

QUARTERLY ECONOMIC UPDATE

BANGLADESH

June 2005

Bangladesh Resident Mission
Asian Development Bank

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Asian Development Bank
June 2005

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Notes

- (i) The fiscal year (FY) of the Government ends on 30 June.
- (ii) In this report, "\$" refers to US dollars.

MACROECONOMIC DEVELOPMENTS

Highlights

- For FY2005, GDP growth is estimated at 5.4%, lower than 6.3% recorded in FY2004 due to serious flooding.
- Lower taxes and non-tax revenue caused a reduction in the projected revenue outturn for FY2005.
- The current account deficits remain moderate due to a sharp increase in workers' remittances.
- Increase in oil prices threatens the balance of payments.
- Monetary policy stance continues to accommodate credit demand.
- The exchange rate came under pressure and was volatile.
- Inflation edged up due to flooding-related increases in food prices and higher petrol import prices.

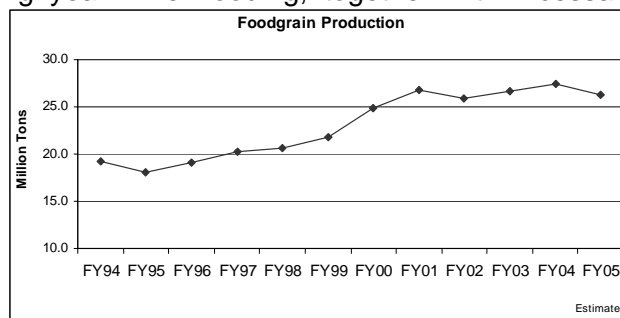
Agriculture

1. The agriculture sector, particularly food crop production, suffered a setback in FY2005 due to serious flooding. However, output of other sub-sectors including animal farming (mainly due to higher poultry production), forestry and fishing (both inland and marine catches) recorded steady growth.

Agriculture sector suffers a setback

2. The *aus* production was 1.5 million tons, a 17% decline from the preceding year. The flooding, together with incessant rainfall, also damaged the *aman* crop.

Aman production was only 9.8 million tons, implying a 15% year-to-year decline. However, the



boro crop is likely to be bumper due to an anticipated 8.9% increase in crop areas as the farmers, encouraged by higher food grain prices, compensated for the loss of the *aman* crop. In addition, the Government's flood rehabilitation program and good weather have contributed to higher production in the *boro* season. The latest estimate of the *boro* crop is 14 million tons, a 9.4% increase over preceding year. Wheat production is, however, estimated at less than 1 million ton due to a 13% decline in the

crop area. Total food grain production during FY2005 is currently estimated at 26.3 million tons, 4% lower than the preceding year. In addition, jute production declined by 7.8% to 4 million bales in FY2005, potato production is expected to significantly increase while production of minor crops including pulses, spices, sugarcane, fruits, vegetables and tobacco are expected to be about level with 2004 production. Overall, agriculture growth during FY2005 is estimated at only 0.3%, down from 4.1% in FY2004.

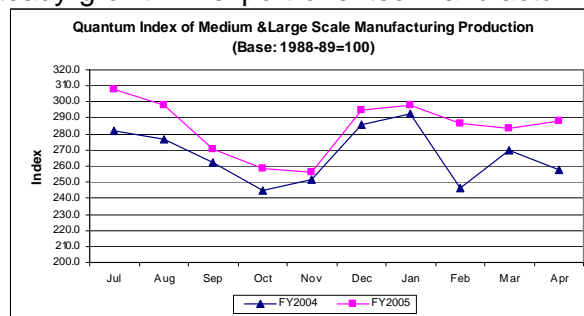
Food grain production declines by 4%

Agriculture shows only 0.3% growth

Industry

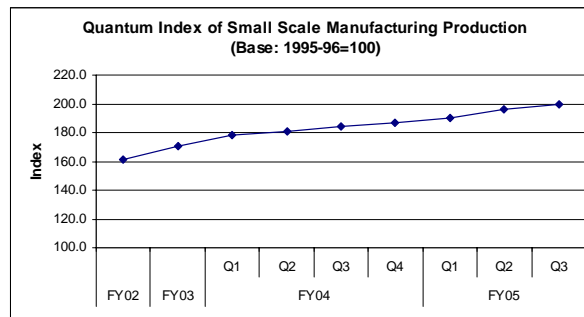
3. Industrial production maintained its robust performance, primarily due to a steady growth in export-oriented manufacturing supported by strong growth in the construction and utilities sub-sectors, which include power, gas, and water supply. The adverse impact of flooding was localized and limited to small-scale enterprises, particularly in the rural areas.

Industrial performance rebounds



4. Output of the large and medium scale manufacturing sub-sectors rose by 8.1% during July-April 2005 compared with the same period of the preceding year. The output of food and beverage, textiles, garments (mainly knitwear), pharmaceuticals, chemicals, ceramic, plastic products, and footwear recorded steady increases. Output of small-scale manufacturing enterprises during July-March 2005 rose by 7.9%, with growth led by the food processing, textiles, leather, garments, wood products, paper, printing and publishing, metal products and machinery and equipment sectors. The construction, power, gas and water supply sub-sectors also exhibited solid performance. Improvement in law enforcement has also had a positive influence on economic activity, particularly private construction activity. This was reflected in an increase in cement production and imports of construction materials including clinker, iron, steel and base metal suggesting robust improvement in construction activity.

Manufacturing shows steady growth



5. The overall growth in industrial sector during FY2005 is estimated at 8.6%, one percentage point higher than 7.6% in the previous year. The growth in manufacturing is expected to reach 8.4% from 7.1% in the previous year while the growth in power, gas and water supply together is estimated at 9%, at the same level as in FY2004, while construction is expected to grow by 8.7% as against 8.3% in the preceding year.

Industrial growth increases to 8.6%

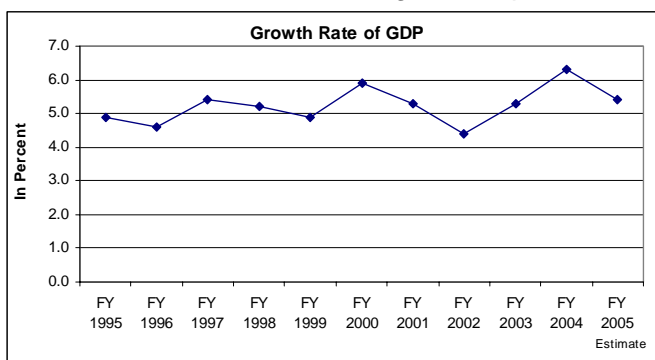
Services

6. The services sector, which contributes 49.7% of GDP, registered steady improvement due to strong growth in foreign trade and manufacturing. Improvement in wholesale and retail trade, an increase in public administration recruitment, expansion of the cell telephone network and the number of private TV channels, and an upsurge in the profitability of private sector banks were the main engines of growth. Overall, the growth of the services sector during FY2005 is estimated at 6.6% compared with 5.7% in the preceding year.

