Macroeconomic Status

Money and Credit

- Broad Money grew 14.03% YoY to USD 122 bn, Reserve Money grew 16.56% YoY to USD 24 bn and Credit to the Private Sector grew 15.61% YoY to USD 92 bn in Jul-Jan of FY17.
- Weighted Average lending rate declined to 9.93% in December from 9.94% in November while deposit rate declined from 5.29% to 5.22% in the same period.
- Average inflation fell to 5.44% in January from 5.52% in December.
- BDT depreciated by 1.0% YoY as of February 2017.

Fiscal Balance

- Budget Deficit stood at USD 2 bn in December 2016. The Government financed 52% of its deficit from domestic sources.

Banking Sector

- Classified loans increased to 9.23% of total loans in December 2016 from 8.79% in December 2015.
- Excess Liquidity in the system declined moderately from USD 16.07 bn in October to USD 15.65 bn in December.
- State-owned and Specialized banks failed to maintain regulatory capital requirement of 10%; 12 banks failed to maintain the Capital Conservation Buffer in accordance with BASEL-III (As of September 2016).

External Sector

- Exports grew 4.36% YoY to USD 20.11 bn in Jul-Jan of FY17.
- Remittance declined 17% YoY to USD 8.11 bn in Jul-Feb of FY17.
- Imports (C&F) grew 8.18% YoY to 20.92 bn in Jul-Dec of FY17.
- Current Account Deficit stood at USD 793 million in Jul-Dec against surplus of USD 1.8 bn in corresponding period of FY16.
- Forex Reserve stood at USD 32.6 bn in February, equivalent to nine months' imports.

Context

In our macro outlook for 2016, we forecasted a healthy pickup in GDP, slow reflection of falling interest rate on investment activities, growth in industrial and service sector, and flat remittance. Over the year, our projections played out quite accurately. The economy, riding on the key economic drivers, emerged from its two-year long hibernation. Furthermore, waves of new investment commitments by the Government and foreign partners revived investors' confidence, generating optimism to a whole new level.

With such upbeat sentiment, growth expectation in FY 2017 remains at a high level. Except for Fitch, all the other multilateral agencies have projected a growth rate close to 7% while the Government maintained its traditional buoyancy and projected a growth rate of 7.5%.

We believe a cautious assessment of the growth engines of the economy is necessary to understand whether the props to support the fast pace of the economy are in healthy shape. The objective of this paper is to help the readers understand the status and potential of Bangladesh Economy based on our assessment of the key economic drivers.

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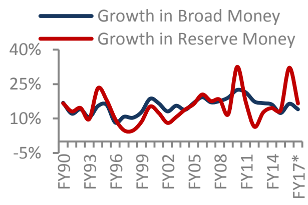
MONETARY AFFAIRS

Continual sliding of interest rate and excessive buildup of liquidity are signals that savings are not being channeled to investments at the desired pace. In the search of yield, savers are lured into channeling their funds to unproductive sectors. Meanwhile, the Central Bank, being barely able to keep up with the inflow of foreign exchange, faces the challenge of prioritizing between containing money growth and stabilizing currency exchange rate. If remains unchecked, the gushing cheap money poses the threat of another 'asset bubble' in the unproductive sectors of the economy.

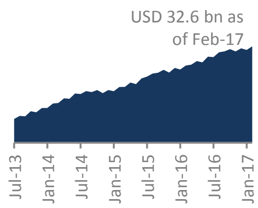
Broad Money and Reserve Money

- In Jul-Jan of FY17, Broad Money grew 14.0% YoY to USD 122 billion whereas Reserve Money grew 16.6% YoY to USD 24 billion.
- Bangladesh Bank continued its intervention in the Forex market throughout the year. Reserve Money expanded beyond target since 'sterilization' could not mop up the local currency injected into the system by the Central Bank.

