MOODY'S
INVESTORS SERVICE

# Rating Action: Moody's affirms Bangladesh's Ba3 rating, maintains stable outlook

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Singapore, October 10, 2018 -- Moody's Investors Service ("Moody's") has today affirmed the Government of Bangladesh's long-term issuer and senior unsecured debt ratings at Ba3 and maintained the stable outlook. The short-term issuer ratings are affirmed at Not-Prime.

The key drivers of the rating affirmation are:

1. Robust growth and policy that are conducive to macroeconomic stability;

2. Low debt affordability owing to the government's weak revenue generation capacity, balanced by a low debt burden and fiscal discipline; and

3. Infrastructure, human capital and institutional constraints that weigh on economic competitiveness and limit economic diversification.

The decision to maintain the stable outlook reflects Moody's expectation that risks to the ratings are balanced. On the upside, effective implementation of measures to expand the tax net and attract foreign direct investment could raise government revenue beyond Moody's expectations and aid economic diversification. On the downside, a sharp increase in risk premia, which could result in sharp local currency depreciation that raise inflation and interest rates, and/or a continued increase in government borrowing through National Savings Certificates (NSCs) would weigh on debt affordability.

Bangladesh's Baa3 local currency bond and deposit ceilings remain unchanged. The Ba2 foreign currency bond ceiling and the B1 foreign currency deposit ceiling are also unchanged. The short-term foreign currency bond and deposit ceilings remain unchanged at Not-Prime. These ceilings act as a cap on the ratings that can be assigned to the obligations of other entities domiciled in the country.

RATINGS RATIONALE

RATIONALE FOR THE RATING AFFIRMATION

ROBUST GROWTH AND POLICY CONDUCIVE TO STABILITY

Moody's expects Bangladesh to continue achieving high growth rates of around 7.0-7.5% over the next few years, supported by its globally competitive ready-made garments (RMG) industry. Strong growth and policies conducive to macroeconomic stability support the sovereign's rating.

The RMG industry has gained global market share over the past decade to account for more than 6% of global apparel exports in 2017 from less than 3% in 2007, and Bangladesh is now the second largest exporter after China. The industry's global competitiveness stems from a variety of factors ranging from low labour costs to vertical integration and investment in technology and environmentally sustainable processes, which help raise efficiency and meet evolving consumer demand.

Prudent and credible monetary and fiscal policies further underpin macroeconomic stability. In particular, moderate reserve money growth -- the central bank's operational target -- anchors credit growth and inflation expectations. Adherence to fiscal deficit limits of 5% of GDP also fosters moderate inflation and reduces growth volatility arising from pro-cyclical fiscal policy. Policy effectiveness has been demonstrated by the stability in economic growth over the past decade, low growth and inflation volatility, and the absence of boom-bust credit cycles.

External vulnerability risks also remain low despite Moody's expectations for slightly wider current account deficits to persist, driven mainly by fuel prices and higher infrastructure-related imports -- in part related to the government's large infrastructure projects. Moody's expects the current account deficit to remain around 2-3% of GDP over the next few years, after widening to an estimated 3.5% of GDP in fiscal 2018 (the year ending in June 2018). The ongoing rebound in remittances will lend some support to the current account balance, while external financing from multilateral and bilateral lenders for the infrastructure projects supports the broader balance of payments dynamics.

Moody's expects foreign exchange reserves in Bangladesh to remain adequate, sufficient to cover around 5-6 months of imports and more than 90% of the government's gross external debt, which is largely long dated and on concessional terms.

WEAK REVENUE GENERATION CAPACITY LIMITS FISCAL SPACE, BALANCED BY FISCAL DISCIPLINE PRESERVING A LOW DEBT BURDEN

Balanced against the broad macroeconomic stability is the government's very low revenue generation capacity. At 11.7% of GDP in fiscal 2018, the government's revenue base is one of the lowest in Moody's rated universe. Persistently low government revenue adds to relatively high financing costs to weigh on debt affordability and constrain the government's fiscal space, particularly in light of infrastructure and social spending needs. These credit constraints are balanced by fiscal discipline that support the low government debt burden.

The authorities are implementing a number of measures to raise revenue by widening the tax base and improving tax compliance. Measures include the digitisation of value added taxes (VAT) and the electronic filing of income taxes; organising week-long annual tax fairs to increase tax registration and return filing; and enforcing severe penalties on tax evaders.

Moody's baseline assumptions include some, albeit not all, of the revenue increase planned by the government. Given Bangladesh's track record, revenue shortfalls are likely to persist. In general, delays in the implementation of revenue-raising measures reflect the political, and in some cases technical, complexity of meeting the government's targets. For instance, the VAT law that is currently targeted by the government for implementation in fiscal 2020 now seems likely to be passed but after it has been deferred for four years.

