Bangladesh

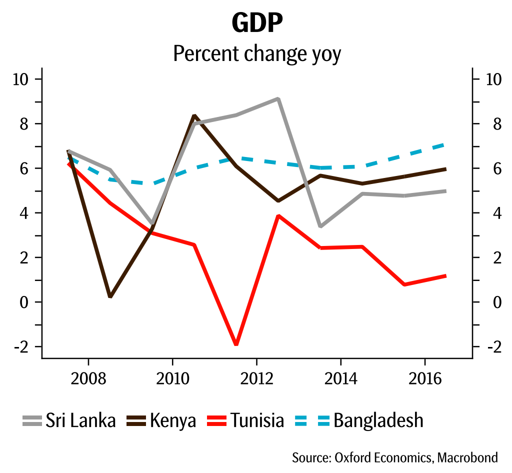
SEB MERCHANT BANKING – COUNTRY RISK ANALYSIS **25 November 2016**

Analyst: Martin Carlens. Tel: +46 8-763 96 05. E-mail: martin.carlens@seb.se

The economy continues to expand strongly supported by household spending and exports. External balances are improving while public finances keep struggling with low revenues. Political strife has calmed from elevated levels in 2015 but the security situation is challenging.

Country Risk Analysis

Growth surprises on the upside yet again. High economic growth has long been one of Bangladesh's main credit strengths. The authorities estimate that real GDP expanded by 7.1% in the fiscal year (FY) 2016 that ended in June this year. This is an acceleration from 6.6% in the previous year and quite a remarkable achievement in the current global context. An average GDP growth of about 6.4% in the past five years is higher and more stable than the average for economies in the same risk class. This is being said while noting that observers such as the World Bank have expressed some scepticism over possibly exaggerated official headline growth numbers.



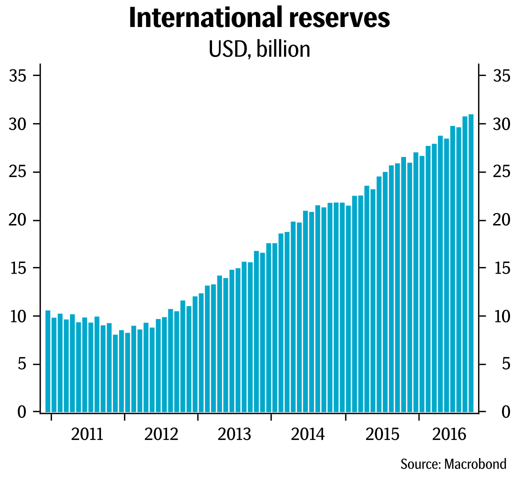
Consumption continues to propel the economy. The rapid growth is upheld by consumption, mainly by households. This comes despite a decline in workers' remittances from the Middle East. Overall consumption stands for about 80% of Bangladesh's economy. Exports and public investment have also picked up with several large construction projects nearing completion, including the Padma bridge, the Dhaka metro rail network and several power plants. On the supply side, the manufacturing industry, standing for nearly 28% of GDP did particularly well in the past year.

Inflation edging down. Bangladesh has a history of higher inflation than its peers (7.2% in the past 5 years) which is commensurate with higher than average economic growth. At the same time, inflation has been reasonably stable. In FY 2016 it edged down to 5.5% mainly due to lower food prices which compensated for upward pressures from wage increases for public sector employees. The central bank which cut interest rates to 6.75% in early 2016 targets inflation of 5.8% in the current fiscal year.

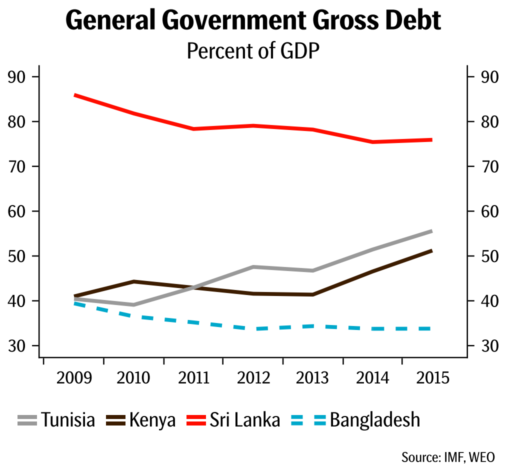
External balances are relatively favourable. Bangladesh has had, contrary to most peers, a broadly balanced (or even positive) current account in the past decade. Earnings returned from workers abroad have traditionally not only supported household spending but also provided a significant boost to the capital account. Bangladeshis working abroad return funds that on average amount to nearly 10% of GDP in the past four years. This is comparable to countries such as the Philippines and Sri Lanka. During 2016, however, remittance inflows have started to shrink, most importantly due to lower flows from the Middle East. As this largely is related to a lower oil price regime, there is a risk that these flows will not rebound in the medium-term. Despite the decline, the current account shifted from a marginal deficit to a small surplus in the fiscal year ending in June 2016. The main reason was a compensating uptick in exports, chiefly garments exports.

