Contents

Overview of Economic and Financial Developments

During the second quarter of fiscal year 2004-05 (FY05), the economic activity recovered from floods, which caused severe damage to country's infrastructure, agricultural and small scale economic activities. While rice crop production fell below the target, available data indicate that non-crop agriculture, manufacturing and service sector activities showed signs of strong recovery and growth, assisted partly by increased availability of credit and some acceleration of public expenditure.

Inflationary conditions eased during the quarter with a sharp decline in food price inflation in December. After substantial increase at the end of the first quarter, the12-month CPI inflation declined to 5.5 percent in December due mainly to a steep decline in food price reflecting improved supply situation of major food items and easing of prices of some commodities in the international market. Non-food prices also declined during the period.

Overall monetary policy stance remained accommodative to private and public sector credit demand. Although stock of reserve money declined, broad money growth was substantially higher than growth in the first quarter and the corresponding quarter in the FY04. This reflects a sharp increase in money multiplier due largely to a decline in reserve deposit ratio as banks used up an increasing amount of excess reserve to meet the credit demand of both private and public sector. Private sector credit growth continued during the quarter reflecting buoyant credit demand and increased interest rate flexibility.

Foreign exchange market remained largely stable during this quarter but the Taka-US dollar exchange rate experienced some strong pressure in December due to high demand for dollars associated with much higher than expected import growth and Hajj pilgrimage in the face of a seasonal decline in export earnings. The real effective exchange rate (REER) also remained largely stable albeit with a moderate depreciating trend.

During the quarter, both revenue and expenditure level of the government increased somewhat in real terms but as before remained substantially below the quarterly targets. In particular, public expenditure increased significantly due to increased utilization of the budget for current goods and services as well as ADP related to post-flood rehabilitation program. As a result, overall budget deficit was much higher than the first quarter of FY04, financed almost equally by domestic and foreign resources.

The external current account balance turned to a sizeable deficit position during the quarter while overall balance also recorded a modest negative position reflecting a seasonal decline in export growth in the face of a much higher than expected growth in import payments. In spite of the deficit in overall balance of payments, there has been some accumulation of official foreign exchange reserves reaching about at $3.2 billion or 2.9 months of import cover. The accumulation of reserves also reflected some net purchase from the markets by Bangladesh Bank.

In the second half of 2004, gross and net NPL ratios decreased for all groups of banks while profitability situation also improved for all banks except the NCBs. NCBs remained under strong supervision of the Bangladesh Bank and the restructuring program of the NCBs with the assistance of the external management team is now underway. Strong growth in the market capitalization, turnover and the all share index of Dhaka Stock Exchange continued in the second quarter mainly on the strength of the strong performance of financial institutions and to a lesser extent textiles, pharmaceutical and cement industries' stocks.

I. Developments in the Real Economy

In the aftermath of a devastating flood, economic activities in the country show signs of recovery and improvement during the second quarter of FY05 (October-December 2004). With the exception of crop agriculture, all available direct and indirect indicators of economic activity, such as quantum index of manufacturing industries, trends in private sector credit, cargo handled by Chittagong Port, export and import trade, show increased level of economic activity compared with both the previous quarter and with the second quarter of the previous year. Overall, during the first six months of the FY05, annualized GDP growth is likely to be below 5 percent due to the floods and hike in oil prices in the international market[1].

After the production of Aus which was directly affected by the flood, Aman crop was also adversely affected by incessant rainfalls in many regions, leading to a delay in plantation and decline in the area planted. As a consequence, Aman harvest in November fell to 110.24 Lac MT, about 14 percent lower than the initial target of 127.88 Lac MT and about 4 percent lower than the last year's production of 115.21 Lac MT (Table I.2 and Chart I.2). Other than the rainfall noted above, the decline also reflected prolonged dry spell in northern region and localized pest attack. However, the outlook of the Boro rice and wheat are