Besides a narrow revenue base, Bangladesh's debt affordability is weakened by a relatively high cost of government debt. Increased issuance of National Savings Certificates (NSCs) -- social savings instruments that currently offer an interest rate premium over domestic treasury bills and bonds -- has raised the government's overall financing costs. The share of general government debt financed from the higher yielding NSCs increased significantly to 34% in fiscal 2018 from 25% in fiscal 2016. The authorities plan to introduce reforms to the NSCs in the upcoming medium-term debt management strategy, due in December 2018, by tightening eligibility requirements and improving the monitoring of limits.

Bangladesh's low government debt burden offsets these fiscal constraints. Moody's expects the general government debt to GDP ratio to remain around 30-32%, anchored by the country's strong nominal GDP growth and the government's track record in meeting its deficit targets.

INFRASTRUCTURE, HUMAN CAPITAL AND INSTITUTIONAL CONSTRAINTS CONTINUE TO WEIGH ON ECONOMIC COMPETITIVENESS AND LIMIT ECONOMIC DIVERSIFICATION

Notwithstanding stability-conducive macroeconomic policies, Bangladesh continues to face challenges in government effectiveness, control of corruption, and weak credibility in its legal structures. Institutional weaknesses limit efficacy in long-term measures to improve the quality of infrastructure and human capital.

Inadequate physical infrastructure continue to constrain Bangladesh's manufacturing and export capacity and limit diversification prospects. Road traffic is congested, rail routes are limited, and there is only one major port in Chittagong servicing exports. The government aims to reduce infrastructure constraints through its large infrastructure projects, which include two deep sea ports, the country's first mass rapid transit network in Dhaka, a road-rail bridge, and power plants, all due to be completed between 2019 and 2023. While additional and newer infrastructure may relieve some of the constraints on the economy, demand for infrastructure is growing at a fast pace. It is likely that such demand will only be partially met, with the economic returns materialising over a long period of time.

A further constraint to economic competitiveness in general and to the development of adequate infrastructure in particular is persistent weaknesses in corporate governance and lengthy judicial and bankruptcy processes that raise operational risks in the country and deter foreign investment. These institutional constraints have resulted in weak asset quality and capital adequacy in the state-owned banks.

Meanwhile, human capital constraints also weigh on global economic competitiveness and limit opportunities for the country to move up the value-added chain. Enrolment rates in secondary education and beyond are low relative to peers. Despite abundant labour supply, Bangladesh's economy continues to face a shortage of skilled managers and specialists. Moody's does not expect significant improvements in the quality of human capital.

RATIONALE FOR THE STABLE OUTLOOK

The stable outlook reflects balanced risks to the ratings.

On the upside, effective implementation of the new VAT law and measures to expand the tax net and attract foreign direct investment could raise government revenue and economic growth beyond Moody's expectations and aid economic diversification.

On the downside, although external financing needs are low and provided for by multilateral and bilateral development partners, a sharp increase in risk premia could result in sharp local currency depreciation, which would raise inflation and interest rates, and weigh on debt affordability. Continued increase in government borrowing through NSCs would also raise interest expense and weaken debt affordability further. Meanwhile, persistent financial weakness in state-owned banks could compromise the implementation of essential infrastructure projects.

WHAT COULD CHANGE THE RATING UP

The stable outlook indicates that a rating change is unlikely in the near future.

Over time, the rating would likely be upgraded in the event of (1) improvements in the fiscal environment, including a significant increase in the government's revenue generation capacity and lower cost of financing, that would increase debt affordability and the fiscal space; and/or (2) material progress in developing critical physical infrastructure and institutional and economic reforms that would raise economic competitiveness, income levels and the economy's shock absorption capacity.

WHAT COULD CHANGE THE RATING DOWN

Conversely, the rating would likely be downgraded if (1) the debt burden increased sharply, possibly through large borrowing to fund infrastructure projects that do not provide commensurate economic returns; (2) the banking sector's financial health weakened, particularly for state-owned banks, with rising contingent liability risks to the government; and/or (3) political tensions increased and undermined macroeconomic policy stability.

GDP per capita (PPP basis, US$): 4,784 (2017 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 7.3% (2017 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 5.9% (2017 Actual)

Gen. Gov. Financial Balance/GDP: -3.4% (2017 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -0.6% (2017 Actual) (also known as External Balance)

External debt/GDP: 18.1% (2017 Actual)

Level of economic development: Moderate level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

SUMMARY OF MINUTES FROM RATING COMMITTEE

On 08 October 2018, a rating committee was called to discuss the rating of the Bangladesh, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's institutional strength/framework, have materially increased. The issuer's fiscal or financial strength, including its debt profile, has not materially changed.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2016. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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