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Global Headwinds, Local Resilience and Rising Markets: Update on the Macro Economy and Capital Markets

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FOREWORD

A prudent monetary policy and a more ambitious fiscal policy realization with regard to revenue generation and ADP implementation are important to weather external sector headwinds in H1 FY 2017.

Maintaining the country's strong growth performance in FY 2016 will become challenging in FY 2017, as will an output target of 7%. A balancing act between generating higher rates of investment and not injecting excessive liquidity into the economy, in light of capital markets rally, is required in H2 FY 2017.

With regard to capital markets, although the recent rally, if sustained, may disconnect from fundamental valuation of the listed equities, the current cautious monetary policy is encouraged so as to not enable a bubble and burst.

The capital markets, however, are a significant growth driver in the longer run, in order to effectively utilize the country's relatively large pool of savings. It is also important to develop policies that encourage issuance of fresh and fundamentally strong equities.■

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Introduction

Although Bangladesh's economy, according to PwC, is expected to become the 23rd largest global economy by 2050, what also merits attention is the projection for 2030, by which time it may become the 28th largest. In that timeframe, the economy is expected to grow from US$ 628 billion in 2016 to US$ 1324 billion in 2030, which will render parity with impressive economies such as Malaysia's. Of course, such projections assume sustained economic performance, in the 5-6% annual growth range. In this report we assess the performance of Bangladesh's macro-economy in H1 FY 2017 and capital markets with a view towards H2 FY 2017 and beyond.[1]

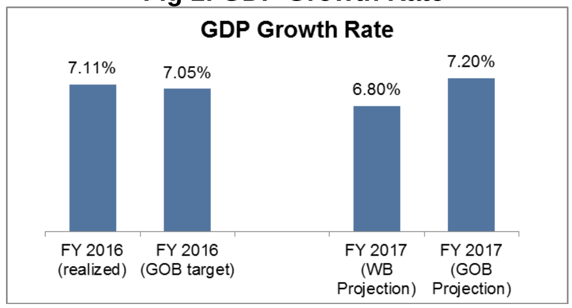
GDP Growth

Bangladesh had posted around 6% growth for nearly a decade before gaining the worldwide attention that its economy deserved. The economy bettered this trend in FY 2016, when it posted its highest ever growth rate, at 7.11%, which was even higher than the government's target of 7.05%. This was also a significant 56 basis points higher than the growth rate achieved in the previous fiscal (6.55%).

With regard to projections for the current fiscal, the World Bank, in its recent half-yearly report, Global Economic Prospects, projected a growth rate of 6.8%. This was an improvement over the lender's previous projection for 6.3% for FY 2017, communicated in June 2016.

Meanwhile, the government's own target stands at 7.2%, despite World's Bank's more conservative estimates.[2] We think that a 7% growth rate is still achievable, on the back of moderate credit growth, higher rates of public and private sector investment, stabilization of remittance earnings, and stronger exports, due to a stronger dollar, in H2 FY 2017.

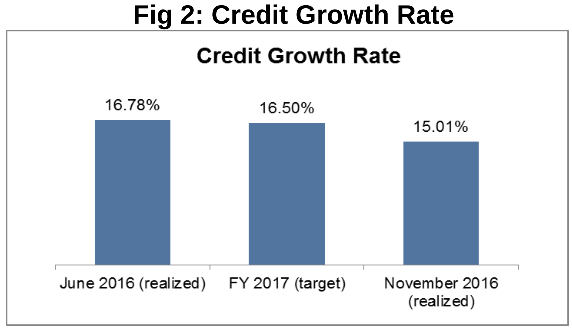
Fig 1: GDP Growth Rate



Monetary Sector

As per Bangladesh Bank's Monetary Policy Statement (MPS) of January 2017[3], the central bank will maintain the same policy in H2 FY 2017, signaling the need for caution, despite the fact that credit growth fell short of target of 16.5% by end of FY 2017. The banking sector credit growth declined to 15.01% in November 2016 from 16.78% in June 2016. The Bangladesh Bank will hold its two policy rates, Repo and Reverse Repo, at 4.75% and 6.75%, while Broad Money target remains at 15.5%. As of November 2016, Broad Money growth stood at 13.8%.

