Trip Notes

South Asia: Bangladesh and Sri Lanka

Photo: View on Bangladesh's capital, Dhaka, from Gulshan Avenue

Aktia

Summary

- In June, we visited Dhaka and Colombo, where we engaged with various stakeholders in the economy to gain a comprehensive understanding of ongoing developments after a challenging 1.5 years.

- Since the 2022 mass protests and subsequent government changes, Sri Lanka has been actively working to stabilise its economy and engaging in discussions with creditors for debt restructuring. An announcement regarding debt optimisation is anticipated by the end of June. The reforms mandated by the IMF are currently in progress.

- Bangladesh, a fast-growing frontier market, benefits from robust fundamentals including domestic consumer demand, ready-made garment exports, and remittances. To ensure macroeconomic stability amidst concerns about similar social unrest to Sri Lanka, the government proactively sought assistance from the International Monetary Fund.

- These trip notes offer an overview of some topics discussed during the meetings and may not cover all aspects. For further details or specific inquiries, we are happy to continue the dialogue.

Photo: The Presidential Secretariat in Sri Lanka's capital Colombo

Overview

In June, we traveled to Bangladesh and Sri Lanka, two South Asian nations. During this trip, we had the opportunity to meet with different institutions and companies representing various sectors of the economy. Our goal was to deepen our understanding of these countries and gain insights into their current market sentiment.

Sri Lanka underwent significant economic crises attributed to years of mismanagement, which resulted in a depletion of foreign exchange reserves and a dire shortage of crucial imports such as medicines and fuel. Therefore, the country had to implement rationing measures and endure power cuts, leading to widespread protests against the Rajapaksa-led government starting in March 2022. The protesters demanded the resignation of President Gotabaya Rajapaksa and key officials associated with the Rajapaksa family. In April 2022, Sri Lanka experienced a notable event as it faced a default on its foreign debt for the first time in its history.

In 2022, Bangladesh's foreign exchange reserves began to decline amid a sustained increase in global commodity prices following Russia's invasion of Ukraine. Consequently, the country's trade deficit widened. Fearing a similar fate as Sri Lanka, the government of Bangladesh proactively sought assistance from the International Monetary Fund (IMF) in August 2022.

Sri Lanka and Bangladesh are both commodity importers, making them vulnerable to rising prices. Additionally, their reliance on the garment and textile industry leaves them exposed to potential slowdowns in their key export markets, namely the US and Europe. Limited value is added domestically as they depend on imported cotton.

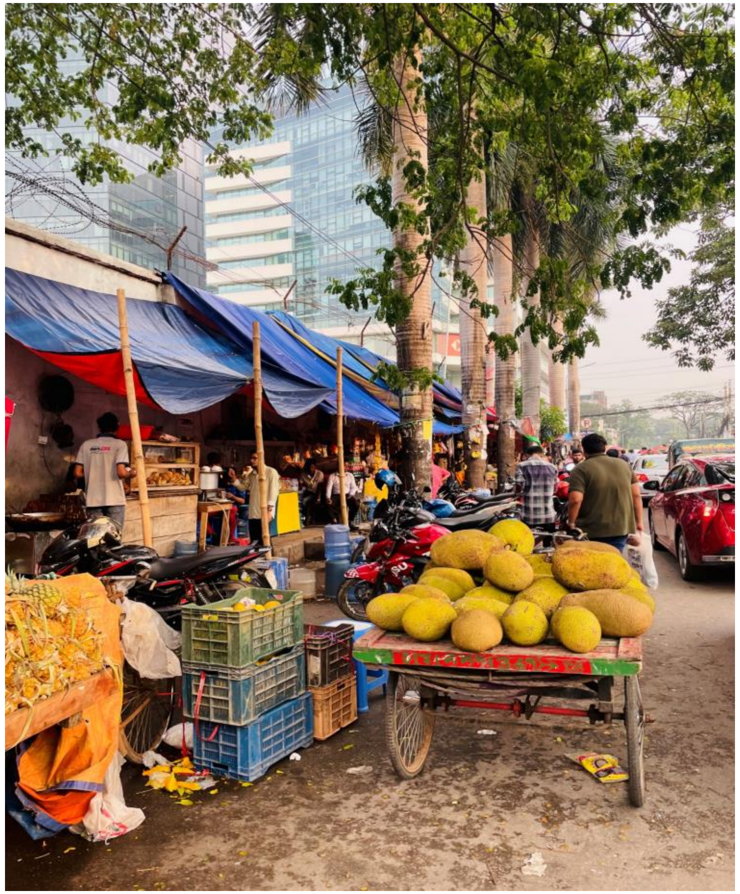
Bangladesh benefits from a large pool of labor at low costs. As the world's 8th most populous country, with approximately 173 million people growing at a rate of over 1% annually, Bangladesh faces challenges due to its high population density. This density places limitations on available land, such as insufficient space for setting up solar farms. In contrast, Sri Lanka is a small island nation with a population of nearly 21 million, experiencing an annual population growth rate of about 0.3%. However, both countries possess a significant working-age population, with Bangladesh having 68% of its population aged between 15-64 years and Sri Lanka having 67% in the same age group.