Chart I.1 Growth of Real GDP

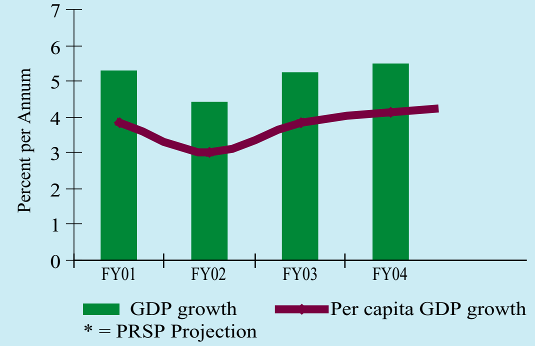
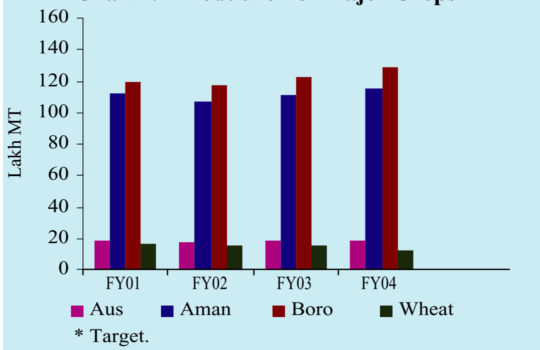


Chart I.2 Production of Major Crops



favorable, reflecting timely distribution of seed, fertilizer and agricultural inputs combined with channeling higher volume of agricultural credit. Overall, total cereal production in FY05 is expected to be about 282 lac MT, nearly 2 percent higher than last year's production level.

With regard to minor crops, there is some evidence to indicate that maize, potato and sugarcane and vegetable production have increased substantially, reflecting farmers' efforts to move into these high value items. In particular, farmers seem to have brought a sizable amount of land under vegetable cultivation in the second quarter leading to marked improvement in the supply situation in the second quarter of FY05 as reflected in some decline in prices of products.

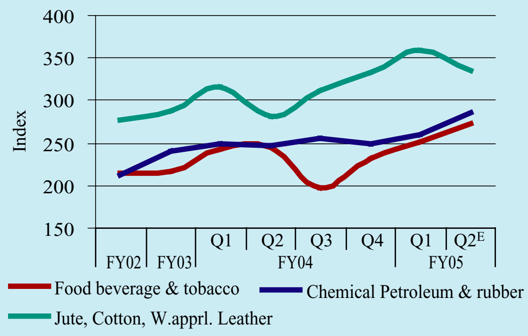
1 An assessment of the floods during the first quarter of FY05 and the impact of recent oil price hike on Bangladesh economy may be seen at Annex I and Annex II respectively of Bangladesh Bank Quarterly, July-September 2004 (Vol. II, No. 1).

Similarly supply of fisheries and live stock also appeared to have improved in the aftermath of the recent floods. No outbreaks of cattle or poultry disease, which often occur after floods, were reported.

An indirect indicator of movement in economic activity in the agricultural sector is the disbursement of credit. Government, by a policy decision, waived the interest payment on overdue agricultural loans up to a specific amount and channeled substantially higher volume of credit to agricultural activities. As indicated in Table I.7 total disbursement of agricultural credit stood at Taka 14.6 billion during the second quarter of FY05, about 85 percent higher than the previous quarter and about 60 percent higher than the amount disbursed during second quarter of the FY04. Overall, during the first six months of FY05, the disbursement was Tk. 22.5 billion, about 60 percent higher than the disbursement during the same period last year estimated at Tk 14.0 billion.

Preliminary estimate indicates that despite the flood, quantum index of manufacturing industries (covering mainly medium and large scale industries) show an increase of nearly 18 percent during the second quarter of FY05 over the same quarter of FY04. However, due to strong seasonality in the exports and production of textiles which has high weight in the new index, the quantum index indicates a slight decline in the second quarter over the level in the previous quarter (Table I.3 and Chart I.3). Thus, taking into account of the seasonality, there was a pick-up in the production of the medium and large scale manufacturing activity during the quarter and this may have complemented the recovery of the small-scale and rural industries which was adversely affected by floods. Within the quantum index, other major manufacturing activities, notably food beverages & tobacco, chemical, petroleum & rubber as well as metal & metal products sub-sectors showed robust growth reflecting strong growth in domestic demand partly related to post flood recovery activities.

Chart I.3 Quantum Index of Manufacturing



Although no quarterly data on construction activity are available, indirect indicators like level of imports of construction materials (iron, steel and base metal) and related capital goods (Table V.3) seem to suggest sizeable growth in the construction sub-sector during the quarter under consideration.

Other than the data on crop production and quantum index which are the only two direct sources of data on quarterly activity, the cargo handled by Chittagong port, alongside data on foreign trade could also be considered as a good proxy of economic activity in the real sector, in particular manufacturing, construction and service sectors. Such quarterly data on cargo handled presented in Table I.4 indicate a robust growth of about 12 percent in overall volume with import cargo growing by over

16 percent in the second quarter while the export cargo declined during the quarter reflecting strong seasonality in textiles exports noted above. There is strong correlation with the volume of cargo handled and trade and transport activities, two very important service sectors within the country.