Services sector shows a robust 6.6% growth

Economic Growth

7. Extensive flooding and rainfall affected Bangladesh during the first quarter of FY2005. While the damage was quite severe, the adverse impact on the economy was somewhat offset by a strong growth in exports and workers' remittances,



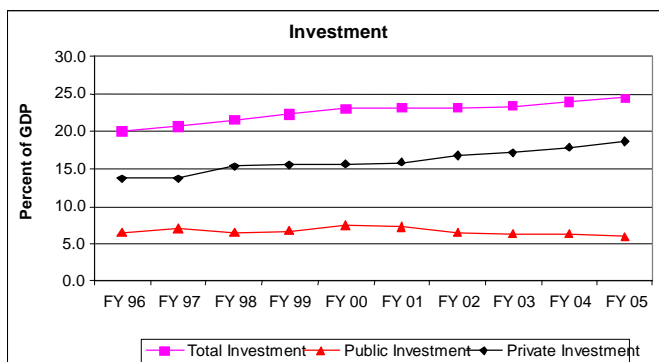
and flood rehabilitation measures. In addition, the supportive macroeconomic environment, marked by a surge in credit, particularly to industry and agriculture sectors, and an increase in foreign direct investment (FDI) inflows, aided the economic recovery following the serious flooding.

8. Based on recently released estimates of the Bangladesh Bureau of Statistics (BBS), GDP growth in FY2005 is estimated at 5.4%, lower than 6.3%¹ in the preceding year, mainly due to the adverse impact of the July-September, 2004 floods. Offsetting the weak performance in the agriculture sector, was a steady expansion in the industry and services sectors. On an expenditure

GDP growth is estimated at 5.4%

¹ BBS revised upward FY2004 GDP growth estimate to 6.3% from the earlier estimate of 5.5%.

basis, GDP expansion in FY2005 was driven by 4.8% increase in consumption with the private sector accounting for 93% of consumption. At 24.4% of GDP, investment was modestly up on 24.0% of GDP in the preceding year due to an increase in private investment, while public investment slightly declined.



Bangladesh faces several challenges

Over the medium-term, Bangladesh faces several challenges to sustaining high rates of economic growth. In the near term, this includes surging global oil prices, the consequences of the MFA phase-out on competitiveness in the garments industry, political uncertainty, especially in the run-up to the January 2007 elections, and weak governance.

9. Continued high global petroleum prices pose a considerable risk to the domestic economy. Higher petroleum prices have an adverse effect on business investment, and contribute to inflationary pressures, and strain the balance of payments. Globally, higher petroleum prices could depress demand for Bangladesh's exports. Heightened pressures on the domestic balance of payments could affect the imports of capital goods and raw materials, negatively affecting economic growth and investment.

10. There remains some uncertainty about the impact of MFA phase out on the country's garments exports. In the first few months since the MFA phase-out, exports of woven garments and knitwear to US continued to grow rapidly. However, in other markets, particularly in the European Union, while knitwear exports showed robust growth, exports of woven garments slowed down. The prices of some products dropped markedly as suppliers have come under pressures to be more competitive. The restraints imposed on the exports from the People's Republic of China (PRC), are likely to benefit Bangladesh in certain goods and in certain markets. However, there are several challenges that need to be addressed. These include (i) reducing costs relative to other competitors (price competitiveness), (ii) reducing lead-time and (iii) improving social compliance. Over the years, the role of foreign direct investment (FDI) in the garments industry has significantly declined as the Government opted to preserve export quotas for locally owned factories. This has deprived the country of the benefits from the inflow of superior technology and management, as well as direct market access and links to EU and

US buyers. In a post-MFA world, purchase order to delivery cycle (lead-time) has emerged as a crucial determinant of competitiveness in the apparel trade. Bangladesh's garments manufacturers have one of the longest lead-times amongst competing countries, about one month longer than in major competing countries. The principal reasons for the longer lead-time are the limited availability of local fabrics and poor infrastructure including ports, rail and roads. Following several incidents at factories, the garments sector has now also come under mounting pressures from international buyers and other agencies to ensure that social practices comply with international standards.

11. Private sector development is key to move onto a higher growth path and it can be fostered by easing key infrastructure bottlenecks to growth, strengthening basic skills, fostering public-private partnerships, nurturing a vibrant SME sector, and improving the policy and regulatory environment. The Government has to sustain a stable and competitive macroeconomic environment and address weak governance that includes law-and-order, corruption, and bureaucratic bottlenecks to stimulate sustained development of the private sector. Diversifying the industrial base, and mitigating risks posed by changing global trade conditions, will need to be addressed if industrial development is to contribute to higher growth and structural transformation. SME development needs to be fostered by improving access to medium to long-term credit, and by expanding access to markets, technology, expertise, and information. To realize the potential for the higher export-led growth, significant improvements are also required in infrastructure provision and operations, including in the ports, road, rail and in the supply of energy. The financial sector and the capital market are undeveloped, distressed, and need to be reformed (see pages 18-21 for a discussion of the issues affecting private sector development).

Private sector is the engine of growth

Fiscal Management

12. The lower taxes and non-tax revenue collection yielded a lower-than-projected revenue outturn for FY2005. Although revenue collection in FY2005 increased by 10.7% over FY2004, it fell short of the original growth target of 16.7%. Revenue collection from NBR taxes, accounting for 96% of tax revenue and 76% of total revenue, is estimated to grow by 14.4% over FY2004. Income tax is estimated to increase by 20.5%, customs duty by 11.4%, VAT by 19.7% and supplementary duty by only 6.4% with collection of customs duty and supplementary duty recording lower than projected growth. To meet an ambitious revenue target for FY2006, revenue mobilization drives would need to be substantially scaled up, the institutional and human resource capacity of the revenue machinery would have to be upgraded,

Revenue collection falls short of target

and there would need to be greater transparency and accountability in revenue management.

13. In FY2005, total expenditure was 2.8% lower than the original target, with current expenditure above the budgeted level by 3.5% while the annual development program (ADP) was lower by 6.8%. Due mainly to the need for financing flood-related expenditures, current expenditure posted a high growth of 17.8% in FY2005 over FY2004, which was also much higher than the nominal GDP growth of 10.7% for the year. In FY2005, the ADP is projected to grow by only 7.8% compared with the original growth target of 15.8% due to slow implementation of projects.

14. At 4.5% of GDP in FY2005, the fiscal deficit exceeded the projected level of 4.3% of GDP. In spite of the sizable ADP underperformance, the higher fiscal deficit was caused by the slippage in revenue mobilization and higher than projected level of current expenditures. Domestic resources financed 2.1% of GDP and external resources 2.4% of GDP. Domestic financing was higher than the targeted amount with bank borrowing exceeding its target by 38.5% and net foreign financing, both loans and grants, falling short of the budgeted amount by only 0.2%.

