection efficiency improved from 84% to 99%, and collection to generation ratio from 59% to 74%. • Arrears to public utilities fell from 9 months equivalent in FY02 to about 4.5 months in FY05.
State Enterprises	<ul style="list-style-type: none"> • Role of SOEs in manufacturing substantially curtailed, also reducing prospects for political patronage and business practices favoring vested interests 	<ul style="list-style-type: none"> • Number of manufacturing SOEs reduced from 121 in FY01 to 92 in FY04. • 60% reduction in manufacturing SOE losses since 2001.
Education	<ul style="list-style-type: none"> • Expenditure tracking initiated • Creation of National Teachers Registration and 	Reduced scope for rent seeking from these sources.

	<p>Certification Authority cleared. NTRCA should improve teacher quality and reduce scope for bribery during recruitment</p> <ul style="list-style-type: none"> • Textbook production at the secondary level is being privatized • Most of delivery of secondary school education contracted out to private sector and NGOs 	
Social Safety Nets	Social safety programs being monetized.	Surveys show this has reduced leakage.
Economic Deregulation		
Regulatory Reforms	Sharp cut back in domestic investment regulations including number of clearances	Reduction in rent seeking opportunities.
Telecom	<ul style="list-style-type: none"> • Establishment of Bangladesh Telecom Regulatory Commission has improved regulation of telecom. • Deregulation of wireless telephone. 	<ul style="list-style-type: none"> • Greater competition has improved access and lowered rent seeking from public sector telephone authority • Landline density has grown by 50% since 2002. • Density of cellular coverage is doubling each year.
Trade	Virtual elimination of QRs	Removed one important source of rent through discretionary granting and exemptions
Public Sector		
Financial Management	<ul style="list-style-type: none"> • Greater transparency in public accounting, tightened auditing, and strengthened C&AG's office. • PAC made functional and recommendations regularly communicated to the line Ministries 	<ul style="list-style-type: none"> • Audit committees set up in 22 ministries • By December 2004, PAC had reduced the backlog of outstanding audit objections against ministries by 20 percent.
Procurement	<ul style="list-style-type: none"> • Procurement regulations issued • Annual procurement audit by independent consultant made mandatory • Provision for independent review mechanism introduced for handling bidders' protests 	<ul style="list-style-type: none"> • Reduction in Bank-declared cases of misprocurement – from 316 in 1999 to 2 in 2002 • Procurement processing time improved. Percent of contracts awarded after 12 months lowered from 40% to 10%
Tax Administration and Customs	<ul style="list-style-type: none"> • Modernization of the National Board of Revenue initiated. Large taxpayers units for income tax and VAT and Central Intelligence Cell established • Streamlining of customs procedures through the introduction of the ASYCUDA++ system 	Full implementation of tax administration reforms will help reduce corruption from this major source
Public Administration	Mandatory submission of income tax returns by Govt. employees introduced, covering official and non-official incomes	Full compliance will help reduce corruption
Watchdog Institutions		
Anti Corruption	Independent Anti-Corruption Commission Established	Effective implementation will establish a major institution to monitor and prevent corruption
Legal and Judicial Reform	<ul style="list-style-type: none"> • Case management information system being installed • Alternative Dispute Resolution mechanisms adopted • Judicial Services Commission established 	An effective legal and judicial system is critical to enforce contracts, settle disputes and create effective checks and balance
Fraud Control		
Anti-Money Laundering	Money Laundering Prevention Act, 2002, enacted	Tighter control on flow of criminal funds.

38. *The Government has sought to improve the management of development spending.* The Government has streamlined preparation of ADP projects, but inadequate prioritization and weak appraisal have been reflected in approval of an unduly large number of projects. This has been accompanied by under-funding, a fragmentation of resources and a backlog of incomplete projects. ADP spending each year has typically fallen some 10 percent short of the budget target. The number of outstanding and new approved projects at 856 remains high, and the number of unapproved projects was increased in the FY06 budget to 369, compared to 330 in FY05. Nevertheless, the Government has made some progress. The estimated time needed to complete ADP projects at current funding levels has been reduced from almost 10 years in FY02 to around 7 years, although this is still higher than the Planning Commission's target of five years. It will take

some time for the new practices to be fully institutionalized and address the issues of over-programming in development planning.

39. The new Public Procurement Regulations are a milestone achievement. The landscape of procurement has been reshaped since 2003 when the Government put in place a uniform procurement policy (October, 2003) for all public sector entities in Bangladesh. The PPR substantially reduced layers in the procurement approval process and introduced a procurement tracking system through MIS. The new regulations have increased awareness among the contracting/ business community and contributed significantly towards harmonizing donors' and Government procurement procedures. The World Bank and key development partners have accepted the regulations for all local procurement. However, despite the new regulations there are still a number of cross-cutting governance, institutional, and implementation issues, including inadequate enforcement of regulations, delays in award, allegations of fraud and corruption, and political interference. To further strengthen the public procurement system: (i) the public procurement regulations will be replaced with a new procurement law, which also covers concessions and BOTs, is expected to be presented to the Parliament this year; (ii) a second reform program targetting e-procurement, compliance monitoring, and social accountability is under preparation. Going forward, the procurement law, if well implemented, could pave the way for renewed private sector interest in the infrastructure sectors, especially power, and help Government get more value for money in its public spending.

40. Fiscal accountability and transparency are being improved through better Public Financial Management (PFM). Recent initiatives include:

- (a) computerization of accounts and strengthening of the Controller General of Accounts (CGA) system with production of meaningful monthly accounts disaggregated by administrative unit, economic code and function with a lag of five weeks compared to the previous six months;
- (b) monthly fiscal reports produced by the Finance Division of the Ministry of Finance (MoF), based on these monthly accounts;
- (c) assignment of a Chief Accounting Officer (CAO) to each ministry, and changes in the organization structure of country-wide pay-points accounting offices under the CGA;
- (d) the improved reporting of fiscal data, with Bangladesh being included for the first time in the IMF's *Government Finance Statistics (GFS) Yearbook*; and
- (e) separation of accounting from auditing by placing the CGA under the administrative control of MoF instead of the Comptroller and Auditor General (C&AG).

41. Further, the backlog of audit objections, identified by the Parliamentary Accounts Committee has been reduced: by December, 2004, the number of outstanding audit objections against ministries had been reduced by 26 percent. Implementation of the *Report on Observance of Standards and Codes (ROSC) - Accounting and Auditing Recommendations* is also underway. Value for money audits (performance audits) are being introduced, for example in the roads sector, by Roads and Highways Dept (RHD), with support from ADB, and audit committees have been set up in 22 ministries to resolve outstanding issues. DFID's FMRP has also played an important role in assisting to strengthen public financial management.

42. Tracking studies to better monitor expenditures are now mainstream PFM tools. The Government has undertaken three expenditure tracking surveys, supported by the UK-DfID and the Netherlands. Interim results of the Secondary Education survey suggest that the public financial resources reached schools as intended, but the survey showed evidence of mismanagement in the authorization of spending. Pupil attendance, based on a headcount organized by the survey, was 41

percent, compared with 59 percent according to the registers. Teacher attendance, however, was not as low as some alternative recent estimates, although the observed quality of teaching was poor even among extensively trained teachers.

43. Interim results of the Health and Family Planning tracking survey suggest that DG Health outpatient services are well used and that service utilization is pro-poor. The efficacy of drugs dispensed, however, was compromised by the poor storage as well as by the low proportion of patients who received written instructions on how to take their medications. The average level of clinical knowledge of key health workers was well below acceptable standards and varied between different individuals with the same designation. Building infrastructure was often poor, and the lack of medical equipment raised concern over how union health centres could undertake essential diagnosis. Findings like these could be used to establish benchmarks against which to track the effectiveness of service delivery over time, by follow up surveys.

Toward a More Responsive and Efficient Public Administration

44. *A number of public administration reforms have been initiated in recent years, although progress remains slower than hoped for.* Promotion policy has been improved for Class I (senior) officers and there is enhanced emphasis on merit in performance evaluation and career development. An improved training policy has been issued, and more importance is being given to training, particularly in public sector management, for promotion. A Career Planning and Training Wing was created in the Ministry of Establishment in September 2003 as a result of which initiatives are underway to improve career planning and effective deployment of Class I officers. Further, modalities are being determined to organize ministries around four clusters, based on type of functions. Deliberations and preparatory work that could lead to the development of a senior civil service or management pool are also underway.

45. The Government has contained employment in public administration at around 1 million, including the central government and some staff in semi-autonomous bodies. It has left more than 100,000 sanctioned posts unfilled, mainly among support staff at Class III and IV (bottom two categories) levels by limiting new post creation and controlling the filling of vacancies. The previous practice of permanently accommodating staff temporarily hired for projects has been streamlined and a more rigorous process of review has been put in place. Various services, such as cleaning and maintenance, are also being outsourced.