External debt is low and mostly held by the public sector. External debt is very low compared to peers. The public sector stands for the vast majority of it. This debt is entirely due to official creditors, a significant share of it is on concessional terms and its average maturity is long.

Capital inflows driving up reserves and the exchange rate. Inflows of medium and longer term capital have continued to put upward pressure on the nominal exchange rate. While active interventions from the central bank has managed to keep the exchange rate versus the USD roughly stable, the Bangladeshi taka has appreciated quite significantly in real trade weighted terms. The inflows have led to a continued rise in foreign reserves which recently surpassed USD 30 bn. Covering roughly 8 months of imports this provides an adequate cushion.



Fiscal policies struggle with low revenues. Bangladesh has comparably high nominal tax rates but one of the lowest tax revenue to GDP ratios in the world. This is due to both poor administration and naturally due to low incomes. Although budget deficits, despite this, traditionally have been manageable, low revenues put limits to growth critical expenditures. The FY17 budget targets a deficit of 5% of GDP, slightly higher than the actual deficit in FY16. Meanwhile, the government is seeking to broaden the tax base. Measures include getting more people to pay income tax (less than 1% of the population pays income tax) and, more importantly introducing a new and long delayed VAT in mid-2017.



Debt burden is very low. Public debt is on a gradually declining trend and, at about 34% of GDP, it compares very favourable to peers. Most other debt metrics also compare very favourably but the government's interest rate costs as a share of the country's minimal revenues are high compared to peers. In addition, more than 40% of the debt is denominated in foreign currency which raises the vulnerability to swings in the exchange rate. Bangladesh has a default-free track record.

Banking sector remains in poor state. Bangladesh's banking sector is relatively large given the country's level of development, and assets as a share of GDP continued to rise in the past year. Consequently, financial problems in the sector would risk spilling over to the sovereign. Moreover, it is the state-owned banks accounting for a significant although shrinking share of the banking sector's assets that are facing the greatest challenges. Although the share of non-performing loans among these banks have declined marginally recently in line with the rest of the sector, they still average above 20%. Meanwhile, poor asset quality has led to a continued decline in profitability for the sector as a whole, and capital adequacy has worsened with the state-owned banks lying below the regulatory minimum.

Outlook is characterized by high potential and deep challenges. Most observers tend to agree that the economy's potential is vast. However, it remains undermined by various bottlenecks to supply, including from infrastructure, excess regulation and persistent political and social conflicts. The government aims at reaching average economic growth of 7.4% in the period up to 2020. This is feasible assuming that pubic investment spending stays robust. However, growth around 6-7% appears more realistic.

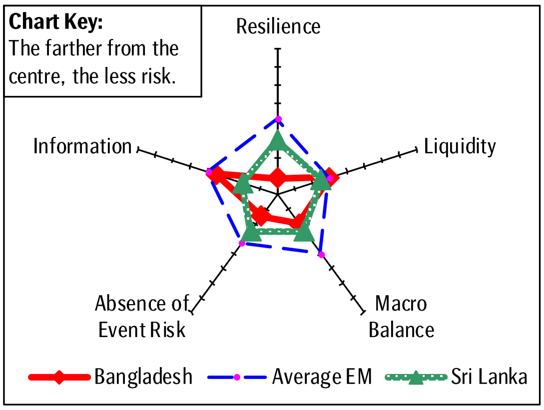
Although a continued progress with foreign-backed infrastructure projects is expected, the political, social, and economic situation is likely to remain relatively unconducive to private foreign investment. The poor business climate is reflected in the World Bank's most recent doing business indicator where the country advanced two places but still lies at 176 out of 190 countries. The investment environment also suffers from poor infrastructure which is reflected in Bangladesh's ranking of 106 of 138 countries (previously 107 of 140) in the most recent World Economic Forum global competitiveness index. Infrastructure is deemed the most important obstacle to doing business.