Indirect evidence indicate that in the second quarter, the activities of the services sector have recovered fast from flood related damage during the first quarter. As noted above, data on volume and value of foreign trade clearly suggest that the major sectors like transport, communication and trade adversely affected by flood registered a strong growth during the quarter under review. Similarly, publicly provided services (relief operations, education, health and public administration) continued to show positive growth as public expenditure under ADP increased significantly in the second quarter. In contrast to the developments in the first quarter, the services sector is likely to have experienced a positive growth during the second quarter.

II. Price Developments

After an increase in the first quarter, 12-month CPI inflation declined substantially during the second quarter of FY05 reflecting sharp decline in food prices as well as some decline in non-food prices (Table II.1 and Chart II.1). Following an increase from 5.64 in June to 7.35 percent in September, the 12-month change in CPI index declined to 5.5 percent mainly on the strength of a steep decline in food prices. After an increase in October, the food price inflation declined to 6.7

Chart II.1 12-Month CPI Inflation

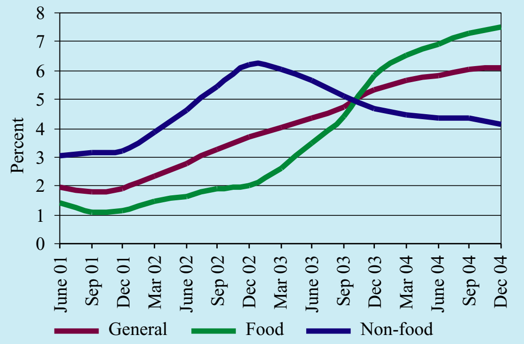
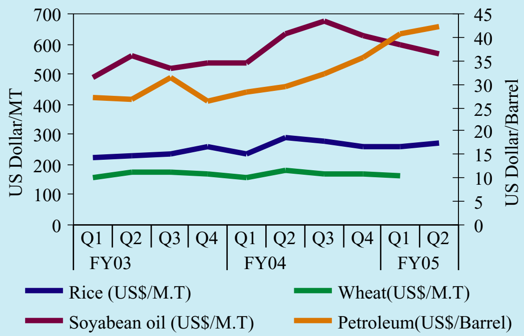


Chart II.2 Commodity Prices at International Market



percent in December from 9.5 percent in September, reflecting aman harvest and increased supply of vegetables, fisheries and poultry combined with easing of prices of some primary commodities (with the exception of rice) in the international market. A notable feature of the price developments during the quarter is that non-food prices also declined significantly from 4.2 percent in September to 3.7 percent during the quarter under review despite some upward adjustment of fuel prices in December. While 12-month point-to-point CPI inflation declined markedly, inflation measured by changes 12-month average CPI remained largely unchanged around 6.1 percent in December 2004 as decline in marginal prices of food and non-food items affect the 12-month average only slowly over time.

During October-December, 2004 the price developments in the international market is somewhat 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 in inflation, after a sharp increase during July-September, inflationary situation in south Asian countries seems to have eased during the October-December period reflecting some tightening in monetary policy and some decline in food prices (Table II.3 and Chart II.3).

III. Monetary, Credit and Exchange Rate Developments

During the second quarter overall monetary stance remained accommodative to credit demand of both the private and public sector with higher than envisaged growth in money supply propelled by high growth in demand and time deposits. Although the stock of reserve money declined in the quarter reflecting BB's effort to tighten its net domestic asset position, broad money increased substantially, higher than the growth experienced in the first quarter as well as the second quarter of the previous year (Tables III.1-III.2 and Charts III.1-III.2). This reflects a sharp increase in money multiplier due largely to a decline in reserve deposit ratio as banks used up an increasing amount of excess reserve to meet the credit demand of both private and public sector.

