Challenges and opportunities of growing forex reserves

Thursday, Jul 30, 2015

By *Dr. Ahsan H. Mansur*

In fiscal Year 2014/15 (FY15), Bangladesh's foreign exchange (forex) reserves crossed the US$25 billion mark, setting a new record for the emerging South Asian nation. With current level of reserves, Bangladesh will be able to afford seven months of imports.

The foreign currency reserve hit this record in FY15 despite a slowdown in exports and workers' remittances growth (Chart 1),

a sharp rise in money being laundered out of the country, and the resulting widening of the external current account deficit (Chart 2).

Given the weaknesses in the key external sector indicators, this reserve buildup is a surprising yet welcome development for Bangladesh which has been grappling with intense political unrest earlier in 2015 for almost one quarter.

What is behind this extraordinary growth in foreign exchange reserves in Bangladesh? As can be seen from Chart 2, the current account balance has been on a steady rise since 2011 despite prior undulations. However, the current account balance in FY15 registered the largest decline in 2015 since FY06.

Bangladesh's capital account has been more or less stagnant between 2006 and 2015. In contrast, the financial account balance was negative until FY 2011, after which it has been

growing rapidly, recording a surplus of US$5 billion in FY15. This surge in the financial account balance is attributable to a number of factors contributing to inflow of funds into Bangladesh from abroad, including Bangladesh Bank's (BB) easing of restrictions on private sector's dollar denominated borrowing from abroad.

This rapid growth in the financial account balance is a relatively new phenomenon and would require careful understanding of why it is happening, from what sources it is happening, and stability of such flows over the medium term.

In the remainder of this note we briefly cover the following issues: What benefits generally result from high level of reserves? What kind of policy challenges may result from the rapid accumulation of reserves? What kind of mitigating strategies may be adopted by BB and Government to manage the exchange rate without undermining export competitiveness and helping boost domestic investment?

High levels of foreign exchange reserves act as a self-insurance policy at times of balance of payment crises. This is important for a small open economy like Bangladesh where current account balances are often vulnerable to terms of trade fluctuations. The example of East Asian countries, which rapidly built up foreign exchange reserves to record high levels in the post-Asian Crisis period is worth mentioning in this regard.

http://www.thefinancialexpress-bd.com/2015/07/30/102032

Rising forex reserve

Monetary & exchange rate management options

Ahsan H. Mansur and Muhammad Shafiullah in continuation of their front-page analysis titled 'Challenges and opportunities of growing forex reserves'

A large foreign currency reserve is likely to improve the credit rating of the country as the likelihood of repayment is greatly increased. This has a knock-on effect on the country's external borrowing costs as both sovereign and private interest rate spreads over the London Interbank Offered Rate (LIBOR) decrease. With the decline in country risk, there will be

increasing interest from foreign investors in making FDI (foreign direct investment) in labour-intensive and industrial and information technology (IT)-related sectors in Bangladesh. High level of reserves will also improve government's capacity to finance large infrastructure projects like the Padma Bridge, elevated express ways, and power projects.

In spite of these benefits, accelerated inflow of foreign assets also creates a number of policy challenges including market pressures for exchange rate appreciation and complications for monetary management. Bangladesh Bank (BB) needs to incessantly buy dollars to prevent a nominal appreciation of the exchange rate of Taka against the dollar. However, buying dollars from the interbank exchange market has the side-effect of increasing money supply beyond the target level, undermining the inflation target. Any sizable sterilisation operation – which BB had to do in recent years due to exchange market interventions – to contain monetary growth within the intended limit-entails quasi-fiscal cost through reduced profitability of BB.

It is also important to note that while BB has been successful in keeping Nominal Exchange Rate (NER) stable against the US dollar, it could not prevent a significant appreciation of the Taka against the currency baskets of Bangladesh's trading partners. The Real Effective Exchange Rate (REER) is at its highest point in recent years as it appreciated by more than 19 per cent since FY11 undermining the competitiveness of domestic exporters. The rapid appreciation of the REER in recent years can be attributable primarily to the higher inflation in Bangladesh relative to its trading partners.

Source: Ministry of Finance

This puts Bangladeshi exports at a tremendous competitive disadvantage, especially in the European markets as the Euro has depreciated substantially against the US dollar in recent times and is expected to remain low in the foreseeable future. Bangladesh's exports, mainly ready-made garments, are priced in US dollar and as such, the unit value of exports has gone up sharply in recent months hurting export growth.

