THE WORLD BANK

CONFIDENTIAL

LOAN COMMITTEE

LC/M/86/08

March 21, 1986

Minutes of Loan Committee Meeting to Consider the Initiating Memorandum for the Proposed Industrial Sector Credit for Bangladesh Held on March 4, 1986 in Room E-1208

A. Present

Loan Committee	Others	
Messrs. Stern	Messrs. Aksoy	El Serafy
Husain	Cheetham	Gould
Dherse	Chernick	Hamid
Ms. Krueger	Clements	Kopp
Messrs. Goldberg	Clift	Temple
Lerdau	Dubey	Ms. Gurgen (IMF)
Wood		

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COMMITTEE
- Senior Vice President, Operations (Chairman)
- Senior Vice President, Finance
- Vice President & General Counsel
- Vice President, Operations Policy
- Regional Vice President concerned*
- Vice President, Energy & Industry (for lending in these sectors and SALs)
- Vice President, Economics and Research (for non-project lending)

OTHERS
Standard (see OMS 9.25 page 7)

*Copy to all other Regional Vice Presidents

B. Issues

1. The meeting was called to consider: (a) a memorandum from Mr. Hopper to Mr. Stern dated February 14, 1985 setting out a revised lending strategy for Bangladesh; and (b) an Initiating Memorandum for the proposed Industrial Sector Credit submitted to the Loan Committee under Mr. Cheetham's memorandum of February 25, 1985. As a basis for its agenda the Loan Committee had before it Mr. Dubey's memorandum to the Loan Committee, dated February 28, 1986.

C. Discussion

Revised Lending Strategy

2. The Region recalled that the series of 13 Imports Program Credits (IPCs) since Bangladesh's independence had been important vehicles not only for transferring much needed fast-disbursing program type assistance to Bangladesh, but also for conducting the country dialogue on a variety of critical policy issues. The Region had recently reviewed the range of policy issues likely to constitute the main focus of the country dialogue during the next five years and had concluded that there were a number of policy and institutional issues in the industrial, energy and education sectors which might most suitably be addressed through the vehicle of sector credits. However, the Region foresaw other macro-economic and cross-sectoral policy issues, e.g. resource mobilization, public investment programming, possibly financial sector issues, and public administration policies, for which IPCs seemed a more suitable instrument. The Region thus proposed a revised lending strategy comprising a mix of sector credits and IPC operations for the purposes of conducting the policy dialogue as well as transferring fast disbursing resources.

3. The Loan Committee considered that the series of sector credits proposed by the Region constituted an acceptable approach to addressing the sectoral policy issues identified in the Region's memorandum. However, the Committee questioned whether there was justification for continuing IPCs. The Government should, as a matter of sound economic management, be taking steps to formulate a sound public investment program and to introduce measures to increase domestic resource mobilization; action to improve macro-economic management did not, therefore, constitute a convincing case for IDA financial support through IPCs. The Region noted that the revised lending strategy was based on a gradual phase-out of IPCs; this would be less disruptive to the program than an immediate termination of IPCs. The Committee recognized the need for an instrument through which to address cross-sectoral issues and that it might prove difficult to transfer a sufficient level of program type assistance to meet Bangladesh's reasonable needs, if reliance was placed solely on sector credits. One possibility might be to consider Structural Adjustment Lending (SAL) in substitution for IPCs. For this, the country needed a medium-term development strategy which would hold out the prospect of a significant reduction in deficit in the external current account over

the next few years so that Bangladesh could over time reduce its reliance on program assistance; this strategy would also need to include a satisfactory public investment program but identify policies which could lead to increased domestic resource mobilization in both the public and private sectors.

4. The Committee (a) requested the Region to prepare over the next year a medium-term development strategy along the lines indicated in paragraph 3 above; this strategy should be discussed with the Government as a basis for implementing an adjustment program; (b) endorsed the Region's proposed approach to sector credits, although requested the Region to plan alternative lending instruments to IPCs (e.g. SALs) in support of macro-policy reform and as a means of transferring fast disbursing resources to Bangladesh; (c) endorsed the Region's proposals for up to 40% of IDA lending commitments to be in the form of fast disbursing non-project operations, provided the Government in due course put in place a medium-term adjustment program designed to gradually reduce the external current account deficit; and (d) endorsed the Region's proposal that the proceeds of sector credits could be utilized for general imports.

Resource Mobilizaton

5. Loan Committee members felt that the present level of domestic savings (around 5% of GDP) was unsatisfactory and that the country needed to demonstrate improved performance over the medium term. The Region pointed out that there were obvious limits to increased mobilization in a country with a largely subsistence economy. The primary sources of potential revenue were from taxing domestic consumption or production incomes or certain assets e.g. land, and improved cost recovery. The Region had initiated sector work in FY86 and preliminary findings indicated that raising revenue from the land tax was constrained primarily because of poor land registration data, difficulties in differentiating between land of widely varying value and the weakness of the Ministry of Local Government collection administration. However, there might be a scope for increasing tax revenue from agricultural incomes. Further study would also be made of the potential for increasing revenue from excise duties, presently accounting for about 20-25% of budgetary revenues. Also, while there had been some improvement in cost recovery and reductions in subsidies in recent years, more could be achieved in the direction of economic pricing of goods and services. On private resource mobilization, the Region pointed out that interest rates were positive in real terms and that the real problem was in loan recovery.

