Contents

Overview of Economic and Financial Developments

During the third quarter of FY05, economic activity picked up sharply following a relatively fast recovery from the floods. Even though crop production fell somewhat due mainly to floods, available data indicate that growth in economic activity was broad based covering non-crop agriculture, industry and service sectors, which was assisted by strong growth of foreign trade and credit to private sector.

Inflationary pressure increased during the quarter due to increase in food prices and increase in the cost of imported goods induced mainly by depreciation of Taka and rise in the prices of some commodities in the world market. The 12-month point to point inflation increased from 5.5 percent in December 2004 to 6.7 percent in March 2005 reflecting increase in: food price from 6.7 percent to 8.2 percent and non-food prices from 3.7 percent to 4.3 percent.

Money and foreign exchange market experienced substantial pressure during the third quarter of FY05 with marked depreciation of exchange rate and high level of overnight call money rates. Overall monetary policy stance remained cautiously accommodative during January and February 2005 but was tightened somewhat in March 2005 to contain inflationary pressure and stabilize the foreign exchange market. On a yearly basis, broad money registered a growth of 15.4 percent propelled mainly by 19.5 percent growth in private sector credit. **After a long period of relative exchange rate stability, foreign exchange market experienced some pressure since early January leading to a sharp depreciation of exchange rate during January and February 2005 reflecting mainly much higher growth in import payments than the growth of export receipts and workers' remittance receipts in the preceding months.** The Taka-Dollar exchange rate in the interbank market depreciated by about 5.5 percent in three months. Following sizeable net sale of foreign exchange by the central bank, some monetary tightening and some improvement in the net flows of foreign exchange, the exchange rate stabilized somewhat since mid-March 2005.

Both revenue and expenditure increased during the quarter in nominal terms and in ratios of GDP, but fell substantially below the budget target due to continuing weakness in tax administration, complexities of the procurement process and capacity problem in the line ministries. However, the resulting fiscal policy stance remained prudent with the overall deficit and domestic borrowing falling substantially below the budget target.

Rapid growth in import demand in the face of slowdown in export growth led to widening of external current deficit putting some pressure on the balance of payments and external reserve position. In spite of the BOP pressure and some net sale of foreign exchange noted above, Bangladesh Bank maintained foreign reserves of US$3 billion equivalent to 2.5 months of import cover.

During the quarter the quality of banks' asset improved with decline in both gross and net NPL of banks. During January-March 2005 period, while gross NPL position of all banks declined marginally from 17.6 percent at end December 2004 to 17.5 percent at end March 2005, net NPL ratios declined substantially from 9.8 percent to 8.6 percent due mainly to provisioning and write-off. Towards the end of the quarter, capital market also experienced some pressure with modest decline in both the market capitalization and turnover. Share of banks, however, continued to maintain its values.

I. Developments in the Real Economy

During the third quarter of FY05, economic activity appeared to have picked up sharply following a relatively fast recovery from the floods. Data on area under boro production, quantum index of manufacturing industries, trends in credit flows, cargo handled by Chittagong Port, export and import trade suggest that the pick-up in economic activity was broad based covering all sectors of the economy. Level of economic activity increased in comparison with both the previous quarter and the same quarter of the previous year. Even though no quarterly GDP data are available, provisional projection of GDP for FY05 made recently by BBS (Table I.1) show that while value added in agriculture is projected to rise by only 0.3 percent, value added in industry and service sectors are projected to rise by 8.6 percent and 6.6 percent respectively. Given the fact that industrial and service sector activity was somewhat depressed during the first quarter of FY05 (July-September), economic activity in industrial and service sectors have increased sharply during second and third quarter of FY05.

While crop production fell during the first half of FY05, production of boro and other minor crops have increased in the second half of FY05. The updated estimates indicate that Aus and Aman harvest made during the first half of FY05 fell to 16.14 Lac MT and 106.85 Lac MT respectively, which are about 21 percent and 16 percent lower than the initial target respectively and 12 percent and 7 percent lower than the last year's production. (Table I.2 and Chart I.2). In the backdrop of a lower than expected Aman harvest, the acreage under boro crop went up significantly from about 39.44 lac hectare in FY04 to about 42.93 lac hectare aided by favorable weather, timely distribution of seed, fertilizer

