ADB

BANGLADESH

Quarterly Economic Update

March 2006

Asian Development Bank

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Notes

(i) The fiscal year (FY) of the Government ends on 30 June.
(ii) In this report, “$” refers to US dollars.

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MACROECONOMIC DEVELOPMENTS

Highlights

- For FY2006, gross domestic product (GDP) growth is estimated at 6.5%, higher than the 5.6% recorded in FY2005.
- The agriculture sector has significantly recovered with a good summer crop and an encouraging expectation for the winter crop.
- Driven by export-oriented manufacturing, the industrial sector continues to register robust performance.
- The mobile phone industry is growing rapidly, significantly contributing to economic development and employment generation.
- Earlier concerns about the adverse effects arising from the phase out of multifiber arrangement (MFA) quotas have not been realized.
- Despite some success in revenue administration reform, revenue collection continues to lag behind projections.
- Despite a tight monetary policy stance, money and credit growth continues to be high.
- Retail fuel prices must be urgently adjusted to avoid serious macroeconomic consequences arising from continuing upward movement in international oil prices.
- Higher petroleum prices have contributed to rising fuel subsidies which have further burdened the nationalized commercial banks and crowded out much-needed public investment.
- The combination of higher import costs and rapid monetary expansion is contributing to a slide in the value of the Taka.

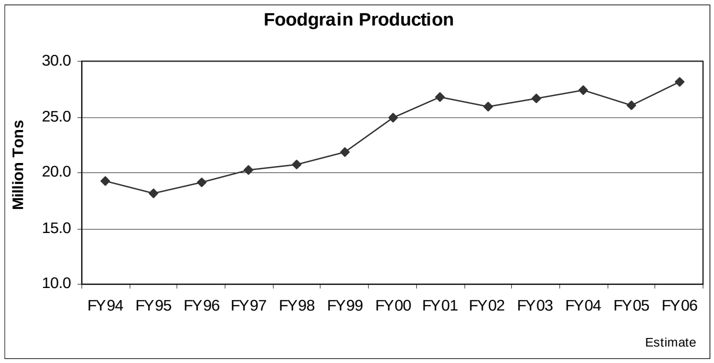
Agriculture

Agriculture sector recovers significantly

1. FY2006 was a period of strong agriculture recovery, with a good summer crop and expectations of an equally positive winter crop. The *aus* (i.e. the first rice crop) was planted on 1.03 million hectares and production stood at 1.75 million tons, an increase of 16.7% over the preceding year. 5.4 million hectares were brought under *aman* cultivation, slightly higher than the 5.3 million hectares planted in the preceding year. Due to incessant rainfall and minor flooding, there have been minor losses to the standing *aman* crop in some districts. On balance, foodgrain output is above-trend due to generally favorable climatic conditions, and to a sufficient supply of high yielding varieties, and other agro-inputs. This year's *aman* production is estimated at 10.8 million tons, an increase of 10% over production a year ago. Thanks to an uptrend in *aman* production, buoyant

agriculture growth is expected to underpin overall strong economic performance in FY2006.

2. Maize production has recorded especially strong growth for the second consecutive year. A decline in the cost of production, growing domestic demand, and stable-cum-remunerative prices have encouraged farmers to substitute maize for wheat in their crop rotations. The planting of the *boro* crop, which is traditionally the largest crop of the year, has been completed. Plantation areas under *boro* crop increased to 4.4 million hectares, representing an increase of 7.3% over the land brought under cultivation in the previous year. Despite some disruption in the delivery of key agro-inputs, notably diesel fuel and fertilizer, the *boro* crop is expected to be close to the forecast of 14 million tons, provided that weather conditions continue to remain favorable. In addition, early production estimates for jute, potatoes, winter vegetables and both inland and marine fisheries are promising.



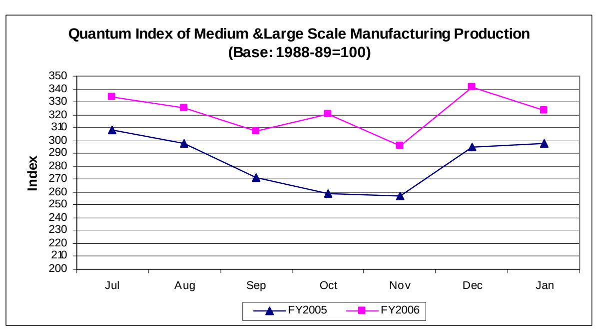
Growth in agriculture vital for sustainable poverty reduction

3. Although the share of agriculture in the economy continues to decline with its current contribution to GDP approximately 22%, performance in the sector remains vital to the national poverty reduction effort. To sustain rural economic development, there is a need to encourage farmers to move from low-value food grains to a diversified cropping pattern, including an increase in the contribution of non-rice crops to overall output to attain higher agricultural growth rates in the future. Besides enhancing growth, agriculture diversification also contributes to improved nutrition, poverty alleviation, employment generation, and export-led growth.

Industry

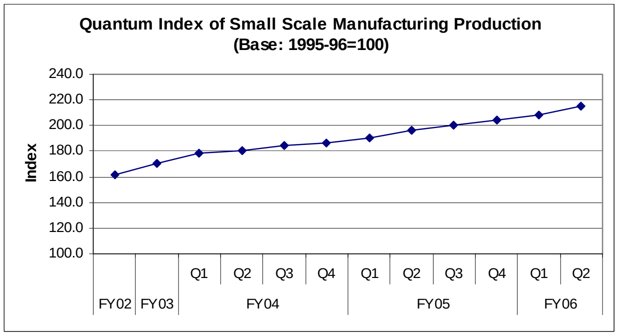
Industry shows robust performance

4. Driven by export-oriented manufacturing, the industrial sector continues to register robust performance. In the first seven months of FY2006, output of medium and large scale manufacturing expanded by a strong 13.2% compared with the same period of the preceding year. The increase in production was broad-based covering both export and domestic market oriented



enterprises. The output of food processing and beverage, textile, garments, knitwear, leather footwear, furniture, paper and paper products, non-metallic products, basic metal products, cement, ceramic and pharmaceutical registered a steady increase. In addition, the output of small scale manufacturing sector registered a strong performance with first half of FY2006 production increasing by 9.6% over the same period of the preceding year. Although growth in the manufacturing sector is encouraging, production could have been higher still were it not for frequent power disruptions and low gas supply pressures (see pages 14-19 for the article on reforming the power sector in Bangladesh). The construction sector also expanded at a steady pace, as indicated by the high growth in the production of cement and import of construction materials. Electricity and gas production also experienced a substantial surge reflecting strong consumer and industrial demand growth.

Manufacturing sector is affected by power disruptions



Services

5. There has been a strong and sustained expansion in the services sector in FY2006, in line with rapid growth in agriculture and industry. There has been a substantial increase in cargo handled by the port and a sharp expansion of bank credit to the trade and transport sub-sectors. Rapid growth in the mobile phone market (see box 1), and an expansion of health care service providers also contributed to robust service sector growth. Profit margins in the private sector banks remain quite healthy and this is also likely to have a positive effect on the growth in financial services.