Strengthening and Modernizing Revenue Mobilization

46. *The NBR has prepared a medium-term modernization strategy to improve low revenue yields which are depriving the Government of resources needed for key social programs.* Tax revenues account for only 8 percent of GDP and Bangladesh relies unduly on highly protective trade taxes. The Government undertook at the start of the PRGF program with the IMF, to increase revenue as a share of GDP by 0.5 percent a year, but the out-turn for FY2005, at 8.3 percent of GDP, was little-changed from FY2003. Poor taxpayer services, lack of transparency in collection, inadequate audit and enforcement, and protracted taxpayer disputes have all hampered revenues. The NBR suffers from ineffective human resource policies and lack of authority and autonomy to tackle those, and a weak compensation system and lack of training. Renewal of some tax exemptions in the FY06 budget is likely to adversely affect the tax collection levels.

47. *Revenue administration must improve if government is to fund pro-poor expenditures.* A low revenue effort also restrains government from paying a civil servant a living wage, allocating adequate resources for operations and maintenance, improving infrastructure or social services.

Low revenue thus creates huge incentives both for corruption and poor service delivery, and the rationing of essential public services which ensues, creates opportunities for rent-seeking.

48. *Initial NBR reforms are already underway, but progress is painfully slow.* In November 2003, the Large Taxpayer Unit (LTU) for income tax was restructured along functional lines (taxpayer services, revenue collection, accounting, audit, and enforcement). It was also given responsibility for collecting withholding taxes. Steps were taken to strengthen filing and payment procedures, improve detection of stop-filers, increase capacity for conducting audits, and introduce computerization of certain LTU operations. In October 2004, the NBR established an LTU for value added tax (VAT) and is in the process of operationalizing it. Ideally, for effective enforcement, the LTU needs to combine both income tax and VAT, and NBR is being encouraged to revisit this design. A Joint Commissioner has been appointed but other staff are temporary or part-time, pending approval of the LTU's organogram by the Ministry of Establishment. To improve enforcement and expedite the processing of appeals, two special High Court tax benches have been established. In addition, to discourage fraudulent appeal cases, the Government has increased the amount that taxpayers will have to pay upfront from 15 percent to 50 percent of the difference between the contested and admitted amount. Finally, a "Tax Ombudsman" has been established, to assist citizens with their complaints against NBR.

Establishing and Operationalizing an Independent Anti-Corruption Commission

49. *An independent Anti Corruption Commission Act was passed by the Parliament in February 2004,* providing the Commission with a mandate to prevent corrupt practices and investigate specific offenses. Three Commissioners of the ACC were selected in November 2004, of whom one was appointed Chairman. The Government has sanctioned an initial 500 posts. The Commission has screened 85 senior former BAC staff for recruitment. These will be reviewed by a placement committee for suitability for specific posts in the ACC. The ACC also needs to present its organogram and procedural rules to the Government for approval before it can effectively undertake operations.

Reforming the Civil Justice System

50. *Settlement of civil court cases quickens.* Major reforms in the Civil Procedure Code were made in 2003, with the objective of modernizing court processes, reducing case backlog, expediting dispute settlement, and facilitating access to justice. These reforms facilitated different forms of case management, including introduction of court-annexed mediation, alternative dispute resolution mechanisms, and enforcement of pretrial procedures in pilot courts to weed out frivolous lawsuits. These efforts have resulted in an increased number of out-of-court settlements and in quicker disposal of court cases.

51. *The Money Loan Court Act 2003* provided money courts with exclusive jurisdiction over credit disputes and has vastly improved the loan recovery mechanism. Creditor institutions are now required to exercise *self-help* by selling collateral in public auction after giving due notice to the defaulting debtors. The Act also provides for summary procedure and disposal of cases solely on the basis of written pleadings and documentary evidence. The maximum time for case disposal is 180 days, although most cases are settled well before that time. As a result, in the 12 months after the new law became effective, recovery increased by over 200 percent.

52. *Full separation of the judicial branch from the executive remains a contentious issue.* The Supreme Court is (sometimes awkwardly) independent, but district court magistrates are recruited by the Public Service Commission, drawn from the administrative cadre and have their careers

managed by the Establishment Ministry. As a step toward full separation, a Judicial Service Commission has been created under the jurisdiction of the Supreme Court to take over the recruitment process.

B. REDUCING SECTORAL GOVERNANCE IMPEDIMENTS TO IMPROVE INVESTMENT CLIMATE

53. A good record of implementing first generation reforms – macro stability and domestic deregulation in particular – has facilitated good economic growth. The Government recognizes the need to now deepen the structural reforms program to sustain and accelerate growth performance; in particular by deepening trade liberalization and further strengthening the sectoral and cross-sectoral underpinnings of the investment climate.

Ensuring Continued Macroeconomic Stability

54. The Government's medium-term macroeconomic framework commits to fiscal and monetary prudence and deepening structural reforms. The framework envisages acceleration in GDP growth from 5.4 percent in FY05 to 6.5 percent in FY06 and 7.0 percent in FY08. Such faster growth would require a significantly higher level of investment and more efficient investment decisions than in the past. Achievement of these, in turn, assumes acceleration in the pace of structural reforms to tackle supply-side bottlenecks.

55. Fiscal policy aims to finance social development and key public investment while containing the deficit and maintaining debt sustainability. The Government's success in containing the central government deficit at around 3.5 percent of GDP partly through curbs on wasteful expenditures, coupled with greater reliance on concessional external financing, has improved the prospects for fiscal sustainability.⁷ A relatively high 60 percent of total expenditure is on infrastructure, education, health, social safety nets and rural development. In contrast, defence expenditure remains lower than most of the region. Interest payments on government debt have stabilized at less than 2 percent of GDP. The level of public expenditure, however, at nearly 14 percent of GDP, remains low by global standards, reflecting weak revenues and low implementation capacity (tax and revenue collection rates remain among the lowest in the world, at 8 and 10 percent of GDP respectively). The quality of expenditures at the project level remains a concern.

56. Public debt is currently sustainable although concerns are emerging. Public sector debt, including contingent liabilities, is manageable at about 60 percent of GDP, more than half of it on concessional terms from external official creditors. Longer-term risks to sustainability, however, arise mainly from weak revenues and escalating energy SOE losses, as described in Chapter II.

Reducing Opportunities for Corruption by Reducing and Streamlining Trade Restrictions

57. Trade liberalization has been advanced, with a reduction in customs duties and near-elimination of trade-related quantitative restrictions, although expanded use of para tariffs partly offset this. The average rate of customs duty was lowered from 21 percent in FY01 to 15.4

⁷ A recent review by the National Pay Commission concluded with a recommendation of an across-the-board 50 percent increase in public sector salaries. The full cost of implementing this is estimated at about Tk 59 billion. A five-member committee headed by the Cabinet Secretary subsequently reviewed the proposal and concluded that its full implementation would jeopardize macroeconomic sustainability. The Government has accepted the committee's recommendation of a more modest increase of about Tk 40 billion to be phased over three years.

percent in the FY06 budget, and the top rate was lowered from 37.5 percent to 25 percent. The number of non-zero customs tariff rates was reduced from four to three. This progress, however, was partly offset by an increase in the protective incidence of para tariffs which now account for about 40 percent of total protection, compared to only 12 percent in the mid-1990s. The net result has been a reduction in average nominal protection from 29.4 percent in FY02 to 26.5 percent in FY05. Substantial progress has been made with removing quantitative restrictions (QRs). The number of items subject to QRs was reduced from 122 in FY01 to 15 in the FY06 budget, and all but three trade-related QRs were eliminated.⁸ Removal of longstanding ban on a wide range of textile imports has been particularly important.

58. *The remaining trade liberalization agenda is substantial.* Despite significant trade liberalization in the 1990s, Bangladesh still has the highest level of trade protection in South Asia and among the highest amongst developing countries as a whole. High tariffs and duties on imported inputs discourage export diversification and constrain growth (see Chapter V). A cumbersome and inefficient duty drawback system for non-garment manufacturers seeking to reclaim duties paid on imported inputs for export hinders their competitiveness. So, stronger efforts to accelerate liberalization of the economy are essential to achieve the Government's growth goals set out in the PRSP. A pre-announced program of reductions in customs duties and, especially, para-tariffs to bring Bangladesh in line with the developing country average within five years would give industry a clear signal and allow companies to plan their investments.