Chart I.1 Growth of Real GDP

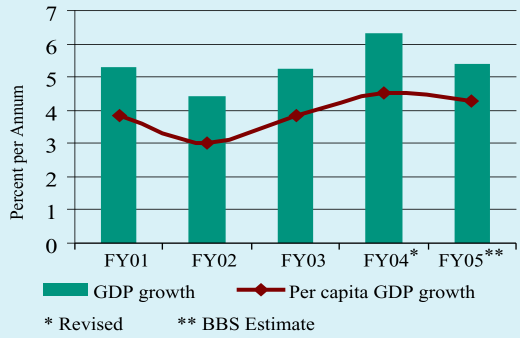
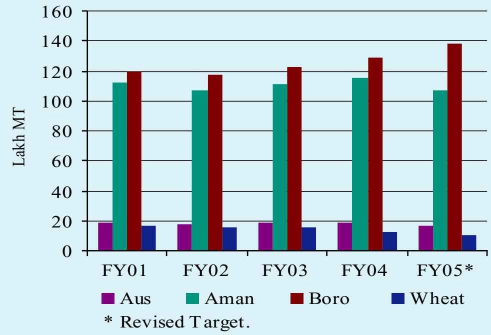


Chart I.2 Production of Major Crops



and agricultural inputs combined with availability of higher volume of agricultural credit. As a consequence the prospect of the Boro crop (constituting about 50 percent of the total cereal production), appears very bright-resulting in bumper harvest. According to the latest estimate by the DAE, the Boro production is expected to rise to 138.1 Lac MT, exceeding the target of 137.5 Lac MT and substantially higher than the 128.4 Lac MT recorded last year.

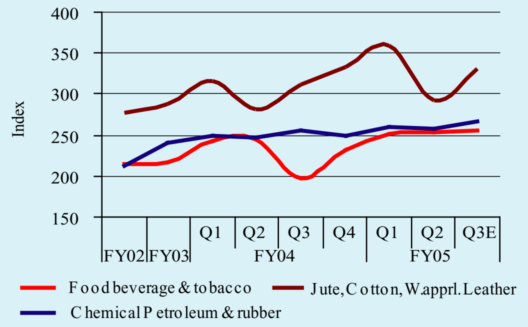
Preliminary estimate indicate that production of minor crops, such as maize, potato, sugarcane and onion registered substantial growth during the quarter. In particular, the acreage under maize and potatoes increased significantly over the level observed in FY04 reflecting farmers' efforts to move into some high value items. BBS projection show that the level of activities in livestock and poultry sub-sector is expected to rise by 7.8 percent in FY05 which point to robust activities during the third quarter propelled by growing urban demand. Activities in the forestry and fisheries sub-sectors, on the other hand projected to grow by 4.3 percent and 4 percent respectively during FY05 based mainly on sizeable growth during the quarter under review.

Following a high volume of disbursement in the second quarter, agricultural credit disbursement slowed down in the third quarter of FY05 due partly to end of Boro plantation (Table I.7). However, the disbursement was about 23 percent higher than the disbursement recorded during the same period last year.

After a significant decline in the second quarter reflecting seasonality in demand and production, quantum index of the manufacturing industries (covering mainly medium and large scale industries) registered a sizeable growth during the third quarter of FY05 reflecting buoyant growth in Jute, Cotton, RMG and leather sector. Preliminary estimate indicates that the quantum index of manufacturing industries increased by 7.6 percent due mainly to sizeable growth in RMG and leather sub-sectors reflecting strong growth in export demand (Table I.3 and Chart I.3). Most other lines of activities show lower than average estimate of growth rate noted above. The estimate of quarterly growth is consistent with BBS projection of 8.4 percent growth in manufacturing sector for the entire year (FY05).

Although no quarterly data on construction activity are available, indirect indicators like cement production and level of imports of construction materials (clinker, iron, steel and

Chart I.3 Quantum Index of Manufacturing Industries



base metal) and related capital goods (Table V.3) seem to suggest robust growth in the construction sub-sector during the quarter in line with 8.7 annual growth projection made by the BBS.

Quarterly data on the volume of cargo handled by Chittagong Port presented in Table I.4 indicate14 percent growth in overall volume with import cargo growing by about 15 percent and export cargo by about 6 percent. These data are in line with import value data shown in Table V.1. In addition to link with overall economic activity, there is a close correlation between the volume of cargo handled (imports and exports) and trade & transport activities, two major service sectors within the country.

Indirect evidence indicates that services sector activities recorded sizeable growth in the third quarter, which is in line with the 6.6 percent growth projection for FY05 made by the BBS. As noted above, data on volume and value of foreign trade clearly show that the major sectors like transport; communication and trade registered strong growth in activity level. According to the BBS projection, the wholesale & retail trade and transport, communication & storage sub-sectors are projected to grow by 6.9 and 7.3 percent respectively during FY05. Similarly, publicly provided services (rehabilitation of roads and infrastructure, education and health) continued to show sizeable growth as public expenditure under the ADP increased significantly in the third quarter (Table IV.1). Table I.1 also show strong annual growth of public administration (11.2 percent), education (8.4 percent) and health (6.9 percent) sub-sectors based on sizeable growth during the third quarter.