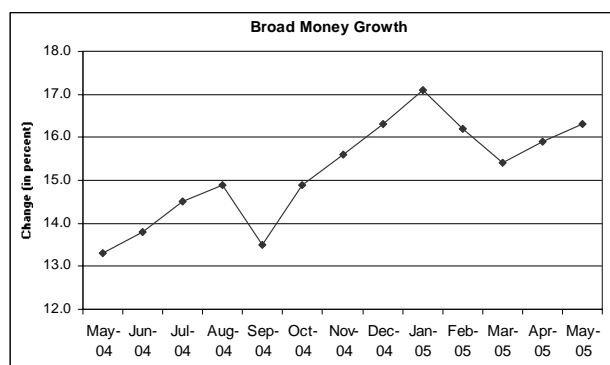
Fiscal deficit increases to 4.5% of GDP

Monetary Developments

15. Monetary policy stance remained accommodative to higher credit demand. On a year-on-year basis, broad money increased by 16.3% in May 2005 compared with 13.3% in May 2004. Domestic credit grew by 17.8% in May 2005 compared with 8.7% in May 2004, while private sector credit grew by 18% in May 2005 as against 12.6% in May 2004, reflecting a pick up in domestic manufacturing and service sector activities. Credit to the Government

Monetary policy remains expansionary

registered a negative growth during July-May of FY2005, as Government was repaying earlier loans to the banking system due to lower levels of financing



requirements in view of ADP underperformance. However, there was a considerable increase in credit to the Government in June 2005 due to delays in the disbursement of budgetary support from the development partners. Consequently, credit to the Government during FY2005, recorded a high growth of 16.4%. Growth of net foreign assets of the banking system accelerated to 20.4% during July-May of FY2005 from 16.4% during the

Government borrows heavily in June

corresponding period of FY2004 reflecting a pick up in migrant worker remittances. This contributed to the higher broad money growth of 11.2% during July-May of 2005 as against 8.8% growth in the previous year. Reserve money increased by 11.1% during July-May of FY2005 compared with growth of 7.1% in the corresponding period of the previous year. Bangladesh Bank conducted regular auctions of treasury bills with the yield on 28-day treasury bills moving up from 4% in January 2005 to 6.6% in June 2005 due to the monetary tightening that began in March 2005 in line with Bangladesh Bank's stance on reserve money growth. Call money rates displayed considerable volatility, mostly remaining between 14-18% during April-May 2005. However, call money rates stabilized and fell to about 5% by the end of June 2005. Repo rates and reverse repo rates moved upward in line with market conditions.

16. In the face of the sharp monetary expansion accompanied by rising inflation, rapid import growth, and pressures on foreign exchange reserves, the banks were under pressure to increase interest rates on lending and deposits. The sharp increase in credit growth was taking place at a time when government borrowing from the banks was negative, and non-bank borrowing was quite low, giving rise to the prospects of even higher monetary and credit growth in the event of the usual pick up in public expenditure at the end of the fiscal year. In addition, the low real interest rate paid on most bank deposits did not augur well for savings mobilization, capital formation and eventually, growth. With limited options available to the authorities to contain inflation, tightening of monetary policy appeared to be the only available means to rein in inflation.

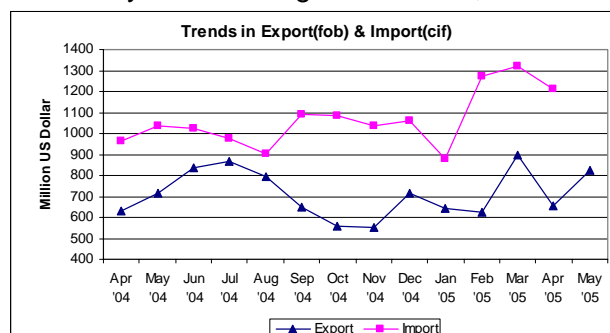
Balance of Payments

17. Export performance in FY2005 started off robustly with 21.7% growth in July-September 2004 over the corresponding period of the previous year. The growth rates, however, moderated

thereafter, reaching 15% during Jul-May of FY2005. Even though growth of woven garments slowed down, growth of knitwear

registered a robust growth of 34.6% - resulting in overall steady rise in merchandise exports. The growth in exports was also supported by growth in frozen food, raw jute and jute goods and chemical products. Year-on-year imports have grown at a high rate of 26.6% during the first ten months of FY2005 compared

Exports grow by 15%



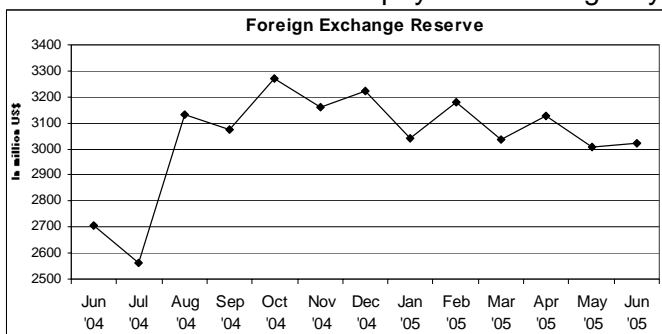
with the 13.1% growth experienced during the same period of the previous year. There have been large increases in import bills for crude and refined petroleum, rice and wheat, pulses, milk and cream, spices and oil seeds, sugar, fertilizer and plastics. Significant increases were also observed in imports of clinker, chemicals, dyeing and tanning materials, yarn and textile and iron and steel ---all industrial inputs, indicating pick up in industrial performance. Imports of capital goods also recorded notable growth. The latest data for imports (in terms of L/C's opened) during FY2005, suggested a more moderate growth in imports of 13.5% over FY2004. This includes an 82% increase for foodgrains, a 55.2% increase for capital machinery, 19.9% increase for petroleum products, 24% increase for intermediate goods, and a 16.1% increase for non-food grain consumer goods.

Imports grow by 26.6%

18. The trade deficit during July-April of FY2005 recorded an increase of 65.9% to \$2,882 million from \$1,737 million during the corresponding period of FY2004. In view of the sharp increase in the trade deficit and in spite of a higher growth in worker remittances (a 14.8% year-on-year increase), the surplus of \$394 million in current account of the balance of payments during July-

Trade deficit increases sharply

April of FY2004 was transformed into a deficit of \$402 million during July-April of FY2005. The steep rise in



Current account shows a deficit

the surplus in the financial account due to the sharp increase in MLT loans and other short term loans offset the deficit in the current account and led to a higher overall balance of payments surplus of \$249 million as against a surplus of \$167 million in the corresponding period of FY2004. The foreign exchange reserves rose to \$3,126 million at the end of April 2005 from \$2,747 million at the end of April 2004. The latest available data indicate that foreign exchange reserves stood at \$2,879 million as on 23 July 2005, equivalent to 2.7 months of imports.