Fig 2: Credit Growth Rate



However, the central bank is prudent in not signaling for excess liquidity in light of downsides, such as rise in default loans and

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capital markets bullishness in 3Q FY 2017. Excess liquidity could find its way to the capital markets and prolong a bull market, which at some point, may not be justified by earnings and valuation fundamentals.

We do expect however moderate private sector credit to grow in light of the upcoming Eid festivals. It is important to time such growth to whatever extent the central bank is able to manage such growth, so that the capital markets rally is not catalyzed unnecessarily.

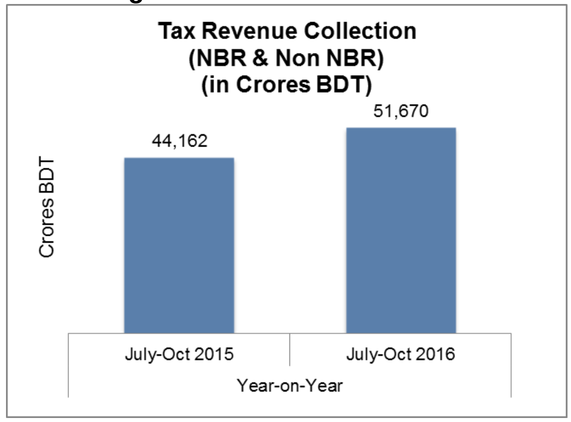
The government has also significantly lowered borrowing from banks, which allows for easier management of credit as well as interest rates in the economy.

Meanwhile, on the interest rates front, the government's inflation target of 5.8% for the year appears realistic and according to Dr. Zahid Hussain, lead economist of the World Bank, it could do well to pursue an even more ambitious/lower target of 5.5%.[4] In December 2016, the general point-to-point inflation stood at 5.03%, which was the lowest in 53 months, lowering the annual average to 5.5%. The lower interest rates have been possible largely due to steady supply of commodities, decline in non-food prices, and political stability.

Fiscal Sector

In the first four months of the fiscal, July-October 2016, tax revenue collection (NBR and non-NBR), stood at BDT 51,670 crore, about 17% higher, year-on-year. Meanwhile, NBR tax revenue collection stood at BDT 49,874 crore, which is 17.8% higher, year-on-year.

Fig 3: Tax Revenue Collection



With regard to public expenditure, the rate of implementation of the Annual Development Programme (ADP) appears to have marginally improved in H1 FY 2017. In this period, about 27.11% of the total outlay has been spent, compared to 23.55% a year earlier.

Public expenditure in the first half of the year, given historical trends for Bangladesh, tends to be significantly slower than in the second half. It is important to reconsider the rate of expenditure nonetheless and actualize more speedy and effective implementation of development projects, given the increased outlay for FY 2017.[5]

For FY 2017, the ADP budget was kept at BDT 1.107 trillion (BDT 707 billion from domestic resources and BDT 400 billion from foreign).[6] Meanwhile, in a recent pre-budget discussion with research organizations, Finance Minister Mr. Abul Maal Abdul Muhith has announced intentions for a BDT 4.0 trillion plus budget.