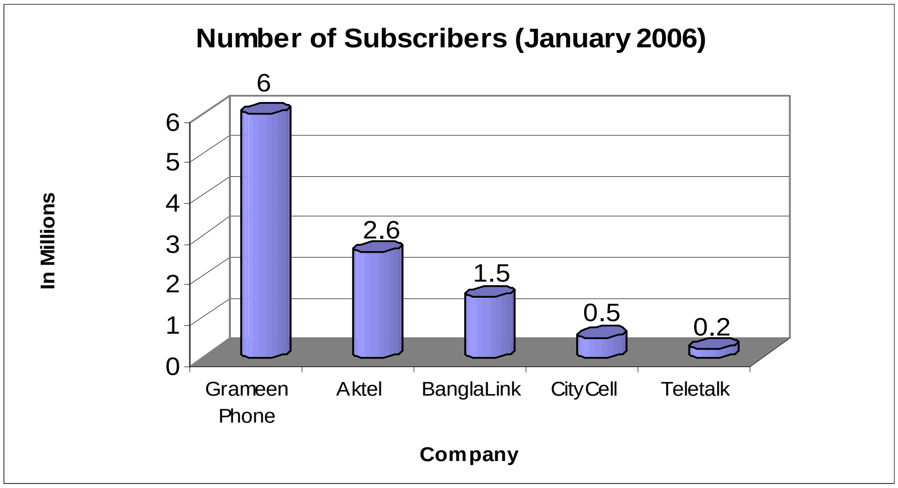
Substantial pick up in services

Box 1: Mobile Phone Market Grows in Bangladesh

The mobile phone industry in Bangladesh is growing rapidly, and is making a significant contribution to economic development and employment generation. The number of mobile subscribers increased to 11 million in 2006, from 3.85 million in 2004, registering an impressive growth of 186%. Consequently, the country's mobile telecom density went up to 6.7% from 2.75% during these few years. Among the five companies that are currently operating, Grameen Phone (in partnership with Telenor of Norway), which has the highest market share, more than doubled its customer base to over 6 million during this period. Other companies, which include Aktel, Banglalink, CityCell, and Teletalk, also experienced robust growth in terms of number of subscribers and customer revenue. A sixth operator, Warid Telecom, is preparing to enter the market after obtaining an operating license in December 2005. Telenor, Telekom Malaysia (TM), Orascom, Sing Tel, and UAE based Warid Telecom are amongst the main foreign companies that have invested in the mobile phone sector in Bangladesh. Despite rapid growth in the subscriber base in the past three years, there is still substantial scope for growth in the mobile industry as some 93% of the

Mobile phone market growing rapidly

population still do not subscribe to a mobile phone service. Indeed, industry analysts expect that the total number of cellular phone subscribers will double to over 20 million by 2007.



The spectacular growth in the mobile phone sector is making a significant contribution in both rural and urban areas. There is ample evidence that improved telecommunications access has benefited lower, middle and upper income groups alike. Greater connectivity has enhanced business activity, reduced the cost of doing business, generated new employment opportunities and contributed to poverty reduction. Greater availability of mobile phones, especially in the rural areas where land phone connections are scarce, enables access to information on available health and education services, and markets, and facilitates income generating activities, employment and remittances from abroad. As a result of the Village Phone (VP) program provided by Grameen Phone, a large proportion of the rural population now has access to telecom services. The VP program provides telecom facilities to more than 40,000 villages in 61 districts, which covers 58% of the 68,000 villages in the country. Other mobile phone providers, such as Aktel, Banglalink, CityCell, and Teletalk have also considerably enhanced their network coverage around the country.

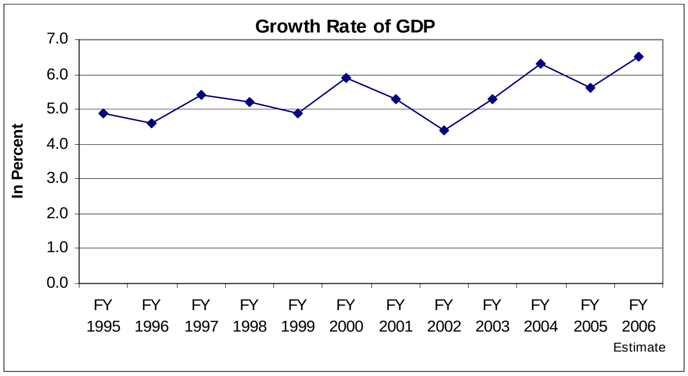
Connection fees and call costs have come down significantly over the last two years due to increased competition in the sector. Network coverage has also improved as a result of greater interconnectivity amongst the different providers and with Bangladesh Telegraph and Telephone Board. In the major urban areas, coverage has substantially improved. However, despite rapid progress, the quality of services continues to be a challenge for the mobile industry with high levels of call disconnection and poor call completion rates owing to capacity constraints and inadequate infrastructure. To further enhance the market potential of the industry, leading mobile companies have been investing to address the issue of service quality. Since mobile phone companies are major participants in the services sector, offloading their shares in the stock exchanges would significantly boost the capital market.

Economic Growth

6. GDP growth is estimated at 6.5% in FY2006, higher than 5.6% in the preceding year, reflecting a steady increase in domestic and external demand. Private consumption will be the main driver of growth during this period, bolstered by strong remittance inflows. Growth in FY2006 will also be underpinned by steady expansion in industry and services, aided by a strong recovery in agriculture.

GDP growth is estimated at 6.5%

7. Bangladesh faces several medium-term downside risks. The phase-out of MFA quota system implies that the global textile trade is bound to become increasingly competitive, and garment exports have been a leading contributor to exports and growth over the last decade. Soaring global petroleum prices are also a considerable risk to the domestic economy. Heightened pressures on the country's balance of payments could affect the imports of capital goods and raw materials, negatively affecting growth and investment. There is also considerable political uncertainty as the country enters the election cycle with the formation of the caretaker government in October 2006, and with general elections scheduled for early 2007.



8. Earlier concerns about the possible adverse effects on the industrial sector of Bangladesh because of the ending of MFA quotas have not been realized. Knitwear exports continue to register strong growth, while after some initial difficulties, exports of woven garments have also shown signs of steady growth. However, uncertainty remains about the long-term impact of the MFA phase-out. This will be more evident from 2008 onwards when the temporary safeguard quotas for People's Republic of China (PRC) will expire.