19. Higher oil prices in the international market have posed major risks to the balance of payments. According to latest estimate, oil import bills in FY2005 increased by 54% over the previous fiscal year. The incremental cost (around \$550 million) due to oil price increase reduced foreign exchange available for other essential imports and put pressures on reserves and the exchange rate. The higher import prices of oil, together with the administered retail prices, have also threatened the financial viability of the state-owned Bangladesh Petroleum Corporation (BPC), responsible for importing crude and refined petroleum for

Higher oil prices pose major risks to macroeconomic management

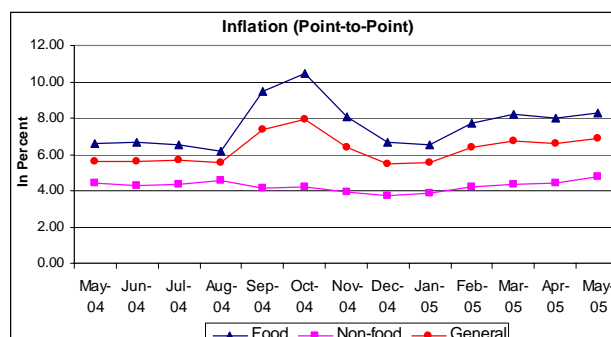
the country. The high oil import costs and government taxes have resulted in large losses for BPC due to the inadequate adjustments in the domestic energy prices. Over last one year, domestic prices of various oil products were increased by 9-30%. However, in terms of dollar, the increase was only 2-21%. Despite recent partial adjustment in oil prices, the loss of BPC in FY2005 is estimated at \$445 million. In view of the Government's reluctance in raising retail prices in line with rise in international prices, the duties and taxes on oil imports have been significantly reduced in budget FY2006 to reduce BPC losses. Although the Government has increased the customs assessable values of oil imports, it remains well below prevailing international oil prices.

Inflation and Exchange Rates

20. The rising trend in inflation continues. On a point-to-point basis, inflation increased to 7.9% in October 2004 from 5.7% in July 2004, mainly due to a rise in food prices. Thereafter, inflation declined to 5.5% in January 2005, but rose again to 6.4% in February, 6.7% in March and 6.9% in May 2005, because of rising food prices.

Price pressures accelerate

Direct inflationary effects of the oil price increase have been limited due to the incomplete pass-through in view of the administered



retail price of petroleum products in the domestic market. However, increased prices of imported goods caused by the higher international oil prices combined with the rise in import prices due to the Taka depreciation has also fueled inflationary pressures in the economy. The exchange rate experienced increased pressures and exhibited significant volatility due mainly to the rapid growth in imports relative to export growth, aided by the sharp rise in private sector credit. This resulted in the Taka depreciating by about 5% between December 2004 and June 2005. The US dollar traded within a band of Taka 63.73 and Taka 63.79 to a dollar in the formal inter-bank market on 30 June 2005. The exchange rate also rose in the informal curb market, with the rate varying between Taka 64.9 and Taka 65.1 to a dollar on 30 June 2005.

Political Developments

21. The Government has taken several new initiatives to improve the law-and-order situation including launching a highway police unit to ensure safety and check crimes on the highways and adding six new police stations to reduce crime in Dhaka. The political situation remains confrontational in several respects. The Parliament passed the national budget for FY2006 following a two-week general discussion. However the Awami League (AL) continued to boycott the parliament sessions. The opposition, particularly the AL, staged demonstrations and enforced a *hartal* to protest the FY2006 budget.

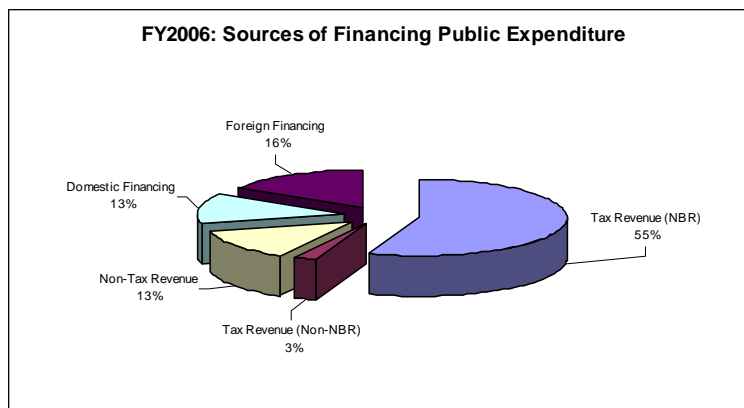
THE FY2006 BUDGET

Overview

22. On 9 June 2005, Mr. M. Saifur Rahman, the Finance Minister, presented the fourth budget of the present Government and his eleventh, to the Parliament. The FY2006 budget, which became effective on 1 July 2005, was passed with certain amendments to the tax proposals on 30 June 2005. The budget reaffirms the Government's commitment to address poverty reduction. The budget speech highlighted the Government's continued emphasis on addressing key core and economic governance issues essential for rapid economic growth and poverty reduction. The central theme of the budget is harnessing the country's productive potentials for economic prosperity and to that effect, the budget is structured around the following key building blocks:

- The budget underscores the critical importance of raising productivity and expanding the economy's productive capacity through deepening investments in social and physical infrastructure and increasing economic efficiency by addressing key reform issues.
- The budget seeks to build on the achievements in reducing income and human poverty and capitalize on the resilience and courage of the farmers, dynamism of the private sector, creative energies of women and successes in microfinance through joint Government-NGO initiatives, in the country's drive for high growth and eradication of poverty.
- Against a backdrop of the weak revenue performance of FY2005 and moderate pick up in utilization of external resources, the budget aims at systemic consolidation of tax instruments and strengthening tax administration and less on new tax measures, to generate additional domestic resources for financing public expenditure.
- In keeping with the PRSP's strategic focus, the budget aims to facilitate economic growth for creating jobs through exploiting growth potentials of rural farm and non-farm sectors and SMEs, and further developing rural electrification and communication networks.
- The budget attaches continued priority to agriculture, rural development and rural infrastructure to raise productivity and output in the farm and non-farm sectors and expanding rural employment opportunities, together with an emphasis on strengthening local government institutions for improved service delivery.
- Consistent with the main thrust on economic growth to produce jobs, the budget expands social safety nets and targeted poverty reduction programs to benefit the disadvantaged and vulnerable, especially poor women.
- A medium-term expenditure framework was used to generate budget forecasts over a longer period of time (Box 1). This is aimed at adding predictability and stability to fiscal plans.

23. The budget corresponds to the first year of the PRSP, and seeks to operationalize its strategic elements through ensuring broad-based people's participation, good governance, improved service delivery, and environmentally sustainable development. Key indicators for revenue and expenditure are broadly in line with the targets set out in the Medium Term Macroeconomic Framework (MTMF).