Money Supply



Forex Reserve

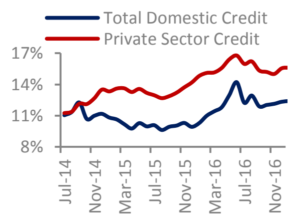


*Source: Bangladesh Bank, *July-January of FY17*

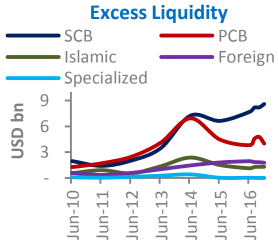
Credit Growth

- Net disbursement of credit in Jul-Jan of FY17 was USD 6.93 billion against USD 6.22 billion in the corresponding period of last fiscal year, registering 11.4% growth YoY.
- Excess liquidity in the banking sector has declined by USD 0.18 billion in August-December of 2016. Excess liquidity in the SCBs and Islami banks increased by USD 0.44 billion while that in other banks declined by USD 0.63 billion.

Credit Growth



Excess Liquidity

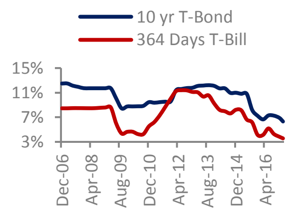


Source: Bangladesh Bank

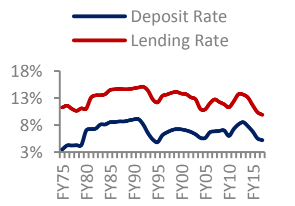
Interest Rate

- Interest rate continued its downward trend throughout the year reaching its historical low. The yield on both the short-term and long-term Government securities reached their respective bottoms as well.
- Flooded with excess reserve, banks have cut the deposit rate more than they have reduced their lending rate. Against the backdrop, the Central Bank has recently directed the banks not to cut down the deposit rate below 5%.

Yield on Govt. Securities



Lending & Deposit Rate

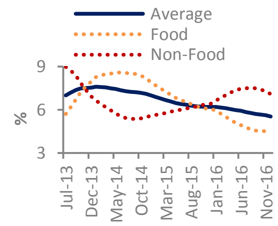


Source: Bangladesh Bank

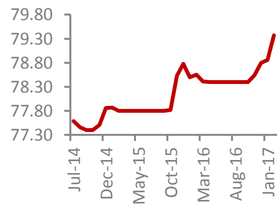
Inflation and Exchange rate

- 12-Month average inflation declined to 5.44% in January from 5.52% a month earlier. Although the regulators have been rejoicing over the success of controlling inflation, our inflation target is far from ambitious compared to our neighbors. **Furthermore, inflation is highly likely to balloon in upcoming months following price hike of gas**.
- High inflation differential between Bangladesh and its trade partners has also resulted in an overvalued currency through continual appreciation of Real Effective Exchange Rate (REER) of BDT.
- Although BDT remained strong in the last 2 years while other currencies continued to depreciate against USD, a strong dollar caused by fiscal stimulus in the USA and rising oil price in the international market might soon put an end to that trend.

Inflation



USD to BDT



Source: Bangladesh Bank

Inflation Target

Bangladesh	India	Pakistan	Sri Lanka	Vietnam
5.8%	4%	6%	4%	4%

Source: Bangladesh Bank, Reserve Bank of India, State Bank of Pakistan, Central Bank of Sri Lanka, State Bank of Vietnam

A moderate depreciation in BDT is expected in near term. To protect the fundamental value of BDT, the policymakers need to set a lower inflation target, foster investments through the implementation of major infrastructure projects, and raise productivity to boost domestic demand in the country.

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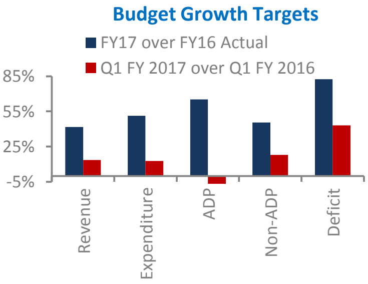
THE EXCHEQUER'S HEALTH

On the fiscal front, the Government is faced with the challenge of crowding in private investments with infrastructural spending, which is constrained by dismal revenue collection. ADP expenditure is yet to achieve any significant breakthrough and fast-track projects are definitely not progressing at the expected 'fast' pace. Meanwhile, the fiscal deficit is being financed through the sale of high-interest bearing National Savings Scheme, creating a huge pressure on the Government's debt service capacity.

