Contents

		Pages
Overview of Economic and Financial Developments		1
I.	Developments in the Real Economy	2
II.	Price Developments	4
III.	Monetary, Credit and Exchange Rate Developments	5
IV.	Fiscal Developments	7
V.	External Sector Developments	8
VI.	Health of the Banking System	10
VII.	Capital Market Developments	11
VIII.	Near-Term Economic Outlook	12

Charts

I.1	Growth of Real GDP	2
I.2	Production of Major Crops	3
I.3	Quantum Index of Manufacturing Industries	4
II.1	12-Month CPI Inflation	4
II.2	Commodity Prices in International Market	5
II.3	Inflation in South Asia	5
III.1	Components of Reserve Money	5
III.2	Components of Broad Money	6
III.3	Trends in Private Sector Credit	6
III.4	Yields on Treasury Bills	6
III.5	Movements in Interest Rates	7
III.6	Taka-Dollar Exchange Rate and REER	7
IV.1	Trends in Government Revenue and Expenditure	8
IV.2	Financing of Budget Deficit	8
V.1	Trends in Current Account and Overall Balance	9
V.2	Trends in Exports and Imports	9
V.3	Forex Reserve and Exchange Rate	10
VI.1	Ratio of Gross NPLs to Total Loans	11
VII.1	Trends in Market Capitalization and DSE Index	12

Pages

Annexures

Annex I. Macroeconomic Impact of Flood in Bangladesh-Assessment and Recommendations 15

Annex II. Impact of Recent Oil Price Hike on Bangladesh Economy 21

Boxes

Box-1 Interest Rate Spreads in Bangladesh 29

Box-2 Bangladesh Bank Accounts and International Financial Reporting Standards (IFRS) 30

Tables

I.1 GDP Growth by Sectors 33

I.2 Crop-wise Agricultural Production 33

I.3 Quantum Index of Manufacturing Industries 34

I.4 Trends in Private Sector Credit 34

I.5 Bank Credit by Economic Purpose 34

I.6 Micro-Credit Operations of the Grameen Bank and Large NGOs 35

I.7 Outstanding Term Lending by Banks and NBFIs 35

II.1 Trends in Inflation 36

II.2 Commodity Prices in the International Market 36

II.3 Inflation in South Asian Countries 36

III.1 Movements in Reserve Money 37

III.2 Movements in Broad Money 37

III.3 Interest Rate Developments 38

III.4 Outstanding Stock of Treasury Bills and NSD Certificates 38

IV.1 Government Fiscal Operations 39

V.1 Balance of Payments 40

V.2 Trends in the Commodity Composition of Exports 41

V.3 Trends in the Commodity Composition of Imports 41

V.4 Country-wise Workers' Remittances 42

VI.1 Risk-Weighted Capital-Asset Ratios by Type of Banks 42

VI.2 NPL Ratios by Type of Banks 42

VI.3 Profitability Ratios by Type of Banks 43

VII.1 Indicators of Capital Market Developments 43

VII.2 Group-wise Market Capitalisation of Dhaka Stock Exchange 43

Overview of Economic and Financial Developments

During the first quarter of fiscal year 2004-05 (FY05), the country was affected by a devastating flood, which caused extensive damage to country's infrastructure, rural housing, farming and small scale economic activities. While the loss of current output (estimated at 1.5 percent of GDP) could be recovered in subsequent quarters, the damage to infrastructure and capital stock (estimated at 2.3 percent of GDP) will require a major rehabilitation programme and reallocation of resources for rebuilding, in some cases going beyond the current fiscal year.

Inflationary conditions worsened during the quarter induced by higher than expected food price inflation. After a decline in July and August, the 12-month CPI inflation reached 7.4 percent in September due mainly to a marked acceleration of food price to 9.5 percent while non-food price inflation moderately declined to 4.2 percent as sharp increase in oil prices in world market has not been passed through. The food price increase mainly reflects domestic supply bottlenecks and market rigidities, only partly related to the floods.

Overall monetary policy stance remained accommodative to private sector demand. Monetary growth was notably higher than the corresponding quarter in the previous fiscal year mainly reflecting increased credit and currency demand. Commercial bank deposit and lending rates continued to decline modestly owing partly to prevalence of excess liquidity. Private sector credit growth continued during the quarter reflecting buoyant credit demand and slight decline in lending rates.

After some turbulence in June, foreign exchange market remained largely stable and Taka-U.S. dollar exchange rate displayed little variation over the three-month period despite signs of weakening of U.S. dollar vis-à-vis major currencies. The real effective exchange rate (REER) also remained stable albeit with a slightly depreciating trend.

During the quarter under review, revenue collections and expenditure of the government was notably higher than the corresponding period of the last fiscal year reflecting enhanced efforts for tax collection and accelerate ADP expenditure in the aftermath of the floods. As a result, overall budget deficit was somewhat higher than the first quarter of FY04. Bunching of foreign assistance in this quarter as a spillover from last fiscal year meant that there was no domestic bank financing, but rather a modest repayment, which is expected to be reversed in the next quarter.