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

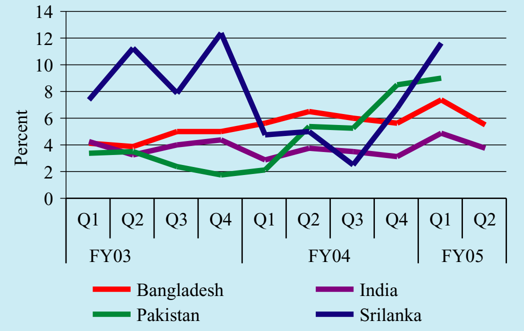


Chart III.1 Components of Reserve Money (RM)

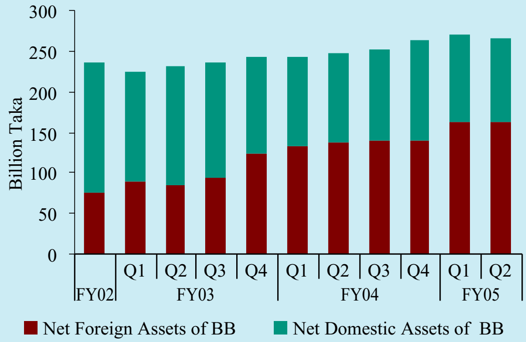
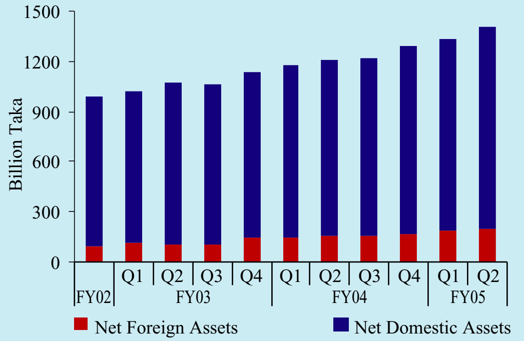


Chart III.2 Components of Broad Money (M2)



As noted above, during the second quarter the reserve money under the control of BB declined by 1.7 percent reflecting a decline in NDA of the BB by 5.9 percent while net foreign assets increased modestly 1.2 percent as BB's official foreign exchange position improved. On the liability side the decline in RM is driven by a decline in deposits while currency demand also increased modestly. Looking at the monetary aggregates, broad money increased by 5.4 percent due mainly to a 5.7 percent growth in NDA of the banking system driven by large expansion of public and private sector credit. On the liability side, the growth reflected substantial increase in both demand and time deposits while expansion in currency demand remained moderate.

After a decline in the first quarter, credit to the government sector increased by over 6 percent in the second quarter of FY05 reflecting acceleration of government expenditure and the need to borrow from the banks as non-bank borrowing fell below the target. Credit to private sector also registered an increase of over 6 percent which reflected high credit demand of the agriculture and of the industrial sector in the aftermath of the flood and some flexibility in the lending rates (Table I.5). Credit extended by micro finance institutions, confined mainly in rural areas, increased by 5.8 percent during the quarter. On the other hand, credit extended by NBFIs (making up about 5 percent of total credit), increased marginally by 1.5 percent. However, disbursement of term lending by the NBFIs registered an increase of 45.2 percent during the quarter.

The monetary authorities actively used repo operations alongside regular auctions of treasury bills to mop up liquidity to meet the quarterly reserve money target. Call money rate remained stable (on average 5.48-5.97 percent) during the quarter under review except for two hikes, one in mid November (11-13 percent) due to higher demand for cash in hand for Eid-ul-Fitre festival and another in end December (20-25 percent) due to shortage of liquidity as there was net absorption of liquidity through open market operation during the last week of December