Government Revenue

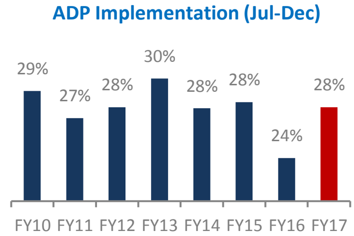
- Against a growth target of 41.6%, Revenue Collection in July-December of FY17 registered a 17.9% YoY growth. As projected by Center for Policy Dialogue (CPD), the Government might see a revenue shortfall of USD 5.1 billion in FY17.
- To improve revenue collection, NBR has taken preparation to implement the VAT and SD Act 2012 from July 2017. Given the track record of revenue collection and inadequate capacity of NBR, we expect a further delay in implementation of the act.



Source: Ministry of Finance

Government Expenditure

- Even though the implementation of ADP in FY16 was better than that of FY16, it did not achieve any significant breakthrough in July-January of FY17.
- Except for two projects – Rooppur Nuclear Power Plant (RNPP) and Chittagong-Cox's Bazar Railway, all of the fast-track projects have made sub-par progress in Q1 of FY17.
- Non-Development expenditure was USD 4.8 billion in July-October of FY17, achieving 24.3% YoY growth driven by salaries and allowances (YoY growth 33.7%), and subsidy and transfer payment (YoY growth 34.3%).



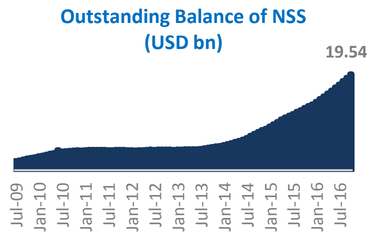
Source: Ministry of Finance

Fast Track Projects	Target	Project Cost*	Allocation in FY 17*	Cumulative Progress**	Expected Progress 2017
Padma Bridge	Dec-18	3,599	753	40.3%	59.1%
Padma Rail Link	Jun-22	4,374	513	1.6%	11.7%
Ctg-Cox's Bazar Railway	Jun-22	2,288	77	9.4%	10.5%
Dhaka Metro Rail	Jun-24	2,748	278	4.3%	14.1%
Payra Deep Sea Port	Jun-18	141	25	28.3%	45.5%
RNPP (Phase 1)	Jun-24	636	77	93.9%	100.0%
Matarbari Power Project	Jun-23	4,498	30	1.8%	8.2%
Rampal Power Project	Jun-23	1,875	318	1.8%	17.7%

**All the Figures are in USD millions, Source: Ministry of Finance, IMED, CPD **Cumulative Progress till October, 2016*

Budget Deficit

Total budget deficit of the Government during Jul-Dec of FY17 was USD 2.0 billion, registering no significant change from the corresponding period in FY16. Flooded with the sales receipt from National Savings Scheme (NSS), which grew 46.5% YoY in Jul-Dec, the Government not only financed 52% of its deficit from domestic sources but also repaid USD 1.9 billion worth of low-interest bearing domestic bank loans with the high-interest bearing NSS money.



Source: Bangladesh Bank

The quality of public expenditure remains a concern which is aggravated by the current mode of budget financing that further reduces Government's accountability. The high interest rate on National Savings Scheme (NSS) not only raises the fiscal burden but also undermines the development of domestic debt market. Eventually, the absence of a vibrant bond market limits the effectiveness of monetary policy transmission channels. Although the high yield bearing NSS acts as a proxy to the social safety net for the senior citizens of the country (about 13% of current population), the allotment of NSS is not particularly limited to this group. Ultimately, the challenges raised by a high interest rate on NSS far outweigh its true benefits. Immediate policy actions should be taken to ensure rationalization of the risk-free rates and development of financial markets. Besides, the Government must focus on creating a safety net to reduce poverty and empower its young labor force to achieve its full potential.

BANKING SECTOR WOES

The hidden fault lines in the financial sector of the country pose a major threat to the economy. Burdened with poor-quality assets, the banking sector is not in an optimal position to support above 7% growth of the economy. The sector awaits a painful reform and the longer the reforms are delayed, the more the economy will be injured. While other fast-growing economies such as India and Vietnam have already undertaken strict reforms to reshape their banking industry, our banks are still stuck in the vicious loop of poor governance. We remain concerned with the underlying health of our financial sector and our focus will be on regulators' stance rather than the alluring upticks in the sector's performance metrics in future.