Based on the continuing strength of the export sector, the external balance of payments improved further during the first quarter despite high oil prices and pressure on imports in the aftermath of floods. Despite the risk of slowdown related to phasing out textiles quota beginning January 2005, textiles exports, making up about three-fourth of total export earnings registered a double-digit growth during the quarter. The gross official foreign exchange reserves of Bangladesh Bank continued to rise and reached US$3.1 billion or about 2.9 months of import cover in end-September.

In the first half of 2004, with the exceptions of the NCBs banking system soundness indicators i.e., risk - weighted capital ratios, asset quality & profitability continued to show improvement. The restructuring program of the NCBs is now underway in FY05.

The increase in the market capitalization, turnover and the all share index of Dhaka Stock Exchange continued in the first quarter partly on the strength of the strong performance and rising prices of financial institutions, pharmaceuticals and cement industries' stocks.

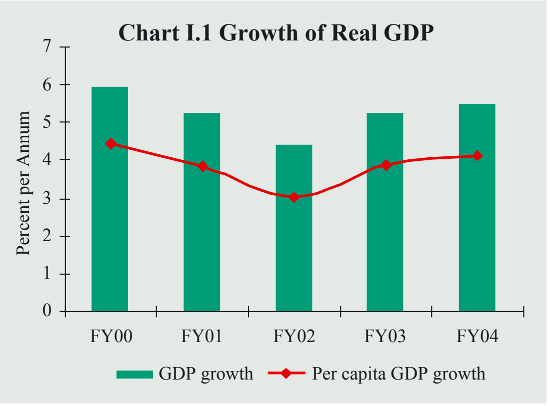
I. Developments in the Real Economy

During the first quarter of FY05 (July-September 2004) economic activity was heavily influenced by onset of floods in late July and early August 2004 that engulfed a large part of the country, including the capital city. While the 2004 flood was widespread and severe, it was less severe and widespread than 1988 and 1998 floods in terms of duration, inundated area, number of people affected and loss of income and assets (see Annex I for the details). The duration of 2004 floods was 21 days and inundated area was 38 percent of land area compared with duration of 72 days and inundated area of 68 percent in 1998 floods.

Impact of Flood- Damage Assessment

Precise estimates of economic loss based on comprehensive survey data are not available for any of the floods. Available estimates, however, indicate that loss of income and assets of 2004 floods (about US$2.2 billion) was comparable to that of the 1998 floods (about US$2 billion). Preliminary estimates of assets and output loss of 2004 floods made by a joint World Bank and ADB team indicate that the loss of current output to be US$860 million or about 1.5 percent of GDP and loss of assets to be about US$1.3 billion or about 2.3 percent of GDP (for detailed estimates of damage and macroeconomic impact of floods see Annex I).

According to the joint WB-ADB flood assessment, of the total asset/capital stock loss estimated at US$1.3 billion, about 35 percent represented the loss in housing stock, followed by 26 percent in transport infrastructure, 13 percent in agriculture (including livestock and fisheries), 5 percent in industry and the rest in power, irrigation, shipping and school and hospital



infrastructure in rural areas. With regard to loss of current output estimated at US$860 million, most of the loss (about 47 percent) occurred in agriculture, followed by 21 percent in wholesale and retail trade (about 22 percent), transport sector (20 percent) and industry (11 percent), located mostly in rural and semi-urban areas.

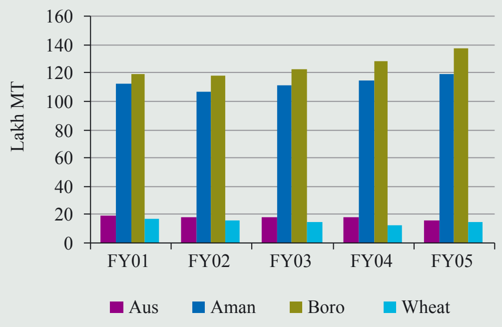
Thus, it appears that agricultural sector suffered most of the losses in current output adversely affecting about 4.9 million farm families. Loss of Aus rice, jute, summer vegetables, fruits and sugarcane (all relatively minor crops) constituted most of loss in crop sub-sector. The losses in fisheries sub-sector was in the form of damage to infrastructure (farms, ponds, hatcheries and nurseries) and loss of fries, fingerlings, fish and shrimp. Significant losses were also incurred by poultry and livestock sub-sectors, covering both subsistence and commercial farms. This included loss due to dead animals and poultry birds, loss in production of milk, eggs and meat; damage to animal/poultry sheds; loss of feed, fodder and pasture.

While loss to industry sector was relatively small, available evidence indicate that worst hit area was greater Dhaka and Narayanganj districts which account for substantial part of small scale textiles sub-sector (handloom, knitwear). Apart from loss in current output, the direct losses include damage to machinery due to rusting, deposit of mud, chemicals and other pollutants; damage to physical infrastructure and inventories; losses for non-fulfillment of contracts; and damage to goods in transit.

As a result of the damage to the transport and communication infrastructure, the transport, wholesale and retail trade services suffered substantial loss in current output (about 40 percent of total), second only to agriculture sector.

