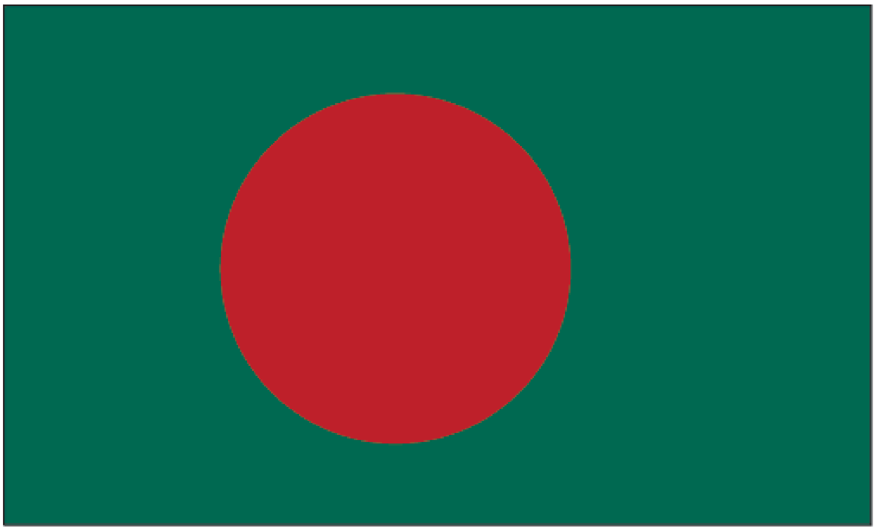
Rabobank

Country report **BANGLADESH**



Summary

Benefitting from its comparative advantage in producing ready-made garments and its relatively low degree of integration into the global economy, Bangladesh's economy continues to prove its resilience amid a deteriorating external environment. In 2011, the economy expanded by 6.7% and 6% growth is expected for this year. Yet, despite its strong economic performance, Bangladesh remains one of the poorest countries in the world, as its weak physical and administrative infrastructure, widespread corruption and recurrent vast floods prevent higher growth rates. Recent government efforts to strengthen secularism and address war crimes committed during the 1971 war of independence have deepened political polarization, while progress on the government's policy agenda is slow and important reforms to free more funds for social and economic development are lagging. Despite foreign grants, budget deficits remain stubbornly high and are partly financed by the central bank, which contributes to double-digit inflation levels. The external position remains acceptable, even though the current account will post limited deficits in the coming years.

Things to watch:

- Progress on the policy agenda amid considerable political polarization
- Impact of rising commodity prices on social stability
- Ability of the central bank to rein in double-digit inflation

Author: **Fabian Briegel**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-64053
F.Briegel@rn.rabobank.nl

Bangladesh

National facts		
Type of government	Parliamentary democracy	
Capital	Dhaka	
Surface area (thousand sq km)	144	
Population (millions)	164.4	
Main languages	Bangla	
	English	
Main religions	Muslim (90%)	
	Hindu (10%)	
Head of State (president)	Zillur Rahman	
Head of Government (prime-minister)	Sheikh Hasina Wajed	
Monetary unit	Taka (BDT)	
Economy		**2011**
Economic size	*bn USD*	*% world total*
Nominal GDP	109	0.16
Nominal GDP at PPP	267	0.34
Export value of goods and services	26	0.12
IMF quotum (in mln SDR)	533	0.22
Economic structure	*2011*	*5-year av.*
Real GDP growth	6.7	6.2
Agriculture (% of GDP)	18	19
Industry (% of GDP)	29	28
Services (% of GDP)	53	53
Standards of living	*USD*	*% world av.*
Nominal GDP per head	655	6
Nominal GDP per head at PPP	1600	13
Real GDP per head	522	6