Streamlining and Reducing Scope for Discretion in the Regulatory Environment

59. *A number of measures have been initiated to streamline the domestic regulatory environment and reduce the scope for corruption arising from it.* Regulatory reforms have involved streamlining of process related to customs and port clearance, investment facilitation, land registration, utility regulation, and the financial sector. Specifically:

- **Customs and port clearance:** A noteworthy step has been the introduction of the ASYCUDA++ system, involving electronic processing and tracking of files. Further, a one-stop service was recently introduced at the Chittagong port to facilitate port and customs related paperwork, thereby shortening the time taken for clearing and also improving the turn around time for ships.
- **Investment facilitation:** The Board of Investment has introduced e-government processes that allow on-line tracking of various approval requests. Business registration process has been streamlined and further progress would come from automation at the Registrar of Joint Stock Companies, work on which has already started with support from IFC's South Asia Enterprise Development Facility (SEDF) and AusAID.
- **Land registration.** A Land Registration Act came into force from July 1, 2005. This will help reduce the scope for false and multiple registration of land. A pilot project to computerize land records has been initiated in the Demra thana of Dhaka district. This project aims at simplifying the title deed requirements, putting the title, the location of the land, and map on a single page with all other documents in a back-up data base. This follows the completion of the survey of greater Dhaka by the Land Department.
- **Utility regulation.** The Bangladesh Telecom Regulatory Commission (BTRC) has been set up, leading to rapid growth in the private telephone sector. The Energy Regulatory Commission was recently been set up and has now starting to become functional.

⁸ GOB received waivers on poultry, eggs and salt from WTO under Article XVIII.

Improving Financial Sector Accountability, Transparency, and Performance

60. *Improved governance of the financial sector, including continued restraints on lending, strengthened loan recovery efforts* and tighter supervision have reduced the market share of nationalized commercial banks (NCBs) and given a greater role to private banks. MOUs between Bangladesh Bank and the four NCBs have set a ceiling of 5 percent on annual growth in lending, put a limit on single borrower exposure to 5 percent of paid-up capital of each bank, and set monitorable targets on cash recoveries and cost reductions. The MOUs are to be extended beyond 2005 for Agrani and Janata banks and until divestment for Sonali bank. The net result has been a reduction in the NCBs' share of total bank assets from 54 percent in 1998 to 40 percent by FY04. Their non-performing loans, net of provisions and collateral, fell from 27 percent in FY98 to 18 percent by end - FY04. Private banks have strengthened considerably their financial positions and are steadily increasing their share of the market. Net NPLs of private banks fell from 16 percent in 1998 to less than 3 percent by end-FY04. Indeed, NPLs nearly halved as a percentage of GDP from 2000 to 2004 (Table 3).

Table 3 : Non-performing loans (NPLs) as percentage of GDP

Year	2000	2001	2002	2003	2004
NPL/GDP	9.64%	9.31%	8.77%	6.76%	5.62%

Source: Government of Bangladesh

61. *Bangladesh Bank's regulatory powers have been further strengthened.* Bangladesh Bank has continued to align its prudential norms more closely with international standards and enforce these more strictly. Its capacity to carry out its regulatory authority is being strengthened under the Bank's Central Bank Strengthening project. NCBs and development banks were brought under Bangladesh Bank supervision in FY03. The minimum risk-weighted capital adequacy requirement for banks was increased from 8 percent to 9 percent and the minimum capital requirement increased from Tk 400 million to Tk 1 billion (US\$17 million). At the same time, limitations on dividend payout were tightened and special audits based on IAS were conducted for all NCBs. In March 2005, Bangladesh Bank tightened loan classification with the introduction of a "Special Mention" category for loans overdue by 90 days or more but less than 180 days. Banks will not be allowed to accrue interest into their income on such loans and will have to make general provisions against them. The exposure limit for private banks for a single borrower has been reduced from 50 percent of a bank's capital to 35 percent.

62. *Bangladesh Bank has also introduced measures to improve banks' corporate governance.* These include: (i) tightening "Fit and Proper" tests for bank CEOs and introducing these for bank directors; (ii) making it mandatory for banks to have independent directors represent the interests of depositors; (iii) limiting the maximum number of directors for a bank to 13; (iv) limiting directorship of banks to two consecutive terms of three years each; (v) allowing only one director from each shareholding family; (vi) requiring the establishment of an independent Audit Committee of each bank's board to assist in financial reporting, audit, and internal control; and (vii) requiring significantly enhanced annual financial disclosures including publication of audited financial statements in newspapers and ensuring their availability for public view in bank branches. Risk management guidelines covering credit, market and operational risks have been introduced.

63. *Bangladesh Bank has enforced its prudential regulations more strictly.* Some 65 bank directors and chairmen have lost their directorships for loan default, insider lending and other violations. Five managing directors of banks have been removed since 2000 for allowing their banks to be engaged in irregular or illegal transactions. The guidelines on early warning system and problem bank categories have been strengthened, followed by the institutionalization of a

Systems Audit of banks with a risk rating (viz., core risk areas) after completion of an inspection. Bangladesh Bank has also initiated audit of IT transactions and IT security for banks, and 25 banks have been audited so far.

64. *The Government is in the process of strengthening the NCBs' management with the aim of improving their operational performance, and preparing them for divestment.* Management team and experts funded under the World Bank's *Enterprise Growth and Bank Modernization* project are supporting the restructuring and corporatization of three NCBs – Agrani, Janata and Sonali – before they are divested. Rupali Bank has been brought to the point of divestment. A key part of the strategy for resolving NCBs is that they should restructure their operations, including credit allocation, cost controls, branch closures and staff rationalization. Progress on these fronts has been slow.

Reducing State Role in State-owned Enterprises and Strengthening Their Financial Performance

65. *Financial losses of manufacturing SOEs have continued to fall, and the Government has reduced its role further.* The Government has focused on partial divestment and withdrawal of direct and implicit budgetary support. Manufacturing SOEs have cut their losses by 60 percent since 2001, including a further 10 percent fall in FY2005 (Figure 6). Despite the politically charged nature of the reform, the Government reduced the number of manufacturing SOEs from 121 in FY01 to 92 in FY04 and the employment level in these from 134,000 to 83,000. Further progress on privatization was made in FY05, with successful privatization of six SOEs and approval of the process for five others. Non-manufacturing SOEs, (excluding Bangladesh Petroleum Corporation, BPC) recorded a profit for the third consecutive year.

66. In other measures, the Government has cut funding of public sector jute mills, and consequently 12 previously loss-making jute mills are virtually non-operational due to lack of working capital. In FY05, about 10,000 SOE employees chose early retirement under the voluntary retirement scheme (VRS). The Government has put in place counseling and retraining programs for workers availing the VRS. These programs will be managed by BRAC, the largest local NGO.

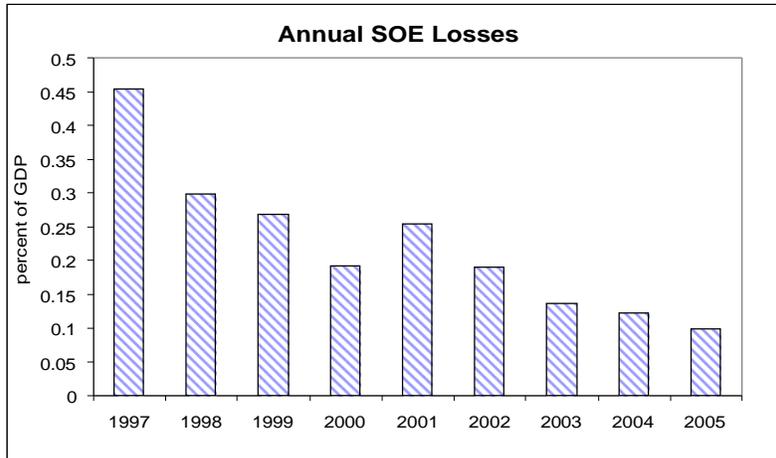
Addressing Governance Constraints to Infrastructure: Power, Energy, and Transport

67. *The Government has made further gradual progress in addressing key infrastructure issues in energy, transport and communications.* In the energy sector, it has adjusted prices for petroleum products, gas and power partially in line with the framework adopted in FY03 which linked these key prices to international prices and cost recovery. The Government has begun unbundling the gas sector and developing a gas strategy. It has also started restructuring the power sector, improving its operational performance and seeking to enhance supply. It has made progress, after some delays, in operationalizing the Energy Regulatory Commission (ERC), which will oversee the energy sector as a whole. The Government, however, has not developed an overall energy strategy. This has become more urgent in view of interest from both foreign and domestic investors wishing to take advantage of not only Bangladesh's gas but also coal resources. In transport, the Government has adopted new shipping and land transport policies. Cellular telecommunications, in turn, are developing rapidly – despite lagging reforms to BTTB, where the next step would be corporatization.

68. *Between FY2002 and FY2005, during which period international oil prices more than doubled, domestic petrol prices increased by about 50 percent, and the prices of kerosene and diesel*

increased by almost 77 percent, including 50 percent during FY05. Insufficient price adjustments have resulted in considerable financial losses for BPC and are a major source of macroeconomic risk. The Government, however, felt that a full pass-through of international price increases in line with the agreed pricing formula risked adding to cost inflation, and would also negatively affect poor households. Domestic gas price adjustments, likewise, have lagged behind the formula with a modest total increase of 5.77 percent – all during FY05. A further increase of around 20 percent would be required to align them with the formula. Power tariffs were last adjusted in September 2003 and the required adjustments in September 2004 were not carried out.