While, loss of current output is significant and estimated at about 1.5 percent of GDP, this loss reflects one time loss that can be partly compensated with higher output in future. On the other hand, loss of assets (including capital stock) estimated to be US$1.3 billion or about 2.3 percent of GDP noted above, is more critical as it affects the productive capacity of the economy. The sectors or entities most affected are: Housing, Transport and Water Board Infrastructure, Agriculture and Industry. In the 39 flood affected districts, floods washed away or damaged homes, particularly in riverbanks and heavily flooded areas. A total of about 1 million housing units were fully damaged and about 3.4 million were partially damaged. The transport and in particular road transport infrastructure suffered most damage. About 3,000 km (14 percent of total) of the primary road network managed by the Roads & Highways Department and about 25,000 km (25 percent of total) of the secondary road network, managed by the Local Government Engineering Department (LGED) was affected by floods. Railway network also suffered some damage in some sections while inland waterways and airports

Chart I.2 Production of Major Crops



were only marginally affected. Extent of loss incurred by the power sector was minimal.

To repair the damage and rebuild the infrastructure and physical assets/capital, the government has undertaken a rehabilitation and public investment programme in FY05 as part of the post-flood recovery strategy, financed partly by additional foreign assistance and partly by reorienting resources from the current ADP. Donors have pledged to provide assistance in phase one: immediate recovery period of about 15 months, until the onset of rains, and phase two: mid-term recovery assistance for other works and major mitigation efforts.

Economic Activity-Trend and Outlook

The available estimates/forecasts for crop production in FY05 (Table I.2) indicate that Aus crop production is about 16.14 lakh MT, significantly lower than the original target of 18.5 lakh MT and FY04 production of 18.32 MT. Aman crop, on the other hand will be somewhat lower than the target but still moderately higher than last year's level. There is no revision of target production level of Boro and wheat, which are about 5-6 percent higher than the FY04 levels. Regarding minor crops, the outlook is mixed. Vegetable, potato and sugarcane production are targeted to increase while that of maize, pulses and onion are likely to go up reflecting high profitability and intensive efforts by farmers to diversify production into these high value items.

Despite the flood, quantum index of manufacturing industries (covering mainly medium and large scale industries) showed an increase of nearly 10 percent during the first quarter of FY05 (Table I.3). This seems to indicate that the adverse impact of flood on the large and medium-scale industries was not severe and increased output in this sub-sector may have partly compensated possible flood induced decline in output of the small-scale and rural industries. Relatively high growth of the manufacturing sub-sector largely reflects 11.7 percent growth of the jute, cotton, RMG & leather sub-sector, making up about two-third of the medium & large-scale manufacturing sub-sector. Within this broad group, RMG production led the growth as strong recovery and growth in the export demand continues in the first quarter of the year. Other major manufacturing activities, notably chemical, petroleum and rubber showed much lower rates of growth reflecting slow growth of domestic demand partly related to floods. Although no quarterly data on construction activity are available, indirect indicators like level of imports of construction materials and related capital goods seem to suggest some decline in the sub-sector during the first quarter.

The performance of the services sector appears to be mixed during the first quarter of FY05. While the major sectors like transport, communication and trade adversely affected by flood suffered a decline, foreign trade related and publicly provided services (relief operations,

Chart I.3 Quantum Index of Manufacturing

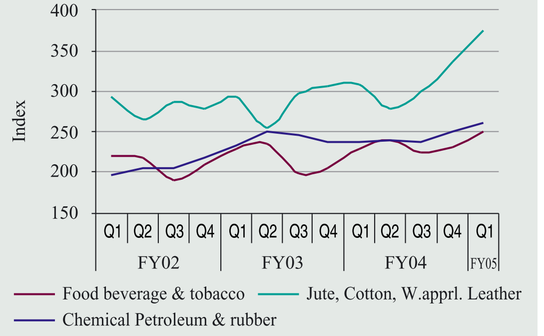
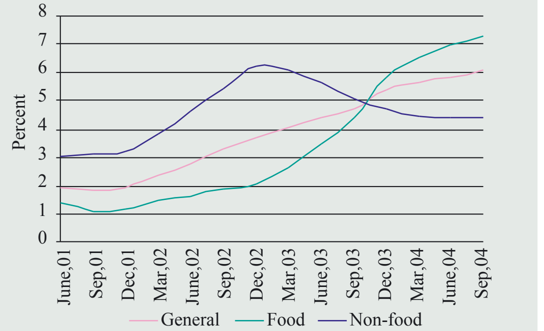


Chart II.1 12-Month CPI Inflation



education, health and public administration) showed some positive growth as foreign trade experienced a moderate growth and government made an effort to accelerate public expenditure in the aftermath of floods. Overall, however, the services sector is likely to have experienced a slightly negative growth during the first quarter as domestic transport and trade, which make up a large share of the sector, was adversely affected by floods.

II. Price Developments

After a moderate decline in July and August, 12-month CPI inflation displayed an upward movement in September 2004 due to sharp rise in food price inflation (Table II.1). Despite a declining trend, 12-month food price inflation remained high-between 6-7 percent during June, July and August and reached about 9.5 percent in September 2004 due partly to shortage associated with supply bottlenecks related to floods and partly due to continued high prices of some major items in the international market. Inflationary expectations in the aftermath of flood and monopoly elements in the distribution and sales of imported commodities also played a role in the price increase. On the other hand, the 12-month change in non-food prices remained moderate in the range of 4.0 - 4.5 percent during the quarter under review. This partly reflects stable prices of fuel-notably petroleum products and gas. Notwithstanding a sharp rise in oil and oil products in international market, domestic prices of petroleum products remained unchanged as government decided to absorb the price shocks through fiscal means-reduced taxes and implicit subsidies to state-owned oil company and refinery. The macroeconomic impact of sharp increase in oil prices is discussed in Annex - II.