Political unrest remains most important risk. Although domestic political risk may have declined from early 2015 it still weighs on country risk. On the one hand the ruling Awami League's political monopoly contributes to stability as it allows it to easily pass legislation. This monopoly situation is widely expected to last until the next elections around late 2018. On the other hand, the government's increasing reliance on the police, the army, and other security services to handle its opponents and more recently terrorist attacks by Islamic fundamentalists risks straining public finances and poses a threat to the country's democratic system over the longer term.

Loss of competitiveness is medium-term risk. Another risk relates to the country's growth model which is narrowly focused on exports of ready-made garments and remittance driven household spending. Few observers expect any change in this regard over the medium-term as links between government representatives and the garment industry are tight. The poorly diversified economic structure makes the economy vulnerable to external shocks and an appreciation of the exchange rate which would render exports less competitive.

Bangladesh: Risk Profile

Key ratios	2016
Population (mn)	159
GDP/capita (USD)	1525
Real GDP growth (%)	6.9
Inflation (%)	6.3
Current account balance (% of GDP)	1.5
Reserves/imports (months)	9
Budget balance (% of GDP)	-2.8
Government debt (% of GDP)	34



External Ratings:
Fitch: BB- / Stable
Moody's: Ba3 / Stable
S&P: BB- / Stable

Peers:
Kenya
Nigeria
Sri Lanka

Graph: Weak institutions and low GDP per capita hold back "resilience". "Event risk" is high due to the deep-rooted antagonism between the two main parties and their respective begum. A low external debt supports the liquidity score.

Bangladesh: Key Indicators*

Macroeconomic	2012	2013	2014	2015	2016	2017	2018	2019
GDP real (chg)	6.0%	6.1%	6.6%	7.1%	6.9%	6.8%	6.7%	6.6%
GDP (bn USD)	146.5	172.0	195.2	221.9	248.4	275.3	305.2	334.7
GDP/capita (USD)	943	1 094	1 227	1 378	1 525	1 671	1 831	1 986
Investments/GDP	18%	18%	17%	16%	15%	14%	13%	13%
Trade/GDP (%)	4%	4%	4%	4%	3%	3%	3%	3%
Money & Prices								
CPI inflation (%)	6.2%	6.8%	7.3%	6.4%	6.3%	6.5%	6.6%	6.3%
Interest rates	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
Exchange Rate (USD)	81.9	78.1	77.6	77.9	79.0	81.0	83.0	85.7
Government Finances								
Budget balance/GDP	-2.9%	-2.9%	-2.7%	-2.9%	-2.8%	-2.7%	-2.5%	-2.3%
Govt debt/GDP	34%	34%	34%	34%	34%	34%	34%	34%
Balance of Payments (USD bn)								
Current account	2.6	2.1	0.8	2.7	3.6	3.2	3.5	3.9
(% of GDP)	1.8	0.8	-0.8	1.2	1.5	1.2	1.2	1.2
Export of goods	2.5	2.9	3.0	3.2	3.4	3.7	4.1	4.4
Imports of goods	3.9	4.4	4.8	4.9	5.2	5.6	6.0	6.4
Net FDI	1.3	1.4	1.9	2.2	2.3	2.4	2.7	2.9
Loan repayments	--	--	--	--	--	--	--	--
External Debt & Liquidity (USD bn)								
Reserves	11.4	16.6	20.8	25.8	29.4	32.8	36.0	39.2
Gross external debt (% of GDP)	19	19	18	16	16	15	15	14
Gross External Debt	28.3	33.5	34.9	36.3	38.9	41.5	44.4	47.5
o/w short term debt	2.0	3.7	4.2	1.5	1.5	1.5	1.5	1.5
Oil price (Brent)	$112	$109	$99	$52	$44	$50	$52	$59

** Fiscal year (July 1 - June 30).*

Source: OEF (Oxford Economic Forecasting), IMF and SEB estimates.

Rating history				
Fitch (eoy)	n.a.	n.a.	n.a.	BB-
Moody's (eoy)	n.a.	n.a.	n.a.	Ba3
S&P (eoy)	n.a.	n.a.	n.a.	BB-

Type of government:	Parliamentary democracy
Next elections	Parlimentary - By January 2019. Presidential - 2018
Other:	
Latest PC deal	None
Recent IMF programmes	Three-year Extended Credit Facility, expired October 2015