Social and governance indicators			rank / total
Human Development Index (rank)			146 / 187
Ease of doing business (rank)			122 / 183
Economic freedom index (rank)			130 / 179
Corruption perceptions index (rank)			126 / 178
Press freedom index (rank)			120 / 182
Gini index (income distribution)			32.1
Population below $1 per day (PPP)			36%
Foreign trade			**2010**
Main export partners (%)		*Main import partners (%)*	
US	20	India	16
Germany	13	China	13
UK	9	Kuwait	8
France	6	Singapore	5
Main export products (%)			
Readymade garments			67
Fish & prawns			3
Jute products			3
Leather & hides			2
Main import products (%)			
Textiles			21
Capital goods			20
Petroleum & petroleum products			12
Iron & steel			6
Openness of the economy			
Export value of G&S (% of GDP)			24
Import value of G&S (% of GDP)			33
Inward FDI (% of GDP)			1.0

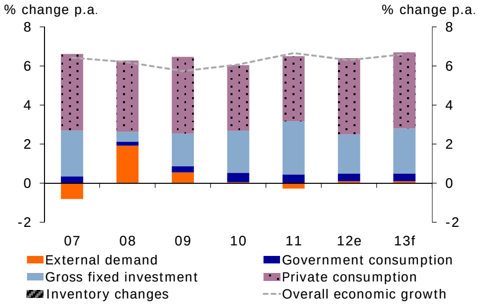
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Bangladesh is a small South Asian economy, located in the delta region of the Brahmaputra and Ganges rivers. The country borders India, by which it is almost completely enclosed as far as its land borders are concerned, and Myanmar. Owing to its Muslim majority, in contrast to Hindu-dominated India, Bangladesh became part of Pakistan in the aftermath of the dissolution of former British India, despite a distance of about 1,600 km between the two territories. In 1971, however, following an India-supported war of independence, the former East Bengal split from Pakistan, as Bengals felt dissatisfied and marginalized in the union. Today's Bangladesh has a population of about 164 million inhabitants and a nominal GDP of USD 109bn, which corresponds to a very low USD 655 per capita (USD 1,600 in PPP terms), illustrating that Bangladesh ranks among the world's poorest countries. Since domestic politics have been characterized by ongoing polarization, and the very weak infrastructure represents a major obstacle to economic development amid regularly recurring floods during the monsoon season, still about one-third of the population lives on less than USD 1.25 a day.

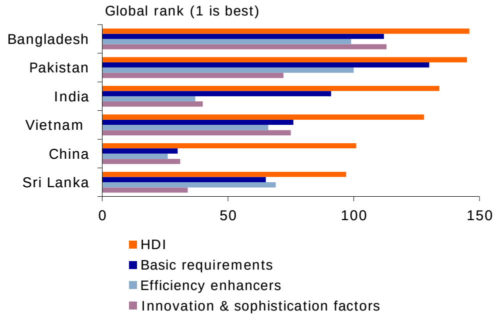
Even though about half of the population works in the agricultural sector, the production of ready-made garments from imported fabrics represents the cornerstone of the local economy, reflecting Bangladesh's comparative advantage in low-cost industrial labor. Industrial production contributes about a third to national income, while agriculture and services account for 20% and 50%, respectively. Bangladesh's weak infrastructure and public institutions, regular power outages and notorious and widespread corruption continue to obstruct higher economic growth. Bearing witness to the paramount position of the ready-made garments sector, exports and imports are largely undiversified, both in terms of products and destinations. Ready-made garments represent almost 70% of exports and are mostly destined for the US and European markets, while textiles account for one-fifth of imports. Owing to current public infrastructure investments, capital goods imports have gained in importance. As Bangladesh's domestic natural gas production can only meet 80% of the country's energy demand, leading to the above-mentioned power outages, petroleum imports have become essential.