In addition to crude oil price, which on average increased by about 12 percent during June-September 2004, prices of a number of food and non-food commodities, notably rice and sugar also increased during the quarter (Table II.2 and Chart II.2). Prices of soybean oil and other products, on the other hand, declined somewhat. As before, all the South-Asian countries, notably India, Pakistan and Sri Lanka experienced the increase in inflation in varying degrees (Table II.3 and Chart II.3).

Chart II.2 Commodity Prices at International Market

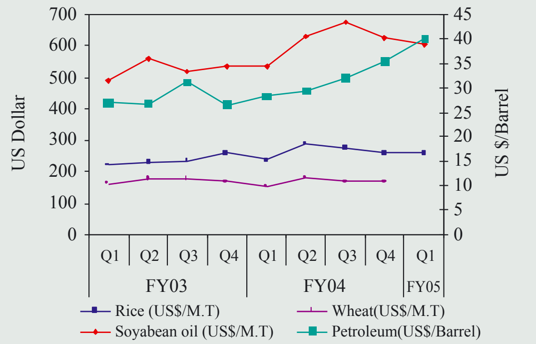


Chart II.3 Inflation in South Asia (12-month average)

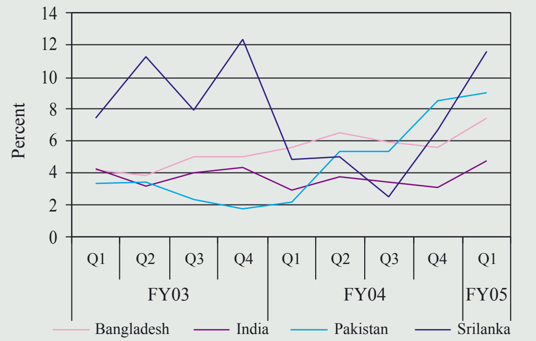
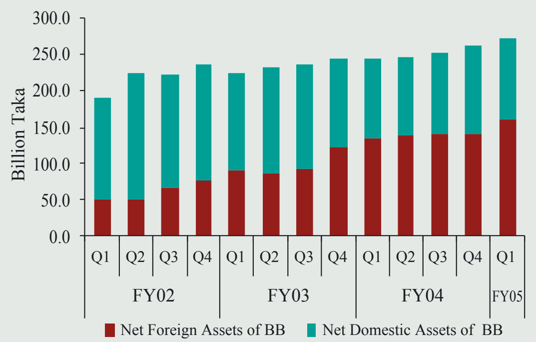


Chart III.1 Components of Reserve Money (RM)



III. Monetary, Credit and Exchange Rate Developments

Despite some tightening in September, monetary policy was accommodative to private sector demand during the first quarter of FY05 and monetary growth was higher than the corresponding period in FY04. Reserve money registered an increase of 3.4 percent during the quarter, somewhat lower than the previous quarter growth of 3.8 percent but notably higher than the zero percent growth recorded in first quarter of FY04, reflecting high growth in currency demand on the liability side and unusually high growth in net foreign assets (NFA) on the asset side (Table III.1). The latter was linked to large disbursement of programme aid mainly from the World Bank that was due in the fourth quarter of FY04 but was not disbursed during the period due to administrative and conditionality related constraints. Broad money increased by 2.9 percent, substantially lower than 6 percent growth recorded in the fourth quarter of FY04 and moderately lower than the 3.1 percent growth experienced in the first quarter of FY04 due mainly to lower growth in public sector credit and sizeable downward movements in other items net which was reflected in the substantially lower growth of net domestic assets (Table III.2). High growth in the NFA of the banking system has been more than offset by the lower growth of net domestic assets.

During the quarter, there was no change in CRR (cash reserve ratio) and SLR (statutory liquidity ratio) set by the Bangladesh Bank. The money multiplier displayed an upward trend during the last 12 months and in end-September 2004 its level was moderately higher than the level recorded in end-September 2003, which partly reflected somewhat lower level of currency deposit ratio in end-September 2004. Towards the end of the September 2004, the monetary authorities actively used repo operations alongside regular auctions of treasury bills to mop up some liquidity to meet the quarterly reserve money target. As a consequence the repo rates showed an increase during the month (Table III.3).

