INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

I. Bangladesh

The International Monetary Fund (IMF) restricts preparation of assessment letters to only where there has been a change in a country's circumstances, if the request for an assessment letter is made within six months of an IMF board meeting on that country. A formal request for an IMF assessment letter was made by ADB on 22 May 2012 in connection to the proposed Second Capital Market Development Program (CMDP2). In response, the IMF replied in June 2012 that it would not issue a separate assessment letter in this instance and referred ADB to their published staff report including a staff appraisal and press release associated with the recently approved Extended Credit Facility. The IMF held a Board meeting on Bangladesh in April 2012 to approve the $987 million Extended Credit Facility. Since the six month period only expired at the end of October and given that the SASEC Trade Facilitation Program is being processed and proposed alongside CMDP2, the mission used the same published staff report to help assess the country's macroeconomic conditions.

INTERNATIONAL MONETARY FUND ASSESSMENT LETTER

INTERNATIONAL MONETARY FUND

BANGLADESH

REQUEST FOR A THREE-YEAR ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY

March 28, 2012

KEY ISSUES

Background: Macroeconomic pressures have intensified since late 2010 due mainly to a negative terms-of-trade shock, rising oil imports, and accommodative policies. More recently, global headwinds and increasing oil prices have accentuated these pressures. As a result, the balance of payments went into a deficit in FY11 (July 2010–June 2011) and reserves declined significantly. The 2011 Article IV consultation staff report noted that without policy adjustments and additional external support, further anticipated reserve losses would heighten vulnerability to external shocks and increase risk of a payments crisis.

Program objectives: The government of the People's Republic of Bangladesh has requested a three-year Extended Credit Facility (ECF) arrangement with access of 120 percent of quota (SDR 639.96 million) in support of their reform program. It aims to restore macroeconomic stability, strengthen the external position, and engender higher, more inclusive growth—Bangladesh's key development objective. During the program period, the authorities are committed to taking actions to create more fiscal space, reinvigorate the financial sector, and catalyze additional resources to boost social- and development-related spending, tackle power shortages and the infrastructure deficit, and stimulate export-oriented investment and job growth.

Main components: Under the ECF-supported program, the main components are upfront macro-tightening measures buttressed by greater exchange and interest rate flexibility, sound debt management, and complementary reforms to tax policy and administration, public financial management, and the financial sector. Longer-term measures are also expected to focus on liberalizing the trade and investment regime.

Risks: A further rise in world oil prices could jeopardize the program's fiscal and reserve targets, necessitating additional policy adjustments and external support. Delays in legislative actions, weaknesses in implementation capacity, and opposition to a rationalization of energy subsidies without better-targeted support could undermine program objectives. These concerns will be addressed through extensive policy consultations and sizable technical assistance, as well as safety net reform.

Approved By
Masahiko Takeda and Thomas Dorsey

A staff team comprising Messrs. Cowen (head), Almekinders, and Toh and Ms. Kvintradze (Resident Representative) (all APD); Ms. Kaendera (FAD); and Mr. Leichter (SPR) visited Dhaka during November 30–December 13, 2011 and February 7–15, 2012. Mr. Maino (MCM) participated in the first mission. Mr. Eapen (OED) also joined the December discussions. Mses. Hussiada and Loucks (APD) assisted in the preparation of this report.

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PROGRAM MODALITIES

22. Program reviews. Semi-annual program reviews will be conducted (Table 7) based around quantitative targets and structural benchmarks. Test dates for the first and second program reviews will be end-June 2012 and end-December 2012, respectively.

23. Access and use. Under the current outlook and on the strength of envisaged reforms, the proposed access of SDR 639.96 million (120 percent of quota) has been determined by staff's assessment of the BOP financing need and guided by the norm of ECF arrangements for countries with outstanding concessional IMF credit of less than 100 percent of quota. Seven equal disbursements to BB are envisaged, beginning with program approval.

24. Gross external financing requirement. During the program period, the gross financing requirement is around US$19 billion, of which US$1 billion will be covered by the requested access to IMF resources and another US$0.6 billion from other exceptional financing (Table 8). Most of the rest of the external financing requirement will be met by multilateral and bilateral agencies (US$11.4 billion), led by the World Bank Group, AsDB, and Japan International Cooperation Agency, mainly as project-based lending; FDI (US$4.7 billion); and nonconcessional short-term oil credits (US$0.8 billion).

25. Capacity to repay. Bangladesh is expected to be able to meet its obligations to the IMF under the proposed ECF arrangement. With the proposed access, outstanding IMF resources would peak in Bangladesh's FY15 at SDR 670 million, equivalent to 1.7 percent of exports and remittances (Table 9). Debt service to the IMF (including previous obligations) would peak at SDR 131 million in FY13, equivalent to 0.4 percent of exports and remittances.

26. Poverty Reduction Strategy. Bangladesh's SFYP, entitled *Accelerating Growth and Reducing Poverty*, was released in July 2011. It provides a framework for implementing the government's poverty reduction strategy during FY11–15, as Bangladesh pushes to meet it Millennium Development Goals (Table 10). The government has also published its longer-term Outline Perspective Plan (2010–21), laying out its development vision, which will be implemented under the sixth and seventh five-year plans.