II. Price Developments

After a notable decrease in the second quarter, 12-month point-to-point CPI inflation showed an upward trend during the third quarter of FY05 resulting mainly from increase in food prices and to a lesser extent in non-food prices due in part to rise in the cost of imports induced by depreciation of Taka (Table II.1 and Chart II.1). Overall 12-month point-to-point CPI inflation increased from 5.5 percent in December 2004 to 6.7 percent in March 2005 propelled mainly by increase in food prices[1]. Following a decrease in 12-month point to point food price-inflation from 9.5 percent in September 2004 to 6.7 percent in December 2004, the index increased to 8.2 percent in March 2005 reflecting mainly rise in the cost of imported food due to substantial depreciation of Taka against all major currencies and poor harvest of aman crop. At the same time 12-month point-to-point non-food prices also increased from 3.7 percent of December 2004 to 4.3 percent in March 2005 reflecting mainly upward adjustment of fuel prices affecting prices in the transport and communication sector and notable rise in prices of clothing & footwear as well as medical care & health expenses. In part the rise in non-food prices also reflect increase in the cost of imported goods due to

[1] As expected 12-month average inflation increased at a much slower rate from 6.1 percent in December 2004 to about 6.2 percent in March 2005.

Chart II.1 12-Month CPI Inflation

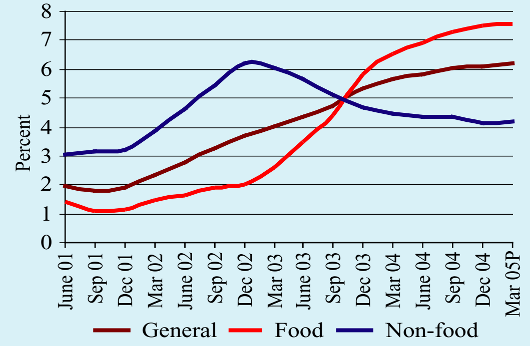


Chart II.2 Commodity Prices in the International Market

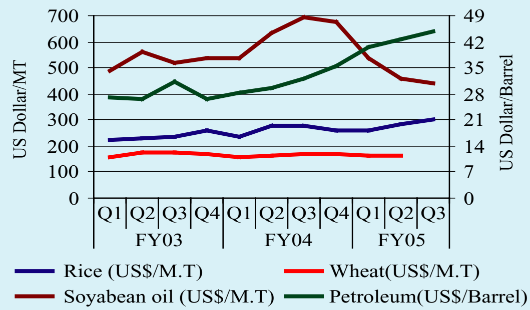
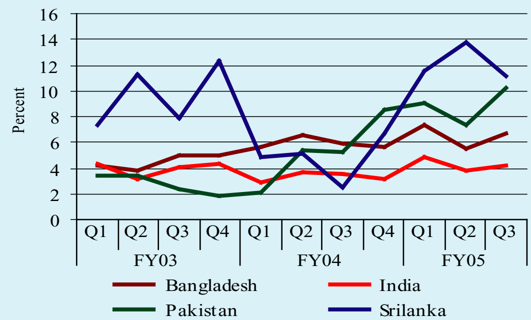


Chart II.3 Inflation in South Asia
(12-month average)



depreciation of Taka and demand pressure fuelled by rise in private sector credit, including consumer credit.

During the period under review, the price developments of international market has been mixed. While prices of a number of food and non-food commodities, notably rice, sugar and petroleum products increased, prices of other products like soybean and wheat declined during the quarter (Table II.2 and Chart II.2). Looking at the regional developments, after a trend toward moderation during October-December 2004, inflationary situation in South Asian countries seems to have showed a rising trend during the January-March 2005 reflecting rise in commodity prices in the international market combined with demand pressure in the domestic market (Table II.3 and Chart II.3).