Overall, yields on treasury bills did not display significant change during the three-month period although yields on some tenors

Chart III.2 Components of Broad Money (M2)

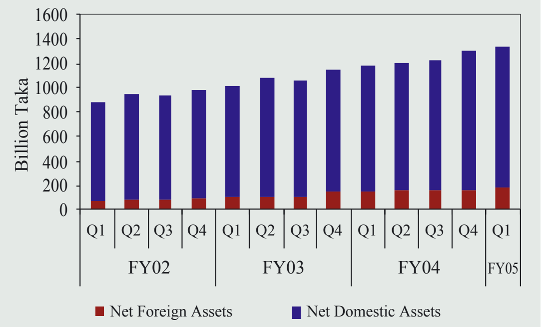


Chart III.3 Trends in Private Sector Credit

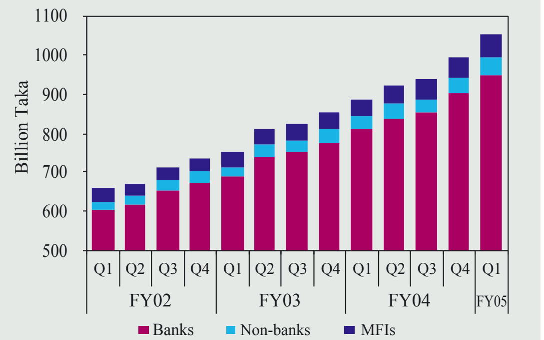
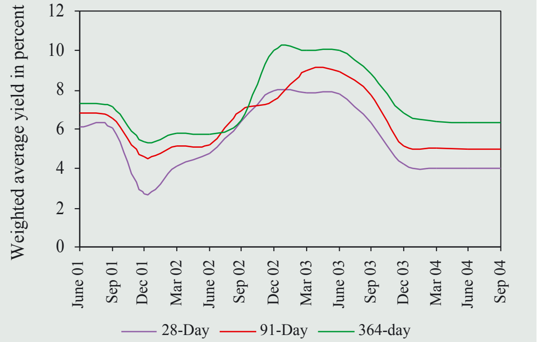


Chart III.4 Yields on Treasury Bills



show slight decrease (Table III.3). After some increase in August, the call money rate declined somewhat in end-September 2004 and the level remained significantly lower than the level recorded at the end of first quarter of FY04. There is some evidence to suggest that both the deposit and lending rates of banks continued to show declining trend, owing partly to the prevalence of excess liquidity and improvement in the health of the banking system. However, spread between deposit and lending rates increased for some banks as deposit rates came down faster than the lending rates. In general, despite a moderately declining trend, bank spread continued to remain high, which reflects weak competition, segmented markets and high cost of operations in a number of banks.

Despite the onset of floods, credit to private sector registered an increase of 8.3 percent in the first quarter of FY05, which partly reflected some flexibility in the lending rates and high credit demand of the agriculture and of the small scale industries (Table I.4). While credit extended by banks estimated to have increased by 8.3 percent, credit extended by micro finance institutions, confined mainly in rural areas, increased by 7.7 percent, even though its share in total is about 5 percent. Likewise, credit extended by NBFIs (making up about 5 percent of total credit) increased by about 13 percent reflecting high demand of the products offered by NBFIs (e.g., lease finance).

After experiencing some volatility in the last quarter of FY04, the nominal Taka-US dollar exchange rate remained stable and showed little variations during the first quarter of FY05. The nominal exchange rate in the inter-bank foreign exchange market varied between Tk. 59.3 - Tk. 60.1 per U.S. dollar during the quarter. The stability was underpinned by strong growth of export earnings and bunching of large volume of foreign assistance resulting from delayed disbursement noted before. Taking advantage of the improved supply of

Chart III.5 Movements in Interest Rate

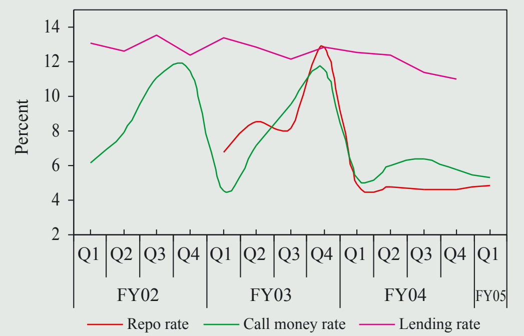
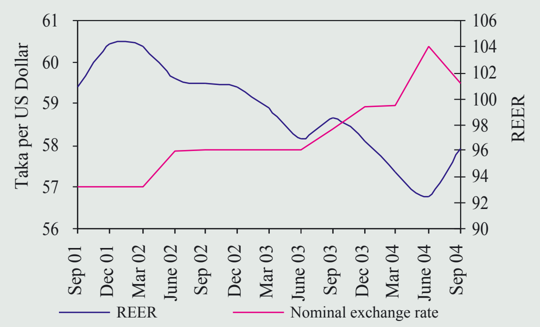


Chart III.6 Taka-Dollar Exchange Rate and REER



foreign exchange, the central bank made some net purchase from the market. During the quarter under review, U.S. dollar showed signs of weakening vis-à-vis all other major currencies (Euro, Yen and Pound Sterling) reflecting persistent deficits in U.S. external current account and federal budget. During the first quarter of FY05 the real effective exchange rate (REER) remained largely stable notwithstanding a moderate trend towards depreciation (Chart III.6).