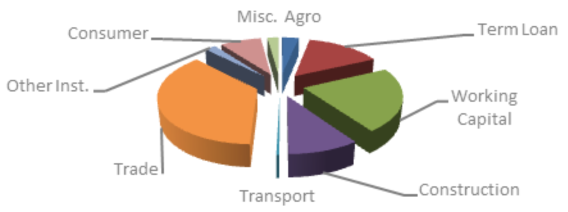
Asset Growth

- Balance Sheet size of the banking sector stood at USD 145 billion as of September 2016. After registering an exceptional growth in June 2016 (caused by a sudden pickup in credit), asset growth moderated again in September.
- A closer look at the credit flow to different sectors in Jul-Sep of FY17 reveals that 'trade and commerce' received the highest allocation of the incremental credit flow, followed by 'working capital finance', 'industrial term loans', and 'construction sector'.

Outstanding Credit (USD bn)	Sep-15	Sep-16	Growth
Trade	24.9	28.8	15.8%
Working Capital	13.7	16.0	17.2%
Term Loan	12.3	13.9	12.7%
Construction	6.1	7.2	17.0%
Consumer	6.0	6.8	14.4%
Agriculture	3.7	4.0	9.5%
Institutions	1.3	1.5	18.9%
Miscellaneous	0.5	0.7	50.6%
Transport	0.5	0.6	7.3%
Total	**68.9**	**79.5**	**15.4%**

Source: Bangladesh Bank

Flow of Credit (Sep-15 to Sep-16)

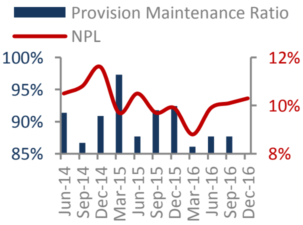


Source: Bangladesh Bank

Asset Quality

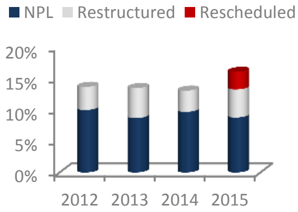
- Asset quality deteriorated and the provision maintenance ratio declined in March-September of 2016.
- The grim health of the banking sector becomes more conspicuous once we look at the Stressed Advances (NPL+Restructured+Rescheduled) in the sector. Increasing amount of restructured and rescheduled assets in the banks with a major share of industry assets poses a significant threat to the entire sector.

NPL and Provisioning



Source: Bangladesh Bank

Stressed Advances



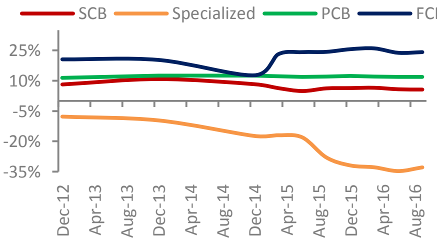
Source: Bangladesh Bank

Capital Adequacy

Capital Adequacy Ratio in the banking sector stood above the minimum requirement of 10% in September 2016. However, when it comes to Capital Adequacy, there is more than what meets the eye. Some of our findings are presented below:

- At the aggregate level, SCBs (representing 28.4% deposits of the entire industry, deposit size as of 2015 USD 29 billion) failed to maintain the minimum required Capital Adequacy Ratio. Effectively the banks have lost about USD 1.3 billion of depositors' money.
- The Capital Adequacy Ratio in the PCBs (representing 65% of industry assets) remained stable since December 2012. However, at an individual level, at least two PCBs failed to maintain the minimum required Capital.

Capital Adequacy Ratio



Source: Bangladesh Bank

From 2016, banks are required to meet the Capital Conservation Buffer requirement (2.5% comprised of CET-I Capital above the regulatory minimum capital requirement). As of September 2016, 12 banks failed to maintain the buffer on a solo basis. It should be noted that failure to meet the buffer bars a bank from disbursing any cash and bonus dividend. In 2015, a few banks that could not even meet the 10% capital requirement paid out dividends to their shareholders and it remains to be seen whether the regulators can prevent non-compliant banks from disbursing dividends in 2016. Overall, the banking sector, being the major source of financing in Bangladesh, should improve its corporate governance and credit monitoring system. Otherwise, the sector's ability to cater to the investors by ensuring smooth credit flow will be severely constrained.