This merits closer assessment. Although the economic literature regarding optimal budget sizes is contentious, it is important to focus on criteria such as tax revenue as a share of GDP in addition to the absolute size of the budget.[7]

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Bangladesh's tax collection is still around 9.0% of GDP, which is significantly below the average for low-income economies, and its emphasis on trade taxes (27%) is much higher than the average of low-income countries (16%). There has been improvement in the performance of income taxes. However, close to two-thirds of income taxes are generated by the private sector, which ought to be addressed in the intermediate-term, so as to not discourage Bangladesh's potential for FDI growth. Furthermore, the debate on the VAT policy needs to be reconsidered, despite progress in strengthening the VAT infrastructure (drafting of a new law, computerization, and modernization of the VAT administrative system). [8]

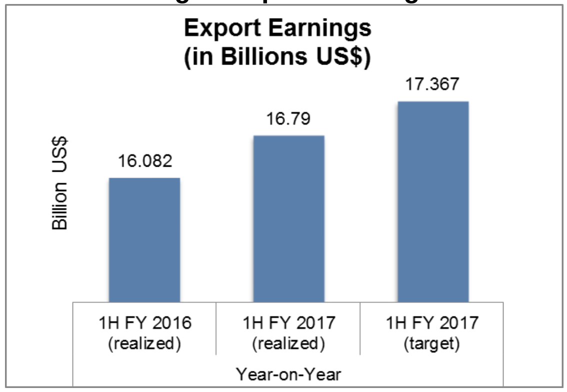
External Sector

Exports

The external sector has been the lifeblood of the Bangladesh economy ever since RMG manufacturing witnessed an outward turn, towards overseas markets.

This key pillar of the external sector, have fared relatively well in H1 FY 2017, reaching US$ 16.79 billion, 4.44% higher year-on-year. However, exports earnings fell below target (US$ 17.367 billion) due to labor unrest in Ashulia, slower demand in the international market, a relatively stronger taka against the dollar, and a weaker British pound due to Brexit.

Fig 4: Export Earnings



Nevertheless, the RMG sector contributed to over 80% of export earnings in the first half of the ongoing fiscal. Woven garments, knitwear, leather, footwear, frozen and live fish, and plastic products witnessed growth while agricultural products, engineering, cotton and ceramic products witnessed a decline.[9]

Imports

Slightly disconcertingly, import payments reached higher levels. As of H1 FY 2017, import payments registered a 34.54% growth compared to a 5.04% negative growth in the same period in the previous fiscal. According to Bangladesh Bank data, L/C's worth US$ 3.88 billion were settled in January 2017 compared to US$ 2.88 billion in January 2016. There are several reasons for the rising import bills, namely, higher price of global food products, petroleum, industrial raw materials, and capital machinery.

However, the most significant driver of higher import payments is recent increase in global oil prices, towards the end of H1 FY 2017. This is reflected in Bangladesh Bank accounts as import of petroleum products rose by 150.8% in January 2017 year-on-year. Given Bangladesh's dependence on imported petroleum products, the economy

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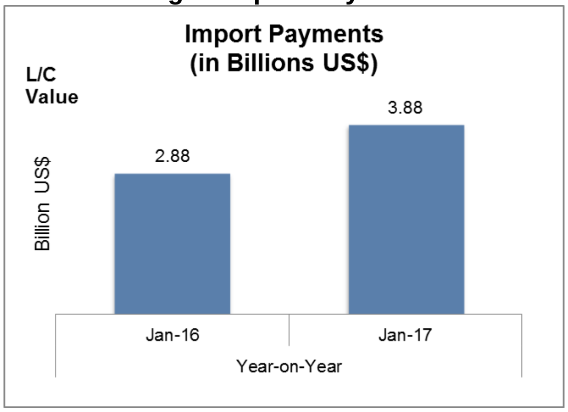
remains vulnerable to global oil price movements.[10]