Industrial Sector Credit

6. The Loan Committee generally endorsed the policy recommendations outlined in the Initiating Memorandum and summarized in Annex I thereof, subject to the conclusions summarized below. The Committee underlined the need to accomplish irreversible changes in the policy environment, particularly in the area of de-regulation, to ensure that policy changes will be maintained in the longer run.

Investment Sanctioning

7. Several members of the Loan Committee questioned the need for continuing the Investment Schedule and having a "discouraged" list of industries. The Region pointed out that in view of very weak financial institutions, the "discouraged" list would serve a useful purpose in supplying information to the financial institutions; however, it would not be binding on them. The Region pointed out that a rapid dismantling of investment regulations without significant reform in other areas might lead to investments that have high financial but low economic returns. The Loan Committee agreed that broadly parallel action is desirable, and that mutually reinforcing reforms should be undertaken in related areas; however, it would be desirable to try to reach an understanding with Government on a program to eventually phase out the Investment Schedule. The Loan Committee also emphasized the need to agree on a precise definition of a "free sector" and suggested that the Region try to reach agreements with GOB on a time-phased program to increase the number of free sectors.

Private Sector Response to Liberalization

8. It was suggested that, in view of the very limited response by private investors to the Export Processing Zone (EPZ), there were risks that the proposed policy reforms might not achieve their objectives. The Region accepted the existence of such a risk; however, it pointed out that there were a number of problems, e.g. lack of autonomy, poor administration, associated with the EPZ which should not be regarded as indicative of the potential for promoting exports; a better example would be the remarkable expansion of the garment manufacturing industry, which provided the model for a number of the policy reforms proposed in the Initiating Memorandum.

Tariff and Import Regime

9. Some members of the Loan Committee considered that the dual exchange rate system should be unified and asked the IMF representative whether a timetable had been agreed under the recent Stand-By Arrangement (December 1985-June 1987) for the unification of these markets. The Fund representative said a timetable had not been agreed but the GOB was moving towards unification by increasing the proportion of imports under the secondary market. The Loan Committee endorsed this policy and considered that understandings should be sought by the appraisal mission with GOB that an increasing share of total imports should be financed through the secondary market; to assist this process the proceeds of the credit should be used to finance imports through the secondary market.

10. On the issue of import restrictions it was suggested that in view of the revenue constraints facing the Government, first priority might be given to replacing QRs with tariffs; a program for the tariff reductions could be developed in a second phase. The Region pointed out that the move to a nega-

tive list was very recent and that the list itself was being revised by the Government in light of appeals by the importers. The Loan Committee concluded that priority should be given to phasing out the restricted list, which contains industry and firm specific import restrictions, and the associated regulatory administration. The Committee recognized that revenue considerations might limit the pace at which tariff reductions could be made and accepted that reforms needed to be undertaken in parallel with alternative resource mobilization efforts; initially, emphasis should be placed on revenue neutral rationalization of the tariff system.

Public Sector Industrial Enterprises

11. The Committee noted the extensive denationalization that had taken place in Bangladesh and enquired about potential for further denationalization under the proposed credit. The Region replied that extensive and very rapid denationalization had caused problems in the financial sector, particularly with regard to settlement of financial liabilities and a period of consolidation was desirable. The Committee concurred but considered that it would be desirable to have a general policy statement by Government, perhaps set out in the Development Policy Letter, regarding its future intentions with regard to denationalization of public sector assets.

Financial Sector

12. In view of the severity of the problems of the public sector financial intermediaries described in the Initiating Memorandum, some members of the Loan Committee asked what measures were being taken to improve these institutions structurally, while others suggested that it might be preferable to abandon the public sector institutions in favor of the privately owned banks. The Region explained that an Action Program aimed at strengthening the development finance institutions had been agreed between IDA, KfW, ADB and GOB and its implementation was now underway; the private banks were still relatively new and very small; they also suffered from a variety of problems of their own. Improvement in the performance of both public and private sector institutions is dependent on broader systemic reform with respect to such matters as the autonomy of the bank system, the quality of Central Bank supervision and the legal recourse of lenders to collect from borrowers. A study of the financial system was planned for FY87 and based on this work it was hoped to formulate a program of further financial reform to be supported through future lending operations. The Region also pointed out that, although no proceeds of the proposed industrial sector credit would be channelled through financial intermediaries, the further processing of the industrial credit as well as future agricultural and industrial credit projects would be contingent on significant improvements in the financial sector, including recovery rates. The Loan Committee endorsed the Region's proposals in the Initiating Memorandum making the processing of the Industrial Sector Credit conditional upon improvements in the recovery performance by the public sector financial institutions.

Appraisal

13. The Loan Committee agreed that the appraisal mission should proceed to Dhaka on the basis of the Initiating Memorandum taking into account observations made in the Loan Committee meeting.

Cleared with: Members of the Loan Committee
Messrs. Cheetham, Dubey, El Serafy, Gould

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