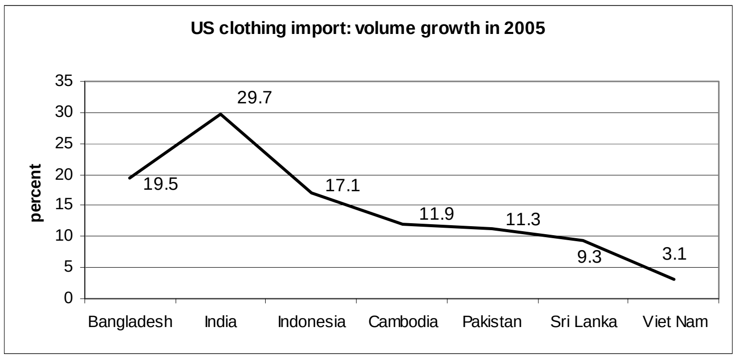
9. The end of quota restrictions at the end of 2004 on textile and clothing exports of developing countries has provided substantial market access benefits to the more competitive Asian suppliers, including Bangladesh, while adversely affecting some of the high-cost exporters in the Asian and Pacific developing countries[1]. The competitive Asian producers have outperformed non-Asian preferential suppliers with robust growth in both volume and value based share of exports to the United States (US) and European Union (EU). Elimination of quota has resulted in overall expansion in market share despite reversals in some market segments. For marginal producers, however, the end of the MFA quotas

MFA phase-out benefited major competitive countries including Bangladesh

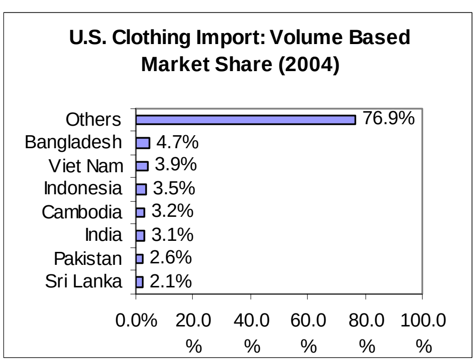
[1] See Asian Development Outlook, 2006, ADB for details.

has made production of readymade clothes for distant markets such as EU and US unprofitable and has led to factory closures and downsizing. For countries where unit labor costs are comparatively high, some reduction in market share has occurred but the adjustment process in these countries was assisted by the reintroduction of safeguard quotas on textile and clothing exports on the PRC in the later part of 2005.

10. In the US, the annual imports of clothing from all major suppliers increased by 10.3% in 2005 over 2004, demonstrating a sharp acceleration of growth. PRC, which experienced a volume growth of about 100% and value based growth of 70%, maintained its position as the lead supplier of US imports of clothing. A group of competitive Asian suppliers led by Bangladesh,



Cambodia, India, Indonesia, Pakistan, Sri Lanka, and Viet Nam cumulatively increased their volume share to 24% in 2005. Countries like India and Indonesia enjoyed value based growth rates of 34% and 20% respectively, reflecting a shift in production to higher quality clothing lines. Bangladesh maintained a positive increase in both export volume and value of 19% and 20% respectively in 2005 compared with 2004. In contrast to the low-cost suppliers, small producers such as Fiji Islands and Nepal, which had already been losing ground before the ending of quotas, were hard hit in 2005. Some countries such as Malaysia, Philippines, and Thailand continued to have fading performance in clothing shipments in both volume and value terms due to their relatively higher unit-labor costs.



Bangladesh's share in US clothing imports increased to 5.1%

11. In the EU, PRC and India continued to expand their market share, while Bangladesh recorded a decline in export volume and value of 1.2% and 6.4% respectively. The impact of final phase of quota integration by the EU is expected to be less than in the US, largely because the EU

eliminated quotas for many small supplier countries earlier under various arrangements.

12. Evidence from 2005 and 2006, suggests that the fear that Bangladesh would be squeezed out of the US and EU market as a result of quota elimination was greatly exaggerated. In future, prospects in the US market appear to be favorable for continued growth and increasing market penetration by competitive Asian producers. However, the most significant event influencing market access in the US for Asian suppliers in the next 2-3 years is likely to be the negotiated new quantitative limits on 21 categories of imports of textile and apparel products under the memorandum of understanding between US and PRC. Asian producers should seek to improve domestic competitiveness and market access to the EU, Japan, and US markets by supporting a successful completion of the Doha round, which has the potential to lower peak tariffs in the industrial countries. Trade negotiators should try to adopt simple and consistent rules of origin in order to avoid undermining the development of efficient production-sharing networks. This will be crucial to maintaining the long-term competitiveness of Asian suppliers in the world markets.

Behind-the-border barriers need to be addressed

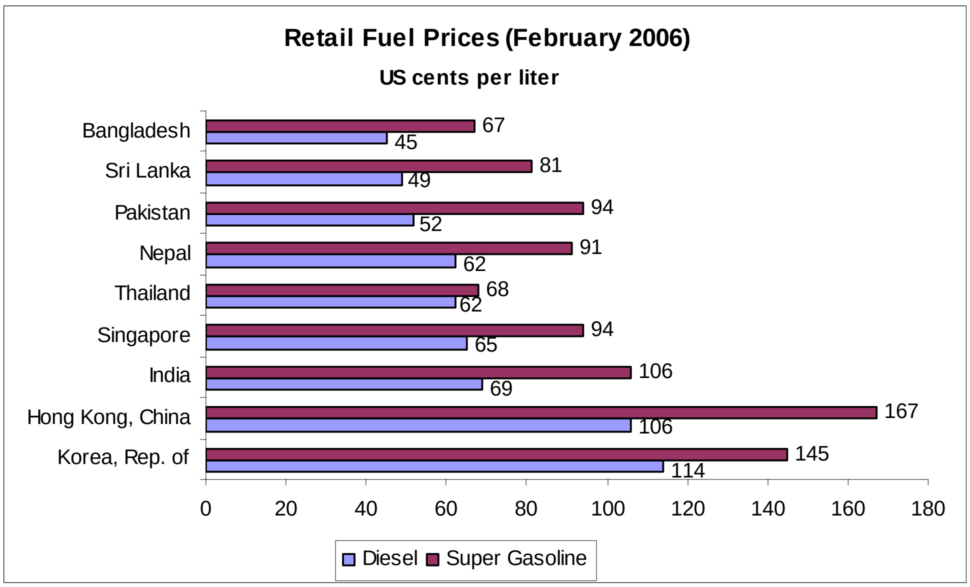
13. Bangladesh needs to address three major behind-the-border barriers to trade including (i) a weakness in economic governance, (ii) inadequate physical infrastructure and (iii) high cost of trade, which impinge on export competitiveness. In economic governance, main problem is lack of transparency in rules and regulations and business transactions, which create opportunities for rent-seeking and corruption that vitiate the investment climate and harm long-run growth. Although the regulatory procedures involved in starting a business in Bangladesh compare favorably to many other large Asian economies, the cost of starting and transacting business in Bangladesh in terms of per capita gross national income is one of the highest. On other indicators, Bangladesh lags behind comparator countries, particularly for various indicators of regulatory quality. The country also lags behind most comparator countries in physical infrastructure development, particularly with respect to the availability and quality of power, gas, ports, and telecommunication services. These bottlenecks significantly increase the cost of production, impede productivity growth and, thus, hamper export competitiveness of local firms. The high cost of bank borrowing also represents a significant obstacle to stronger export performance across the board in Bangladesh. The cause of these high costs can be found in long-standing structural rigidities, and poorly functioning public institutions, of which the nationalized commercial banks (NCBs) with their high volume of non-performing loans, is a particular concern. High trade costs discourage investment and constrain the ability of local firms to integrate into global production chains.