III. Monetary, Credit and Exchange Rate Developments

Money and foreign exchange market experienced substantial pressure during the third quarter of FY05 with marked depreciation of exchange rate in January and February 2005 and high level of overnight call money interest rates (Tables III.1-III.2 and Charts III.1-III.2)[2]. Nominal interest rate for long tenor, however, has been slow to change. Overall monetary policy stance remained cautiously accommodative but was tightened somewhat in March 2005. Reserve money increased by 5.3 percent during the quarter and by 11.2 percent on a year on year basis. However, the money multiplier declined in end-March due to rise in reserve deposit ratio induced by increase in cash reserve ratio by Bangladesh Bank from 4 percent to 4.5 percent, effective March 1 2005. As a consequence, broad money growth slowed down to only 0.4 percent during the quarter, substantially lower than the growth of 5.4 percent in the preceding quarter reflecting a mainly unchanged level of Net Foreign Assets and slow growth of NDA resulting in part from sizeable decline in the public sector credit along with slightly lower growth rate in

Chart III.1 Components of Reserve Money (RM)

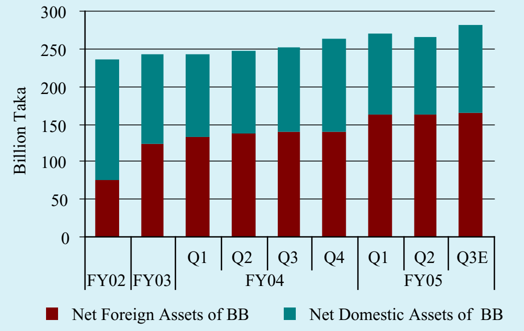


Chart III.2 Components of Broad Money (M2)

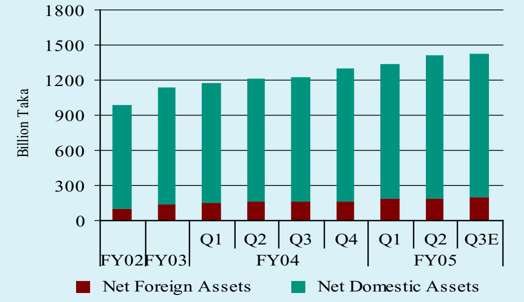
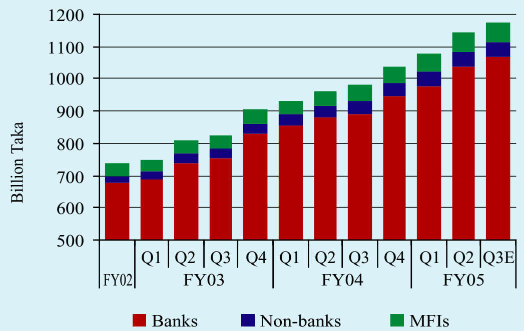


Chart III.3 Trends in Private Sector Credit



the private sector credit. On a yearly basis, however, broad money registered a growth of 15.4 percent propelled largely by high rates of private sector credit growth.

On a year-on-year basis outstanding private sector credit from banks, non-bank financial

[2] Annex I provides a detailed and systematic account of the nature and causes of recent volatility in the money and foreign exchange market.

institutions and micro-finance institutions grew by phenomenal 19.5 percent (Table I.5). The continued very high growth rate in private sector credit is attributable to increase in aggregate demand and decline in real interest rate resulting from moderate downward trend in nominal lending rates in the face of upward trend in inflation. After an increase in the second quarter, credit to the public sector declined by 3.4 percent in the third quarter of FY05 due to much lower than budgeted government expenditure (Table III.2).

Data on bank advances by economic purpose show a significant share of the advances to private sector going to industrial term-loan, working capital financing, trade, transport and communication registering quarterly growth of 3.5 percent, 11.4 percent, 3.9 percent, 7.5 percent respectively (Table I.6). While private sector credit growth remained high propelled in part by decline in real interest rate, short-term funds in the money market experienced sustained pressure and tightness (as evidenced by decline in excess liquidity of the banking system) leading to rise in call money rates, repo and reverse repo rates[3]. Monthly average call money rates increased from 5.9 percent in December 2004 to 13.9 percent in March 2005 with substantial intra-day and inter-day variation in rates. Weighted average repo rates also increased from about 4 percent in November-December 2004 to 8-10 percent in during the quarter under review. With a view to easing excessive pressure in the market the central bank also on occasion injected liquidity through repo operations (Table-III.3).

To contain the inflationary pressure emanating from high credit and money growth as well as pressure on exchange rate,

[3] With a view to facilitating day-to-day liquidity management within a short period of time repo and reverse repo auctions were introduced in FY03. While repo injects money in the system, the reverse repo withdraws money from the system.