IV. Fiscal Developments

During the quarter, both revenue collections and expenditure of the government were notably higher than the first quarter of previous fiscal year but remained somewhat below the quarterly target. Provisional data indicate that total tax revenue is estimated at 2.3 percent of GDP, compared with 2.2 percent of GDP collected during the first quarter of FY04 partly reflecting enhanced administrative efforts (Table IV.1 and Chart IV.1). However, it seems that the full impact of the operations of the Large Tax Payers Unit (LTU) Central Intelligence Cell fully could not be realized as it took time to make these units to be fully functional. While VAT and income tax collection registered some improvement, tax collection rates, particularly that of income tax remained substantially below the target due to continuing weakness in the tax administration. Collection of non-tax revenues (fees, duties, etc.) was 0.5 percent of GDP, about the same level as in previous quarters. Overall revenue collection at 2.3 percent of GDP fell short of the pro-rated quarterly target.

Government expenditure measured in ratios of GDP was also somewhat higher than the first quarter of previous fiscal year. Preliminary estimate shows that public expenditure was 2.5 percent of GDP compared with 2 percent of GDP recorded in the first quarter of FY04. The increase occurred mainly in current and other expenditure categories, largely due to increased utilization of the budget for goods and services as well as transfers and relief operations during and after the floods. The ADP expenditure remained low at 0.4 percent of GDP, about the same level as recorded in the first quarter of last fiscal year. However, during the period, government undertook a major review of the ADP budget in coordination with major donors and reallocated a part of the resources to infrastructure and flood rehabilitation programmes.

Reflecting the quarterly movements in

Chart IV.1 Trends in Govt. Revenue and Expenditure

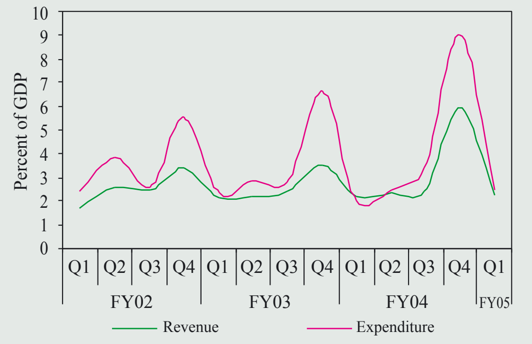
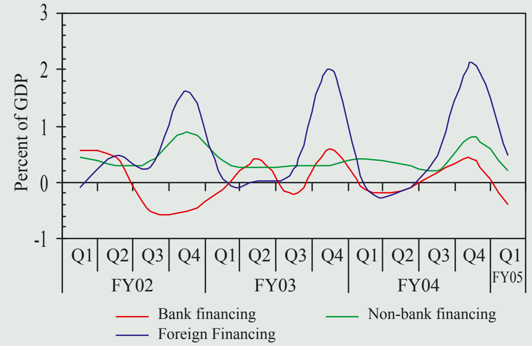


Chart IV.2 Financing of Budget Deficit



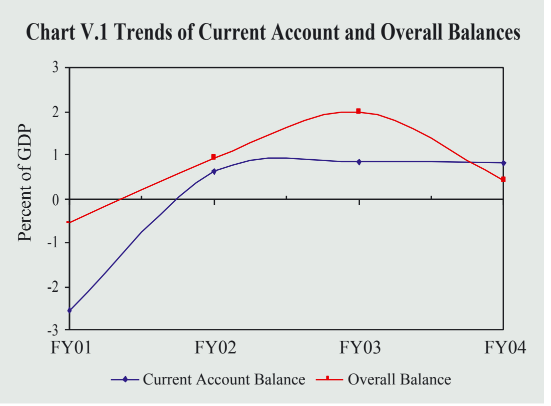
revenue and expenditure and consistent with past trends, first quarter fiscal deficit remained typically low at 0.3 percent of GDP compared with a deficit of 4 percent targeted for the entire year. As net foreign financing was much higher than planned due to some bunching of foreign aid inflows, it appears that there was substantial net repayment to the banking system (about 0.5 percent of GDP) which partly reflected some positive financing from non-bank resources during the quarter under review.

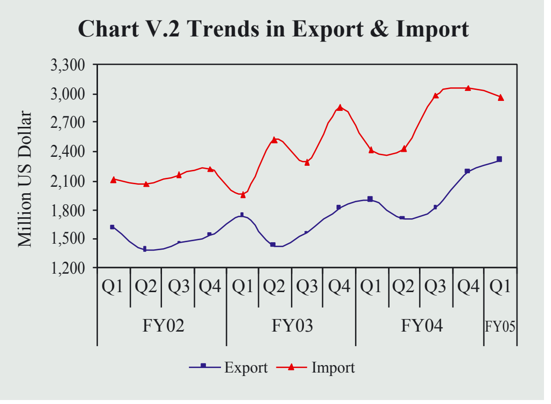
V. External Sector Developments

The improved performance of the external sector continued during the first quarter of FY05 underpinned by strong growth of exports. Despite the risk of slowdown of textiles exports, making up about three-fourth of total exports resulting from phasing out textiles quota beginning January 2005, export earnings during first quarter of FY05 registered a growth of 6.6 percent over previous quarter and about 21 percent over the same quarter last year. As before, the textiles exports led the growth with knitwear exports (nearly 30 percent of total) registering a growth of 17.5 percent and exports of woven garments (about 45 percent of total) recording 9.8 percent growth. However, export earnings from most other traditional and non-traditional exports (jute and jute goods, leather, frozen shrimp and other exports) declined somewhat due partly to supply side bottlenecks some of which may be related to floods (Table V.I and V.II).