14. The impact of higher oil prices on the economy has been significant, but manageable so far, due to strong growth in remittances and exports[2]. However, oil price shocks may have serious macroeconomic impacts in the

[2] See Quarterly Economic Update, December, 2005 for the detailed analysis on the macroeconomic impact of oil price increase in Bangladesh.

period ahead as fuel prices in the international market are continuing to trend upward. In the past 2 years, the Bangladesh government allowed retail fuel prices to rise modestly, effectively shielding domestic consumers from higher import costs. Between May 2004 and September 2005, the domestic fuel prices, in dollar terms, were increased in the range of 16-35%, well below the 90% surge in world prices over the same period. Despite the price adjustment, the oil subsidy was estimated at over $520 million or 0.8% GDP. As global prices rise, the fiscal pressures resulting from the petroleum price subsidy continue to increase. The Bangladesh Petroleum Corporation (BPC) has so far financed its losses by borrowing from the commercial banks, which will eventually become a government liability. BPC is now finding it increasingly difficult to open letters of credit at NCBs due to its huge outstanding loans and to a shortage of foreign exchange reserves at the NCBs.

Oil price shocks may have serious macroeconomic consequences



15. The above figure provides an indication of how high the fuel subsidies to consumers are in Bangladesh. In February 2006, retail prices of diesel and super gasoline in Bangladesh were only 65% and 63% respectively of prices of same items in India. Compared with the Republic of Korea, the prices are only 39% and 46% respectively in Bangladesh. From the February level, fuel prices have further increased in the international market, implying a steady increase in the consumer subsidy and in the financial burden to BPC.

Retail prices of fuel are lowest in Bangladesh

Fiscal Management

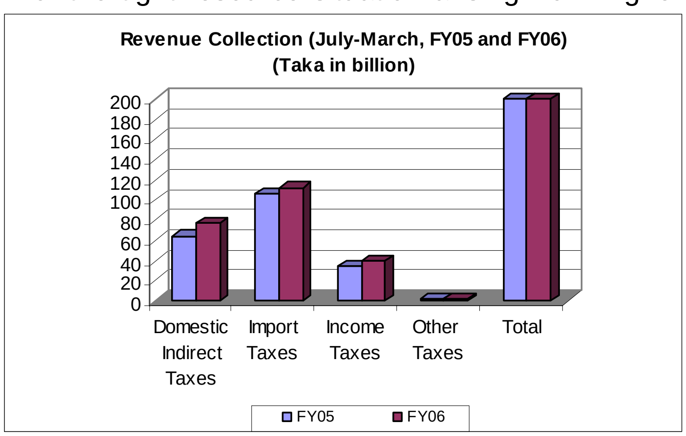
16. Despite some success in revenue administration reform, revenue collection continues to lag behind projections. Revenue collection under the National Board of Revenue (NBR) during July-March of FY2006 increased by 12.4% over the corresponding period of the preceding year. Collections in the first 9 months are just 64.6% of that targeted for the entire fiscal year. With only three months of the fiscal year remaining, the revenue

Revenue collection lags behind projection

mobilization drive needs to be stepped up to achieve fiscal targets and contain the deficit. During the first three quarters, domestic indirect taxes exhibited more robust growth (21.1%) compared with the relatively subdued growth performance (5.7%) for import-based taxes. Income taxes also showed reasonably high growth of 16.7%. Domestic supplementary duties increased by 22% and domestic value added tax (VAT) increased by 20.6%. Excise duty, which has a narrow base, increased by 14.5%. Amongst the import-based taxes, VAT at the import-stage increased by 15.3% but customs duty increased by only 1.9% while supplementary duty at the import-stage declined by 5.4%, reflecting a decline in the import of consumer items. In the wake of trade liberalization, custom duty as a source of revenue is declining in importance.

17. Structural reforms in revenue administration need to be accelerated to achieve a quantum jump in the nation's revenue-to-GDP ratio, which is currently at just 10.3% of GDP. Far higher revenues are needed to finance the economic infrastructure and social services required for faster economic growth and poverty reduction. Modernization of tax administration involving also greater coordination amongst the various wings of NBR is essential for raising efficiency in resource mobilization. The promise of achieving major revenue gains through setting up the large tax payers units for income tax and VAT remains largely unfulfilled due to inadequate preparation and lack of operational clarity. The setting up of the central audit cell is expected to help detect the source of revenue leakages.

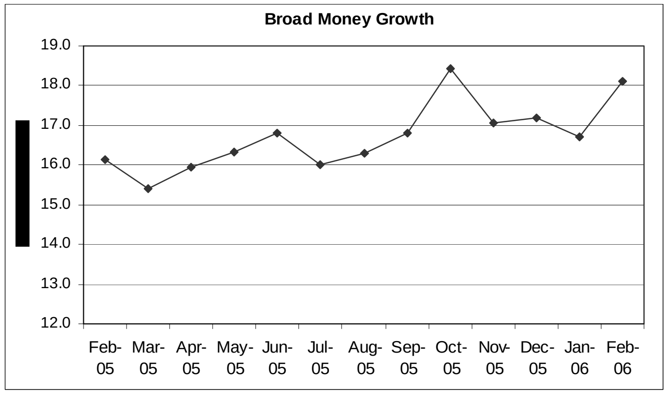
18. Weak institutional capacity and poor quality at entry for projects are adversely affecting Annual Development Program (ADP) implementation. In view of the tight resource situation arising from higher-than-anticipated outlays on fuel, the Government reduced ADP spending by 8%. In addition, a tighter policy on allocation of new funds for non-ADP projects has been adopted due to difficult resource envelope. Spending financed from general revenues is also to be reduced by 10% as part of a general fiscal austerity program. There are also a number of new and important fiscal measures including a phased introduction of pro-poor expenditure tracking in various line ministries, and an extension of the medium term budgetary framework from 6 to 10 ministries in FY2007.



Monetary Developments

Money and credit growth continues to be high

19. Despite a tight monetary policy stance, money and credit growth continues to be high. In the 12 months ending February 2006, aided by a 23.5% growth in reserve money, broad money increased by 18.1% compared with 16.2% in the previous 12 months. Private sector credit also grew at a rate of 16.2%. Net credit to the Government also recorded high growth of 21% compared with



19% in the previous 12 months. Higher money and credit growth supported private sector activity but exerted pressure on the price level and exchange rate. The weighted average yield on 28-day treasury bills was 7% in January 2006 and remained at around the same level until March. Although repo operations were undertaken in January 2006 with an average repo rate of 8%, no repo operations took place in the February-March 2006 period signifying a tighter monetary stance by the Bangladesh Bank. The inter-bank call money rate displayed considerable volatility in the January-March 2006 period. The rate shot up to 40.4% on 30 March due to a sudden shortfall in liquidity as commercial banks complied with cash reserve requirements of the central bank.