Figure 6 : Annual Losses of Manufacturing State-Owned Enterprises



Source: Ministry of Finance.

69. Power utilities have improved operating efficiency and reduced arrears. System losses fell from 28 percent in FY2002 to less than 24 percent in FY2004. (Table 4) Collection efficiency also rose slightly, so that collection increased from 70 percent of generation to 75 percent. Arrears to major power utilities companies have been reduced, from an equivalent of 8 months in FY03 to 4 months in FY05. This reflects a major drive by the Government to ensure that public entities pay their electricity bills, coupled with utilities' more aggressive efforts to collect bills owed by private customers. The Government has decided to write-off the arrears of the closed SOEs but hopes to recover at least part of these arrears from future sales proceeds. The Government has employed consultants to draft a financial recovery plan for the power sector which should provide the basis for further action.

70. The transfer of lines from BPDB to the better-managed Rural Electrification Board has recently speeded, which should further reduce system loss. The Government agreed in FY2002 that 9,047 km of lines would be transferred from BPDB to REB in three phases. The process stalled during the second phase, however, after about 7,000 kms had been transferred due to opposition from BPDB labor unions and various litigations. More recently, the line transfers have restarted after the courts vacated most of the injunctions against them. An additional 1,500 kms of lines have been transferred since June 2005. The Government expects to complete in FY06 the agreed line transfers that are not facing litigation.

71. The Government has belatedly initiated measures to improve power supply and reduce present and prospective shortages. Demand for power is growing at about eight percent a year but increases in generation capacity have been largely stalled for several years amid a series of controversial decisions to qualify or disqualify particular bidders. The resulting shortfall in generating capacity has led to frequent, widespread blackouts, particularly in rural areas.

Recognizing that transparency in procurement practices needs to be at the centre of any solution to the resulting power supply crisis, Government has committed itself to adhering to the *Public Procurement Regulations*, the *Private Sector Infrastructure Guidelines*, and the *Private Sector Power Policy*, as applicable, in procuring all future power generation capacity. The recent decision to revisit the planned non-competitive awards of small scale power plants and an unsolicited offer for a large-scale generation plant are steps in the right direction.

72. *After some delays, progress is being made in operationalizing the Energy Regulatory Commission (ERC)*, which is to oversee the energy sector as a whole, including oil, gas, power and coal. Institutional fragmentation has, however, inhibited development of an overall energy strategy, which has become more urgent in view of interest from both foreign and domestic investors wishing to take advantage of not only Bangladesh's gas but also coal resources.

Table 4 : Bangladesh Power Sector Performance Indicators

		FY99-00	FY00-01	FY01-02	FY02-03	FY03-04	FY04-05
T&D Loss	%	29.66	28.65	28.12	24.70	25.04	24.67
Collection Efficiency	%	90.62	92.88	97.24	96.28	101.65	98.72
Collection Import Ratio	%	67.79	70.04	71.12	74.96	81.28	80.37
Profit / (Loss)	Million Tk.	(6,305)	(3,618)	(3,372)	(512)	(1,727)	(1,980)
Accounts Receivable	Million Tk.	23,396	25,817	27,637	29,636	29,049	19,913
Accounts Receivable	Eqv. Months	8.75	8.32	7.74	7.13	6.45	4.12

Source: Power Cell

73. *The Government is also moving ahead with reforms in key infrastructure areas such as transport and telecommunication.* In *transport*, the Government endorsed the National Shipping Policy and National Land Transport Policy, an Integrated Multimodal Transport Policy, and established a Transport Sector Coordination Wing. It also liberalized the domestic civil aviation market to allow private competition against the national airline, Biman. The construction of a new container terminal inside the Chittagong port has started and its operations will be concessioned to the private sector. In *telecommunications*, improved sector outcomes have resulted from important initiatives by the Bangladesh Telecommunication Regulatory Commission (BTRC) and other sectoral reforms. For instance, landline teledensity has grown by over 50 percent since 2002 and the cellular teledensity is more than doubling each year. Besides the five cellular phone licenses, BTRC has issued licenses to 10 fixed line operators. An interconnection regime is in place and BTRC is now working on spectrum management and other regulatory issues including tariffs. Progress would have been even more remarkable but for the delays in the restructuring of the government-owned Bangladesh Telegraph and Telephone Board (BTTB). BTTB lacks financial and operational autonomy and is unable to meet demand and provide quality services. The BTRC, too, faces important institutional challenges despite its relative effectiveness so far.

C. EMPOWERING THE POOR

Improving Governance of Social Service Delivery

74. *Delivery of essential social service delivery continues to be strengthened* with the adoption of programmatic approaches in health and education, sustained emphasis to the sector in the budget, and continued NGO-Government partnerships that have proved effective in the past. There is a common understanding that the next generation of reforms would need to focus on strengthening the institutional framework for service delivery along with increased social sector spending.

75. In the *education sector*, the Government has launched several reforms – that the development partners are actively supporting – to address the problems of poor quality and weak accountability. At the primary education level, a multi-donor group is supporting the Ministry of Primary and Mass Education’s efforts to implement the Primary Education Development Program II (PEDP II) which aims to strengthen access, and improve quality and efficiency of primary education. At the secondary level, the Ministry of Education has finalized a medium-term framework that includes targets related to quality improvements, strengthening of governance, financing, and enhanced use of ICT, and policy measures and actions to achieve these. Similarly, in the area of vocational education and training and higher education the Government is developing options aimed at enhancing the relevance, quality and cost-effectiveness, as well as developing greater linkages with the private sector. Furthermore collaboration between Government and NGOs in the education sector is increasing - Government has recently begun piloting a project which aims to help out of school children receive primary education, with NGOs being key facilitators. This collaboration will enhance Bangladesh’s chances of achieving the MDGs in the education sector.

76. The Government has undertaken a number of measures to improve the governance of the education system. Major steps include:

- *At the secondary level, school subsidies have been linked to performance criteria* and schools not meeting these have had their subsidies suspended. At the same time, a pilot program is setting up secondary schools in 60 of the most disadvantaged and underserved areas to ensure that these do not suffer because of the stricter criteria;
- *Schools’ registration process* and their eligibility to receive public subsidies is being contracted to competitively selected private institutions who have the capacity to undertake this task;
- *Community participation in school management* is being enhanced with the inclusion of more community representatives in school management committees;
- *Pilot surveys to track performance and expenditures have been completed* and plans are being developed to mainstream these, in order to improve information and M&E systems;
- *Information on examination outcomes and school performance* are being disseminated widely to stakeholders;
- *The establishment of a National Teacher Registration and Certification Authority (NTRCA)* has recently been approved. The NTRCA will screen and certify a pool of individuals eligible to be hired as teachers in secondary and higher secondary schools and all recognized schools will need to choose from this pool. This would help strengthen the transparency of the hiring process, and ensure that only qualified teachers get entry into the profession.

- ***The restructuring of the National Curriculum and Textbook Board***, responsible for curriculum development and textbook production both at primary and secondary levels, has included a clear demarcation in the functions of the curriculum and textbook wings. Textbook production at the secondary level is also being privatized, leading to a significant reduction in scope for rent-seeking and improvements in the quality.

77. A means-tested stipend program is being piloted to attract poor girls into secondary schools. Similar measures are also being taken at the primary level: For instance PEDP II aims to increase access in underserved areas through enhanced collaboration with NGOs and provide stipends to 40 percent of students from the poorest families to attract them into primary education. At both the primary and secondary levels, greater attention is also being paid to teacher training.

78. Progress on reducing child labor needs acceleration through advocacy and incentive-based programs. While school participation and the age at which girls marry have risen over the last decade, progress on reducing child labor has been much slower⁹. There is consensus that the existing child labor situation requires attention from all levels of Government and civil society to determine how to bring an end to this widespread practice¹⁰. A National Plan of Action against Sexual Abuse and Exploitation of Children has been prepared and a National Policy on Child Labor is under formulation. The Government has also approved a project to prepare a Time Bound Program for the elimination of child labor. Government and NGOs have had successes in advocacy programs, which play an important role in influencing norms and practices related to children. These notwithstanding, there remains considerable room for a firmer advocacy position against child labor, on grounds of equity or universal rights to education and protection; highlighting the value of delaying children's involvement in work for longer term gains; focusing attention on the costs to society of harmful child labor; and tailoring advocacy messages to local experiences and idioms.