Both countries hold strategic locations in South Asia, thereby making geopolitics a relevant factor. The Indo-Pacific Alliance, commonly referred to as Quad, is a strategic security dialogue led by the United States and involving Australia, India, and Japan. This alliance aims to manage and contain China's influence in the Indo-Pacific region. Moreover, both countries are expected to undergo elections within the coming year.

> “
> **Sri Lanka underwent significant economic crises attributed to years of mismanagement.**

Bangladesh

Photo: Street vendors in Dhaka



Bangladesh's export-oriented development strategy since 1971 has consistently driven strong economic growth, averaging over 6% in the past decade. For FY23, the IMF projects a GDP growth rate of 5.5% and the government estimates 6%. Unfavourable global macroeconomic conditions in the previous year temporarily impacted growth, influenced by factors like government austerity measures and import restrictions. However, both the IMF and the government expect a rebound in FY24, with projected GDP growth rates of 6.5% and 7.5% respectively. Bangladesh is supported by robust growth drivers and a steadfast commitment to private sector-driven growth across political parties.

Inflation in Bangladesh is high, exceeding the targets set by the Bangladesh Bank and the government. May's CPI reached 9.9%, resulting in an average CPI of 8.8% over 11 months of FY23. Factors such as the Bangladesh taka (BDT) depreciation, fuel and energy price revisions, and a lack of competitive market conditions contribute to inflationary pressures. Despite declining global commodity prices, persistently high inflation remains a concern for the central bank, likely due to delayed BDT depreciation impact and the absence of competitive forces. Measures have been taken, including raising policy rates, to curb inflation, but the transmission mechanism has been ineffective.

Bangladesh has experienced a prolonged period of unchanged government, with Prime Minister Sheikh Hasina serving since January 2009. The last two elections in 2014 and 2018 have raised concerns about the electoral system's effectiveness, resulting in low voter turnout. The upcoming elections, to be held by January 2024, are expected to have a stronger geopolitical context. The US has demanded free and fair elections, primarily focusing on human rights rather than the economy. The West is particularly concerned about the Rohingya issue. Stability and prosperity in neighboring India also play a significant role for Bangladesh, as China's influence is viewed as a potential threat by India. The current government enjoys support from China. The prevailing expectation is that the incumbent government will continue in power, as even in the event of free and fair elections, a significant opposition presence is lacking. However, there is hope for improved policy-making, as Bangladesh faces challenges associated with poor governance. It is worth noting that many Members of Parliament are also businessmen who may prioritize their personal interests.