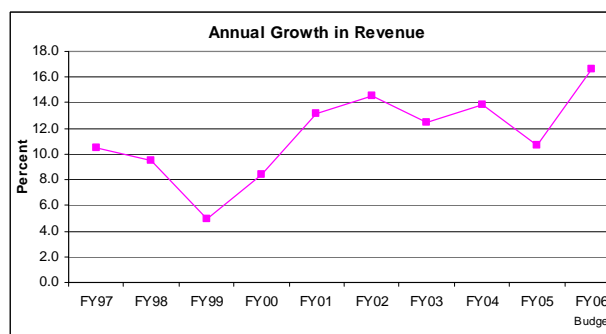
Budget at a Glance

(Billion Taka)

Description	FY2006 (A)	FY2005 Revised (B)	FY2005 (C)	A/B%	A/C%
Total Revenue	457	392	413	117	111
Tax Revenue	373	320	336	117	111
Non-tax Revenue	84	72	77	117	109
Total Expenditure	644	556	572	116	113
Current Expenditure	378	329	334	115	113
ADP	245	205	220	120	111
Other Expenditures	21	22	18	95	117
Fiscal Deficit	187	164	159	114	117
External Resources (Net)	103	88	88	117	117
Foreign Grants	33	26	19	127	174
Foreign Loans	70	62	69	113	101
Financing of Deficit	187	164	159	114	117
Domestic Resources	84	76	71	111	118
Domestic Bank Borrowing	37	36	26	103	142
Domestic Non-Bank Borrowing	47	40	45	117	104

Revenue Measures

24. Simplification of tax collection procedures, an increased drive to expand income tax coverage, and improved enforcement of VAT law are expected to result in a 16.6% increase in total revenue in FY2006 relative to the revised estimates for FY2005. Tax revenues are expected to increase by 16.6% and nontax revenues by 16.7% compared with the revised estimates for



FY2005. This will raise the revenue-GDP ratio to 11% of GDP in FY2006 from 10.6% in FY2005. To achieve this target strengthening tax administration and closer monitoring and supervision will be essential. The Office of the Tax Ombudsman, which is to be set up soon is expected to address tax disputes, raise transparency in enforcement of tax laws, and contribute to higher revenue collection.

Tax and Tariff Policy Reforms

Income Tax

25. Continued emphasis on direct taxes has been placed in the budget to generate more revenues through systemic improvements, greater transparency and dynamism in tax administration, and a reduction of discretionary powers of tax officials. Alongside VAT, the importance of income tax has been highlighted for increased mobilization of domestic resources considering the inevitable decline of trade taxes due to globalization and also in view of the need to move away from these distorting taxes to the more stable and broad-based income and domestic consumption taxes. Continuation of the tax amnesty for undeclared income will give a new lease of life to holders of such income and may not result in greater revenue unless detection of such income and harsh consequences on expiry of the amnesty period are anticipated. Extension of tax deduction at source to a number of taxable sources and considering them as final settlement is justified from a revenue administration point of view and will also provide relief to the taxpayers. Amendments in income tax laws disallowing setting off losses from tax-exempt sources against taxable sources, mandatory submission of accounts to tax departments by insurance companies and auditing of returns certified by chartered accountants will support revenue mobilization efforts. Reduction of advanced income tax on approved securities and bonds from 20% to 10% will encourage investment in bond market and replacement of dividend distribution tax by the 10% advanced income tax on dividends will encourage companies to declare dividends. Tax rebates for donations to philanthropic and educational institutions will encourage such donations. Extension of tax holiday facility to 2008, while eroding the tax-base, could provide temporary relief to the tax-holiday eligible sectors. Enhancing ceiling of tax-exempt income for assessment year 2006-07 will reduce the tax burden on low-income earners.

Import Duty Structure

26. The decision to maintain unchanged a three-tier rate structure will provide stability in the tax regime. Withdrawal of taxes and duties on fertilizer will contribute to lower fertilizer prices and encourage greater use of fertilizers by the farmers. A reduction of the customs duty on raw materials for parts and accessories of rice and wheat mills will reduce the cost of services provided by the millers. Withdrawal of duties and taxes on raw materials, medicines and capital machinery used in the dairy and poultry sector will encourage expansion of these employment-generating sectors. Concessionary rates of customs duty on dyes and chemicals for the textile sector and withdrawal of duties and taxes on machinery and spares used by this sector is aimed at reducing production costs in the domestic textile products sector. A reduction in duty rates for dyes and chemicals used in leather industries will reduce costs in this sector which has possible export potential. Reduction in duties for

Major Tax and Tariff Measures

Income Tax

- Exemption limit of personal income tax, which was raised from Taka 90,000 to Taka 100,000 in the last fiscal year, has been raised further to Taka 120,000 for assessment year 2006-07.
- The limit of total income attracting the highest rate of 25% has been raised to Taka 1,020,000.
- Corporate tax for non-listed companies has been raised from 37.5% to 40% for 2006-07.
- Allowing banks to make provision for bad and doubtful debts up to 1% in place of 2% of total outstanding loans till 2006-07.
- 10% advanced income tax (AIT) on dividends is imposed replacing the dividend distribution tax.
- AIT on profits from securities and bonds is reduced from 20% to 10%.
- Tax deduction at source at varying rates are introduced for freight charges of resident ocean-going ships, on profit/interest paid on deposits by non-banking and other deposit collecting institutions, total export proceeds of knitwear and RMG, on transaction value of shares for stock-exchange members, and sale of apartments and land by real-estate business.
- Losses from a tax-exempt source cannot be set off against taxable income from other sources.
- Submission of accounts by insurance companies to tax authorities has been made mandatory.
- Tax exemption period on income from hospitals, poultry, dairy farms and poultry feed production extended to 2008.
- Tax holiday facilities for some designated sectors extended by three years up to 2008, with periods re-fixed at 4 and 6 years in place of 5 and 7 years.
- Time limit for disclosure of undisclosed income is extended by a year up to 2006, on payment of 7.5% tax.
- Tax rebates are allowed on donations to philanthropic and education institutions.

Import Duties

- Three-tier duty structure has been retained.
- Number of supplementary duty-rates has been reduced from 5 to 3.
- Duties and taxes on certain fertilizers have been withdrawn and customs duty on raw materials for manufacturing parts and equipment of rice and wheat mills has been reduced from 15% to 7.5%.
- Duties and taxes on raw materials for dairy and poultry feed, medicine, medical inputs and capital machinery for dairy and poultry sectors have been exempted.
- Lower customs duty rates have been allowed for dyes and chemicals for textile and knitwear industries and duties and taxes on machinery and spares for these industries and on waste cotton have been withdrawn.
- Duties on raw materials for transformers, pre-fabricated buildings and bicycle industries have been reduced.
- Duties on journals and periodicals have been withdrawn.
- Duty rate on mobile phone set has been reduced from Taka 1500 to Taka 300 and Taka 900 has been fixed as indirect tax for the complementary good, SIM card connection at the local stage.
- Tariff values on crude and refined petroleum have been re-fixed and duty rates have been reduced.
- VAT law and regulations have been amended to simplify collection procedures and strengthen enforcement.
- VAT exemption on certain services and utility charges for enterprises in EPZ areas and deemed exporters has been allowed.
- VAT on the trade of insecticides, fungicides, pesticides, anti-sprout products, plant-growth regulator and disinfectants used in the agriculture sector has been withdrawn.