The sharp deceleration in export growth in FY15 is a manifestation of this problem. This produces a tricky situation for BB: it has to buy more foreign exchange from the interbank

market if it wants to engineer a depreciation of the Taka in nominal terms; at the same time it has to mop up the excess liquidity injected through this intervention by conducting sterilisation operations if it wants to prevent an acceleration of the inflation which would undermine the nominal depreciation through a corresponding real effective appreciation of the Taka.

If the reserve build-up continues supported by sustained and increasing inflows through the financial accounts or a positive turnaround in the current account balance through a rebound in exports and remittances, mopping up of liquidity through sterilisation operation cannot be a permanent solution and the authorities must find ways to boost investment and domestic demand in general to accelerate import payments.

The high interest rate differential between the Taka and dollar-denominated borrowing from abroad also encourages domestic investors to borrow from abroad; some market players may also be engaged in “carry trade” entailing borrowing abroad at lower interest rates and lending in Taka at higher interest rates at home. These activities accentuate reserve accumulation and results in the problem of “idle financial savings” at home. High domestic interest rates, coupled with political hostilities-related slower investment, are also blamed for stagnant investment in relation to gross domestic product (GDP), creating the problem of excess liquidity in the banking system.

Now, what should the strategy be for managing this situation and making the best utilisation of the opportunities created by the high level of foreign inflows and continued reserve build-up? A number of options – all of which aimed at boosting domestic investment, sustainable economic development, further liberalisation of the foreign exchange regime, and at the same time helping management of foreign capital inflows – may be considered in this respect.

We will refer to these options in the order they could be adopted by the authorities.

First, the discount facilities like Export Development Fund (EDF) for exporters, Green Financing Facility for environmentally sustainable investment promotion, Funds for Cleaner Textiles and Leather Processing Industries, Infrastructure Financing Facility etc., which are already in operation or are going to be in operation very soon. In this front Bangladesh Bank

is already very active with total committed resources in the range of US$2.5-3.0 billion. The amounts can certainly be increased in line with growth in demand and accumulation of external reserves by BB.

Second, the Ministry of Finance, in consultation with the relevant line ministries/agencies, should formulate an “Infrastructure Development Programme” for accelerating implementation of nationally important major infrastructure projects. The projects could include transforming all national highways to four lanes within a five-year period; construction of a number of major bridges and tunnels and elevated express-ways, further expansion of Dhaka Mass Transit System (including new lines for elevated or underground mass transit routes; and co-financing of some Public-Private Partnership (PPP) projects including power projects. The initial starting fund size could be US$2.0 billion and increasing over time to US$10 billion or more. Availability of these funds will also help mobilise donor financing and PPP sponsors for infrastructure projects. The fiscal deficit may have to be increased by 1.0-2.0 percentage points in relation to GDP on a time-bound basis in order to accommodate such spending. After taking into account the additional growth, the net increase in debt/GDP ratio will still not exceed 45 per cent of GDP.

Finally, foreign currency reserves of BB, if equivalent to more than six months of imports, can also be used to create a Sovereign Wealth Fund (SWF). SWFs are investment funds owned by the state and may be invested either locally or internationally or both. In the case of Bangladesh, the focus of the proposed SWF should be on investing and catalysing investment in domestic infrastructure projects which are suffering from funding constraints due to longer gestation and payback periods for such investment. Until long term domestic funding sources like pension and gratuity funds in the public and private sector are widely available and the insurance sector is more developed, the proposed SWF can play a major role in Bangladesh’s infrastructure financing.

One of the key limiting factors in balancing the challenges and opportunities of the foreign exchange reserve is Bangladesh’s domestic inflation. Although BB has attempted to maintain a stable nominal exchange rate vis-à-vis the US dollar, the real exchange rate has appreciated sharply because Bangladesh has higher inflation compared to most of its trading partners. The adopted mitigation policies must ensure that there are measures to bring down current inflation rates of 6.0-7.0 per cent closer to the rates prevalent in Bangladesh’s trading

partners. There needs to be specific “inflation targets” to achieve the feat of lowering Bangladesh’s inflation further, which would ultimately lower the domestic interest rate structure and the inflation and interest rate differentials with trading partners.

The challenges posed by a burgeoning foreign exchange reserves have to be mitigated using market-based instruments. The mitigation instruments have to be carefully chosen, and should be prudent and strategic in nature. Only then can Bangladesh’s flourishing foreign exchange reserves can open up many opportunities.

The opportunities, if exploited adequately and on time, can boost Bangladesh’s growth performance, enhance employment generation, and strengthen macroeconomic stability. If implemented properly and effectively, the strategy will surely help Bangladesh break the “6.0 per cent growth trap” and shift it to an 8.0 per cent growth trajectory. Will our policy makers and administrative machinery rise up to this challenge and help realise the cherished dream of transforming Bangladesh into a high middle-income country?