Chart III.3 Trends in Private Sector Credit

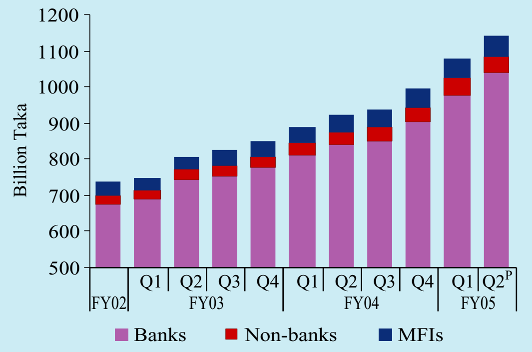


Chart III.4 Yield on T-Bills

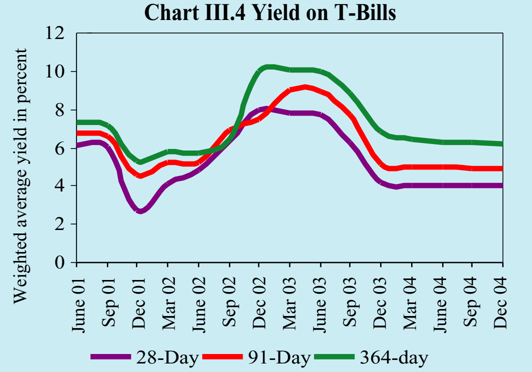
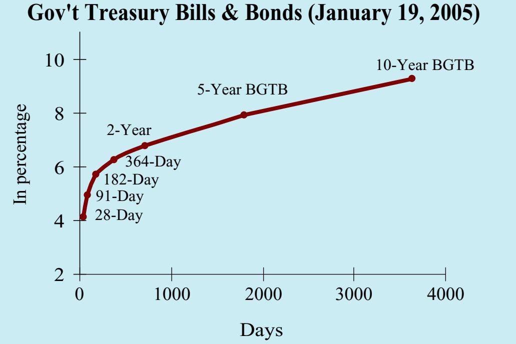


Chart III.5 Weighted average yield of accepted Gov't Treasury Bills & Bonds (January 19, 2005)



2004 (Table III.3). During the quarter, there was no change in CRR (cash reserve ratio) and SLR (statutory liquidity ratio) set by the Bangladesh Bank.

Overall, yields on treasury bills did not display significant change during the three-month period although yields on some tenors show slight decrease (Table III.3 and Charts III.4 and III.5). Outstanding stock of Government treasury bills including NSD certificates stood higher at around Taka 530 billion at end of December 2004 as compared with Taka 511 billion at the end of first quarter of FY05 (Table III.4). There is some evidence to suggest that both the deposit and lending rates of banks continued to show declining trend, owing partly to improvement in the health of the banking system and possibly decline in the cost of funds. However, spread between deposit and lending rates is likely to have 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 many banks (Table III.3).

Foreign exchange market remained largely stable during this quarter but the Taka-US dollar exchange rate experienced some strong pressure towards depreciation reflecting very high dollar demand associated with higher than expected growth in merchandise imports and service payments (partly related to Hajj Pilgrimage) in the face of a sharper than usual seasonal decline in export growth. As discussed in section V, external current account position turned to a sizeable deficit position in December from a positive position in

Chart III.6 Movements in Interest Rate

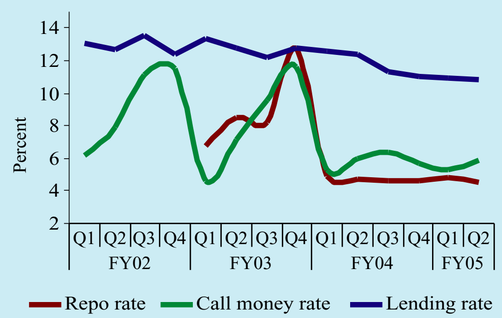
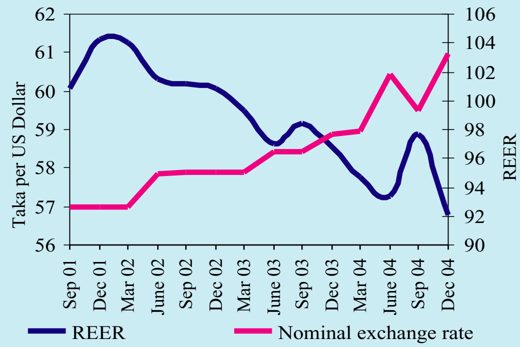


Chart III.7 Taka-Dollar Exchange Rate and REER



September. The nominal exchange rate in the inter-bank foreign exchange market varied between Tk. 59.5 - Tk. 61.1 per U.S. dollar during the quarter with the rate hovering around 59.5 during October-November and around 60.5 in December. During the quarter under review, U.S. dollar showed sign of some strengthening vis-à-vis all other major currencies (Euro, Yen and Pound Sterling) reflecting improved outlook of the US economy. During the second quarter of FY05 the real effective exchange rate (REER) showed a trend towards depreciation at the end of the quarter (Chart III.7).

IV. Fiscal Developments

During the quarter, both revenue and expenditure level of the government

increased in real terms but as before remained below the quarterly targets. Measured in ratios of GDP revenue collections estimated at 2.2 percent of GDP was higher than the first quarter but fell somewhat below the level of the second quarter of previous fiscal year and substantially lower than the quarterly target due to continuing weakness in tax administration (Table IV.1 and Chart IV.1). While collection of VAT and registered some improvement and reached closer to target, collection of customs duties and income tax as well non-tax revenue remained substantially below the target. Overall revenue collection at 2.2 percent of GDP fell much below the pro-rated quarterly target of about 2.8 percent of GDP.