79. Bangladesh has made impressive progress toward most of the health related MDGs, but the sector remains beset with weak governance. Much of the credit goes to NGOs; providers outside of the public sector deliver 60-70 percent of health care services in Bangladesh, and a higher proportion of curative care. Public sector service providers are generally not accountable to clients, especially the poor and, with some exceptions, service quality has deteriorated significantly while the share of public sector spending going to delivery of primary health care has actually declined over the last few years. There are a number of reasons why public health services have tended to be non-responsive to service users. They include: (a) service providers are not accountable to the service users but rather to a distant centralized bureaucracy; (b) normal supervision system within the bureaucracy which could have helped to enforce accountability has broken down over time; (c) facility managers have little training and independence in decision making; (d) support services such as drug supply etc. are managed by a part of the Ministry bureaucracy which has little to do with consumer inter-face and thus may not respond to the needs; (e) in common with many

⁹ According to a national child labor survey of children aged 5-17 conducted by the BBS in 2002-03, one in every six children are working in Bangladesh. Interests of poor households to supply child labor remain strong under the existing economic and social conditions. The steady pace of economic growth over the last decade and a half, and the impact of livelihood diversification, may also have increased the economic opportunities available for employing child labor. NGOs and DPs have agreed that eliminating child labor is not realistic in the near term and that the emphasis must be on ensuring all working children are given access to education and that they work in safety.

¹⁰ Bangladesh has signed the UN Convention on the Rights of the Child (CRC) and has ratified relevant international conventions, including ILO Convention 182 on the Worst forms of Child Labor (WFCL), the SAARC Convention on Preventing and Combating Trafficking Women and Children for Prostitution and the SAARC Convention on Regional Arrangements for the Promotion of Child Welfare.

bureaucracies the world over – the health bureaucracy suffers turf battles and other forms of in-fighting; and (f) the situation is made even more complicated by having two health service delivery organizations within the Ministry – the Directorate-General of Health and the Directorate-General of Family Welfare. There is little coordination between these two service delivery wings and the result has been duplication of facilities and employees while the services provided have continued to deteriorate.

80. *The recent Health Nutrition Population (HNP) Strategic Investment Plan 2003-2010 confirms Government commitment to pro-poor health service provision and addresses the need to reappraise the essential core functions of the public sector.* The plan identified some key long term challenges for the sector which include: First, restructuring the way services are provided including ensuring greater efficiency and responsiveness to HNP challenges as they emerge; guaranteeing free provision of emergency services to those in need; and expanding HNP services in urban areas for provision of coordinated primary, secondary and tertiary care. Second, improving equity: ways are being explored for shifting resources towards areas with the greatest needs, through a revision of norms for per capita allocations to districts, weighted by a poverty-related index of health needs, for incentives for practitioners to attend to the needs of the poor, and for systems of demand-side financing. Third, improving service efficiencies by enhancing workforce motivation and productivity and by the use of service providers according to their comparative advantage.

81. *The Government and Development Partners are addressing these issues under the Health, Nutrition and Population Sector Program (HNPSPP) umbrella.* The HNPSPP includes accountability instruments and seeks to improve targeting. It will seek a better partnership with non-public providers via a Management Support Agency and Performance Monitoring Agency, while simultaneously aiming to strengthen its stewardship role to ensure quality services under HNPSPP at all levels of the system. A Management Information System for producing credible statistical, personnel and procurement reporting is a priority issue for the HNPSPP.

82. *Finding cost-effective ways of improving demand for/ consumption of essential Health Nutrition Population (HNP) services by the poor is critical.* Attention should be focused on targeting consumption subsidies and restructuring allocation mechanisms based on population and poverty indexes. Service improvements in health will use a variety of instruments such as vouchers and the contracting out of health services to the NGO and private sector. In the latter approach, accountability will be enforced through a greater reliance on union parishads (lowest level of elected government), which will have an enhanced monitoring role, in place of service users relying solely upon a central government hierarchy over which they have little influence.

83. *Micro-credit now reaches as many as 37 per cent of all Bangladeshi households and around 60 per cent of poor households.* Growing financial sustainability has meant declining dependence on donor funding, and the bulk of revolving loan funds are now from client savings and micro-credit surpluses. The Government's role in financing the expansion of micro-finance through PKSF, and ensuring that PKSF retains its autonomy to make professional resource allocation decisions, is a highly successful example of Government-NGO partnership. The recent initiative to modernize the regulatory framework for micro-finance needs to ensure that any new legislation protects the interests of depositors while preserving the space given to NGOs to innovate and scale up. Moreover it is essential that both Government and NGO micro-finance programs are covered by the new regulatory framework in order to create a level playing field in the industry.

84. *The establishment of the Government's Small Enterprise Fund, has helped improve access to finance by small enterprise - the 'missing middle' traditionally beyond the reach from Banks*

or micro-finance institutions. The SEF is a refinancing window set up at the Bangladesh Bank, which allows banks and NBFIs to increase their lending to small enterprises. Disbursement figures indicate that the SEF has already enabled many financial institutions such as BRAC Bank, NCC bank, MIDAS Financing, and some other private commercial banks (PCBs) to rapidly expand their small enterprise portfolio by aggressively entering this market. In the past year these financial institutions have disbursed loans to over 2,600 small enterprises across the country. A Bangladesh Bank survey has shown that funds to date have been used properly, generating additional rural and semi-urban employment, with satisfactory loan repayments. The SEF is, however, far from meeting the demand for funds. Further growth of this sector can be facilitated by deeper reforms in rural finance to increase the supply of funds to meet this huge latent demand. Moreover, since the clients in this sector do not have immovable assets they cannot offer any collateral for accessing bank finance. Regulatory reforms would therefore be needed to create a secured transaction regime which would allow the banks to register their claim on the moveable assets of these clients, whilst institutional reforms would be required to increase competition and outreach of banks to serve this sector on a sustainable basis.

85. *Social safety nets, especially for the poor, are accorded high priority in the PRSP, although an integrated approach to administering safety net programs is still not in place.* Evaluation studies indicate that non-cash-based social safety programs in Bangladesh are plagued by large leakages. The cash-based programs (such as the secondary schools stipend program) are much less vulnerable. The Government is now monetizing some of its larger programs in the hope of curbing corruption and containing transaction costs. The *Food for Education* program that had been plagued by high leakages was replaced by an expanded *Primary Education Stipend Program*. An estimated 7 million children benefit from the program. Other in-kind programs such as the Food-for-Work program and Food Aid are also being monetized. But cash-transfer programs are not in themselves a panacea. It is important that monitoring systems be strengthened and adequate checks and safeguards be put in place.

86. *Bangladesh's constitution provides for gender and social equality in all public spheres, and reducing gender gaps and promoting women's advancement is also one of the goals of PRSP.* The policy prioritization of gender equality in Bangladesh is manifest in the attainment of the MDG on gender equality in primary and secondary enrollment. Further, Bangladesh has ratified the Convention on the Elimination of All forms of Discrimination against Women, with a few reservations (pertaining to marriage, divorce, and inheritance). Special clauses have been included in family laws to give women the right to divorce and the power to stop practice of polygamy by husbands. Tougher laws for preventing violence against women (VAW), e.g., throwing acid on women and trafficking of women and children, were enacted in 2003 and special arrangements – such as inter-ministerial task force and VAW cells in the Ministry of Home and in police stations – to enforce these were established in 2004. Quick trial courts under these acts were established in 2004 for punishing the perpetrators. The strong focus in the PRSP for women's issues provides the basis for further advancing gender equality.

D. OVERALL STATUS OF POLICY REFORMS

87. *Bangladesh's basic economic policies are and have been sound for decades, and have helped Bangladesh establish a record that is in many ways enviable among low-income countries.* Conservative fiscal management has kept inflation low and limited the public sector's capacity to misdirect resources. The currency is stable and government is small. The NGO movement has been not only tolerated but encouraged to grow to a size and importance in people's lives that would be considered threatening by many governments; NGOs now deliver major portions of health, education and microcredit services.

88. ***Much remains to be done, however.*** Perception based governance indicators may fail to capture positive economic and social outcomes, but perceptions can still significantly affect outcomes. Pervasive corruption and unreliable law and order are major deterrents to economic enterprise in general and investment in particular. If governance improved in Bangladesh, economic growth would be about two percent per year faster. This is coincidentally the acceleration that the PRSP shows is needed if Bangladesh is to meet its poverty reduction and MDG goals.

89. ***The road ahead is hard to predict.*** It is possible for Government to make real progress on governance, as shown in Table 2 and elaborated in the text. And development partners have also helped, especially at critical junctures. Such a progress would, however, have been difficult to map out in advance. Progress in Bangladesh was, and perhaps is, best made by pursuing a broad reform agenda and pressing forward on those items and at those times where progress was/is possible. Looking forward such a flexible and opportunistic strategy can be expected to have more success than a strategy based on staking out specific goals in advance and focussing entirely on attaining those goals.

IV. IMPLEMENTING THE PRSP AND BEYOND

A. THE GOVERNMENT'S POVERTY REDUCTION STRATEGY

90. ***The Government has recently approved its Poverty Reduction Strategy Paper (PRSP), titled "Unlocking the Potential: National Strategy for Accelerated Poverty Reduction."*** The PRSP has benefited from a comprehensive participatory process, including consultations at the regional levels with representations from a wide spectrum of the society. The PRSP has been fully owned by Government, who managed and financed the process, while welcoming donors' interest.