20. Bank-by-bank resolution strategies for the four NCBs have made some progress with steps taken to revive the divestiture of the Rupali Bank. Investor road shows took place in Kuala Lumpur, Karachi, Mumbai, Dubai, London and Dhaka with a good response, and this has helped to build confidence about the bank amongst potential investors. The selected bidder is expected to be announced in August and the privatization process is expected to be completed by September 2006. NCBs' performance under MOUs signed with the Bangladesh Bank is being strictly monitored to restrain new lending and improve risk management. To expedite the restructuring of the Agrani Bank, the Government has revised the terms of reference of its management advisory team to allow them to implement a program of operational restructuring and to serve as the financial advisor for the eventual sale of the bank. To improve oversight of NCB management, the boards of the Sonali, Agrani and Janata Banks are being re-constituted. Gross non-performing loan (NPL) ratios of NCBs declined from 24.5% in the quarter ending September 2005 to 21.4% in the quarter ending December 2005 while their net NPLs declined from 15% to 13.2% during the same period.

Balance of Payments

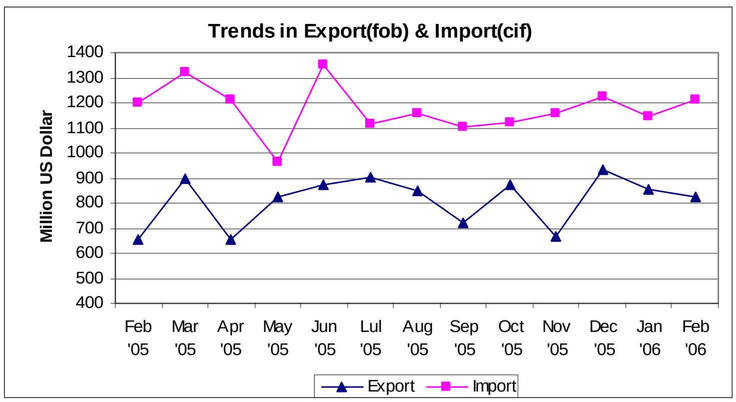
Exports show robust growth

21. Growth in exports steadily improved as the fiscal year progressed. Exports during July-February of FY2006 were $6,624 million (f.o.b. basis),

recording a 17.9% growth over the corresponding period of FY2005. Knitwear and woven garments, the two main export items accounting for 75% of the export earnings during the period, grew by 30.2% and 8.4% respectively. Other major items recording positive growth include raw jute (62.6%), jute goods (20.8%), agriculture products (35%), chemical products (16.1%) and leather (15%). The rise in jute exports, a welcome departure from past patterns, was likely caused by an increase in the cost of synthetic (petroleum by-products) substitutes. In addition, the central bank has relaxed foreign exchange restrictions on negotiating export bills, which will also contribute to timely repatriation of export earnings.

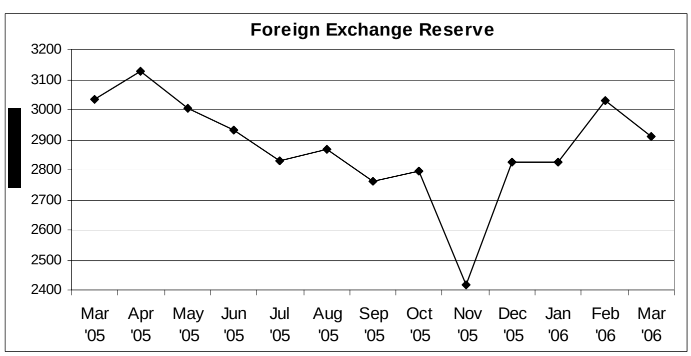
Growth in imports slows down

22. Growth in imports has decelerated during the year, mainly reflecting a fall in the imports of food and consumer items. Imports during July-February of FY2006, (on a c&f basis) grew by 9.8% to $9,234 million. In the corresponding period of the preceding year, growth was substantially higher at 26.8%. Based on data available for the first seven months, imports of crude petroleum increased by 50.1%, iron and steel by 55.1%, clinkers by 35.8%, fertilizers by 23.3%, capital machinery by 33.5%, and chemicals by 23.9%. There was an absolute decline in imports for major food items e.g. rice, milk, spices, oil seeds and sugar. The decline in rice imports was primarily a result of higher domestic production. Based on LCs opened during July-February of FY2006, imports exhibit a decelerating trend with only 4% growth over the corresponding period of the preceding year.



Trade deficit declines

23. Rising exports and slower-than-trend growth in imports caused the trade deficit to narrow to $1,768 million in July-February of FY2006 from $2,028 million during the corresponding period a year ago. Although deficits on service and income accounts increased, migrant workers remittances increased by a robust 23.8% during the same period, turning the deficits in the current account balance (–$405 million) into an overall current account surplus of $232 million. The growth in remittances has been helped by the strong oil revenues in the Middle



East, Taka depreciation, anti-money laundering drives and improvements in money transfer facilities through the private commercial banks. Foreign exchange reserves have continued to be volatile, but despite the oil shock, reserves have remained roughly stable since March 2005.

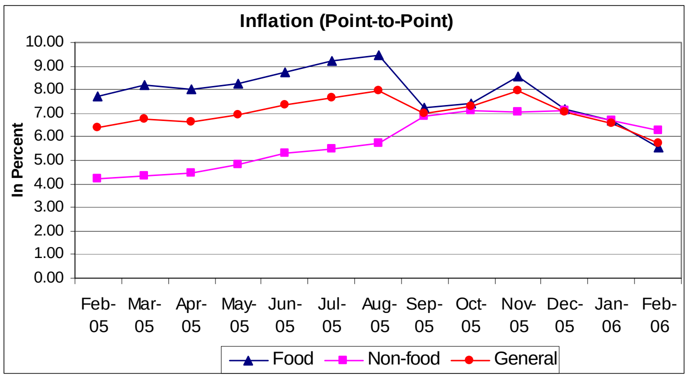
Inflation and Exchange Rates

24. Inflation, on a point-to-point basis, declined to 5.7% in February 2006 from 7.7% in July 2005. The decline was caused primarily by a fall in domestic food prices. Although decelerating, the rate of inflation remains high by historical standards. On an annual average basis, the inflation rate increased from 6.7% in July 2005 to 7.1% in February 2006. The high inflation rate is caused by the growth in money supply and domestic credit, the knock-on effects of higher international prices of oil and other imports (e.g. food grains and sugar), and depreciation of the Taka. The continuing upward trend in oil prices and depreciation of the Taka are likely to heighten price pressures in the period ahead. However, the main mitigating factor is the likelihood of a good *boro* crop and an abundant domestic food supply.