Bangladesh

The IMF program was negotiated in July-August 2022 when the government anticipated an impending economic collapse. They subsequently required financial assistance from the IMF (USD 4.7 billion), World Bank (USD 1.25 billion), and ADB (USD 1.6 billion). While the IMF program includes various benchmarks, the government's response to the necessary reforms remains to be seen. The program spans three and a half years, with the second and third reviews scheduled after the elections. The government is expected to present the IMF program favorably, with some conditions already partly implemented, such as multiple increases in energy prices. The next review is scheduled for July. The economy is likely to pick up due to the mandated reforms, particularly in monetary and exchange rate policies, possibly gaining vibrancy after the elections.

Bangladesh has made significant strides in upgrading its infrastructure, but the economy has yet to reach its full potential. Recent completion of projects like the Padma bridge, which connects the southwestern region to the capital city, is expected to positively impact GDP growth by 1.2%. However, challenges persist, particularly in ensuring uninterrupted energy supply for manufacturing. Power shortages have led to frequent cuts and financial losses for factories. The country is currently grappling with its worst electricity crisis since 2013, exacerbated by erratic weather patterns and difficulties in fuel import payments due to declining foreign exchange reserves and currency depreciation. Bangladesh's heavy reliance on fossil fuels, which constitute 90% of its energy mix, exposes it to carbon transition risks.

The economy of Bangladesh is primarily driven by strong domestic demand. With a population of over 170 million people, the country benefits from a large consumer base. The booming personal consumption is a key driver of economic growth, fueled by an increasing purchasing power among the population. In line with this trend, local companies are emerging, offering domestically produced goods such as smartphones and white goods at affordable prices, catering to the growing domestic market. While Bangladesh has successfully transitioned into a more manufacturing-based economy, it is worth noting that the agricultural sector remains the largest employer in the country.

A major challenge for Bangladesh lies in its low tax base, which accounts for only 8-9% of GDP. The presence of a significant informal economy, estimated to be around 30-40% of the total economy, further exacerbates this issue. Recognising the importance of increasing tax revenue, the IMF has set forth widening tax revenue as one of the conditions for its loans. Under the IMF program, Bangladesh is required to raise the revenue-to-GDP ratio by 1.5 percentage points by the fiscal year 2025-26, with the aim of boosting funding for social, development, and climate projects. Although tax reform efforts are underway, the success of implementation and the actual impact on government tax revenue remain uncertain.

Key Macroeconomic Indicators for Bangladesh	2019	2020	2021	2022	2023F	2024F	2028F
Real GDP (%, end of period)	7.9 %	3.4 %	6.9 %	7.1 %	5.5 %	6.5 %	7.0 %
Inflation (%, annual averages)	5.5 %	5.6 %	5.6 %	6.1 %	8.6 %	6.5 %	5.6 %
General Gov. Overall Balance (% of GDP)	-5.4 %	-4.8 %	-3.6 %	-3.8 %	-5.6 %	-5.1 %	-5.0 %
General Gov. Primary Balance (% of GDP)	-3.7 %	-3.0 %	-1.6 %	-2.1 %	-3.8 %	-3.3 %	-3.2 %
General Gov. Revenue (% of GDP)	8.1 %	8.5 %	9.4 %	8.7 %	8.8 %	9.3 %	10.2 %
General Gov. Expenditure (% of GDP)	13.6 %	13.3 %	13.0 %	12.6 %	14.5 %	14.4 %	15.2 %
General Gov. Gross Debt (% of GDP)	32.0 %	34.5 %	35.6 %	39.1 %	42.1 %	42.4 %	43.6 %
Current Account Balance (% of GDP)	-1.3 %	-1.5 %	-1.1 %	-4.1 %	-2.1 %	-4.2 %	-3.0 %
Foreign Direct Investment (USD bn)	1.9	1.5	1.7	1.6			

Source: IMF April 2023

Bangladesh

Moody's Investors Service recently downgraded Bangladesh's sovereign rating due to concerns about the country's heightened external vulnerability, liquidity risks, and institutional weaknesses exposed during the ongoing crisis. Bangladesh's foreign exchange reserves have declined drastically, and Moody's expects them to remain below USD 30 billion (~3 months' import cover) for the next two to three years. The International Monetary Fund (IMF) has set targets for net foreign exchange reserves, which currently stand at approximately $20 billion. Bangladesh has committed to reporting its net reserves by the end of June.