Fig 5: Import Payments



Remittance

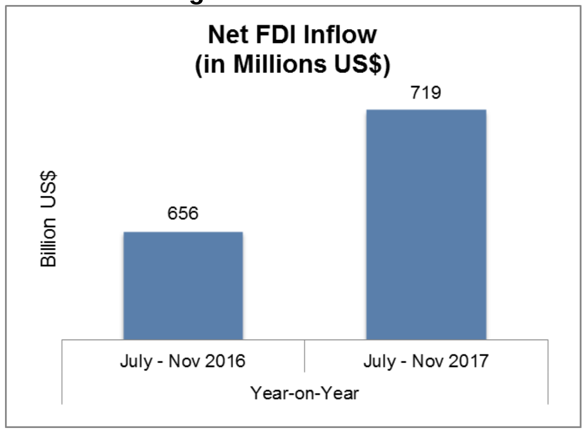
Another potential macroeconomic downside exists in the remittance segment of the external sector. In H1 FY 2017, remittance earnings have fallen by 18%, despite an increase in absolute numbers of employed Bangladeshi workers. There are several headwinds that have contributed to this, on the regional and global front, namely, the lagged effect of lower oil prices on the economies of the Middle East as well as devaluation of foreign currencies such as the Euro, pound, Malaysian Ringgit, and Singaporean dollar.[11]

The effect of local currency shocks in the migrant worker importing countries tends to have a more pronounced impact on remittance earnings than export earnings. Furthermore, in H1 FY 2017, there were instances when although the official market rate stood at BDT 78, the kerb rate went as high as BDT 82-83. This is likely to have discouraged remittance inflows. [12]

FDI, FX & Dollar Rate

Meanwhile, FDI inflows also recorded a modest increase. Net FDI increased by just 9.60% to US$ 719 million from US$ 656 million in July-November FY 2017, year-on-year.[13]

Fig 6: Net FDI Inflow



Overall, the trade deficit has widened given lower remittances and higher import bills, while balance of payments show a surplus of US$ 1.9 billion in the first five months of the fiscal. Foreign exchange reserves stood at a record US$ 32 billion as of December 2016, which will attest to the country's intermediate-run credit-worthiness and investment-friendliness, despite temporary shocks to the external sector.

The FX reserves also help maintain a stable local currency against the dollar. However, there is expected to be a slight depreciation of taka against the dollar given that the same has taken place for other developing market currencies as well as the rise of protectionist policies in the US and other developed world markets.[14] Moreover, uncertainties between the US and trading partners may lead to risk-averse protectionist leadings.

Lastly, the dollar is expected to strengthen in the next two years. These should have positive implications for exports.

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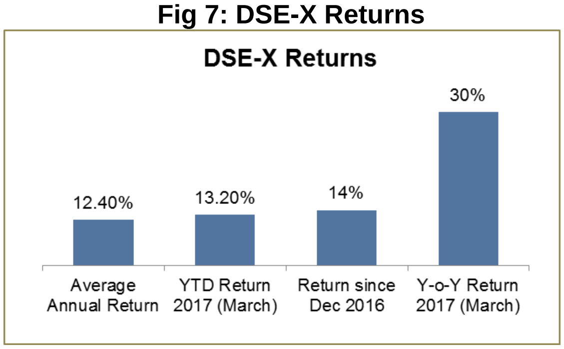
Capital Markets

As of March 26, DSE-X, the benchmark index for the Dhaka Stock Exchange, Bangladesh's primary bourse, stood at 5,701.27 points, after a round of financial sector stock dividends. This represents a 13.2% YTD return in only three months of the calendar year. The benchmark index crossed 5000 points on Monday, December 26, for the first time in two years. The overall market return, since that point, stands at 14%. Considering a longer time horizon, the market, since March 2016, has registered a gain of ~30%. To put this in perspective, the boom and bust of 2009-2010 notwithstanding, the average annual return from DSE stands at 12.4%.

Fig 7: DSE-X Returns



With regard to other market fundamentals, as of February 2017, the market was trading at a trailing price earnings (PE) ratio of 17.4x and price to book value (PBV) of 2.0x. At 17.4x, the market PE is higher than the historical PE of 16.1x, but according to external research, it is still lower than the market PE's of India, Sri Lanka, and Thailand.

There are several reasons for the current rally. Other than speculation driving prices, which continues to be a strong factor, overall corporate profits were higher for the calendar year 2016 than for 2015 and FDR rates are prohibitively low. Both corporate profits and lower FDR rates are driven by macroeconomic highlights such as declining interest rates, a stable exchange rate, and political stability. Moreover, net foreign investment into the stock market, which tends to lay the foundation for rallies, soared to BDT 238 crore in February, which is 150% higher year-on-year. Global asset managers such as Morgan Stanley, JP Morgan, Goldman Sachs, BlackRock, and Templeton have a growing presence in Bangladesh.

