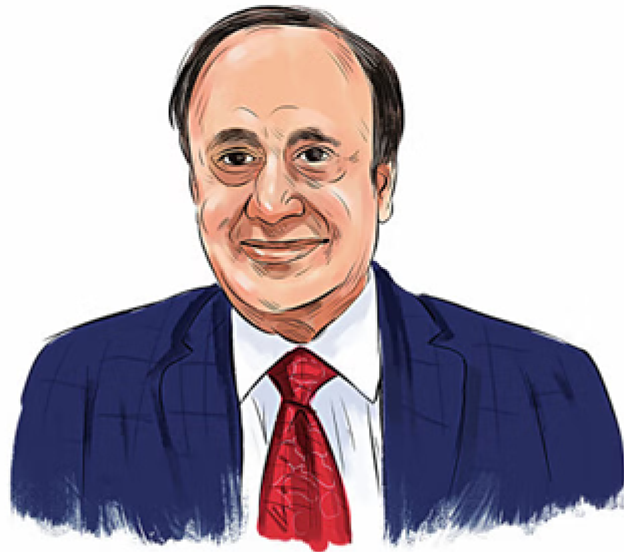

Adoption of a market exchange rate is a smart policy move

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By *Dr. Sadiq Ahmed*

Trade reforms aimed at lowering tariff and non-tariff barriers would support the diversification of the export basket while also helping respond to the challenge of the Trump reciprocal tariff

ANALYSIS

Sadiq Ahmed, Sketch: TBS

The adoption of a market exchange rate system announced recently by the government is a smart policy move. This is a major structural reform that will serve Bangladesh well. I have been advocating this for well over 13 years since the real effective exchange rate (REER) started appreciating in 2012.

The exchange system was flexible in terms of name but essentially became a fixed exchange rate regime that rapidly appreciated the Bangladesh currency in real terms owing to large inflation differential with trading partners. Thus, between FY2011 and FY2023, the REER appreciated by 57% that hurt the growth of exports and also diverted remittance inflows from official channels to unofficial channels.

The fixed exchange system became unsustainable in the wake of a series of external shocks between 2022 and 2023 as the rapid loss of reserves forced the government to sharply devalue the currency and eventually led to the adoption of a crawling peg in May 2024. The crawling peg system brought in important flexibility to the exchange rate and contributed to a healthy expansion of exports and remittances through the official channels.

The crawling peg was always intended as an interim step towards a market exchange system. The issue was timing. I

agree with the IMF that the timing now is right. The reserve level remains low but has been stable for almost 10 months even as debt service expenses have grown and import growth is positive and on the upside. Excess demand pressures prevailing during FY22 and FY24 have subsided as the freeing of interest rate and reduction in fiscal deficit have lowered the growth of domestic credit. The increase in the interest rate and the opening up of T-bills for household savers has sharply improved the asset preference from US dollar holdings to purchase of T-bills. This switch in asset preference combined with the shrinking of the unofficial exchange market has lowered the demand for US dollars in the Bangladesh economy. Additionally, the demand for imports is low as the investment climate and GDP growth remains sluggish.

In this environment, the move from a crawling peg to a market-based exchange system will not likely cause the exchange rate to shoot up. Speculative purchases of US dollars will be very costly because the speculators will tie up taka funds that have a huge opportunity cost in terms of loss of interest earnings from T-bills. The prevailing interest rate on a 90-day T-bill is 11.6%, which is substantial. It is very unlikely that speculators will find a currency market that yields more than 11.6% on US dollar holdings.

There will be some downward trend in the exchange rate owing to the large inflation differential between Bangladesh and trading partners. The demand for imports may go up if the investment climate and the GDP growth outlook improves. But these are precisely the reasons why a market exchange rate is needed. Instead of artificially holding up the exchange rate leading to appreciation in real terms, the exchange rate will function as one important policy instrument for facilitating the efficient functioning of the Bangladesh economy. To avoid putting the full burden of adjustment on the exchange rate, the government must coordinate its exchange rate policy with other policy instruments including monetary, fiscal and trade policies.

Prudent demand management will remain crucial. Focus on inflation reduction will be critical. Demand management policies are basically on track. Monetary policy is functioning well based on a market-based interest rate policy. Inflationary pressures are now responding to the supply crunch that has happened through the large cutbacks in imports, the sharp reduction in manufacturing production, and the inefficiencies in the marketing of agricultural products. These aspects require remedial actions. The weather-related volatility in the supply of food products also needs to be watched and managed.

Fiscal policy adjustments to support demand reduction through cutbacks in fiscal deficit have been helpful. But the way these cutbacks have been brought about is hurting inflation by having adverse effects on the supply side. Instead of cutting growth enhancing spending on human development and infrastructure, the fiscal adjustment should focus on generating greater tax revenues and financial surpluses from state owned enterprises. Growth enhancing spending should be protected to increase domestic supply. Public spending on rural infrastructure, flood protection, farm inputs and marketing support systems are particularly important to enhance and ensure the smooth supply of food products.

The market exchange rate should boost exports and remittances. But the exchange rate is only one policy instrument to boost exports. Trade policy reforms are also necessary to eliminate the anti-export bias arising from large trade protection. The emergence of the Trump reciprocal tariff phenomenon could serve as a blessing in disguise for Bangladesh. Trade reforms aimed at lowering tariff and non-tariff barriers would support the diversification of the export basket while also helping respond to the challenge of the Trump reciprocal tariff. Additionally, these trade reforms are necessary for Bangladesh to make its trade regime WTO compliant as an essential part of the LDC graduation.

Finally, actions are needed to boost capital inflows. A part of the pressure on the exchange rate came from the sharp reductions in capital flows including net official medium and long-term loans (MLT), FDI flows, private sector loans, and short-term trade credits. Higher capital flows will ease the pressure on the exchange rate and help build up reserves.

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