27. Technical assistance. Implementation of the ECF-supported program will be backstopped by considerable TA and capacity building from the IMF, World Bank Group, AsDB, and other DPs. Currently, the IMF envisages providing TA in a range of program-critical areas, notably follow-up tax reforms and VAT implementation; cash management, fiscal reporting, and subsidy reform; bank supervision and central bank accounting; and statistical methods. The World Bank Group is expected to continue focusing on revenue administration and tax reforms; PFM, SSN reforms, and vulnerability monitoring; central bank strengthening and financial sector reform; and statistical policy. The AsDB is also supporting revenue administration and involved in building a PPP operational framework and capital market development.

28. Statistical policy. The authorities are committed to strengthening macroeconomic statistics, in order to better inform policy decisions and monitor outcomes, guided by a national strategy for statistics under

preparation with World Bank support and a new Statistics Act expected to be approved in 2012 (MEFP, ¶30). While data are adequate for program monitoring purposes, work is under way to address deficiencies in national income accounts and the BOP in the context of ongoing IMF TA.

STAFF APPRAISAL

29. Bangladesh faces major challenges in restoring macroeconomic stability, strengthening its external position, and engendering higher, more inclusive growth. These efforts come at a time of increased global headwinds and firming oil prices, making all the more urgent the need for decisive policy adjustments and structural reforms. The government's near-term objectives focus on bringing down inflation, rebuilding a reserve buffer, and solidifying the foundation for sustained growth. To these ends, credible, well-coordinated actions are needed to build upon stabilization measures already in train. While policy buffers are limited, contingencies are in place to mitigate external risk factors, consistent with achieving program targets. Medium-term objectives center on creating more fiscal space and catalyzing additional resources to boost social and development spending and reduce the infrastructure deficit. They also aim at reinvigorating the financial sector and further liberalizing the trade and investment regime to stimulate business creation and job growth.

30. In support, the three-year ECF arrangement embodies a comprehensive set of policy adjustments and reforms aimed at meeting these challenges. Its core priorities in the first year focus on macro-tightening measures, supported by greater exchange and interest rate flexibility, sound debt management, and reforms in tax policy and administration, PFM, and the financial sector, and, over the medium term, improvements to the trade and investment climate. Upfront actions have been taken to begin addressing external, fiscal, and inflation pressures. Program conditionality is focused on macro-critical areas to better ensure lasting adjustment. In support, a number of critical TA and capacity building requirements have been identified, to be met by the IMF and other DPs.

31. A credible path of moderate fiscal consolidation is expected to anchor stability and generate resources to support growth. Further gains in tax revenue and curbs on subsidies will be necessary to create additional fiscal space for development spending, restrain domestic borrowing, and meet program fiscal targets. On tax reforms, the draft VAT law presents an opportunity to usher in a modern tax regime built around transparency and efficiency. Similar decisive steps will be needed on a direct tax law. All are expected to be supported by comprehensive administrative reforms.

32. Recent fuel and electricity price adjustments have helped mitigate fiscal pressures, but the current situation warrants sustained vigilance. In view of the rapid expansion in demand and sustained rise in costs, further price changes and subsidy reforms will be necessary to ensure fuel, electricity, and fertilizer subsidies do not undermine fiscal sustainability, heighten dependence on costly suppliers' credit, or exacerbate broader stability concerns. These efforts are also expected to free up resources

II. Bhutan

Bhutan—Assessment Letter for the World Bank
September 11, 2012

Bhutan's growth has remained robust, but the current account deficit has widened.

- Bhutan's economy has expanded at a robust pace driven by the hydropower sector developments. GDP growth is estimated at nearly 8 percent in 2011/12 (from 8.5 percent in 2010/11), and is projected to reach 12.5 percent in 2012/13 due to the acceleration in hydropower-related construction. Inflation has risen, reaching 13.5 percent in 2012Q2, with both food and nonfood components accelerating. Bhutan's medium-term outlook is favorable, as growth should remain strong at around 8–9 percent over the medium term, driven by developments in the hydropower sector, manufacturing, and domestic services.

- The current account deficit has widened to an estimated 23 percent of GDP in 2011/12 driven in part by strong imports related to the hydropower sector, but the overall balance of payments deficit was 5 percent of GDP due to sizable grants and loan disbursements. Strong growth in domestic demand has fueled the demand for Indian rupees (since about 80 percent of Bhutan's imports are from India), contributing to a rupee shortage. Convertible currency reserves, however, are broadly adequate (US$723 million in July 2012).

- Challenges in the banking sector caused by high credit growth have come to the fore. While credit growth has remained high at 26.2 percent year-on-year in June, it has moderated since March—contracting in sequential terms in June—as a result of tight liquidity and policy measures (see below). Loan concentration, particularly in real estate/construction and personal loans, is significant. Interest rates, albeit low, have started to increase. Financial stability indicators are generally adequate, but concerns about a prospective deterioration in asset quality have intensified as nonperforming loans (net) have risen to 5.9 percent from 3.1 percent of total loans a year earlier.