Price pressures are likely to be heightened

Taka is under pressure

25. The Taka has been under pressure in the inter-bank foreign exchange market, depreciating from Taka 65.6 to a dollar on 1 September 2005 to Taka 67.8 to the dollar on 28 February 2006. The Taka is under pressure due to increased import financing



requirements for oil imports, the need to meet deferred payment obligations for past petroleum and capital goods imports, increased profit remittances by multinational companies and the rising demand for foreign exchange to repay short term loans and for trade credits. The exchange rate rose sharply to Taka 71.4 to a dollar on 30 March 2006. The differential between the inter-bank and curb rates (Taka 72 to a dollar on 30 March 2006) has narrowed down due to the more rapid deprecation in the inter bank market. To reduce inflation and slow down the slide in the value of Taka, the Bangladesh Bank is gradually tightening monetary policy, monitoring profit repatriation by the multinational companies and has advised the commercial banks to discourage non-essential imports.

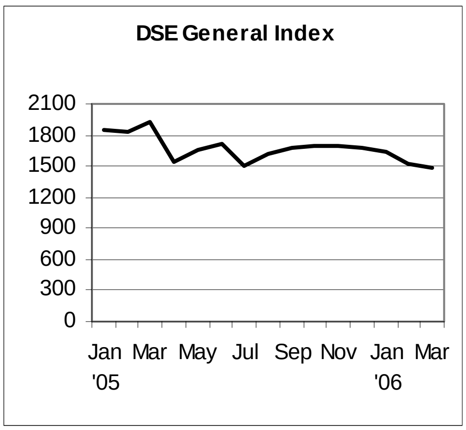
Capital Market Update

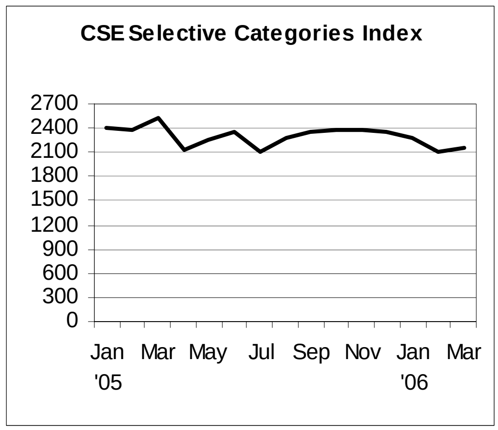
Capital market shows downward trend

26. During the first quarter of 2006 the capital market continued its downward trend due to strong selling pressure from small investors, the absence of institutional investors, and a shifting of funds to the primary market. High interest rates on savings and bank depository instruments, and a general lack of investor confidence also contributed to the depressed

capital market. As of mid April 2006, a total of 3 initial public offerings were issued while 2 new companies were listed on the stock exchange. Decisions have been taken to divest government shares of Power Grid Company of Bangladesh Limited (PGCB) and Dhaka Electric Supply Company Limited (DESCO) to the public, through the stock exchanges. This will considerably boost up the capital market.

27. The Dhaka Stock Exchange general index went down to 1491.77 at the end of March 2006 from 1677.35 at the beginning of the year, registering a drop of 11.1%. The market capitalization decreased by 8.6% during the quarter, standing at $3.2 billion at the end of March compared with $3.5 billion at the beginning of the year. The total turnover stood at $45 million in March, from $43 million in January. The Chittagong Stock Exchange (CSE) selective categories index dropped to 2143.65 at the end of March from 2348.05 at the beginning of the year, registering a decline of 8.7%. The CSE market capitalization fell by 12% during the same period while market turnover experienced a significant decline.





28. The Securities and Exchange Commission has approved amendments to the direct listing regulations, which will be effective following the publication of the gazette by the stock exchanges. Under the new amendments, the public limited companies with a minimum paid-up capital of Tk. 100 million will now be able to get listed directly on the country's stock exchanges. These companies are required to be commercially operational for at least 5 years, make profit for at least 3 years, and have at least a 'BBB' rating. The direct listing regulation previously allowed companies to be listed directly with a paid-up capital of Tk. 50 million and a commercial operation record of 3 years.

REFORMING THE POWER SECTOR IN BANGLADESH[3]

Overview

29. Efficient and affordable power supply is essential for rapid economic growth and poverty reduction in Bangladesh. Industry and commerce need accessible and reliable electricity to conduct business and to expand economic activities. Households need reliable and reasonably-priced electricity to realize their full socio-economic potential and for decent standards of living. The coverage of electricity in Bangladesh is limited with only about a third of the population having access to electricity. Power distribution networks are concentrated in urban areas with insufficient rural coverage (only about 19% of rural households connected to electricity against 80% urban). Poorer rural households have little access to electricity, mostly using kerosene for lighting. For mechanized irrigation, farmers rely much more on diesel (90%) than on electricity. The quality of service by power utilities is poor and the per capita generation at around 158 kilowatt-hours (kWh) a year is also among the lowest in the world. Electricity consumption in Bangladesh grew at an average annual rate of 8.1% during the last ten years. Identical growth in electricity demand is expected to be maintained during the next ten years. The current net generating capacity of the country is about 4,120 megawatts (MW) as against an installed capacity of over 5000MW, while the peak demand is about 4,700 MW (Table 1).

30. Shortage of electricity and unreliable supply are costly to the economy. Frequent and prolonged load-shedding causes large losses to industrial production and disrupts economic activities. This also discourages consumers from regularly paying their bills. Extensive recourse to captive power by the export-oriented industries raises production cost and reduces export competitiveness. Bangladesh Power Development Board (BPDB) and Dhaka Electric Supply Authority (DESA), two of the three (the other being Rural Electrification Board (REB) key state-owned power utilities with huge system losses are financially distressed and are unable to pay their debts. The Government has long serviced the domestic and foreign debts of these enterprises out of government revenues, effectively providing large subsidies to the power sector but shouldering unsustainable budgetary burdens. The Government also provided direct support through equity injection, grants and loans. The large future investment needs of the power sector entities will add new debt service burdens. Losses of BPDB and DESA cannot be supported any further by the Government without depriving other important sectors e.g. health and education, competing for limited government resources. The heavy subsidies provided to power are also inefficient and inequitable. Although the public sector power utilities are incapable of meeting the rising electricity demand due to the lack of financial resources, private sector potential to respond to this need has not been fully harnessed. Bangladesh faces an anticipated shortfall of about 2,000 MW of generating capacity by 2010 and over 5,500 MW by 2015, requiring substantial domestic and foreign investment for building up adequate capacity.

[3] This article draws on ADB TA (4379-BAN) Draft Final Report: Component A: Support for Power Sector Reform and Restructuring.

Reforms in the Power Sector

31. Recognizing the need to improve the performance of the power sector, the Government adopted a policy paper titled *Power Sector Reforms in Bangladesh* (PSRB) in 1994 in consultation with the major development partners in the power sector.