Bangladesh is grappling with a shortage of foreign currency, primarily caused by a prolonged multiple fixed exchange rate system that has kept the Bangladeshi Taka (BDT) overvalued. This situation has constrained export and remittance incomes. Estimates of the backlog of foreign exchange vary between USD 700 million and USD 1 billion, which includes unpaid import bills for foreign energy suppliers and outstanding payments to airlines. Following our visit, the central bank, Bangladesh Bank (BB), announced a 50 basis points (bp) policy rate hike effective from 1 July, along with reforms aligned with the IMF program. BB has implemented a new monetary policy framework, transitioning from quantitative monetary tightening to an interest rate targeting framework. Removing the interest rate cap is expected to help lower inflation. Furthermore, exchange reforms will shift the USD-BDT rate to be determined by the market starting from 1 July.

Bangladesh's external debt-to-GDP ratio stands slightly above 40%, a level that many frontier countries would envy. The government has adopted a cautious approach towards borrowing, opting for long tenors and avoiding short-term volatile capital flows. Bangladesh has a access to concessionary financing and support from international financial institutions. Although foreign direct investment has been modest, there are expectations of growth as the government takes steps to improve the business environment. Chinese loans make up a relatively small portion, estimated at around 8% of the country's public sector foreign debt. While the level of debt distress remains low, there is a growing recognition of increased risks compared to previous periods.

Our View: Foreign investors in Bangladesh's listed markets predominantly engage in equity investments, while the fixed income market lacks attractiveness. Low yields, absence of international bond issuances, high taxation, and restrictions on T-bill purchases deter foreign investment. However, potential yield adjustments in the future may enhance the appeal of the local market. Currently, our investment in Bangladesh is limited to non-deliverable currency forwards within our local currency frontier strategy.

Photo: Threewheeler and rikckswahs waiting for customers in Dhaka

Sri Lanka

Photo: Colombo Lotus Tower

Sri Lanka is currently undergoing debt restructuring and economic revival. The nation's downward trajectory leading to its first-ever default in 2022 began years prior, with credit rating agencies downgrading the country since 2016. Sri Lanka had been grappling with twin deficits, living beyond its means by relying on leverage without generating sufficient revenue. The economy faced additional challenges from the 2019 Easter bombings and the onset of the Covid pandemic in 2020. As the country ran out of funds, impacting people's lives, mass protests against the government erupted in March 2022. Subsequently, the government defaulted on international bonds in April 2022.

The 2022 mass protests led to the resignation of President Gotabaya Rajapaksa. The Rajapaksa family dynasty had been more or less in power since 2005 when Mahinda Rajapaksa was elected president. While the Rajapaksas undertook infrastructure development, it was often accompanied by excessive leveraging. Sri Lanka has struggled to attract significant foreign direct investment (FDI) over the past three decades. However, the economic challenges and public frustration with the Rajapaksa administration may have had a silver lining, as it compelled the new leader to undertake long-overdue reforms.

In July 2022, Ranil Wickremesinghe, a six-time prime minister, assumed the presidency as a non-elected president. He represents the United National Party in parliament and previously served as an opposition leader. While his term will continue for the remaining two years, President Wickremesinghe aspires to become an elected president. Seeking a way out of the economic crisis, he sought assistance from the IMF, leading to a parliamentary referendum on the IMF recovery program. Despite facing unpopularity, President Wickremesinghe has initiated strong reforms, including reversing tax cuts and implementing price increases in response to high inflation. At 74 years old, he remains eligible to run for a second term as the presidential term in Sri Lanka is five years. The timing of elections will be crucial for his re-election, and a presidential election may precede general elections, requiring potential legal considerations. While the opposition lacks significant political power, the influence of the Rajapaksa family dynasty in politics cannot be entirely dismissed. Re-electing President Wickremesinghe would ensure the continuity of ongoing reforms, and his administration has upheld democratic processes.