The strong performance of the textiles exports is largely attributable to buoyant demand and high growth of exports of both knitwear and woven garments in the European market, where Bangladesh enjoys duty free access. In contrast, most items of textiles exports from Bangladesh face about 15-20 percent of import duties in the US market where Bangladesh experienced slowdown of growth of textiles exports (in particular the woven garments) and some loss of market share to other competitors, some of whom enjoys duty free access to the US market. In the face of competitive pressure, the textiles exporters in Bangladesh are also making efforts to explore new markets, notably Japan and Canada. Based on observed trends in orders received so far from Europe and North America, the near-term outlook for textiles exports appear cautiously optimistic.

After a sharp increase in the second half of FY04, overall level of merchandise imports declined modestly from about US$2.8 billion recorded in the fourth quarter of FY04 to





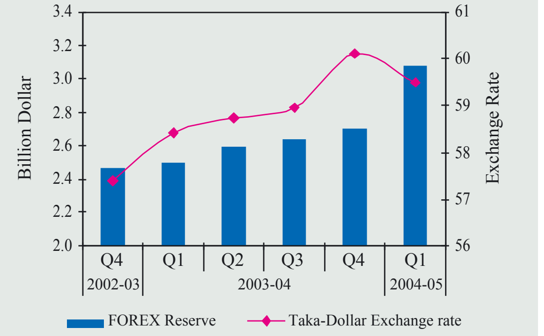
about US$2.7 billion in the first quarter of FY05 reflecting a substantial decline in capital goods and petroleum products imports (Table V.3). While imports of food-grains and other food items showed a modest decline, the import of major capital goods declined sharply to the average level of about US$644 million in the first quarter after an unusually sharp pick-up to about US$1.2 billion in the fourth quarter of FY04. This may reflect slowdown in investment in the first quarter, partly related to floods and which is supported by data on term lending by banks and NBFIs indicating a substantial decline. With regard to the imports of petroleum products (POL), the total import payments declined substantially from US$289 million recorded in the fourth quarter of FY04 to about US$175 million, which given the substantial price increase during the quarter imply sharp decline in the volume of imports. The decline in volume of imports possibly reflect rundown in inventories and some uptake in the capacity utilization of the oil refinery.

During the quarter under review, overall external current account recorded a sizeable surplus mainly reflecting healthy growth of exports and steady inflow of external remittances combined with slowdown in imports. During the quarter the inflow of remittances is estimated at about US$837 million, somewhat lower than the level recorded in the previous quarter but substantially higher than the first quarter of FY04. The capital and financial account also recorded a sizeable surplus during the period resulting from large disbursement of foreign assistance, mainly programme aid. This bunching of foreign aid inflow reflected delay in disbursement of programme aid from the World Bank that was due in the fourth quarter of FY04 but was not disbursed during the period due to administrative and conditionality related constraints.

During the quarter, the overall external balance of payments position improved further and recorded a sizeable surplus estimated at US$423 million. This led to accumulation of official foreign exchange reserves by about US$370 million with the total reaching about US$3.1 billion or 2.9 months of import cover. The accumulation of reserves also reflected some net purchase from the markets by Bangladesh Bank taking advantage of the improved supply situation (Chart V.3).

As elaborated in Annex II (Impact of Recent Oil Price Hike on Bangladesh Economy), the balance of payments impact of petroleum

Chart V.3 FOREX Reserve & Exchange Rate



price increase in the world market is significant-in the order of about US$300-400 million assuming oil price of US$40-45 per barrel and some volume growth. However, given the strong export growth and envisaged inflow of foreign assistance, the BOP impact is unlikely to have a disruptive influence in the economy requiring substantial adjustment.

VI. Health of the Banking System

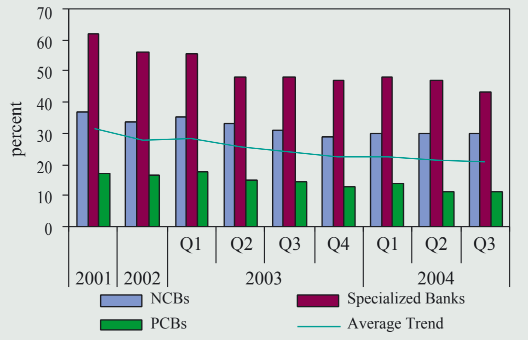
Detailed quarterly data on the health of banking system are not available. However, available data show continued improvements in the banking system soundness indicators, notably risk-weighted capital ratios, ratio of non-performing loans (NPLs) and profitability of banks. Tables VI.1-VI.3 show the trends in capital adequacy, asset quality and profitability of four groups of banks: state-owned Nationalized Commercial Banks (NCBs), state-owned Development Financial Institutions (DFIs), Private Commercial Banks (PCBs) and Foreign Commercial Banks (FCBs).