Government expenditure measured in ratios of GDP was higher than both the first quarter of FY05 and corresponding second quarter of previous fiscal year. Preliminary estimate shows that public expenditure was 3 percent of GDP compared with 2.4 percent of GDP recorded in the first quarter of FY05 largely due to increased utilization of the budget for current goods and services as well as some acceleration of ADP expenditure partly related to post-flood rehabilitation programme.

Preliminary estimate indicate that the overall fiscal deficit was 0.9 percent of GDP in the second quarter of FY05 compared with a deficit of 3.8 percent targeted for the entire year. The budget deficit was financed almost equally by both domestic sources as well as from net foreign assistance. There was virtually no non-bank finance during the period leading to reliance on bank financing of deficit by an estimated 0.4 percent of GDP, which was a reversal of the situation in the first quarter when net foreign financing was much higher than the size of the overall deficit due to bunching of foreign aid inflows, resulting in substantial net repayment to the banking system (Table IV.1).

Chart IV.1 Trends in Government Revenue and Expenditure

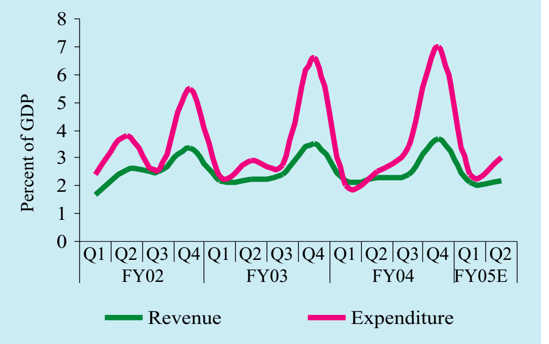
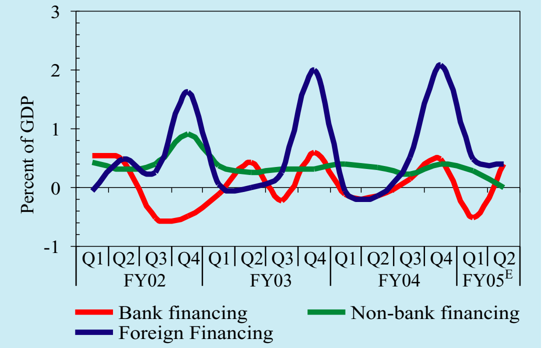


Chart IV.2 Financing of Budget Deficit



V. External Sector Developments

The external current account balance turned to a large deficit position during the quarter while overall balance also recorded a modest negative position due to a much higher than expected seasonal decline in export earnings in the face of a sharp rise in import payments (Table V.1 and Charts V.1 and V.2). While level of exports measured in US dollar generally decline in the second quarter reflecting mainly seasonality associated with the export demand of the RMG, during the second quarter of FY05 the decline was about 21 percent, substantially higher than the average decline of the previous years. Looking at the composition of exports, it appears that not only the textiles exports but the export value of some other major export items like leather, frozen shrimp, fertilizer and other exports, which apparently do not have seasonality also declined substantially during the quarter under review (Table V.2).

However, instead of just looking at just the quarterly developments, if one looks at the export performance of the six months as a whole, one finds that there has been a substantial growth in exports (15.2 percent) over the same period last year as well as over the previous six months with textiles, and more particularly knitwear exports leading the growth. Table V.6 presents product wise export performance relative to the target and relative to the previous six months. It indicates that export performance of knitwear, home textile, chemical products, agricultural products, ceramic tableware, tea and handicrafts recorded higher growth over last year and also over target. Products that fail to achieve target and decline over last year, on the other hand are frozen food, raw jute, textile fabrics and other manufactured goods reflecting supply side problems some of which may be related to recent floods.