Chart 1: Growth performance



Source: EIU

Chart 2: Economic development



Source: UN, World Economic Forum

Bangladesh's small banking system, providing loans worth 39% of GDP in 2010, is relatively healthy, though it should be noted that banks' actual financial situation is likely veiled by local reporting standards' deviation from international best practices. According to the available figures, most banks met the Basel II capital adequacy requirement in June 2011, while the sector-wide non-performing loan ratio (NPL ratio) stood at an elevated 7.1%. This can be largely explained, however, by the relatively weak performance of state-owned commercial banks and development banks. Private banks reported a rather healthy NPL ratio of about 3%. Taking into account accrued losses by state-owned banks that have to be amortized against future earnings, this group remains heavily undercapitalized. Going forward, liquidity pressures on the back of a recent lending binge, banks' stock market exposures and the establishment of weakly supervised banking subsidiaries could confront the sector with new challenges. Still, owing to limited government guarantees, contingent liabilities for the government should be moderate and amount to about 5% of GDP. Benefitting from the strong global position of the ready-made garments sector, increased investments into infrastructure, strong domestic demand on the back of high domestic credit growth and remittances inflows, Bangladesh's economy is expected to have expanded by 6.7% in 2011, up from 6.1% growth in the previous year. Economic growth will likely prove resistant this year, reaching about 6%, despite a deteriorating external environment. Even though the ready-made garments sector's focus on the US and the euro area brings with it increased risks for exports in 2012, especially so if the euro area's sovereign debt crisis were to worsen considerably, the concentration of garments exports in the lower price-segment of the market should shield demand against major drops. Meanwhile, supported by ongoing increases in remittances inflows, mainly from the Middle East, we expect domestic demand growth to continue to propel the economy this year.

Political and social situation

Bangladesh has been able to develop a more or less functioning parliamentary democracy since gaining independence in 1971, despite repeated episodes of military rule. The political landscape is dominated by the center-left Awami League (AL, People's League) and the center-right Bangladesh

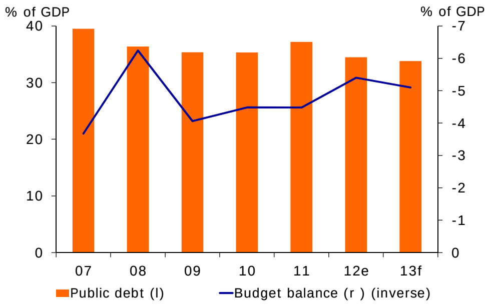
Nationalist Party (BNP), with the latter being allied with the religious Jamaat-e-Islami. Bangladeshi politics are characterized by historical animosities between the two blocks, leading to considerable polarization that results in repeated politically-motivated strikes that hamper the legislative process and affect policy formation. The reciprocal distrust between the blocks also affects the organization of parliamentary elections, which have therefore been overseen by caretaker governments to ensure neutrality in the past. Bearing witness to these problems, a military-sponsored government was in charge from 2006 until 2008, as the armed forces act as a guarantor of stability.
Following its major success in the 2008 parliamentary election, the AL and 13 allied parties (the Grand Alliance) today control 229 out of 300 seats in parliament. Owing to its dominant position within the Grand Alliance, the AL is not dependent on any party to keep its parliamentary majority. The government, headed by AL-leader Sheikh Hasina Wajed, is expected to remain unchallenged until the next parliamentary elections scheduled for 2014, provided it remains supported by the country's military. Still, social unrest remains a constant source of political instability and could be sparked by various causes, varying from public dissent with food price inflation and notorious power shortages to rising tensions over the matter of how secular Bangladesh should be. As the elections are approaching, the incidence of such events will likely increase.
Meanwhile, political polarization continues to deepen as the incumbent government focuses on a series of backward-looking projects that have been highly contested by the opposition. A main point of conflict forms the AL's wish to completely reinstate the 1972 constitution, which defines Bangladesh as being secular, nationalist, democratic and socialist, and bans religious parties. While the current government re-legalized religious parties, which were banned in 2009, and retained Islam as the state religion, both the BNP and the Jamaat-e-Islami remain adamantly opposed to these constitutional changes, which would strengthen the notion of Bangladesh being a secular state. While the former opposes the reinstatement, as it undoes changes being introduced by the party's founder, Ziaur Rahman, during his presidential term (1977-1981), the Jamaat-a-Islami opposes increasing secularism and called the incumbent government un-islamic. Both parties also oppose, at least in their current form, tribunals dealing with war crimes committed during the 1971 war of independence from West Pakistan, as various party members have been investigated, one of whom is a key advisor to the BNP's current party leader. Given the notorious polarization and mutual distrust between Bangladesh's major parties, the war tribunals run the risk of being perceived as a tool to settle current political quarrels and thereby bring with them potential new conflict. This certainly also holds for proposed changes to the rules determining the powers of the caretaker governments, which have traditionally been used to prepare parliamentary elections. While the current government has indicated that it only attempts to limit the powers of the caretaker government in the field of emergency law, the BNP fears that the AL attempts to abolish the caretaker system altogether and thereby increase the AL's chances in the 2014 elections.
Adding to the already tense political situation in Bangladesh, the country's army claimed to have averted a military coup against the AL-led government, which was supposedly led by 'religiously fanatic army officers'. While details about the validity of the threat to the government and the suspected involvement of the global Islamist group Hizb ut-Tahrir remain unclear, the notion of Islamist involvement should not come as a surprise given the rising tensions over the matter of secularity. Against the background of rising political polarization, more violence in the run-up to the 2014 elections can be expected.
In contrast to its strained domestic political landscape, Bangladesh's external relations are relatively stable and border disputes with its neighbors India and Myanmar remain manageable. Foreign policy mainly focuses on strengthening economic and political ties with China and India. Since the AL has come to power, relations with India have improved markedly, leading to the conclusion of various co-operation agreements in the fields of fighting cross-border crime and