Chart III.4 Yields on T-Bills

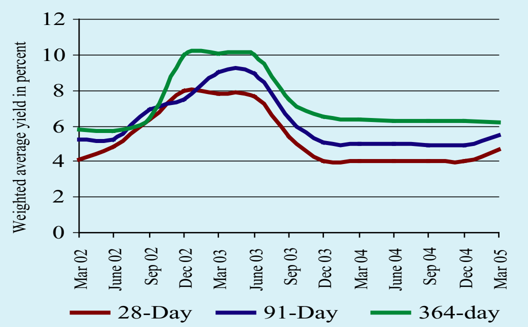


Chart III.5 Weighted Average Yields of Accepted Gov't Treasury Bills & Bonds (24 April 2005)

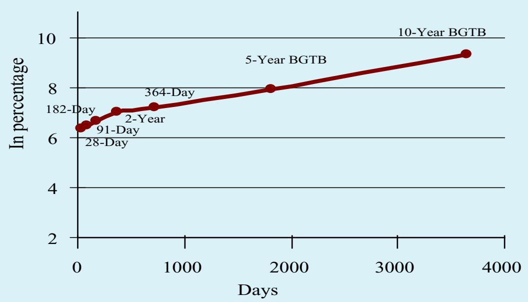
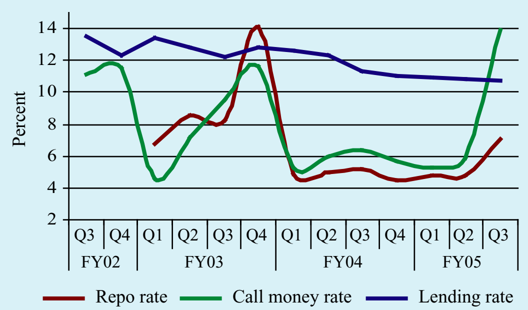


Chart III.6 Movements in Interest Rate

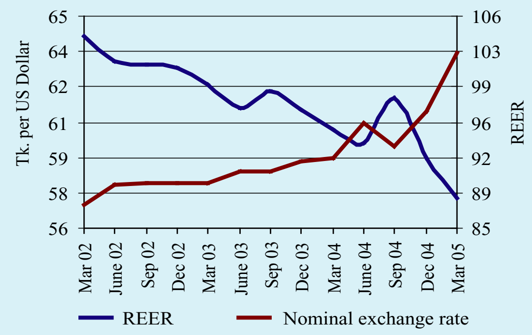


Bangladesh Bank raised the cash reserve requirement for banks from 4 percent to 4.5 percent effective March 1, 2005. At the same time, since early March rates on 28-day and 91-day treasury bill rates were raised by about 1 percentage point (100 basis point) to

5 percent and 6 percent respectively. Yields on 1 year, 2 year treasury bills and 5-year, 10 year treasury bonds remained unchanged as auctions for treasury bonds are held on bi-monthly basis (Table III.3 and Charts III.4 and III.5). Total outstanding stock of government treasury bills fell substantially during the quarter from about Tk. 182.2 billion in end-December 2004 to about Tk. 163.5 billion in end-March 2005 reflecting some repayment to the banking system due to much lower than budgeted government spending[4] (Table III.4).

After a long period of relative exchange rate stability foreign exchange market experienced severe pressure since early January 2005 leading to a sharp depreciation of exchange rate during January and February 2005 reflecting mainly much higher growth in import payments than the growth of export receipts and workers' remittance receipts in the preceding months. The Taka-Dollar exchange rate in the interbank market depreciated from about Tk. 60.5 per USD in December 2004 to about Tk. 61.6 per USD in January 2005, Tk 63.2 per USD in February 2005 and further to Tk. 63.5 in March 2005, representing depreciation of about 5.5 percent in three months. Detailed month-to-month variation in exchange rate and the volume of transactions discussed in Annex I indicate that there has been substantial volatility in both the rates and volume of transaction. To reduce the pressure in the foreign exchange market, the BB sold about US$ 148 million in February 2005. As a consequence of that and partly due to improvement in foreign exchange inflows (induced by exchange rate depreciation) and monetary tightening, exchange rate stabilized somewhat since mid-March 2005. The real effective exchange rate

Chart III.7 Taka-Dollar Exchange Rate and REER Index



(REER) index also experienced significant depreciation during the quarter due mainly to depreciation in the nominal rate (Chart III.7).

As noted above, the pressure in the exchange market occurred due to rapid growth in import demand vis a vis slower growth of exports leading to substantial deficit in the external current account since second quarter of FY05. The growth was slower because of a sharp decline in frozen food exports and also some decline in the growth of woven RMG exports in the post MFA quota free market. Rise in the demand for imports, on the other hand, reflect sharp rise in the import bill of a number of products: petroleum products, induced by price increase; foodgrains, to meet the shortfall in production; capital machinery and raw-materials, due to new investment in a number of sectors, including notably in textiles as part of structural adjustment within the sector in a changing global market environment.