Chart V.1 Trends in Current Account and Overall Balances

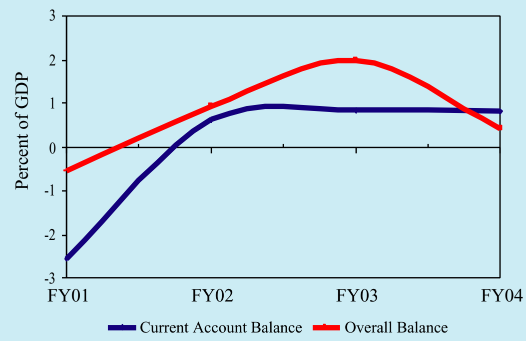


Chart V.2 Trends in Export & Import

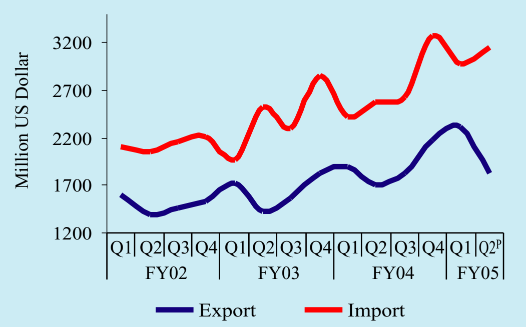
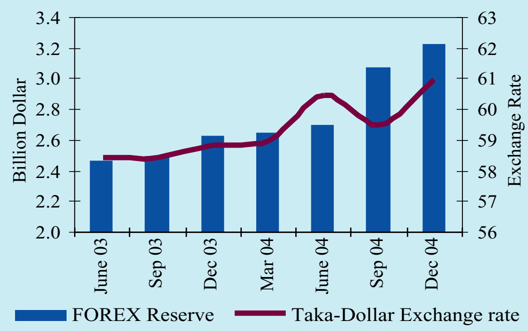


Chart V.3 FOREX Reserve & Exchange Rate



To discern the underlying trend in RMG exports, trend in RMG exports by major destination have been shown at Table V.5. As before it indicates a marked shift of RMG exports from the US market to the European countries. After some recovery in the previous two quarters, exports of both woven and knitwear products declined both in US and European market reflecting seasonality noted above. However, exports to US market declined much more than the decline in the European market. In general, the growth of exports was faster in the European market than the US market. As a result of this trend that became more pronounced since FY02, the share of the European countries in total RMG exports increased from 53 percent in FY02 to 67 percent in the second quarter of FY05 while that of the USA declined from 40 percent in FY02 to 29 percent in the current quarter. As noted in the previous issue of the BB Quarterly, The strong performance of the textiles exports is largely attributable to buoyant demand of both knitwear and woven garments in the European market, where Bangladesh enjoys duty free access on most items. In contrast, most items of textiles exports from Bangladesh faces high level of import duties (about 15-20 percent) in the US market where Bangladesh experienced slowdown of growth (in particular the woven garments) and some loss of market share to other competitors, some of whom enjoys duty free access.

After a decline in the first quarter of FY05, total merchandise imports, measured by settlement of L/Cs increased by nearly 6 percent in the second quarter, reflecting a sharp rise in value of food grains, petroleum products and capital goods imports. The higher level of food grains imported was due to domestic shortfall in food production in the post flood period and some increase in food grains prices in the international market whereas sharp rise in world oil price hike pushed the import of petroleum products to a very high level (Table V.3). Import of major capital goods, on the other hand, reflected increased investment demand in the private and to a lesser extent public sector.

Notwithstanding a strong growth in the remittances, overall external current account recorded a substantial deficit ($351 million) in end-December 2004 mainly due to a sharper than usual seasonal decline in exports combined with steady growth in imports noted above. The capital and financial account, on the other hand, recorded a sizeable surplus during the quarter resulting from sizeable disbursement of foreign assistance, mainly project aid. However, due to unrecorded outflow (negative errors & omissions) the overall external balance of payments position showed a deficit of $30 million. In spite of the deficit, there has been some accumulation of official foreign exchange reserves which reached about at $3.2 billion or 2.9 months of import cover reflecting some net purchase from the markets by Bangladesh Bank.

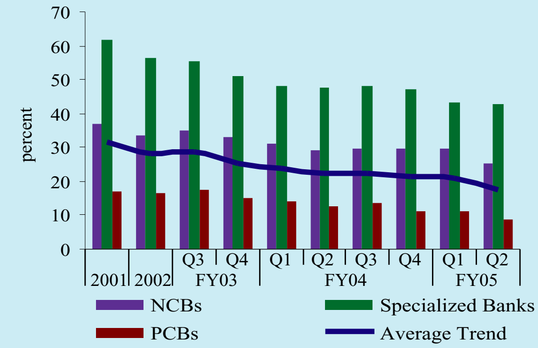
VI. Health of the Banking System

In the second quarter, the most notable feature of the banking sector performance is the striking decline in both gross and net NPL for all groups of banks. At the same time positive trend in the other banking system soundness indicators, notably risk-weighted capital ratios and profitability of banks continued in the second half of 2004 as shown in Tables VI.1-VI.3 and Chart VI.1.