terrorism, as well as the removal of Indian import duties on Bangladeshi garment exports. A free-trade agreement, however, or even an agreement on the transit of Indian goods through Bangladesh - which is practically enclosed by India – could not be reached so far. Still, the ever closer co-operation between Bangladesh and India might lead to a deterioration of the Sino-Bangladeshi relations.

Economic policy

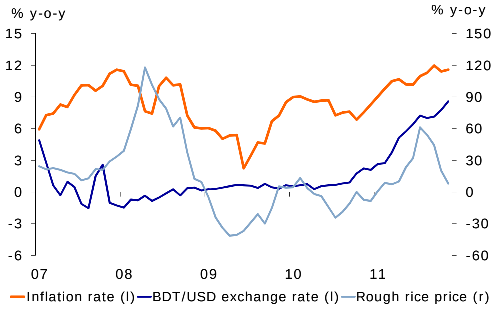
Owing to Bangladesh's low level of development, economic policy is oriented towards poverty alleviation by means of considerable subsidies aimed at the agricultural sector, which employs about half of the country's workforce. As energy shortages and infrastructure bottlenecks represent a structural impediment to growth, the government increases its investments into infrastructure, stimulates the private generation of electricity and tries to increase domestic natural gas production to meet rising demand by means of co-operation with Chinese and Western energy companies. Bangladesh's fiscal position is quite weak and relies on foreign donor support, as a narrow tax base and a rigid expenditure structure generally results in marked deficits. On the revenue side, the complete exemption of the agricultural sector from taxation, various tax holidays, low compliance rates and poor administration limit the government revenues to a very low 11.6% of GDP (fiscal year 2011, 12.2% including foreign grants). On the expenditure side, various subsidies and transfers, amounting to 4% of GDP in recent years, burden the budget and continue to represent a downward risk to government finances. As these transfers play a vital role in the survival of the poor, major cut-backs are politically unfeasible, especially ahead of the elections. Since these subsidies are oftentimes linked to (imported) commodities and goods, related expenses are exposed to changes in global commodity prices. In order to tackle these weaknesses, the government has been working on improved compliance in addition to a reform of VAT and direct taxes, which will likely by voted upon in parliament this year. Still, we neither expect a swift approval, nor substantial impact, as cherished tax loopholes, weak administrative structures and outright tax avoidance will likely render the approval and implementation process cumbersome.