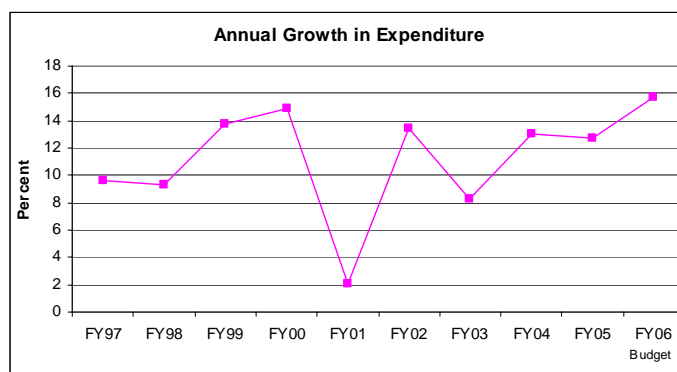
raw materials for transformers, prefabricated buildings and bicycle industry will increase their levels of protection. Tariff values for crude petroleum and petroleum products have been revised to better reflect international prices, while their duty rates have been adjusted downwards to keep domestic retail prices of petroleum products unchanged. Reduction in the number of supplementary duty rates will simplify tax assessment, and an increase in supplementary duty on imported fruit juice and processed foods is aimed at boosting protection to encourage higher levels of domestic production.

Value Added Tax

27. Measures have been taken to consolidate the VAT system and make it more transparent rather than to expand the tax base. Provisions of VAT law and rules have been amended to improve operations of the large-tax payers' unit. VAT on trading of insecticides, fungicides, pesticides, anti-sprouting products, plant growth regulators and disinfectants used in agriculture has been withdrawn to stimulate agriculture.

Expenditure Measures

28. Public expenditure in FY2006 is projected to grow by 15.8% over the revised estimate for FY2005, with current expenditure rising by 14.9% and ADP expenditure by 19.5%. The ratio of public expenditure to GDP is projected to rise modestly from 15.1% in FY2005 to 15.4% in FY2006. With only 7.9% growth in ADP in FY2005 compared with the budgeted target of 15.8%, achieving the projected growth of 19.5% will be a challenging task and require fast



improvement in project processing and implementation capacities. Underutilization of ADP budget in key sectors like education, health, rural development and cooperatives and energy needs to be addressed urgently through improving implementation capacity to shore up the

Box 1: Medium Term Expenditure Framework

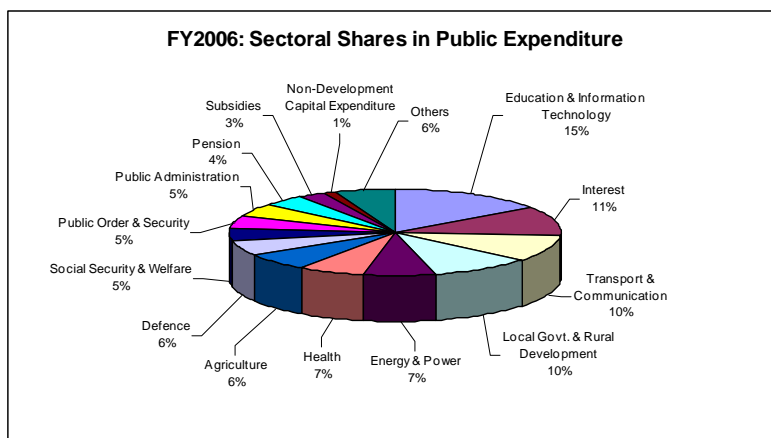
A medium term expenditure framework (MTEF) has been introduced for budget preparation in the Ministry of Education, Ministry of Social Welfare, Ministry of Women and Children Affairs and Ministry of Agriculture for establishing effective linkages between PRSP and annual budgets and enhancing capacity of line ministries in formulating medium term policies. More responsibilities are delegated to these ministries to enable them to prepare budget, determine priorities and plan expenditure in line with targets and PRSP priorities. MTEF will be extended to another 11 ministries in FY2007.

The MTEF contains budget estimates for FY2006 and projections for two outer years i.e. FY2007 and FY2008, which are to be treated as indicative expenditure ceilings. These ceilings will be revised each year based on resource availability and actual progress in fund utilization. MTEF will enable preparation of reliable estimates for domestic and foreign resources and establish balance between policy priorities and resource availability in the medium term. MTEF will facilitate greater stability in short term budgetary management, keeping public expenditure in the medium and long term within sustainable limits and enhance policy predictability. It will make it possible to better address strategic priorities in allocating resources amongst ministries and remove demarcations between development and revenue spending. MTEF is also expected to establish a system of performance measurement for ministries and offices, and link inputs and outputs through the budgetary process.

growth and poverty reduction impacts of public expenditure. Unlike in FY2004, when stricter discipline maintained on the growth of current expenditure restricted actual growth of such expenditure to 5.9%, in FY2005 current expenditure growth shot up to 17.8% as against the budgeted growth of 13.8% highlighting the need for enhancing control of current expenditure. In the FY2006 budget, continued priority has been attached to sectors with potentials for economic growth, poverty reduction and human development.

Social Sectors

29. High priority is attached to education, which received the highest budgetary allocation of 15% of the total FY2006 budget. In addition to the continued emphasis on primary education, attention has been given to building and maintaining infrastructure, supply of teaching inputs, and appliances. To further advance women's empowerment, the size of the female stipend program has been expanded. A monthly scholarship to female students pursuing graduate studies in specialized subjects has been announced. The number of scholarships at primary and secondary levels has been increased and enhanced attention is provided to technical and vocational education. Similarly, the importance attached to health is underscored by the higher allocation to this sector, accounting for 6.6% of all public expenditures.



Physical Infrastructure

30. In the area of physical infrastructure, the energy and power sectors have received high allocations, with 16.9% of the FY2006 development budget earmarked for them. Although allocations to road and railway sectors are not higher than the revised budget of FY2005, attention has been given to building key road networks and bridges during FY2006 with the planned upgradation of Dhaka-Chittagong highway into 4 lanes, building the third bridge over the Karnaphuli river and rebuilding of several important roads and bridges.

Major Expenditure Measures

- Education and Technology sector has received an allocation of Taka 96.9 billion, which is 32.9% higher than the revised allocation for FY2005 but 23.2% higher than the original FY2005 budget.
- An amount of Taka 42.40 billion has been allocated for the health sector, which is 33.5% higher than the health sector allocation under the revised FY2005 budget but 13.6% higher than the original FY2005 budget.
- An amount of Taka 63.80 billion has been allocated for local government and rural development, which is 12.5% higher than the revised FY2005 allocation but 30% higher than the original FY2005 allocation.
- An amount of Taka 66 billion has been allocated to the transport and communication sector in FY2006, which is 2.7% lower than the revised FY2005 allocation but 7.4% higher than the original FY2005 budget.
- Allocations for fuel and energy have increased by 0.47% to Taka 42.9 billion, which again is 1.56% lower than the original FY2005 allocation.
- Allocations for agriculture, fisheries and livestock, land, environment and forest and water resources taken together increased by 5.3% to Taka 47.3 billion.
- Allocations for public order and safety have increased to Taka 32.5 billion, with a 7.4% increase over the revised FY2005 level.
- For social security and welfare, Taka 31.2 billion has been allocated, which is 20.1% higher over the level of the revised FY2005 budget.
- Allocations for interest payments have increased to Taka 70.4 billion with an increase of 8.4% over the revised FY2005 allocation.