IV. Fiscal Developments

Both revenue and expenditure increased during the quarter in nominal terms and in ratios of GDP, but fell substantially below the budget target due to continuing weakness in tax administration, complexities of the procurement process and capacity problem in the line ministries. During the

[4] Borrowing from non-bank sources, however, was positive during the quarter.

quarter, revenue collections improved measured in real terms and as a ratio of GDP due to increased tax effort on the part of NBR (Table IV.1 and Chart IV.1). In particular the collection of custom duties, income tax, other taxes and more prominently non-tax revenue registered notable improvement. However, overall tax collection continued to remain substantially below the quarterly target.

While overall government expenditure remained far below the pro-rated quarterly target the level was notably higher than that of the second quarter of FY05. Preliminary estimate shows that public expenditure was Tk. 112 billion (3.0 percent of GDP) in the third quarter, slightly lower than Tk.103 billion (about 2.8 percent of GDP) recorded in the previous quarter due to lower level of non-ADP expenditure. ADP expenditure, on the other hand, increased from about Tk.29 billion in the second quarter to about Tk.35 billion due in part to ongoing expenditure related to post-flood rehabilitation programme.

The resulting fiscal policy stance remained prudent with the overall fiscal deficit and domestic borrowing falling substantially below the budget target. Preliminary estimate also indicate that the overall fiscal deficit was 0.5 percent of GDP in the third quarter of FY05, lower than that of the previous quarter and compared with the deficit of 4.3 percent targeted for the entire year. The budget deficit was financed by foreign assistance and by the non-bank institutions. There was no bank finance during the period but rather some repayment to the banking system. (Table IV.1).

V. External Sector Developments

During the third quarter pressure on the external BOP position intensified as evidenced by widening deficit in external trade and current account balance emanating from rapid growth in import

Chart IV.1 Trends in Government Revenue and Expenditure

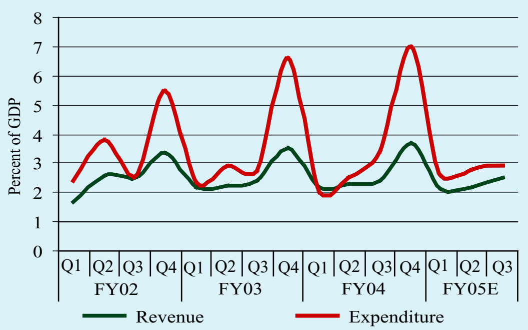
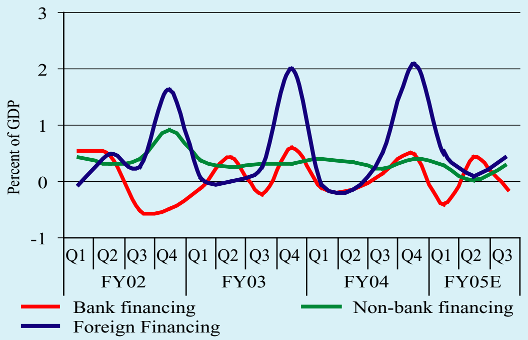


Chart IV.2 Financing of Budget Deficit



demand in the face of slow growth in exports (Table V.1 and Charts V.1 and V.2). The exports earnings registered a growth of about 6 percent in the third quarter as compared with a decline of about 20 percent in the second quarter, which mainly reflected seasonality, and slowdown in RMG exports. Imports, on the other hand continued to grow rapidly, by over 9 percent in the third quarter following nearly 7 percent growth in the second quarter. On a cumulative basis during the first three quarters (or 9 months) of FY05, exports grew by only 12.8 percent compared with phenomenal 26.4 percent growth in imports leading to a sizeable external current account deficit noted earlier in section II.

Notwithstanding recovery in the exports of woven garments and knitwear, some major categories of exports, experienced slowdown in the growth or decline during the third quarter of FY05 reflecting both demand and supply side problems. The export of some major items likes jute goods, tea, leather, and most notably frozen shrimp & fish, fertilizer registered a decline during the quarter under review (Table V.2). From a broader perspective when one looks at the cumulative performance of exports during the first three quarter (July-March FY05) relative to last year's performance and relative to the target in FY05 the picture appears more encouraging (Table V.6). A number of major exports products notably knitwear, home textiles, chemical products and footwear recorded growth over last year's performance and also over target reflecting mainly buoyant export demand abroad. At the same time the products, which recorded growth over last year's performance but did not achieve the target include major products like woven garments (due to intensified competition), leather and engineering products (due mainly to supply side problems). Most disappointing is the performance of major products like frozen food (which continue to suffer from low productivity and problems of compliance with health standards and sanitation), other manufactured goods and jute goods (facing declining demand abroad), which recorded decline over last year's performance and also over target. However, a notable positive feature is the continued high growth of non-traditional exports namely electronics, chemical products, agricultural products and engineering products leading to increased diversification of export base, reducing heavy dependence on the RMG exports.