Sri Lanka

The first review of the initial IMF program is scheduled for September 2023, and upon meeting the targets, the second disbursement can be made. The primary focus of the program is to achieve macroeconomic stability and restore public debt sustainability. In early June, the first-quarter GDP figures were released, indicating a year-on-year contraction of 11.5%, which is a slower decline compared to the previous quarter's contraction of 12.4%. The Central Bank of Sri Lanka (CBSL) expects slightly negative GDP growth for the full year, with recovery anticipated from next year onwards. These indicators suggest that the worst may be behind Sri Lanka's economy.

A swift progress in debt restructuring negotiations would be positive, especially considering the delays witnessed in Zambia's negotiations under the G20 Common Framework. Sri Lanka has pursued a bilateral approach, which could potentially expedite the process compared to the Common Framework. China's debt holdings in Sri Lanka have amounted to approximately USD 7.3 billion, constituting around 20% of the total public external debt. Negotiations for both external and domestic debts are progressing simultaneously, with expectations of concluding external debt talks by September and announcing domestic debt restructuring by the end of June.

The key focus of the Colombo meetings centered around the domestic debt restructuring and the speculation surrounding its implementation and the involved parties. The Central Bank of Sri Lanka (CBSL) has publicly committed to treating only its holdings of treasury bills (T-bills), excluding other T-bills from the restructuring. Similar to Ghana, the government aims to achieve domestic debt optimization on a voluntary basis. The CBSL, the Employees Provident Fund (EPF), and the two major state-owned banks are significant holders of local domestic government bonds. The CBSL has also assured that it will maintain and recapitalize the banking sector if necessary. The details of the restructuring plan have been closely guarded within a small group, with limited public awareness. However, an announcement to the public is expected by the end of June. The low level of foreign portfolio participation in the local market, primarily due to the 5% foreign ownership cap in the local bond market, alleviates concerns in this regard. Domestic debt issuances play a crucial role in sustaining governments, underscoring the importance of a successful restructuring to ensure the continued functioning of the local bond market, unlike the situation in Ghana. If the restructuring involves the banking sector's holdings, it is likely to lead to consolidation within Sri Lanka's banking sector.

Key Macroeconomic Indicators for Sri Lanka	2019	2020	2021	2022	2023F	2024F	2028F
Real GDP (%, end of period)	-0.2 %	-3.5 %	3.3 %	-8.7 %	-3.0 %	1.5 %	3.1 %
Inflation (%, annual averages)	4.3 %	4.6 %	6.0 %	46.4 %	28.5 %	8.7 %	5.0 %
General Government Overall Balance (% of GDP)	-7.5 %	-12.1 %	-11.6 %	-10.4 %	-8.0 %	-6.4 %	-
General Government Primary Balance (% of GDP)	-1.9 %	-5.9 %	-5.7 %	-3.8 %	-0.7 %	0.8 %	-
General Government Revenue	11.9 %	8.7 %	8.3 %	8.5 %	11.0 %	13.3 %	-
General Government Expenditure	19.5 %	20.7 %	19.9 %	18.9 %	19.0 %	19.7 %	-
General Government Gross Debt (% of GDP)	82.6 %	95.7 %	102.2 %	117.7 %	100.0 %	101.6 %	-
Current Account Balance (% of GDP)	-2.1 %	-1.4 %	-3.8 %	-1.9 %	-1.6 %	-1.4 %	-1.3 %
Foreign Direct Investment (USD bn)	0.7	0.4					