Agriculture and Rural Development

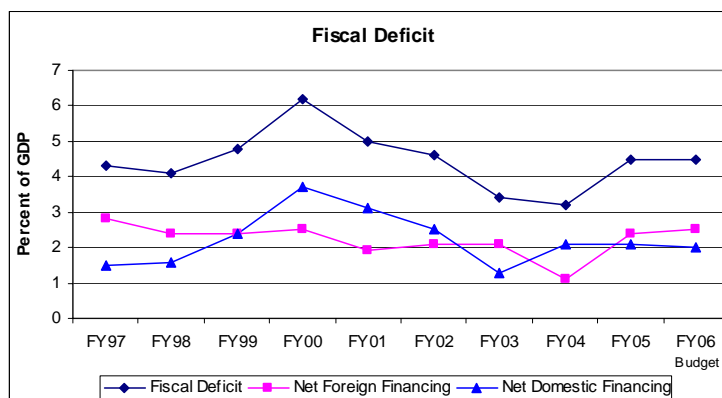
31. Priority has been attached to the agriculture sector with 7.3% of total allocation going to the sector. A reduction in the rate of interest on agricultural loans for producing pulses, spices, mustard seeds and maize and a continuation of the subsidy on electricity bills used for irrigation will provide relief to farmers. Continuation of cash subsidy for export of agricultural products, fruits and vegetables will encourage agro-based industries and promote expansion of commercial farming. Local government and rural development have received 9.9% of total budget for agriculture in view of its important role in improving rural roads and infrastructure to facilitate growth of farm and non-farm activities.

Social Security and Social Protection

32. Higher allocations have been made for targeted employment generation, social safety nets and targeted poverty reduction programs with expansion in the rates and coverage of old-age allowances, enhanced allowances for widowed, deserted and destitute women and coverage of an honorarium for insolvent freedom fighters. Allocations for mitigating risks due to natural disasters, rehabilitation of acid burnt women and for housing of the homeless have been enhanced. Allocations to VGD, VGF, FFW, TR and GR² have also been increased. Monthly allowances for those classified as mentally retarded has been introduced and a seasonal unemployment reduction fund for the marginal poor has been set up. In addition, allocations have been enhanced for the micro-credit programs of government ministries and PKSF (*Palli Karma Sahayak Foundation*).

Fiscal Deficit and its Financing

33. The projected fiscal deficit for FY2006 is 4.5% of GDP, which is at the same level of the actual fiscal deficit in FY2005. Restricting the fiscal deficits within the target level appears feasible in FY2006 if actions are taken to prevent slippages in revenue collection.



34. For financing the deficit of 4.5% of GDP, domestic bank and non-bank borrowing will account for 2% of GDP and foreign loans and grants will account for 2.5% of GDP. Interest payments on domestic and foreign debts will decline from 16.6% of revenue (excluding grants) in FY2005 to 15.4% in FY2006, if the expected revenue increase materializes.

² VGD – vulnerable group development, VGF – vulnerable group feeding, FFW – food for work, TR – test relief, GR – gratuitous relief.

PRIVATE SECTOR DEVELOPMENT³

Introduction

35. In Bangladesh, the private sector is the engine of economic growth. It accounts for 80% of GDP, 90% of total employment, and 70% of investment. The private sector contributed an estimated 88% of the GDP growth and 87% of the investment growth during the period 1991-2003. Private sector development has been supported by numerous factors. In particular, stable macroeconomic environment and favorable government policy towards private sector-led growth from the early 1980s, supported by privatization of key manufacturing industries, gradual liberalization of the trade regime and financial markets, and withdrawal of government involvement in trade and distribution of agricultural inputs (seeds, fertilizers) have induced significant growth in private investment. Additionally, measures to promote competitive and market-determined exchange rates, and more recently, with the floating of the exchange rate have enhanced the competitiveness of the Bangladesh economy.

36. The pattern of private sector development has demonstrated entrepreneurs' response to favorable policy and institutional framework. Export incentives and international market opportunities have encouraged significant participation of the private sector in boosting the country's export earnings. The decision to permit foreign investment in gas and oil exploration induced increasing inflows of FDI. Private sector investments in education, telecommunications, and professional services increased substantially in response to supportive Government policies. Regulatory provision for public-private partnerships in power generation and, albeit on a more limited scale, in the management and operation of airport and road transport facilities, has led to an increase in private provision of infrastructure-related services. Rural infrastructure investments, especially in road, rural power supply, and market infrastructure facilities supported primarily through public investments in the villages and small towns (*paurashavas*) facilitated growth in off-farm rural income and employment generating activities.

37. The Government, in its national poverty reduction strategy (NPRS), recognizes the lead role the private sector must play in increasing investment, productivity and employment. Numerous constraints to private sector development must however be addressed, if the investment, productivity, employment and economic growth challenges are to be met.

Key Issues and Constraints

Conducive Macroeconomic Setting

38. Government has to sustain a stable and competitive macroeconomic environment to foster private sector development. In particular, Government must ensure prudent fiscal policy, improve domestic revenue mobilization, check upward rise in inflation, improve efficiency and deepening of the financial market, further liberalize the trade regime, and ensure that a flexible exchange rate policy is accompanied by the maintenance of gross official foreign exchange reserves adequate to buffer the economy from external shocks. There are also a number of areas in which the pace of structural reform should be accelerated. Divesting of state-owned enterprises (SOEs), which continue to drain the budget and require some 4% of the financial system's outstanding loans, need to be expedited. Similarly, distressed public sector banks

³ Based on ADB's recent Private Sector Assessment of Bangladesh (draft report).

need to be privatized, and, the remaining public sector enterprises/corporations need to be restructured and corporatized.

Governance

39. Weak law and order situation, corruption, and bureaucratic bottlenecks increase transaction costs for the private sector. A recent business competitive environment survey cited corruption, inefficient government bureaucracy, and crime and theft as the top three factors that have adversely affected the business environment in Bangladesh. Other major governance issues that have affected private sector operations include: lack of transparency in the formulation and implementation of policies and regulations, lack of or delay in contract enforcement and dispute resolution, inadequate bankruptcy law, legal impediments to corporate operations, cumbersome and corruption-prone land titling and transfer procedures, and inadequate labor laws. Inefficient administration and corruption subject the private sector to additional costs in meeting various regulatory compliances. This together with delays that enterprises regularly face in securing gas, power, and telephone connections impact negatively on the competitiveness of Bangladeshi firms.