Table-V.5 presents destination-wise trends in RMG exports indicating a stronger recovery of RMG exports in the US market compared with the European market, a

Chart V.1 Trends in Current Account and Overall Balances

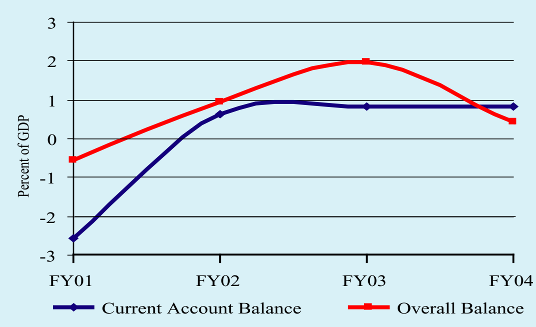


Chart V.2 Trends in Exports & Imports

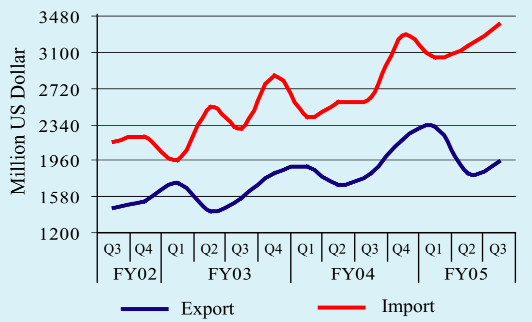
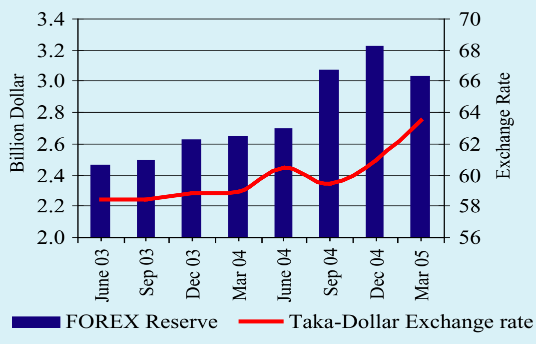


Chart V.3 Forex Reserve & Exchange Rate



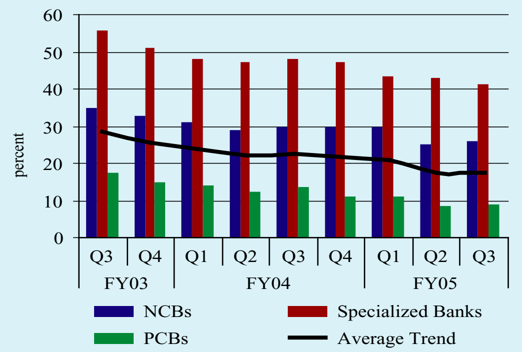
reversal of trend observed in previous quarters. After a decline in the previous quarter, exports of woven and knitwear products increased in both the markets with relatively stronger growth to the US market than that of European market. In the

European market a number of products enter duty free or face much lower levels of import duty than the US market.

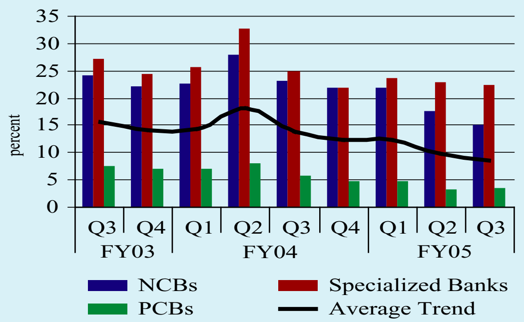
Rapid growth in merchandise imports, measured by settlement of L/Cs continued in the third quarter propelled mainly by growth in capital machinery, intermediate goods and raw materials. In particular, during the first three quarter (July-March FY05) imports of capital machinery increased by about 55 percent, iron, steel and base metal by 35 percent, textiles fabric by 22 percent, yarn by about 21 percent, chemical products by 21 percent, crude oil by 22 percent and petroleum products by about 82 percent. This growth in import demand is related mainly to new investment in RMG and other sectors (notably pharmaceutical, cement and telecom) reflecting structural adjustment in the RMG and textiles sector, growing investors' confidence and in anticipation of expiration of some existing tax holidays in end-June 2005. In addition, increase in the international commodity prices and shortfall in food production requiring higher than normal level of food grains import also partly explain the steep growth in import payments (Table V.3).