91. ***The main national level development goals set by the PRSP*** are: (i) employment generation; (ii) nutrition; (iii) maternal health; (iv) quality education (at primary, secondary, and vocational levels); (v) sanitation and safe water; (vi) criminal justice; (vii) local governance; and (viii) monitoring. In addition to the still daunting levels of income poverty, the PRSP raises the profile on women's advancement, rising inequality, and making governance work especially for the poor. In setting these goals, it acknowledges Bangladesh's encouraging development record but cautions against complacency and slippages in areas where progress has been good. Recognizing the growing significance of the *meso-level* economy (rural market centers), it advocates greater policy attention to it for growth and employment generation. It rightly emphasizes addressing implementation problems and capacity constraints within the Government: particularly by improving (i) the budgetary framework for development spending, (ii) the quality of the civil service, and (iii) the flow of information.

92. ***Espousing a broad definition of poverty, including human deprivations in income, food security, quality of life, and vulnerability,*** the PRSP seeks to address it through a strategically prioritized policy framework that has pro-poor growth, human development, and governance as its main pillars. It aims to unlock the full potential of the country through a sensible mix of public action, private initiatives, and community mobilization. ***The priority policy areas identified in the PRSP are:*** (i) macroeconomic stability; (ii) critical sectors for pro-poor growth, including rural, agricultural, informal and SMEs, rural electrification, roads, and telecommunications; (iii) safety nets for the poor and the vulnerable; (iv) human development of the poor; (v) participation and empowerment of the poor; (vi) good governance; (vii) improved delivery of basic services; and (viii) environmental sustainability.

B. PRELIMINARY PRSP IMPLEMENTATION MEASURES

Operationalizing the PRSP via a Medium Term Expenditure Framework (MTEF)

93. *The Government has set out its PRSP implementation targets in the Medium Term Macroeconomic Framework.* The FY06 budget corresponds to the first year of PRSP implementation, and focuses on the operationalization of strategic elements in the PRSP, including good governance, improved service delivery and broad-based participation. The focus is on key building blocks including investments in social and physical infrastructure, private sector development and NGO partnerships, streamlined tax instruments and administration, employment generation for farm and non-farm sectors and SMEs, social safety-nets and targeted poverty reduction programs. Effective prioritization remains key.

94. The path of the fiscal policy in the Government's medium-term fiscal framework is consistent with Bangladesh's reform needs and public debt sustainability. In light of the growing development spending needs and the envisaged reductions in trade taxes, strengthening domestic tax mobilization is at the core of the medium-term budget strategy. The fiscal framework envisages an increase in tax collection by 1.3 percentage point of GDP and non-tax revenue collection by 0.1 percentage point of GDP over next four years (FY06-09). Total expenditure is projected to rise to 15.2 percent of GDP in FY06, and then increasing further to 15.4 percent over the following three years. Overall budget deficit is projected to peak at 4.2 percent of GDP in FY06 followed by gradual decline to 3.8 percent through FY09. Domestic financing is projected to decline from 2 percent of GDP in FY05 to 1.7 percent through FY09. This implies that net foreign financing will need to increase from 1.5 percent of GDP in FY05 to around 2.2 percent in FY06 and onwards. While ambitious, this is not beyond the realm of possibility if macroeconomic stability is sustained and progress with policy and structural reforms continue.

Monitoring and Evaluation

95. Improving the quality and effectiveness of economic and social policies will require *more timely and reliable information for policy analysis and assessing outcomes*. The PRSP outlines a monitoring framework, which includes monitoring indicators (inputs, outputs and impacts), data sources, and institutional arrangements for monitoring and providing feedback to policymakers. Sources include existing data as well as planned annual surveys for tracking intermediate indicators related to access, usage, and satisfaction with public services. The ongoing *Household and Income Expenditure Survey* will provide an important basis for updated poverty monitoring and analysis. The *Public Expenditure Framework of Accountability* (PEFA) which Government is actively considering to adopt will also provide useful tool to monitor performance in public financial management and improve accountability. Development partners will be actively supporting the development of sound monitoring arrangements.

96. *Successful monitoring depends critically on institutional arrangements and their capacity.* A National Poverty Focal Point has been created in the General Economics Division (GED) of the Planning Commission to monitor poverty and track progress in implementing the PRSP. The NPPF is expected to grow and function as an institutionally effective and technically competent Poverty Monitoring Unit with strong inter-ministerial linkages and interactions with various stakeholders outside the Government, including civil society.

97. Moving ahead, *the poverty diagnostics, drawing on quantitative and qualitative information, should be used to set medium and long-term outcome-oriented targets*. These should be linked to macroeconomic, structural and social policies. The Poverty Monitoring Unit should consult civil

society regularly on the progress of the Poverty Reduction Strategy. The Bangladesh Bureau of Statistics (BBS) and the Ministry of Planning plan to develop a National Databank to provide an integrated database accessible to all government departments and BBS. All these monitoring and evaluation systems, if implemented properly, should further improve the quality of information and analysis for decision-making and inculcate a stronger results orientation within Government.

C. DEVELOPMENT CHALLENGES AHEAD

98. Despite *the remarkable gains that Bangladesh has made, it still remains a very poor country*. The country ranks 174th in per capita income out of 201 countries – India ranks 159th¹¹. The number of people living in absolute poverty remains at the same level – some 63 million - as a decade and a half ago, a sobering reminder of the large unfinished development agenda. Poverty has fallen unevenly across regions, with most of the gains in the Dhaka division while Rajshahi, Chittagong and Khulna have large pockets of poverty. Moreover, inequality is rising, making the task of reducing poverty that much more difficult. Adult illiteracy is very persistent and coming down slowly, particularly for women. In other non-income measures of poverty, malnutrition levels in South Asia generally, remain among the highest in the world, and even though Bangladesh has the lowest malnutrition in the region, over half the children between the ages of 1-3 are underweight, while over 40% of adult Bangladeshi women are severely malnourished. Inadequate access to health services during pregnancy and childbirth and the nutritional status of pregnant women account for the high levels of maternal mortality.

99. *To achieve the MDGs, Bangladesh will need to substantially accelerate growth to 6-7% per annum, and ensure that such growth is much more pro-poor and better distributed*. For the key income poverty goal, it involves a substantial acceleration in the rate of reduction of income poverty over the 1.5% per annum achieved in the 1990-2002 period (Annex 1, Table 5). Moreover, while the initial gains in social indicators have taken up the slack, reaching the targets will require a greater investment in the quality of health and education services, particularly in lagging areas such as maternal mortality or adult literacy.

100. *Accelerating growth will be a challenge*. Two major sources of growth are highly vulnerable. Garments exports are threatened by increased competition from low cost countries like China in a post MFA world. Growth in agriculture is threatened by continued decline in the availability of cultivable land. These potential threats call for urgent efforts to enhance Bangladesh's export competitiveness (to be discussed in detail in the next chapter). The diversification of outputs and enhanced agricultural productivity will also be critical and will require policies which strengthen the rural investment climate and encourage non-farm agricultural output. So will a substantial improvement in the investment climate that encourages foreign direct investment as well as creates a level playing field for domestic investors. Improving the investment climate in turn will require decisive action to address critical constraints facing investors.

101. *Further gains in human development to ensure the poor's participation in the growth process are a serious challenge*. With government highly centralized, the poor find it difficult to hold government accountable and responsive to the needs of the poor. Recent efforts to strengthen local level democracy and to make greater resources available to local governments provide an opportunity to strengthen local governance and enhance the voice of the poor in the identification, design and implementation of programs for rural infrastructure and social services. Reaching the MDG goals will also require improvements in the quality of services, particularly attendance of health personnel at birth and during pregnancy.

¹¹ *World Development Indicators* (World Bank, 2005)

102. **Finally, Governance matters.** Service delivery is also adversely affected by the low revenue effort and weaknesses in the public financial management process. Corruption casts a large shadow over the integrity of tax administration and public procurement. It also diverts scarce funds intended for social services to unintended purposes. Reforming tax administration, strengthening public financial management and making procurement more transparent and competitive will be important to the effective delivery of public services. This will need to be accompanied by strengthening the quality and accountability of the civil service. Inevitably progress will also depend on strengthening deterrents to corruption by making the new anti-corruption commission effective and strengthening the legal and judicial system.

V. A SPECIAL FOCUS ON BANGLADESH'S EXPORT GROWTH AND COMPETITIVENESS

103. **Bangladesh has experienced a dramatic export expansion over the past decade.** Export earnings for 2004/05 reached \$8.6 billion, nearly three times the level of 1991/92. Export growth has played a key role in maintaining a favorable trade balance and macroeconomic stability. Sustaining this export expansion will be vital to achieve the 6-7 percent growth needed to achieve the MDGs. The PRSP recognizes, however, that in spite of Bangladesh's notable export growth, the sector shows some basic weaknesses which, in the face of intensifying global competition, make its future uncertain.¹²

104. **The need for structural reforms to boost domestic and external competitiveness is made even more urgent** after the dismantling of the Agreement on Textiles & Clothing (ATC) from January, 2005, which exposes Bangladesh to competition from garment exporters previously restricted by quotas. This poses a considerable challenge for the economy, because the garment sector accounts for over three-quarter of total exports, and directly employs about 2 million workers, of whom 90 percent are women. It is too early to assess the long-run impact, although a hopeful sign is that new investment and market orders continue to flow, and export growth has remained fairly robust thus far. An important reason for this may be that Bangladesh is competitive in the high-volume, low-margin segment of the world market and retains preferential access to the EU and Canadian markets due to its LDC status.