Industrial growth and export performance

40. The growth of the manufacturing sector has been confined to a few industries: garments, jute yarn and twine, pharmaceuticals, tobacco manufacturing, printing and publishing, beverages and cement. Presently, the garments make up 75% of the total export earnings. The MFA phase-out poses some uncertainty for the garments sector, although early indications are that the more efficient and relatively large size manufacturing units are taking advantage of newly created global market opportunities. Diversifying the industrial base, and mitigating risks posed by changing global trade conditions need to be encouraged if industrial development must contribute to higher growth and structural transformation.

Skills

41. Firm level productivity is adversely affected by lack of skilled labor, particularly middle level management, and a lack of access to modern technology. The poor quality of school graduates translates into a work force whose productivity is quite low. Most enterprises do not have sufficient capital for investment in on-the-job training. Nor do they have sufficient resources to invest in technology and product quality improvements. Weak link between the private enterprises and national research institutes impedes technological diffusion. SMEs contribute 40% of manufacturing output and employ about 80% of the industrial work force. SME development is hampered by limited access to medium to long-term credit, market, technology, expertise, and information.

Infrastructure

42. While there has been considerable investment in the construction of the road transport network in the past two decades, further improvements in the network are required, especially to enhance physical access to the neighboring countries, i.e. Bhutan, India, Nepal and Myanmar. In addition, the road network suffers from a lack of proper repair and maintenance. The railway system has severely deteriorated, and it is increasingly underutilized due mainly to poor management and administration and depleted infrastructure and rolling stock. Inland water transport remains largely unregulated and under-utilized. And, while air transport infrastructure

in Dhaka and Chittagong has substantially improved over the past five years, cargo transport service remains a major bottleneck. Chittagong Port, which handles 85% of the country's sea-borne traffic, is faced with serious problems due to poor infrastructure, low labor productivity, poor management, corruption, a multiplicity of trade unions and restrictive labor practices. Low berth productivity, congestion causing lengthy container turnaround time, and lack of modern equipment (e.g. container cranes) substantially increase the unit cost for accessing the port facilities.

43. Inadequate power, both in terms of access to reliable and quality supply, is cited as the single most important infrastructure constraint to private sector development. Private sector participation in gas exploration and electricity generation has considerably augmented energy generation capacity, but power demand continues to exceed supply. Private sector access to telecommunications and ICT infrastructure has improved in recent years, but access continues to be constrained by lack of landline and submarine cable connection. Businesses with land telephone connections suffer from poor quality service (i.e. billing, connection, etc.) from the public sector telecommunication. Availability of mobile phones, provided by the private sector operators and by the government BTTB, has eased communications access, but costs of mobile communications are high compared with the neighboring countries. Lack of high speed Internet access and absence of suitable laws relating to ICT such as electronic commerce, acceptance of electronic documents, digital signatures, consumer protection, intellectual property rights, etc. undermine the use of modern information technology to strengthen the competitive position of Bangladeshi enterprises.

44. The financial sector and the capital market are undeveloped, distressed, and badly governed. The banking sector's capacity to finance large-scale projects is extremely limited, and the private commercial banks have limited activities in the rural areas. The four nationalized commercial banks continue to suffer from inefficient operations, capital inadequacy and distressed balance sheets due to the large overhang of non-performing loans. Banking reforms have helped to improve efficiency of the financial sector, but restructuring of the distressed government banks has moved at a slow pace. The capital market is still at an emerging stage, the ratio of the stock market capitalization to GDP is a mere 6%, considerably lower than in other developing Asian countries. The market for corporate debt is largely non-existent, although a start has been made in this direction in the first quarter of 2005.

Government's Strategy for Private Sector Development

45. The Government is committed to improving the enabling environment for private sector development. The NPRS confirms that poverty reduction and accelerating the pace of social development are the country's most important long-term strategic goals, and that the private sector must play a leading role in these processes. The NPRS emphasizes that progress towards these goals would require: (i) an open and competitive environment that is conducive to private investment, with a particular emphasis on exports and rural development where 85 percent of Bangladeshi's poor live; (ii) raising poor people's capability to participate more fully in the growth process through access to better quality education, health, safe water and nutrition; and, most importantly (iii) Government must address the issue of governance by improving government administrative and management capacity, promoting local governance, tackling corruption, enhancing access to justice for the poor, and improving security and public order.

46. To stimulate private-sector led growth that would benefit the poor, the NPRS accords priority to: (a) accelerated growth in rural areas and development of agriculture and non-farm

economic activities; (b) development of small and medium manufacturing enterprises; (c) rural electrification, roads, water supply and sanitation, and supportive infrastructure including measures to reduce natural and human induced shocks; (d) information and communication technologies; and (e) maintaining competitive macroeconomic management. Particular emphasis is accorded in the NPRS to upgrading basic skills, improving the quality of education, and enhancing access and quality of economic infrastructure.

ADB's Strategy for Private Sector Development

47. The draft report on ADB's private sector assessment (PSA) for Bangladesh suggested several strategic priorities for the development of the private sector in Bangladesh. Better infrastructure, public policies, regulatory regimes, and improved governance will be needed for higher level of private investment growth and expansion of private sector activities. The private sector development can be supported by easing key infrastructure bottlenecks to growth (in energy, power, roads, bridges, rail and ports, water supply), by strengthening the basic education, skills and health services and delivery structures, by fostering public-private partnerships for increasing the volume and quality of investments in essential infrastructure and economic services, by nurturing a vibrant SME sector, by promoting agribusiness, by improving private financial governance, by facilitating the restructuring and privatization of selected state owned enterprises, and by assisting the Government in its continued effort to improve the policy and regulatory environment for private sector development. Draft PSA also suggested that ADB's public and private sector operations can work in synergy to: improve the enabling environment for foreign direct investment, widen opportunities for public-private partnerships to attract private investment in energy, power, transport, social-sector and financial sector operations, and introduce new and innovative approaches to financing private investment in Bangladesh. ADB's private sector operations can be leveraged to introduce innovative models and approaches to private investment, including equity, and loan assistance, and the introduction of new instruments and contractual arrangements for managing private sector investment risk.

About the Asian Development Bank

The Asian Development Bank (ADB)'s work is aimed at improving the welfare of the people of the Asia and Pacific region, particularly for the 1.2 billion who live on less than \$2 a day. Despite the success stories, Asia and the Pacific remains home to two thirds of the world's poor.

ADB is a multilateral development finance institution owned by 63 members, 45 from the region and 18 from other parts of the globe. ADB's vision is a region free of poverty. Its mission is to help its developing member countries reduce poverty and improve their quality of life.

ADB's main instruments in providing help to its developing member countries are policy dialogues, loans, technical assistance, grants, guarantees, and equity investments. ADB's annual lending volume is typically about \$6 billion, with technical assistance provided usually totaling about \$180 million a year.

ADB's headquarters is in Manila. It has 26 offices around the world. The organization has more than 2,000 employees from over 50 countries.