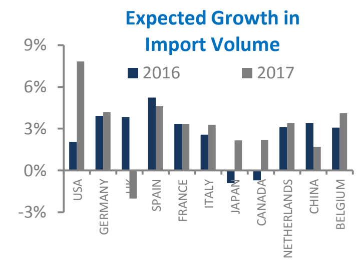
EXTERNAL DRIVERS

Export growth is likely to remain flat in FY17. Remittance might maintain its sluggish pace and Import is likely to register a 9%-10% growth, creating a pressure on the current account balance. Exchange rate policy will play a central role in channeling the earnings of the new migrant labors via the formal channel. Import payments might increase if oil price increases substantially. However, the negative impact coming from the rise in oil price might be offset by an expected decline in other commodities in the international market.

Export

Export stood at USD 20.1 billion (4% growth YoY) in the July-January of FY17 against the strategic target of USD 21.0 billion. We expect a similar trend in exports based on the following factors:

- According to IMF, Imports volume is expected to increase in the USA, Germany, Italy, and Japan while it is expected to decline in the UK. The slowdown in the UK is expected to be offset by robust growth in the USA at least for the next fiscal year.
- While we believe protectionist trade policies, if implemented, might hamper our exports; any drastic change might take some time to be fully reflected.

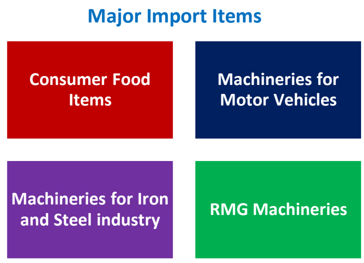


Source: IMF

Import

In the first half of FY17, import payments stood at USD 22.6 billion, registering 8.2% YoY growth. Our major findings from import payments statistics are presented below:

- Fresh LC openings registered the highest growth in consumer goods (food items), motor vehicles, machinery for iron & steel products and scraps.
- Settlement of LCs registered the highest growth in capital machinery for textile and garments sector, iron and steel scraps, machinery for motor vehicles and iron & steel products.

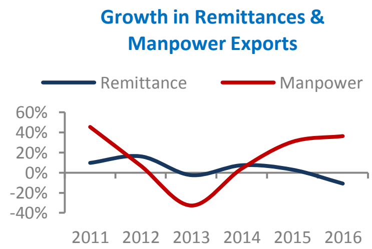


Source: Bangladesh Bank

Remittance

Remittance declined drastically by 17% YoY to USD 8.1 billion in the first eight months of the current fiscal year due to the following factors:

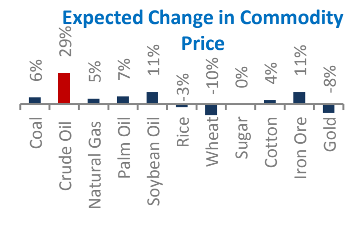
- Lower spending ability by GCC firms put a dent in the earnings of migrant workers.
- Remittance earnings were squeezed by the depreciation of Euro and the British Sterling, which contributes to approximately 5% of total remittances.
- The rise of informal channels of money transfer (Hundi), thriving in the presence of high demand for capital flight from the country, has been a major factor for this development.



Source: Bangladesh Bank

Current Account Balance

Current account balance recorded a deficit of USD 793.0 million in July-December of 2016. Financial account balance of USD 2.6 billion offset the current account deficit and contributed to the overall balance of USD 2.3 billion as of December 2016. Even though the current account deficit continued from September 2016, accumulated foreign reserve stood strong covering import payments for nine months.



Source: World Bank

In the face of stagnant global demand and trade policy uncertainty, broadening our export base from the current level of USD 34 billion necessitates the sizeable development of our manufacturing industries. The deficit in technical know-how and infrastructural facilities especially seaports must be addressed through strategic partnerships with private and foreign partners. Besides, the country needs to look for alternative export destinations such as emerging Asian countries that are experiencing higher growth in consumer demand than that of their western counterparts. Exchange Rate Policy also needs to be revised considering its multi-dimensional impact on export, import, and remittance.