105. **The sources of Bangladesh's competitive weaknesses are well known. Cross-cutting barriers include weak economic governance, corruption, infrastructure bottlenecks and high costs of borrowing.** However, assessments of the real economic impact of these constraints have mostly been based on perceptions. A recent study by the World Bank, entitled *Bangladesh Growth and Export Competitiveness*, has now measured in great detail the extent and direct costs of these bottlenecks on the Bangladesh export sector. The real costs to Bangladesh's export sector are presented below, along with some targeted policy recommendations.

The real costs to export competitiveness

106. **Corruption, burdensome regulation and breakdown in law and order are all significant barriers to investment.** Perception surveys of Bangladeshi entrepreneurs have regularly highlighted corruption as a major constraint on their operations.¹³ Integrated value-chain analyses have now

¹² This chapter summarizes the main findings from a recent World Bank report *Bangladesh: Growth and Export Competitiveness*, World Bank, 2005

¹³ Sixty percent of firms identified corruption as a major constraint on their operations, second only to the lack of reliable and adequate electricity, in a survey undertaken in 1,001 firms in Dhaka and Chittagong for

been able to quantify the extent and costs of corruption on export goods. Bribes paid at the point of import can raise the cost of equipment that knitwear manufacturers bring into the country by 6-10 percent. Footwear makers' costs rise because of the bribes they have to pay both to clear imported materials, and to export finished products. Bribes typically amount to 2-5 percent of import value, and sometimes as much as 10 percent, according to producers/exporters. All export and potential export products without exception have suffered from the disadvantage implicit in the cost-raising effect of corruption at various stages along the value chain. By systematically reducing the (price) competitiveness of Bangladeshi exports, corruption has become a heavy tax on society as a whole.

107. *Infrastructure bottlenecks wreak havoc.* Poor infrastructure, including inadequate power, telecommunications, transport and malfunctioning ports, is generally perceived by owners as the principle constraint on their enterprise, particularly for exports. The costs of infrastructure bottlenecks are indeed very high. The supply of electricity, in particular, is so erratic that it forces many firms to rely on power from captive generators at 2.5 times the cost per kilowatt hour of current from the grid. Some infrastructure bottlenecks are particularly harmful to the performance and growth prospects of certain sectors. For instance, port congestion results in the second highest of all costs T-shirt makers incur for materials. Limited and unpredictable air cargo service blocks the expansion of exports of fresh French green beans and other produce to Europe' supermarket chains – costing up to 86% of the actual delivered price. Bangladesh's export of shrimps supplies 4-5 percent of the world market and represents the second largest export-earning industry in the country. Its most significant short-term obstacle to growth is poor roads (and lack of alternative transport options).

108. *High costs of finance raise costs unduly.* The costs of borrowing represent the third, significant obstacle to stronger export performance across the board. The average real lending rate in Bangladesh is higher than the real rate of GDP growth and substantially more than the real lending rates of such neighbors and competitors as India, Sri Lanka, Malaysia, Thailand and Vietnam¹⁴. The cause of these high costs can be found in long standing structural and other problems of the Nationalized Commercial Banks (NCBs) and their resultant high volume of non-performing loans. Fortunately, as mentioned in Chapter III, the Government has been taking steps to reform these institutions and strengthen supervisory and regulatory authority over them.

109. *Both the pace and scope of banking reform need to be increased.* At present, the high costs of borrowing are still affecting export competitiveness across sectors. Financing costs alone constitute 13.5 percent of the f.o.b (free on board) price of an exported set of ceramic tableware, and interest payments make up as much as 2.5 percent of the f.o.b price of a Bangladesh-made man's T-shirt. Indirectly, bank financing rates limit the growth of produce exports. The charges remain too high to allow a typical fresh-vegetable exporter to borrow money to buy land to help aggregate production and maintain it at a high, export-level quality. Bangladesh shoe manufacturers, operating in a capital-intensive industry, contrast their 7-12 percent interest charges

the study *Improving the Investment Climate in Bangladesh*, World Bank and Bangladesh Enterprise Institute, 2003.

¹⁴ Real interest rates have been on the decline. Reforms in the financial sector during 2002-04 have been instrumental in driving down lending rates in Bangladesh. Bank lending rates to industry were 12-13.5 percent in late 2004 in private banks and 10-12.5 percent in NCBs, compared to an average of 16-17 percent in 2003 and earlier. Due to floods in August 2004 and POL price adjustments in response to higher international oil prices, the inflation rate has been creeping up to nearly 7 percent by late 2004 and further to nearly 8 percent by late 2005. Real lending rates were therefore down from their highs of over 10 percent in 2003 to 5-7 percent by late 2004 and 3-4 percent by June 2005. However, it is not certain that the inflation creep is permanent or the result of a temporary shock. In the latter case, with sound monetary management in place, it is likely to decline in 2006-07 leading to higher real interest rates.

with the rates of around 5 percent at which their main competitors in Indonesia, for example, can borrow.

110. ***Trade policies still have a strong anti-export bias.*** Whilst bonded ware-houses and export-processing-zone schemes have insulated the RMG sector from these high anti-export biases (21-27 percent), too many incentives still favor import substitution. The escalating tariff structure sets lower duties on imports of raw materials and intermediaries and higher ones on processed products, favoring domestic producers without spurring them, through competition, to higher levels of efficiency.

111. ***The import regime is also highly detrimental to much needed export diversification.*** Export concentration in ready made garments makes the economy, jobs and income, extremely vulnerable to external shocks arising from changes in global demand for RMG. Export diversification, therefore, is a high priority. But the import regime for other exports is cumbersome and the duty drawback system dysfunctional, thus literally stopping any prospect of export diversification dead on its tracks. It must be noted that streamlining the import regime for exports in a highly protected economy such as Bangladesh is just as important for ensuring export competitiveness as reducing anti-export bias of the tariff and QR regime.

112. ***The four cross-cutting hindrances to export competitiveness described above (corruption, poor infrastructure, high cost of finance, and tariff barriers) are not the only problems Bangladeshi exporters face in common.*** Labor quality and, therefore, the productivity of labor lag behind the country's Asian neighbors and trade rivals. Industry specific barriers to competitive success also loom large. Further, although Bangladesh has lately been attracting substantial foreign investment in the telecommunications sector, until recently, the ban on FDI in its most promising industry, garments, was at odds with its relatively liberal FDI regime and deterred the kinds of large outside investments that have expanded capital stock and eased technology transfer in other countries.

Strategy for Sustained Economic Growth and Export Competitiveness

113. ***The broad aim of policy measures to improve Bangladesh's competitive performance is to expand exports and to strengthen growth prospects by raising factor productivity and encouraging private investment.*** Total factor productivity (TFP), i.e., the efficiency with which resources are used in production, has been crucial at the margin to the country's overall economic growth for nearly three decades. Clearly, it is important to improve human capital and to mobilize more investment from foreign and domestic sources. What is also critical for export-accelerated growth, however, is the efficiency with which labor and capital resources do their work. Inefficiencies of various kinds and degrees of severity now hamper all sorts of enterprises.

114. ***In order to make the most of its export opportunities on a changing international playing field, Bangladesh needs to follow a strategic game plan,*** invest in infrastructure, technology and skills, streamline policies and improve quality and safety standards. Reforms of Government trade policy instruments alone would significantly untie the hands of the country's exporters and enhance their performance. Specific recommendations include:

- ***Reducing the costs of corruption through a sustained effort to streamline the domestic regulatory environment,*** thereby limiting opportunities for and incidence of bribery in ordinary business dealings. As mentioned in Chapter III, Government has initiated regulatory reforms involving the streamlining of process related to customs and port clearance, investment facilitation, land registration, utility regulation and the financial sector. Payoffs in export

competitiveness are likely to be highest for reforms in customs and port clearance and the Duty Exemption and Drawback Office (DEDO).