Despite healthy growth in the workers' remittances, the deficit in external current account widened due to widening trade and services account balance in the third quarter. The capital and financial account, on the other hand, recorded a moderate surplus during the quarter resulting mainly from sizeable disbursement of foreign assistance, mainly project aid. The overall external balance of payments recorded a modest deficit of US$64 million compared with the deficit of US$30 million in the previous quarter. Due mainly to net sale of foreign exchange by Bangladesh Bank to ease the market pressure, the official foreign exchange reserves declined marginally and was

VI.1 Ratio of Gross NPLs to Total Loans



VI.2 Ratio of Net NPLs to Total Loans



estimated at about US$3,034 million, or about 2.5 months of import cover.

VI. Health of the Banking System

While no new data on capital position and profitability ratios for banks are available, latest data on NPL ratios for banks show that improvement NPL positions of banks continued during the quarter under review (Tables VI.1-VI.3 and Chart VI.1). Overall weighted average gross NPL ratios of all banks declined from 17.63 percent in Q2 of FY05 (Q4 of 2004) to 17.53 percent in Q3 of FY05 (Q1 of 2005) while net NPL (after provision) declined from 9.79 percent to 8.64 percent.

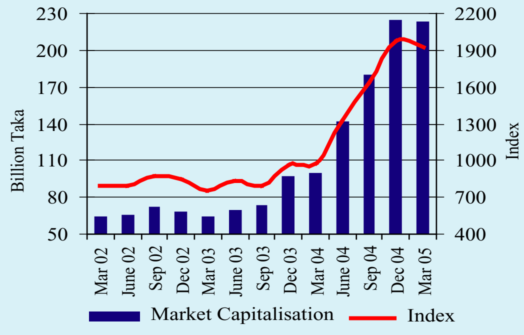
While gross NPL ratios for Nabs increased marginally, their net NPL position declined from 17.56 percent in Q2 of FY05 to 15.10

percent in Q3 of FY05 due mainly to provisioning and write off and improvement in their operations resulting from enhanced supervision and control by Bangladesh Bank and the reform initiative undertaken by the government. For the PCBs, the gross and net NPL ratios increased slightly (insignificant amount) but remained low. Their gross NPL ratio was below 9 percent and net NPL ratio remained below 4 percent, a remarkable achievement if one looks at the historical legacy of high NPL ratios confronting the banking industry. For the specialized banks, which are beset with very high NPL ratios, the improvement was marginal reflecting lack of reform initiative. Foreign commercial banks continued to have very low NPL ratio and were fully provided for.

VII. Capital Market Developments

During the third quarter of FY05, there was a lull in the trend towards growth in market capitalization and all share price index reflecting some specific events as well overall developments in financial market. Market capitalization declined slightly from Tk.224.9 billion in Q2 to Tk. 223.8 billion in Q3 while turnover also declined from Tk.23 billion to Tk.20.3 billion. Adverse development in the profitability of some listed companies and a rise in bank deposit rates and liquidity crunch in the money market led some institutional and private investors to panic sell in the market. However, investor's confidence in the share of banks were largely unaffected by these events and the market capitalization of banks increased from Tk.104.8 billion in Q2 to Tk. 108.2 billion. Similar positive trend was also observed for shares pharmaceuticals/ chemical companies.

Chart VII.1 Trends in Market Capitalisation & DSE Index



VIII. Near-Term Economic Outlook

Despite adverse impact of floods affecting economic activity in the first quarter of FY05 and the recent volatility in the foreign exchange and money markets, the near-term economic outlook in FY05 remain favorable mainly because of strong recovery and growth in industrial and service sectors in the second and third quarter of FY05. BBS estimates show that despite modest 0.3 percent growth in agriculture reflecting sizeable decline (3.3 percent) in crop sub-sector, overall GDP growth is projected to grow by 5.4 percent during FY05 on the strength of 8.6 percent growth in industry and 6.6 percent growth in services sectors (Table I.1). This positive outlook is underpinned by continuous supportive macroeconomic policies, recent surge in domestic private investment, improvement in the climate for foreign investment and ongoing structural reforms. However, as before, a number of downside risks remain in FY05, which include: threat of accelerating inflation and continuing pressure on the balance of payments resulting from continuing growth in import payments (partly due to high level of oil and commodity prices) and adverse impact of the phase-out of textiles quota. The situation is under close watch by the macroeconomic policy making authorities, who, as in the case of past, stand ready to take appropriate policy as and when needed.