Source: IMF April 2023

Sri Lanka

Significant progress has been made on many of the IMF-required reforms, which are currently underway in the parliament. Gradual removal of import restrictions, initially implemented to improve the balance of payments, is taking place, with the remaining restrictions primarily related to vehicles to be lifted once the foreign currency situation stabilizes. Additionally, energy and electricity subsidies are being phased out. The progress of the new Central Bank Act, which will end the central bank's financing for the government, is underway, with a 12-month transition period expected after the law's approval. Furthermore, the Parliament is on the verge of passing a new Anti-Corruption Bill. Surprisingly, significant strides have been made in state-owned enterprise (SOE) reform, with plans to sell three major SOEs (Sri Lankan Airlines Ltd, Sri Lanka Telecom PLC, and Ceylon Petroleum Corporation). It is noteworthy that the state currently owns approximately 400 enterprises in Sri Lanka. One of the hardest reforms is lifting tax revenue from current 8.3% to 15% by 2027.

The Central Bank of Sri Lanka (CBSL) surprised the markets by implementing a substantial rate cut of 250 basis points, lowering the Standing Lending Facility Rate (SLFR) to 14%. This is the first rate cut in three years and comes as inflation is decelerating at a faster pace (22.1% year-on-year in May, compared to 33.2% in April). The CBSL anticipates inflation to reach single digits in the third quarter of this year and has signaled that further rate cuts will be implemented to support economic growth.

Our View: In 2018, we sold our positions in Sri Lanka within our hard currency strategy, and in 2021, we exited our positions within our local currency frontier strategy. Currently, we do not have any investments in Sri Lanka across any of our strategies. However, we hold a positive outlook on Sri Lanka, conditional upon the timely announcement and execution of a debt optimization plan. This would contribute to stabilising the foreign exchange rate in the country.

With the Central Bank of Sri Lanka actively reducing interest rates, we anticipate the yield curve to decrease and normalise. T-bills offering yields of 18-22% are particularly attractive, given the expected decline of inflation to single digits.

Photo: Sri Lankan Airlines is one of the SOEs for sale

This presentation is produced by Aktia Bank plc (“Aktia”) for investors. The information has been collected from available public sources, considered by Aktia to be trustworthy. However, Aktia cannot guarantee that the information is correct or all-inclusive. The presentation is meant as a tool, among others, to help the investor to make decisions. The investor’s investment decision is his own, and it should always be founded on information and analyses that the investor himself deems to be sufficient. The investor should observe that there may be swift changes on the market, affecting this presentation. Aktia, its subsidiaries and associated companies, co-operation partners, or employees of said companies are not responsible for direct or indirect losses or damage caused by the use of this presentation, or parts of it, in investment operations. The presentation is meant to be shown in conjunction to a spoken presentation given by Aktia, and it should not be used without the presentation. The contents of this presentation is aimed for the target group it was presented to, and it shall not be made available to any other recipients. Copying or quoting the presentation, or parts of it, is not allowed without the permission of Aktia.

Investments always involve financial risks. The customer bears the responsibility for the financial impact of his investment decisions. The investment may fail to yield a profit, or the invested capital may even be lost. The customer may be debited the costs for financial services irrespective of the investment results. It is always advisable to study the investment market and alternative investments in detail before making the decision to invest. Aktia cannot give assurance to the materialisation of the expected yield presented. The information is based on assumptions based on the historic yield from different financial instruments, but it is no guarantee for future development of yield or value. This presentation is part of Aktia’s marketing material, and therefore not necessary put together in accordance with the rules for independent investment analysis. Trade restrictions concerning investment analysis is not applied on the financial instruments presented. This presentation is not based on the customer’s individual data, and it is not intended to be investment advice. The aim is to present the financial instruments, and their characteristics, included in the quotation. We would be happy to set a date for preparation of an individual investor profile and to give you individual investment advice. The customer may be obliged also to pay taxes and official charges other than those debited by Aktia. The customer should be aware that investments and investment property are subject to taxation, the impact of which was not necessarily taken into consideration in this presentation. Future performance is subject to taxation which depends on the personal situation of each investor, and which may change in the future. The customer is responsible for the gathering of necessary information regarding taxation of his investments and his decisions concerning these.

Aktia