Exchange rate: Double-edged sword

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THE taka has shown a remarkable degree of stability vis-à-vis the US dollar in recent months despite numerous
shocks. Two floods, Cyclone Sidr, and external shocks resulting from record surges in oil and commodity prices
certainly complicated macroeconomic management, but the exchange rate of the taka remained remarkably
stable.
Exchange rate is the single most important price in any economy, and reflects the underlying economic
fundamentals if determined by market forces. Bangladesh is the only country in South Asia that enjoys a modest
but persistent external current account surplus. Thus it is not surprising that as a net exporter of savings
(although it sounds paradoxical for a poor country like Bangladesh), the taka would tend to be relatively stable.
For the last several years, Bangladesh has been recording surpluses in its current account balance. Strong export
performance and remittance inflows are the main contributing factors, despite higher import payments
associated with domestic economic expansion.
The outlook for the current account also remains favourable, given the buoyant export growth and remittance
inflows. Bangladesh's limited dependence on external private capital flows in the form of portfolio or foreign
direct investment also reduces its vulnerabilities to external shocks like the current

international financial
turmoil.
Stability of the taka will certainly help macroeconomic management by restraining inflationary pressures, which
is the government's priority number one. As commodity prices are declining globally, the stability would allow
these cuts to be passed on to consumers, helping the fight against inflation.
In addition, since many products are imported from India through formal and informal channels, the
appreciation against the Indian rupee would help offset the impact of higher Indian inflation on our imported
consumer goods and industrial inputs. This would allow the Bangladesh government to focus its fight against
inflation to domestic demand management through fiscal and monetary policies.
The bilateral exchange rate with India, however, has a number of important ramifications for our economy since
India is our largest trading partner and the prices of many essential items depend on supplies from India. An
appreciation of Bangladesh taka vis-à-vis the Indian rupee by more than 25 percent will undoubtedly dampen
the price structure in Bangladesh.
Bangladeshi consumers would benefit from this appreciation, but the implications for domestic producers would
not be desirable. Indian products may flood Bangladeshi markets, causing hardships for domestic producers.
Indian suppliers may capture the market for Bangladeshi garment exports and make the domestic textile sector
non-competitive.
The impact on Bangladeshi farmers could also be destabilising. The government has already reduced the
procurement price of rice to Tk. 25 per kg from Tk. 29 due to developments in domestic and international
markets. This reduction may act as a disincentive for rice farmers, especially after taking into account the

domestic input costs.
Bangladeshi farmers have responded strongly to the higher procurement price for boro, and the supply response
may evaporate if rice price falls significantly. If India lifts the rice export ban today, the same quality of rice,
which is now selling in Bangladesh at Tk. 32-35 per kg, could be supplied by India at Tk. 22-24. The
government would have to impose tariffs to protect domestic farmers from an invasion of Indian agriculture
produce.
The services account balance in Bangladesh is always in large deficit, in part because of large payments
associated with travels related to medical treatment, education, shipping, and tourism. The appreciation of the
taka relative to regional currencies would certainly make it more attractive for Bangladeshis to go abroad for
treatment, education and tourism, weakening the services account balance further. The dwindling services
account balance is clearly a source of vulnerability.
Bangladesh Bank (BB) is certainly enjoying a favourable environment in terms of price outlook from the
external side and strong economic activity supported by exports and buoyant domestic demand. Now that the
collapsing commodity prices globally are likely to dampen domestic inflation, Bangladesh should be able to
lower inflation (point-to-point) to 4-5 percent by early 2009.
The inflation target in the budget (8-9 percent) is certainly un-ambitious, given the external environment, and
BB must remain vigilant against the impacts of the current expansionary fiscal stance and the rapid private
sector credit expansion. Some tightening of monetary policy through the recent two rounds of increases in the
repo rate was appropriate, and BB should be ready to do more at the short-end of the interest rate structure if

credit growth continues at an unsustainable pace.
At the same time, BB is coming under pressure from exporters to depreciate the taka in view of its significant
appreciation against the euro and the Asian currencies. This development has made exporters apprehensive
about loss of their competitiveness and profitability. The depreciation of the taka would, however, work against
BB's current policy of monetary tightening (to fight inflation), which would support or strengthen the taka.
At this juncture, BB has to sequence its policy response. The fight against inflation is certainly priority number
one, and if this fight is won decisively in the coming months it will help the exporters by reducing domestic cost
pressures. Gains on the inflation front would also help reduce the domestic interest rate structure and enhance
domestic investment, thereby boosting domestic productivity and competitiveness.
At the same time, while being sympathetic to the cause of exporters, so far there is no sign of export weakness
and the adverse impact of the global recession on Bangladeshi exports. Thus, it would be premature to abandon
the fight against inflation by engineering a depreciation of the currency and easing the stance of monetary policy.
Exchange rate is a very effective instrument, and it should be determined by market forces. Since it works like a
double-edged sword, the authorities need to be very careful before interfering with market forces in engineering
a change.
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