- ***Easing infrastructure bottlenecks requires urgent reforms to strengthen the regulatory environment, including procurement; reduce state involvement in SOEs and improve their performance;*** and encourage private-sector participation by establishing rules of competition. In the power sector, addressing priority institutional and structural constraints will require the continued financial restructuring and unbundling of the sector, strong operational regulatory bodies, and an effective implementation of the Government's least-cost generation expansion plan (through a transparent and competitive procurement process). In the transport sector, changes that are required immediately are modifications of policies, processes, and management rather than capital investments. Table 5 presents the 5 recommended actions deemed most important by Government agencies, manufacturers and logistics providers. Where capital investments are being made, policymakers need to look systematically at the problem of delivering transport services along the major corridors, and plan investments so as to improve overall performance, not just the performance of a specific mode on a specific link of the network.
- ***To correct the severe banking sector weaknesses, including the high cost of borrowing, longstanding governance and structural problems associated with the Nationalized Commercial Banks (NCBs) must be resolved.*** Government has started to address these issues, but reform progress has been slow (see Chapter III). Although the Bangladesh Bank's supervisory and regulatory authority has recently been strengthened, further steps to strengthen creditor rights and contract enforcement will probably be required in order to improve the efficiency and coverage of the banking sector.
- ***Reduce the significant anti-export bias.*** Further trade reforms are needed to provide comparable stimulus to other industries with the potential of diversifying the country's exports. These need to further simplify the import tax regime and reduce the dispersion and average level of nominal (and thus effective) protection, preferably through a pre-announced medium- and long-term schedule of tariff reductions (as done recently by India), and the elimination of any remaining protective quantitative restrictions. At the same time, Bangladesh should avoid using direct export subsidies because of the strong likelihood of their abuse and limited impact. Policy reform should focus instead on addressing the costly bottlenecks that damage not only performance but also the investment climate¹⁵.

Table 5 : Recommended Actions for Improving Bangladesh's Transport and Trade Logistics

Reform	Action	Timeframe
1. Reform container terminal operations in Chittagong Port	Concession or Operating Lease	Within 6 months
2. Establish bonded warehouses and Inland Container Depots	Liberalizing procedures for establishing bonded warehouses	Within one year

¹⁵ A forthcoming World Bank report, *Studies on India-Bangladesh Trade, Trade Policies and Potential FTA*, found that unless non-trade related constraints are removed, a Free-Trade Agreement with India would not enhance Bangladesh's export potential significantly in most sectors. For example, in garments, the high levels of protection provided by India's specific duties on garments are substantially redundant, since actual domestic prices in India are close to international prices, including 'cost, insurance and freight'. The report concludes that the best export prospects may be in industries and products still to be developed, for example natural gas, power, fertilizers, chemicals, steel etc. based on natural gas or coal inputs and/or other resources. This kind of development could be accelerated, and distribution and marketing in India facilitated, by direct investment including joint-ventures with Indian firms.

(ICDs)/Dry Ports		
3. Continue Customs reforms with greater emphasis on imports	Implementation of Asycyda++, full Electronic Data Interchange (EDI), channeling and other risk management	Ongoing, 3 years
4. Increase capacity in the Dhaka-Chittagong Corridor	Road widening; improving rail operations; selected double tracking	Continuous
5. Improve Benapole-Dhaka Corridor performance	Simplifying procedures, increasing cross-docking	One year

Source: World Bank (2005) Bangladesh Growth and Export Competitiveness

115. **Finally, Bangladesh needs to make significant changes to its quality-assurance and safety standards, concerns of special and growing importance for horticultural producers and shrimp growers.** Although quality issues connected to food safety, pesticide and heavy-metal levels are becoming more important internationally, in the medium-term they might not have a huge impact on Bangladesh's export volumes. As yet, in fact, the Bangladesh horticultural export sector has hardly felt the effects of raised international standards for quality. It is, however, only a matter of time before the UK and European food legislation will start to affect Bangladesh exports. The emergent European Food Agency might insist that the Bangladeshi authorities present a plan on how they will control food quality standards in the country's exports to the EU. It is also highly likely that individual markets in the Middle East will step up their own standards for produce imports.

Box 3 : Policy Support for Textiles and RMG in the Post-MFA Era¹⁶

The RMG sector has been the main driver of growth and jobs in the Bangladesh economy. Going forward, the post-MFA trade regime opens opportunities for both knitwear and woven garment exports to seize global market share and to create thousands of more jobs at home. In the six months following the end of MFA quotas in December 2004, Bangladesh's exports of RMG -- 75% of total exports -- have held up better than expected in the face of heightened global competition, growing 13% in FY05

However, competitiveness challenges remain and GOB must find ways to support the continued expansion of RMG exports and jobs. This means a policy package that enhances the competitiveness of both the textiles and garments sectors, since the two are mutually interdependent:

The textile sector has developed behind high tariff protection and suffers from **low productivity**; RMG needs a competitive domestic textile industry to source its inputs, if RMG is itself to remain competitive and grow. In turn, textiles need a vibrant and competitive RMG industry for its own growth

- To raise productivity, the Government should encourage FDI in textiles and support the industry's investments in upgrading technology.

Bangladesh's knitwear sector, as a labor-intensive and relatively low-tech industry, benefits from Bangladesh's low-wage, unskilled labor force, but by the same token faces major challenges in **labor standards and CSR**.

- GOB should assist in ensuring labor standards are met, and consider ways to assist industry in complying with such standards in these vital export-related sectors.

Lead time is a major problem for woven garments (90-120 days), and procurement of imported fabrics takes up the bulk of this time, due to port inefficiencies. Domestic fabrics/textiles can barely meet 15% of RMG requirements. The sector is facing major competition, and "time-to-market" is critical to competitiveness. Bonded warehouses for procuring imported textiles would reduce this lead time considerably, and a central bonded warehouse for duty-free materials would be much more efficient than the smaller bonded warehouses that currently exist. However, GOB has been concerned about leakages of duty-free materials into the domestic market (depriving govt of revenues), and has not therefore supported the proposal.

- To reduce lead time, the Government should allow **setting up Central Bonded Warehouses in EPZ** for stocking fabrics and other inputs

¹⁶ This draws on a 2005 World Bank study, *End of Quotas: Strategic Options for the Readymade Garment Industry*.

- Safeguards, such as computerization of record-keeping, etc, to prevent leakage into the domestic economy and corresponding revenue loss should be introduced, and supported by donors.
- To reduce anti-export bias and minimize incentive for leakages from bonded system, GOB should reduce to no more than 30% the protective tariff on textiles and garments.

Knitwear also suffers from lead time problems: Growth in demand for knitwear exports (30%) is much faster than the domestic yarn suppliers can cope with: local production supplies only 70% of requirements and is also more costly than imported yarn. An extra 3-5 weeks are needed for imports from the region (India), ever since yarn imports over the land border at Benapole were banned in 2001, under pressure from the domestic industry (and concerns over smuggling). Knitwear's competitiveness is thus reduced by the higher cost of local production relative to imports and the greater lead time due to Benapole closure.

- To minimize lead time and lower costs of procuring yarn by knitwear firms, **Government should remove the ban on imports over the land border.**
- GOB's concerns about any possible resultant smuggling can be addressed through pre-shipment inspection or other safeguards, which donors may support.

Bangladeshi woven garments are also losing out substantially on the export potential of the EU market, which provides **preferential, zero-tariff access** to developing country RMG subject to local value-addition criteria¹⁷. Unlike Nepal, Laos and Cambodia, the Government of Bangladesh has not yet taken advantage of the **EU offer of regional cumulation and relaxation of value-addition criteria**, possibly due to pressures from the domestic textile groups who may feel that such relaxation might work in favor of other regional inputs. In fact, a competitive textile sector should have nothing to fear, and can only benefit from a faster growth of RMG in EU markets.

- Government should endorse **SAARC/ASEAN regional cumulation and relaxation of value addition requirement** for exports to EU.

Finally, GOB may wish to pursue a 'trade and growth' agreement with India that allows duty-free import by India of RMG manufactured using Indian and/or Bangladeshi origin textiles (with appropriate safeguards to ensure that RMG manufactured with third-country-origin textiles do not enter duty-free).

Core Post-MFA Policy Support for Textiles and RMG

To reduce lead time and ensure seamless import regime:

1. Allow setting up of central bonded warehouses for fabrics and raw materials for RMG, starting in EPZ (MOF, MOC)
2. Remove ban on import of yarn and fabric via land port; strengthen monitoring and develop systems at border customs to prevent smuggling of these items. (MOC/NBR)

To meet ROO requirements of EU under EBA:

3. Endorse SAARC regional cumulation and relaxation of value addition criteria, for RMG exports to EU (MOC/MOF)

To reduce capital costs of new investments in textiles industry:

4. Consider a technology "upgradation fund" – a refinancing facility to reduce capital cost of installing a positive list of new machinery in textile industries. (MOT/MOC)

To ensure RMG sector contributes adequately to domestic resource mobilization:

5. Raise pre-emptive income tax on RMG exports from 0.25% to 0.5%.

To reduce anti-export bias and minimize incentive for leakages from bonded system:

6. Reduce to no more than 30% the protective tariff on textiles and garments.

¹⁷ Bangladesh does not fulfill Rules of Origin requirements in the EU for zero-tariff access as an LDC exporter, but can take advantage of the offer of regional cumulation and derogation. This is less of an issue for knitwear, where much of the required fabric is woven domestically, and the Rules of Origin (ROO) therefore easier to fulfill.