Table 1: Trend in Power Supply and Demand in Bangladesh FY 1994 – FY 2005

Item	1994	1999	2002	2003	2004	2005
Installed Capacity (MW)	2,608	3,603	4,230	4,680	4,680	4,995
Peak Demand (MW)	-	2,881	3,659	3,947	4,259	4,597
Served Generation (MW)	1,875	2,449	3,217	3,428	3,592	3,720
Load Shedding (MW)	23-500	16-774	5-367	5-468	2-694	7-770

Source: Bangladesh Power Development Board

32. PSRB outlined the reform process to gradually remove constraints in the sector through improvements in the sector and corporate governance, introduction of competition, and public private partnerships. The PSRB envisioned in the long term a structure of the power sector based on (i) separation of sector regulation and operation; (ii) autonomy and commercial orientation of the sector entities; (iii) separation of generation, transmission, and distribution; and (iv) increased private sector participation. Transmission assets would remain in the public sector, while generation and distribution assets would have both public and private ownership. The objectives of these initiatives were to eliminate monopolies and foster competition. Commercial discipline and good customer service were expected to be achieved through competition among entities in the power sector.

33. The Government issued its Vision and Policy Statement for Power Sector Reforms in 2000. This further clarified the specific details of structural arrangements on generation, transmission and distribution along principles of corporatization, commercialization, cost reflective and equitable tariffs and greater private sector participation in generation and distribution.

34. The PSRB provides a sound basis and a clear direction for reforms in the power sector of Bangladesh. In 2005, the Government prepared its 3 Year Road Map for Power Sector Reform, which sets out the proposed reform program for the years 2006-2008. The Road Map is a detailed implementation plan of the Government's Vision Statement cognizant of the lessons learned in establishing sector entities, particularly the need to introduce new management, a commercial culture, and resolution of employee issues while at the same time providing sufficient autonomy and improved governance. The main results to be achieved over the three year period include further unbundling of electricity supply entities into commercially viable generation and distribution companies.

Results of Reforms

35. As a sequel to the PSRB and the Vision Statement, various reform measures have been undertaken in the power sector. BPDB has undertaken the process of internal unbundling and improving operational and financial performance through establishing cost/profit centers. Transmission assets and operations have been transferred to a new transmission company, Power Grid Company of Bangladesh (PGCB), which is still wholly owned by BPDB. In generation, Ashuganj Power Station Company Limited (APSCL), also owned by BPDB, has been set up to takeover the 724MW Ashuganj Power Station.

Electricity Generation Company of Bangladesh (EGCB) has been set up to own the assets of the Siddhirganj Power Station. In distribution, Dhaka Electric Supply Company (DESCO) was created to take over some of the service areas in Dhaka from DESA, which owns the company. West Zone Power Distribution Company (WZPDC) was set up to takeover the south west distribution zone from BPDB, which still owns the company. Similarly, Northwest Zone Power Distribution Company (NWZPDC) has been set up (yet to be functional) to take over the northwest distribution zone from BPDB. In 2005, Dhaka Power Distribution Company (DPDC) was established to takeover the distribution assets of DESA. BPDB is currently responsible for about 60% of electricity generation including APSCL and about 30% of distribution. With the 1994 policy to allow private participation in the power sector, seven plants with new capacity of 1,290 MW have been set up through independent power producer (IPP). In FY2005, out of a total national generation of 21,408 MWh, IPP produced 8,185 MWh representing 38% of the total generation capacity. Seventy rural electric cooperatives—organized, initially funded, and monitored by REB—are in charge of distribution in most rural areas.

36. The reform program has enabled steps to be taken to enhance financial health of the sector entities. PGCB and DESCO have undertaken a number of reform measures to improve their financial position, such as (i) a change in PGCB billing procedures for wheeling charges from asset-based billing to energy-based billing, (ii) load balancing among different transformers, (iii) expansion of computerized billing systems, (iv) upgrading of their power supply systems, and use of pre-paid meters. PGCB and DESCO have become financially sustainable companies yielding net profit before tax of Taka 422 million and Taka 551 million respectively in FY2005. Under the ADB-assisted Power Sector Development Program, the amount of the outstanding dues owed by the Government ministries and divisions was substantially reduced from about Taka3.3 billion in June 2002 to about Taka 1.4 billion in December 2005. At the same time, the outstanding dues owed by the Government's autonomous and semi-autonomous bodies have been reduced from Taka 6.8 billion to Taka 3.5 billion.

37. The reform process has been difficult and uneven due to a lack of political will, labor union opposition and interference by the vested interests. Although BPDB's operational performance improved with current gross system losses (including station use) around 13% and collection-billing ratio of 90%, it still makes losses and the cash it generates is insufficient to meet its debt service obligations (Table 2). Reforms undertaken at BPDB need to be accelerated if it is to achieve the goal of unbundling the remaining generation and distribution facilities. DESA's performance remains poor with distribution losses of around 30% and a billing collection rate at around 91%. The entity remains unable to pay in full for its imported energy bills from BPDB.

Table 2: Performance of Distribution Entities FY1994 – FY 2005

Item	**1994**	**1999**	**2002**	**2003**	**2004**	**2005**
System Losses (%)						
BPDB	30.3	29.7	23.2	20.7	21.3	20.0
DESA	32.8	29.9	35.6	30.9	33.7	30.0
DESCO	-	40.5	26.7	21.2	19.2	16.7
REB	15.6	18.6	16.7	17.3	15.6	13.8
WZPDC	-	-	-	-	-	21.4
Overall Power System	37.2	35.8	32.0	28.5	27.2	25.0
Collection to Import (%)						
BPDB[1]	62.5	55.3	74.6	76.8	78.5	80.1

DESA	54.6	57.2	72.7	72.8	77.4	70.0
DESCO	-	35.2	65.3	69.5	70.9	80.9
REB	83.5	76.5	84.4	82.8	83.5	85.8
WZPDC	-	-	-	-	-	87.8

[1] collection to generation

Source: power sector entities reports

Directions for Future Reforms

38. It is essential to accelerate the pace of power sector reforms. In line with the sector roadmap, a key result to be achieved over the next three year period is the further unbundling of the electricity supply entities into economically viable generation and distribution companies, coupled with full functioning of a strong independent sector regulator and promotion of private sector participation. These efforts are expected to enhance sector governance through improved predictability, accountability, transparency, and fairness in power sector operations.

39. The planned reforms will substantially enhance competition in the sector. Apart from the IPPs in generation that will compete with BPDB generation subsidiaries, three distribution models e.g. subsidiaries under BPDB, Palli Bidyut Samities (PBSs) under REB, and DESCO and DPDC as stand-alone entities, will be operating side by side. The benefits to be derived from the reform agenda, complete with institutional and financial restructuring (below) would be enormous. There would be significantly fewer outages and power quality will improve resulting in a more productive commercial and industrial sector. Increased revenue collection and a financially viable sector would increase government tax revenues. Greater access to electricity will result in improved living standards and contribute to rapid socio-economic development. It will be possible to supply more efficient and lower cost power under a competitive market structure, with greater private sector participation.