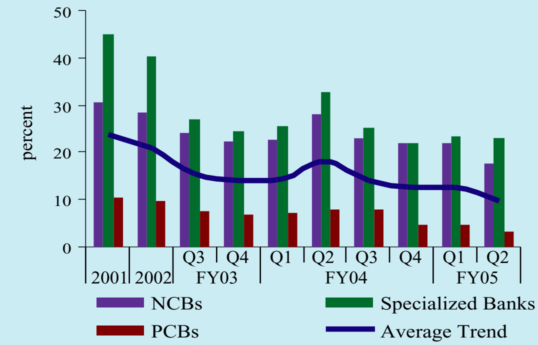
The NPLs of NCB's declined sharply during the quarter under review. The decline in NPL ratio is more pronounced if one looks at the trend in net (gross NPL net of provision). In particular net NPL ratio of the NCBs declined from 21.91 percent in June to 17.56 percent in December 2004 as new accretion of bad loans fell sharply 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 Information Bureau (see Box 2)[2]. For the PCBs, NPL also continued to improve during the period albeit from a much lower level due to the factors noted above alongside marked improvement in the loan recovery. For the FCBs, the NPL ratio, which is already extremely low due mainly to their prudent lending policy, also shows slight improvement during the period under review. For the Specialized Banks, the NPL ratio remained high and the improvement remained marginal reflecting lack of reform initiative. For the NCBs (with about 40 percent of the market share on the asset side) while the net NPL declined, the ratio remains high, over 20 percent. 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 improve the NPL ratio and overall profitability.

Available data show that risk-weighted capital asset ratios remained much higher than the regulatory requirement (9 percent)

VI.1 Ratio of Gross NPLs to Total Loans



VI.2 Ratio of Net NPLs to Total Loans



for the FCB and satisfactory for the PCBs and the Specialized Banks. On the other hand for the NCB capital ratios remained below the regulatory level and decreased marginally during the quarter under review.

Preliminary data for December 2004 position indicate that profitability of banks measured by return on assets and return on equities remained high for FCB and PCB while state-owned NCBs and Specialized Banks, continue to operate at a loss or near loss position. A notable development in 2004 is that the pre-tax profitability of PCBs appears to have increased substantially in 2004.

2 The asset composition of banks in Bangladesh show a high proportion of loans and advances (over 60%) in total assets, which make banks vulnerable to credit risk as NPLs in banks has been historically high.

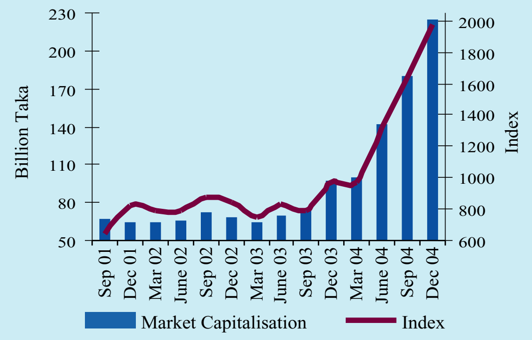
VII. Capital Market Developments

The robust growth of the capital market measured by movements in market capitalization and all share price index continued during the second quarter of FY05. As in the first quarter, double digit growth was recorded for the market capitalization (25.1 percent) as well as DSE All-share price index (20.7 percent) (Table VII.1-VII.2 and Chart VII.1). The liquidity situation in the market also continued to improve as evidenced by the volume of turnover estimated at Taka 23 billion during the quarter indicating a huge increase of about 77 percent over the previous quarter. Sector-wise market capitalization of Dhaka Stock Exchange show that banks acting as engine of the growth alongside cement, pharmaceuticals and textiles. Reflecting continued improvement of the banking sector performance and growing investor's confidence, the market capitalization of banks showed a robust growth of 55.3 percent over the first quarter and 239.2 percent over the same quarter of FY04.

The strong performance of the sub-sectors reflects 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.

[3] 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 have to be fully met by March 2005.

Chart VII.1 Trends in Market Capitalisation & DSE Index



VIII. Near-Term Economic Outlook

Despite of the recent floods, oil price hike, and some instability in the political arena near-term economic outlook in FY05 remain favorable. The economy has recovered from flood reflecting resilience of the people and institutions and is poised for much higher growth in the second half of the FY05. This positive outlook is underpinned by supporting macroeconomic policies, acceleration of investment and ongoing structural reforms. However, as before, a number of downside risks remain in FY05, which include: possible adverse impact of the phase-out of textiles quota and high level of oil prices.