Current policy settings are broadly appropriate, and overheating pressures are being addressed.

- Monetary conditions need *to continue* to be recalibrated to ensure that *prospective* credit growth remains in check and liquidity conditions are appropriate. The Royal Monetary Authority of Bhutan has taken appropriate steps to address high credit growth and improve its ability to manage liquidity, particularly with the introduction of the policy rate and base rate as well as liquidity adjustment facility, though the policy rate has been set at a low level. Financial sector supervision should be strengthened and prudential tools should continue to be used proactively. Greater financial intermediation in recent years may have increased systemic vulnerabilities stemming from rapid credit growth.

- Fiscal policy has generally been prudent, but the widening of the fiscal deficit in 2011/12 has contributed to overheating. The budget deficit, estimated to have reached 4.3 percent of GDP, has led to greater demand for imports, putting pressure on the demand for Indian rupees and exacerbated the rupee shortfall. Strong commitment to the 2012/13 budget deficit target of 1.6 percent of GDP is welcome, as current expenditure declines as a share of GDP on the back of spending restraint and tax revenue is expected to improve slightly. While public debt is sustainable over the long term, the risk of debt distress stems from the possibility of shortfalls in aid-based foreign financing. Public debt has increased significantly since 2009/10 as a result of investments in the hydropower sector and is projected to exceed 93 percent of GDP in 2014/15, putting Bhutan at high risk of debt distress. However, risks are mitigated by the concentration of debt in commercially viable hydropower projects, which account for nearly two-thirds of external debt.

- The rupee shortage reflects a structural imbalance in Bhutan's economy, but overheating has also contributed. The spending on hydropower projects in the pipeline and volatile exports to India (due to the strong seasonality in electricity generation) continue to contribute to volatility in net rupee inflows. While the hydropower projects are financed by rupee loans and grants, ancillary private sector development (particularly construction) and aid inflows have fueled imports. However, loose aggregate demand policies (high credit growth and a widening of the fiscal deficit) have also contributed to the balance of payment pressures. Measures to curb credit growth are expected to alleviate the rupee shortage and fiscal restraint will also help.

The 2011 Article IV consultation was concluded on May 27, 2011. A staff visit took place in July 30–August 7, 2012 and the next Article IV consultation mission is planned for March 2013.

III. Nepal

Nepal—Assessment Letter for the Asian Development Bank

April 12, 2012

Real GDP growth is expected to rise to 4¼ percent in FY2011-12, though the balance of risks is tilted to the downside. Activity is being supported by robust agriculture production and timely budget adoption. However, growth is projected to fall back to 3¾ percent in FY2012-13 owing to banking-sector balance-sheet weaknesses constraining credit growth, negative wealth effects following the bursting of the real estate bubble, and longstanding structural impediments. Inflation has declined, largely reflecting easing inflation in India, and is expected to average 7¾ percent in FY 2011-12. Strong remittances helped push international reserves to US$3¾ billion (6½ months of imports) at mid-January 2012. Banking sector weaknesses pose a key downside risk to macroeconomic stability, though a resolution of political uncertainty presents near-term upside potential. Addressing structural bottlenecks, including infrastructure and hydropower development, is needed to set growth on a higher long-run sustained path.

Financial sector fragilities remain elevated, and should be addressed promptly. Liquidity has increased in the financial system as a whole, but strains remain at numerous smaller institutions. More broadly, asset quality continues to deteriorate as a consequence of the freezing of the real estate market. Meanwhile, legislative weaknesses inhibit the Nepal Rastra Bank (NRB) from taking prompt intervening action in capital deficient banks. Given the heightened risks, the authorities are encouraged to strengthen further banking supervision with the assistance of the IMF resident advisor, apply the Prompt Corrective Action framework and phase out regulatory forbearance, reform the legislative framework for bank resolution to empower the NRB with appropriate intervening authority, and restructure the insolvent state-owned banks consistent with international best practice.

A prudent fiscal policy is essential to safeguarding debt sustainability and macroeconomic stability. Revenue administration and expenditure control efforts have been strengthened in recent months. However, revenue growth remains below the budget target, and additional spending pressures are emerging. The Nepal Oil Company (NOC) is making substantial losses. Staff projects net domestic financing of the budget will likely exceed the budget target to reach 3 percent of GDP in FY2011-12, a level which, if it persists, would be inconsistent with debt sustainability. To put fiscal performance on a sustainable basis, revenue administration should be further strengthened in terms of compliance management, auditing, arrears collection and fraud prosecution, and the authorities should withstand unwarranted pressure to expand current expenditure, in particular transfers. NOC losses should be contained by introducing an automatic fuel price adjustment mechanism. Enhanced public finance management, including further extension of the Treasury Single Account and strengthened cash management, is critical to improve budget execution.

Monetary conditions are very accommodative, and vigilance to developments that justify a firmer policy stance is required. Should reserves decline, exchange rate pressures emerge, or credit growth or inflation accelerate markedly, monetary conditions would need to be tightened.

The 2011 Article IV consultation was discussed by the Executive Board in October 2011.