Financial Restructuring of BPDB and DESA

40. The autonomous successor companies need to start business operations with a clean slate. But BPDB and DESA have significant unpaid and overdue debt service liabilities (DSL) to the Government and there are sizable cross-debts between these and other power sector companies. Both agencies show large and growing unpaid electricity bills by customers. The overdue DSL obligations are unlikely to be paid by BPDB and DESA and much of the overdue electricity bills are also unlikely to be collected. It is necessary to clean up the balance sheets of BPDB and DESA by undertaking financial restructuring involving write-off of unrecoverable cross-debts and customer receivables of BPDB and DESA, a set-off of uncollectible Government, autonomous bodies and DESA dues to BPDB against DSL to Government and conversion into equity of net overdue DSL and long term loans payable to Government. In view of the likely power sector commercialization, the key challenge is to restructure the power sector's long-term debt to deliver tariffs that are affordable and also permit Government and incoming private investors to recover the cost of new investments. The on-going power sector reform provides a good opportunity to restructure power sector debt.

41. The balance sheets of BPDB and DESA contain unrecoverable assets and accumulated liabilities that cannot be met from existing resources or future revenues based on existing tariffs. There are also unrecorded liabilities with respect to unfunded

pension obligations. According to the balance sheets of BPDB and DESA, (30 June 2004), the current ratios of BPDB and DESA were 1.0 times and 0.4 times respectively and the debt-equity ratio for BPDB was 53%. DESA is technically insolvent, as its liabilities exceed assets. If adequate provisions for bad and doubtful debts were made against customer accounts receivables, BPDB and DESA's current ratios would drop to 0.5 times and 0.3 times respectively.

Financial Impact of the Restructuring

42. The impact of the proposed financial restructuring involving write-offs, set-offs and conversion into equity of the net DSL to the Government will be substantial for the power sector. The conversion into equity of the sizable debt burden in the form of past DSL of Taka 68.6 billion will have a profound positive impact on the balance sheets of existing and successor power utilities. This will also have a salutary impact on future tariff levels as the power companies will not have to meet past obligations out of future revenues. The net effect of the proposed financial restructuring measures will be to increase the shareholders' equity by Taka 58.4 billion. This will represent an increase of 66% of the currently reported equities of BPDB, DESA, PGCB, APSC, and DESCO.

Need for Tariff Adjustments

43. BPDB is currently making huge losses since it has to absorb the difference between the bulk selling rate and the generation cost. This is seriously jeopardizing proper operation and maintenance of power stations. Current tariffs are inadequate for the power utilities to meet their operational expenses, debt service obligations and finance a proportion of their investment requirement from internal cash generation. There is an urgent need for cost reflective tariffs and a mechanism for the indexation of tariffs for the effects of inflation, exchange rate movement and changes in fuel prices.

44. In addition to tariff adjustments based on cost recovery, there are needs for addressing inequities and distortions in deriving the benefits of the subsidies through BPDB and DESA. As the poor have limited access to power, they are not able to benefit from the subsidies. It is the better-off urban residents who are the main beneficiaries of energy subsidies. The first block (0 to 100 unit) of urban domestic power consumption is subsidized with a rate of Taka 2.50/kwh. With a large number of the consumers using less than 100 kwh/month, the block is quite wide. Indeed, the tariff is lower than the identical block for the rural areas (Taka 2.53/kwh to Taka 2.90/kwh). Cross subsidies are believed to exist from industrial and commercial customers to urban residential customers. The BPDB/DESA/DESCO irrigation tariff is Taka 1.84/kwh, which is much lower than the REB rate for irrigation (Taka 2.60/kwh to Taka 3.05/kwh). Thus, farmers using BPDB/DESA/DESCO power for irrigation are also enjoying cheaper power compared with those using REB power. Also, with over 90% of irrigation diesel-based involving much higher cost, a small proportion of farmers derive benefits from access to subsidized power for irrigation.

45. Power tariffs have to be increased to enable the power companies to earn sufficient returns on their assets. In addition, it is essential to address weak management and poor governance in power sector entities to reduce losses and subsidies although the improvement cannot be achieved overnight. Pricing needs also to be set at a more appropriate level to attract private investment. To begin with, the BPDB bulk tariff for sale to distribution companies and retail tariff for the lowest block for the urban domestic

consumer may be enhanced This will reduce inequity and generate revenue. The BPDB/DESA/DESCO irrigation tariff may be enhanced to bring it at par with the REB rate for irrigation. Although not too significant as a source of revenue, this will remove an anomaly in tariff structure and make it easier for transferring areas from BPDB/DESA/DESCO to REB, as farmers (under BPDB/DESA/DESCO) will no longer oppose the move. Reduction/removal of BPDB/DESA/DESCO irrigation subsidies will improve the financial position of the power sector.

46. Early operationalization of the Bangladesh Energy Regulatory Commission (BERC) will allow the setting of tariffs on economic rationale. The BERC will also be able to ensure implementation of improved accounting and financial management practices in the power sector entities contributing to raising their levels of operational efficiency and reducing losses and subsidies. Full functioning of BERC is essential to establish a level playing field and to encourage potential private investors for investing in the power sector.

Way Forward: ADB's Strategy for Power Sector Development

47. ADB has established a long-term partnership with the Government to restructure and reform the power subsector. ADB's power subsector strategy for Bangladesh consists of (i) changes in the business environment through corporatization, commercialization, and increasing private sector participation; (ii) institutional improvements in BPDB and DESA; (iii) creation of new power subsector companies such as PGCB, DESCO, NWZPDC, WZPDC, EGCB, and APSCL to serve as role models for the power sector; (iv) enlarging the scope of rural electric cooperatives (PBSs); and (v) strengthening the long-term planning and regulatory processes.

48. ADB will continue to support the Government's implementation of its PSRB to promote good governance at the sector and the corporate levels. At the sector level, governance is to be improved by supporting measures that increase predictability (i.e., long-term planning, codification of rules and regulations, and independence of regulatory processes), transparency (i.e., systematic dissemination of relevant sector information, public hearings, and discussions on issues before they are decided), and accountability (i.e., a cause-effect structure of incentives). At the corporate level, governance is being enhanced through corporatization, independence of the boards of directors from the Government, introduction of a work-based pay structure, defined delegation of powers to staff, computerized management information systems, and commercialization of activities.

49. In addition to its support for expanding and upgrading the power supply systems to meet the targets of the power sector road map, ADB will continue to assist the Government by maintaining its role in coordinating assistance to the power subsector. ADB will continue to review and monitor the reform and restructuring process, and regularly discuss policy with the Government. Further, ADB will help the Government pursue restructuring and deepen reforms to promote good governance, enhance sector efficiency, and encourage greater private sector participation in the power subsector to ensure access of the poor in the distribution.

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