Capital adequacy focuses on the total risk-weighted capital intended to protect the depositors from the risk of adverse shocks or losses that a bank may face. The risk may arise from credit default risk or market risk (foreign exchange risk, interest rate risk, risk involved in off balance sheet operations). In keeping with the Basle guidelines, banks in Bangladesh have to maintain a minimum capital adequacy ratio (CAR) of not less than 9 percent of their risk-weighted assets or Taka 100 crore, whichever is higher. For the private banks, shortfalls, if any in the CAR has to be fully met by March 2005. Available data show that risk-weighted capital adequacy ratios have increased marginally for the NCBs but remained much below the minimum 9 percent level while for specialized banks the level reached 9 percent for the first time in June 2004. For the PCBs, the level remained above the 9 percent even though there was a slight decline during the first half of 2004.

However, it may be noted that within the broad group, few banks have capital below the regulatory amount, which continue to remain under the close supervision of the central bank. The FCBs remained well capitalized and maintained more than twice the level of regulatory capital.

The asset composition of banks in Bangladesh show a high proportion of loans and advances (over 60 percent) in total assets, which make banks vulnerable to credit risk as NPLs in banks has been historically high. The ratio of NPLs to all loans display an improving trend in recent years (Chart VI.1). In particular the NPLs of PCBs continued to improve during the first six months of the year, partly reflecting the improvement in the loan recovery of banks induced by strengthened regulations and enhanced legal powers of the banks (e.g., due to operations of money loan court) and partly reflecting better screening of new loans facilitated by the operation of Credit

VI.1 Ratio of Gross NPLs to Total Loans



Information Bureau. For the FCBs, the NPL ratio, which is already extremely low due mainly to their prudent lending policy, also show slight improvement during the period under review. On the other hand, the NPL ratio of the NCBs deteriorated slightly. However, the overall performance of these banks are likely to improve in future as these banks undergoing restructuring. These banks are currently under close supervision of the central bank which imposed a number of directives, including restrictions on lending limits and target levels of collection of overdue loans with a view to improving the NPL ratio and overall profitability.

Preliminary data for June 2004 indicate that profitability of banks measured by return on assets and return on equities continue to remain high for all except state-owned NCBs and Specialized Banks, which have been operating at a loss or near loss position. It appears that the pre-tax profitability of PCBs increased substantially in June 2004.

VII. Capital Market Developments

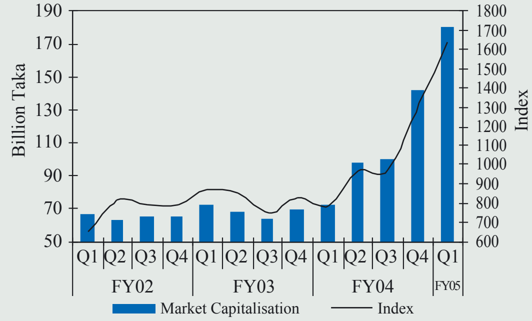
Building on the recent momentum and regaining of investors' confidence achieved in FY04, the strong performance in capital market continued during the first quarter of FY05 with double digit growth in market capitalization and all share price index. The market capitalization increased by 26.3 percent while the DSE-index recorded a growth of 23.8 percent (Chart VII.1 and Table VII.1). The liquidity situation in the market also continued to improve as evidenced by the volume of turnover stood at Taka 14.2 billion during the quarter, an increase of about 22.4 percent over the previous quarter. Sector-wise market capitalization of Dhaka Stock Exchange show that Banks, Insurance, Textiles, Pharmaceuticals & Chemicals, Cement industries led the growth and positive performance.

The strong performance of the sub-sectors reflect underlying fundamentals, profitability and a number of measures taken by the concerned authorities. As noted above, raising the minimum capital of banks to Taka 100 crore led the banks to issue new shares to raise the capital and improvement in the supervision and corporate governance of banks led to decline in private banks' NPL ratio and improvement in profitability. In general, enhanced supervision and enforcement of regulations by the SEC to improve transparency (e.g., more demanding auditing and financial disclosure standards), introduction of credit rating prior to issuing IPOs have helped rebuilding of investors' confidence.

VIII. Near-Term Economic Outlook

In light of the recent floods, the near-term economic outlook in FY05 can be characterized as cautiously optimistic. While, the human distress, damage to infrastructure, and immediate economic dislocation caused by flood is substantial, the economy has developed resilience to such natural calamities and capacity of the authorities to manage and deal with such calamities have improved. Thus, the overall macroeconomic

Chart VII.1 Trends in Market Capitalisation & DSE Index



impact is likely to be limited if the public and private sector response is adequate and timely; in particular to restore public services (health, sanitation and water) and rehabilitate damaged infrastructure, supported by additional international assistance (Annex I).

The government's macroeconomic policy is thus geared towards increase in public expenditure for rehabilitation of infrastructure and public services, facilitated by reallocation of existing ADP and additional quick disbursing international assistance. In the short run, monetary policy remains accommodative to credit demand of the private sector keeping in mind the potential inflationary consequences. On balance, the GDP growth in FY05 is likely to be lower by about 0.25 - 0.5 percent relative to pre-flood projection of economic growth. Given the revenue target, the budget deficit may be higher due to flood induced net additional expenditure but the impact on domestic financing of deficit is likely to be limited if the additional expenditure is financed by incremental foreign assistance noted above. Since impact of flood on export activities appear to be relatively small, the overall impact on external trade and balance of payments is likely to be minimal if part of the incremental government expenditure and imports is covered by additional foreign