Chart 3: Public finances



Source: EIU

Chart 4: Inflation



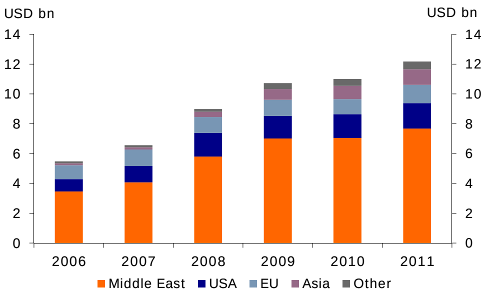
Source: Reuters EcoWin, OANDA

In 2011, Bangladesh ran a sizeable budget deficit of 4.5% of GDP (including foreign grants 3.8%), which is expected to increase to 5.4% of GDP this year. Meanwhile, public debt stood at a moderate 37% of GDP last year and is expected to decrease to 35% on the back of ongoing strong economic growth. About 50% of the government debt is external and largely concessional in nature, while the country's central bank has been financing a considerable part of the domestic debt, reflecting its semi-autonomous state. Consequently, inflation has increased to 11% in 2011, up from 8.1% in the previous year. While part of the inflation hike has been due to the gradual depreciation of the Bangladeshi taka on the back of a balance of payments deficit, as well as rising food and energy prices, the central bank's insufficient monetary tightening in the face of an ongoing lending binge and rising demand-side pressures further aggravated the problem. Mainly driven by declining import duties, inflation is expected to decline to about 9% this year, but considerable upside risks remain, like a further depreciation of the taka, the local currency, and rising fossil fuel prices on the back of escalating tensions in the Middle East. Also, the central bank's multitude of (conflicting) policy objectives does not bode well for successful inflation fighting in the near future. Even though the central bank has in practice pegged the taka to the USD to support the competitiveness of exports in recent years, it let the taka depreciate vis-à-vis the USD dollar in order to protect already limited levels of foreign exchange reserves last year.

Balance of Payments

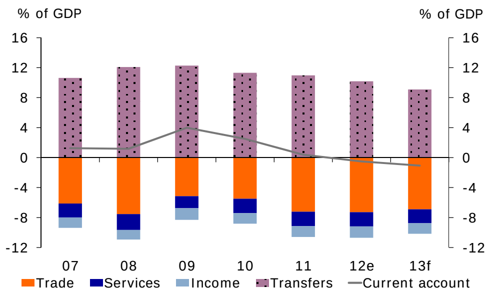
After having posted modest surpluses since 2006, Bangladesh's current account position is on a weakening trend, despite still rising remittances inflows as these are outpaced by an increasing trade balance deficit. While the current account balance posted a surplus of 0.4% in 2011, it is expected to turn to a negative 0.5% of GDP next year. Even though Bangladesh managed to increase its market share for ready-made garments exports, rising capital goods imports on the back of increased public infrastructure investments, as well as increasing demand for imported food and fuel amid surging commodity prices more than compensated improving exports. Meanwhile, growth in remittances inflows, which form the backbone of the current account, slowed as fewer Bangladeshi left the country since 2009. Going forward, we expect remittances inflows to remain relatively stable at the current levels, as more than 50% of these inflows come from comparatively stable Middle Eastern economies, like Saudi-Arabia or the United Arab Emirates, while the gradual depreciation of the taka should compensate for possibly weaker inflows from crisis-stricken Europe. Consequently, in the near future, current account deficits should be limited such that they can be completely financed by Bangladesh's modest FDI inflows.

Chart 5: Remittances



Source: Bank of Bangladesh

Chart 6: Current account



Source: EIU

External position

Bangladesh's external position is relatively sound, as total foreign debt standing at about 20% of GDP in 2011 is relatively low and on a downward trend in terms of GDP. Additionally, only about 8% of foreign debt is short-term, while most of the debt is public and extended at concessional terms by official creditors with long maturities. Thanks to considerable foreign exchange reserves accumulation in recent years, external liquidity ratios are acceptable, as the debt service cover ratio will likely remain above 300% in the coming years, while more than three months of imports can be covered.