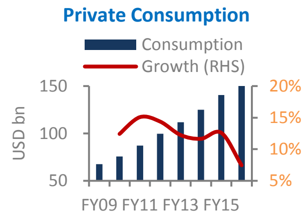
PRIVATE SECTOR DEMAND

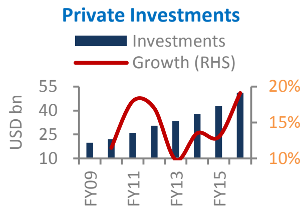
Growth in private consumption and private investments will hinge upon Government's ability to improve infrastructure and create jobs for the fresh entrants in the labor force. The failure to do so will turn the bulging youth population into the economy's 'Demographic Liability'. Significant modification will be needed in fiscal and monetary policies to curb inflation, enhance productivity, and convert excess capital to tangible investments.

Private Consumption

The much talked about 'Demographic Dividend' in Bangladesh, if materialized, will enhance domestic consumption significantly. However, lack of decent employment opportunity might thwart the country from reaping the benefits of its young labor force. Several issues need immediate attention if the Government wants to boost private consumption:

- The Government needs to ensure proper skill-development of the young workforce and create employment opportunity for the 2 million fresh entrants to the labor force each year.
- Steps must be taken to modernize the huge informal sector of the economy plagued with low-pay and low-productivity.
- In order to ensure the development of a sizeable middle-income pie, sound employment opportunities must be created for university graduates.
- Inflation must be curbed further to protect the real income of the consumers.





Source: Bangladesh Bureau of Statistics

Fact Box: Unemployment

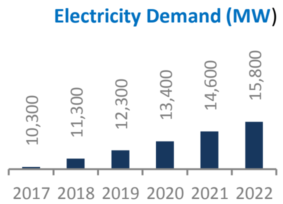
- 41% of Bangladeshi Youths are NEET (Not in Employment, Education or Training) in 2013[1]
- Unemployment Rate (Graduates) increased from 10% (2010) to 16% (2013)[2]
- Share of employed youth with SSC and HSC went up from 10% (2010) to 51% (2013)[2]
- In FY11-FY15, non-formal laborers (87.4% of labor force) lost 7.9% of real income.

Source: 1. ILO, 2. Centre for Development and Employment Research (CDER), 3. Dr. M. A. Taslim

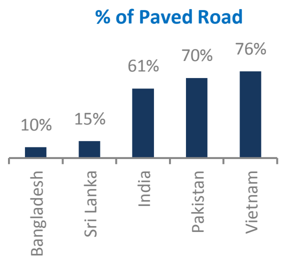
Private Investments

The much-needed development in domestic demand needs to come from private investments. Years of accumulated capital, as reflected in the excess liquidity in the banking system, needs to be channeled to productive conduits of the economy. To take our private investments to the targeted 26.6% of GDP by 2020, following issues must be addressed:

- **Infrastructure:** Power generation to support peak-hour demand, paved highways to accommodate heavy vehicles, deep ports to facilitate trade, and better connectivity to reduce transportation time need to be ensured.
- **Rule of Law:** Modernization of land policy and reduction of cost and time to obtain various licenses would be required to enhance the ease of doing business and attract foreign investments to the country.



Source: Power Sector Master Plan 2016



Source: CIA World Factbook

Major Foreign Investment Commitment

Country	Sector	Investment (USD bn)
China	Power, Infrastructure	24.5
Russia	Nuclear Power	11.4
ADB	Railway	11.3
Japan	Power, Infrastructure	6.7
WB	Social and Environmental	6.3
India	Power	1.5
Total		**61.6**

Source: Compilation from national dailies

The Uncharted Territory of 7% Growth

Opportunities and Challenges Ahead

Bangladesh is one of the largest economies in the 7%+ GDP growth club. To sustain the fast pace of economic growth, solid efforts from all quarters will be required. Government's ability to crowd in private investments through quality infrastructural spending and Central Bank's ability to curb inflation further will be put to test in short-term. Besides, prudent reforms in fiscal policy, exchange rate policy and trade policy would be required to tackle various macroeconomic challenges. It will be interesting to see how our banking sector regains the capacity to support higher demand for investments once the infrastructural woes are put to rest. The only option could be recapitalizing the entire sector as well as adopting a zero-tolerance policy for chronic defaulters. Otherwise, the culture of bailing out distressed banks using taxpayers' money will never end. Considering these issues are resolved, the country is sure to reap the benefits of its young demographics. The resilience of the Bangladeshi people has brought the country to its current position despite many odds. We are confident that the country will emerge as a strong economy given the right policies are in place to catalyze its future growth.

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