However, considering the future, it is still important to render the capital markets a source for profitable long-term financing for the private sector. The largest companies and conglomerates in the country still do not consider the capital markets to be a profitable source of financing are dissuaded by the requirements for transparency and accountability expected of listed companies.

To take the example of PRAN-RFL, one of the largest conglomerates, it has only one out of 50 subsidiaries currently listed in the market, while several others, Abul Khair Group, Bashundhara Group, City Group, Partex, Akij, PHP and Meghna have no formal presence among listed equities.[15]

In the more near-term, it is essential, as discussed earlier, that banking sector liquidity not be encouraged to the point that the market is furthered heated by excess funds. If that were to happen, the current rally will transition into bubble territory, which ought to be avoided without exception.

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Conclusion

Disciplined monetary policy management and a more ambitious fiscal policy implementation are important to weather the shocks to the external sector in the intermediate term.

A balancing act is required that encourages investment without heating up the economy or the capital markets. In addition to private sector investments, mobilizing revenue for public sector investment will be important in the short run.

Bangladesh's strong external reserves are a panacea given the external sector shocks and it will be essential to maintain the current high levels.

The recent rally in the capital markets, while a positive sign of investor confidence, should not be allowed to enter a bubble territory. It is important for brokers to communicate the same to investors just as it is for policy-makers to be surgically precise with regard to monetary policy management.

The capital markets will be an important growth driver in the longer run. The country's large pool of savings, despite low banking sector penetration, may not be adequately utilized by the banking sector. Therefore, in light of investment needs, it is essential to develop policies that encourage issuance of fresh and fundamentally strong equities that render the capital markets a source for financing long-term investment.

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[1] All data are obtained from World Bank's databank, databases of the Bangladesh Bank and the Bangladesh Bureau of Statistics, and MCCI datasets on the Bangladesh economy, unless otherwise stated, in end notes.
[2] http://bdnews24.com/economy/2017/01/11/world-bank-predicts-6.8-economic-growth-for-bangladesh
[3] For the full monetary policy statement issued by the Bangladesh Bank in January 2017, is available at https://www.bb.org.bd/monetaryactivity/mps/mps_current.pdf
[4] http://www.thedailystar.net/business/monetary-policy-remain-more-the-same-1352488
[5] http://www.thedailystar.net/business/budget-promises-continue-remain-undelivered-1349980
[6] http://bdnews24.com/economy/2017/02/28/bangladesh-adp-size-unchanged-more-funds-from-internal-resources
[7] Our analysis has been informed by an insightful article by Dr. Sadiq Ahmed on the fiscal policy as well as interviews with leading economists. For the said article, please see: http://www.pri-bd.org/main/view_publication/adequacy-of-fiscal-policy-a-critical-challenge_380
[8] Ibid.
[9] For a useful discussion on the Bangladesh external sector at http://www.thefinancialexpress-bd.com/2017/03/20/64854/Economy:-External-front-needs-special-care/print
[10] An analysis on imports rising in January is available here: http://www.newagebd.net/article/9558/jan-imports-up-34pc-on-intl-oil-price-hike
[11] http://bdnews24.com/economy/2017/03/05/bangladesh-records-lowest-monthly-remittance-in-recent-years
[12] http://www.thefinancialexpress-bd.com/2017/03/20/64854/Economy:-External-front-needs-special-care/print
[13] Certain data points have had to be cross-checked with multiple sources given that certain H1 data available was preliminary.
[14] http://www.thedailystar.net/business/takas-depreciation-the-horizon-stanchart-says-1364641
[15] http://www.thedailystar.net/business/big-business-groups-not-tempted-stockmarket-1374553

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