Bangladesh

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.4	6.2	5.7	6.1	6.7	6.3	6.6
Consumer prices (average % change pa)	9.1	8.9	5.4	8.1	11.0	8.7	7.4
Current account balance (% of GDP)	1.3	1.2	4.0	2.5	0.4	-0.5	-1.1
Total foreign exchange reserves (mln USD)	5183	5689	10219	10564	10297	11130	11560
Economic growth							
GDP (% real change pa)	6.4	6.2	5.7	6.1	6.7	6.3	6.6
Gross fixed investment (% real change pa)	8.5	1.8	6.2	7.9	9.8	7.2	8.0
Private consumption (real % change pa)	5.9	5.5	5.9	5.1	5.1	6.0	6.0
Government consumption (% real change pa)	6.4	3.6	5.9	8.9	8.2	7.5	6.5
Exports of G&S (% real change pa)	13.0	7.0	0.0	0.9	30.4	15.0	13.0
Imports of G&S (% real change pa)	16.0	-2.1	-2.6	0.7	32.6	14.8	12.5
Economic policy							
Budget balance (% of GDP)	-3.7	-6.2	-4.1	-4.5	-4.5	-5.4	-5.1
Public debt (% of GDP)	40	36	35	35	37	35	34
Money market interest rate (%)	5.0	5.0	5.0	5.0	5.0	5.0	5.0
M2 growth (% change pa)	15	18	21	22	22	20	16
Consumer prices (average % change pa)	9.1	8.9	5.4	8.1	11.0	8.7	7.4
Exchange rate LCU to USD (average)	68.9	68.6	69.0	69.6	73.7	76.0	76.6
Recorded unemployment (%)	4.2	4.2	5.1	5.1	5.0	5.0	5.0
Balance of payments (mln USD)							
Current account balance	857	926	3556	2502	424	-610	-1420
Trade balance	-4195	-6004	-4605	-5485	-7889	-8720	-9240
Export value of goods	12474	15502	15073	19239	23856	26840	30410
Import value of goods	16669	21506	19678	24723	31745	35550	39640
Services balance	-1268	-1669	-1420	-1938	-2086	-2260	-2490
Income balance	-968	-1019	-1399	-1406	-1602	-1840	-1900
Transfer balance	7288	9618	10981	11332	12000	12200	12200
Net direct investment flows	653	1010	713	967	1106	1330	1510
Net portfolio investment flows	141	-38	32	-613	-35	-30	-20
Net debt flows	536	1828	816	563	112	280	370
Other capital flows (negative is flight)	-786	-3215	-563	-2586	-1807	-140	-30
Change in international reserves	1401	511	4555	834	-201	820	410
External position (mln USD)							
Total foreign debt	21296	22886	23820	24634	25092	25210	25190
Short-term debt	1370	1894	1939	1941	1953	1980	2020
Total debt service due, incl. short-term debt	2225	2315	2861	3187	3363	3520	3530
Total foreign exchange reserves	5183	5689	10219	10564	10297	11130	11560
International investment position	-20398	-21931	-19489	-20637	n.a.	n.a.	n.a.
Total assets	7159	7731	12406	13309	n.a.	n.a.	n.a.
Total liabilities	27558	29662	31895	33946	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-6.1	-7.5	-5.2	-5.5	-7.2	-7.3	-6.9
Current account balance (% of GDP)	1.3	1.2	4.0	2.5	0.4	-0.5	-1.1
Inward FDI (% of GDP)	1.0	1.3	0.8	1.0	1.0	1.1	1.1
Foreign debt (% of GDP)	31	29	27	25	23	21	19
Foreign debt (% of XGSIT)	98	83	84	74	65	60	55
International investment position (% of GDP)	-29.8	-27.6	-21.8	-20.6	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	10.3	8.4	10.1	9.5	8.7	8.4	7.7
Interest service ratio incl. arrears (% of XGSIT)	1.2	0.9	0.8	0.8	0.7	0.7	0.7
FX-reserves import cover (months)	3.2	2.7	5.3	4.4	3.4	3.3	3.1
FX-reserves debt service cover (%)	233	246	357	332	306	316	328
Liquidity ratio	123	120	145	135	124	121	118

Source: EIU