



Foreign currency regulations and implications for private investment

Tuesday, Feb 3, 2015

By *Dr. Ahsan H. Mansur*

Difficulties in external borrowing

Ahsan H. Mansur in the first of a three-part paper titled 'Foreign currency regulations and implications for private investment'

Bangladesh has been very slow and cautious in opening up of its capital account transactions including private sector borrowing in foreign currency from abroad. The foreign borrowing

market in Bangladesh was highly controlled and virtually non-existent even a decade ago and access to foreign financing by the private sector was strictly controlled. Until 2008, the domestic private sector, barring some special cases/circumstances, were not allowed to borrow from foreign sources, even though foreign borrowings could be made at lower lending rates than those charged by the domestic banks and other financial institutions. Following an improvement in the foreign exchange reserve position of Bangladesh Bank, the government decided to liberalise such borrowing in the year 2008 primarily for the import of capital goods of new projects and modernisation of existing projects, and for sectors defined in the country's industrial policy.

The isolation of domestic financial sector from international capital market was a deliberate policy which, in part, was also dictated by the weakness of the country's balance of payments and inability of Bangladesh to access the international market in the absence of strengthened macroeconomic stability and a respectable country rating for foreign investors to assess country risk. The isolation of domestic financial market-particularly for borrowing from abroad by the domestic private sector-has contributed to high domestic interest rates, inefficient banking operations/management as reflected through high spread between deposit and lending rates and high levels of nonperforming loans, and also encouraged governments to continue with much higher inflation rates compared with Bangladesh's major trading partners. Since banking sector is the most important component of Bangladesh's financial system, these inefficiencies and the consequent high interest rates contribute to higher cost of doing business in Bangladesh compared to most other countries.

This paper essentially puts forward the case for further integration of Bangladesh financial system with the international capital market. It argues that Bangladesh Bank and government's efforts to lowering of domestic interest rates and maintaining exchange rate stability have been frustrated in the past largely due to higher domestic inflation (compared to trading partners) and a lack of integration with the international capital market. The paper presents the evidence that recent modest liberalisation of private sector foreign currency-denominated borrowing and deceleration of inflation have contributed to lowering of domestic interest rate structures. While closer monitoring of the opening up process will be important in order to avoid situations like the East Asian Crisis with overexposure to international capital market and vulnerability to economic contagion, Bangladesh cannot allow itself to remain disconnected from the international capital market.

CURRENT SITUATION: Bangladesh enjoys continued macroeconomic stability over a reasonably long time in terms of strong balance of payments, manageable public debt and good fiscal management. This stability notwithstanding, Bangladesh has high interest rates structure (both in nominal and real terms), much higher inflation rates compared to its trading partners, and very limited access to private foreign borrowing. These unfavourable developments tend to limit domestic investment and contribute to exchange rate instability in both real effective and nominal terms.

[Difficulties in external borrowing]

MACROECONOMIC STABILITY WITH HIGH REAL INTEREST RATES: Despite macroeconomic stability Bangladesh economy could not come out of the steady 6.0 per cent plus growth rate levels because of stagnation of domestic investment in the range of 24 per cent-26 per cent of GDP (gross domestic product) levels over more than one decade. In addition to a number of other factors such as infrastructure deficiency and lack of serviced land, higher lending rates charged by banks are often quoted as an important impediment against investment by the private sector. Until recently, the borrowing rates used to be 16 per cent-18 per cent in nominal terms. Only recently the interest rate structure has started to come down to 12 per cent-14 per cent range due to increased competition from foreign currency borrowing, a deceleration of the domestic inflation rate, and slower domestic economic activity.

The spread between the lending and deposit rates however still remain high at 5.5 per cent-6 per cent range and somewhat widening in recent months, indicating inefficiencies in the banking system. Higher and growing burden of classified loans and the associated provisioning requirements have also contributed to this widening of the spread. Foreign commercial banks are taking advantage of this situation by charging even higher spread and making greater profits in the domestic market. The recent decline in deposit rates have not been fully passed on to the borrowers in terms of lower lending rates, allowing banks to pass on their inherent inefficiencies to the depositors and borrowers, at least to a large extent.

The spread in Bangladesh banking system is certainly excessive. In most well-managed banking system, due to enhanced competition and better risk management of their loan portfolios, the spreads generally tend to be at or below 3.0 per cent.

[Difficulties in external borrowing]

MUCH HIGHER INFLATION RATES RELATIVE TO TRADING PARTNERS: Bangladesh has generally experienced higher inflation rates compared to its trading partners, which are mostly industrial and emerging economies. The 10-year (FY2004-FY2014) average inflation rate in Bangladesh was 7.9 per cent, while the corresponding average for the industrial economies was only 2.3 per cent.

Certainly the differential inflation rates cannot continue forever without a corresponding impact on the relative exchange rate. The Purchasing Power Parity (PPP) principle while not relevant or significant in the short-term, over the long term would certainly impact the levels of bilateral exchange rates. The currency of the relatively high-inflation country would depreciate in nominal terms as happened in the case of Bangladesh steadily over the long term. In the event the nominal exchange rate is kept unchanged, the exporters would tend to lose export competitiveness with the appreciation of the domestic currency (high inflation country) in real effective terms.

In recent months, with Bangladesh inflation remaining high, the relative stability of Bangladesh taka against the US dollar has simply contributed to a sharp appreciation of Bangladesh taka in real effective terms. The loss of export competitiveness is already significant and if the level of inflation in Bangladesh remains high in the coming months, the competitiveness of Bangladeshi exports in the world market will suffer.

RECENT LIBERALISATION IN FOREIGN BORROWING BY BANGLADESH BANK: Until 2008, the local businesses, barring some special cases, were not allowed to borrow from the foreign sources that offer loans at lower lending rates than those charged by the domestic banks and other financial institutions. After substantial improvement in the foreign exchange reserve position, the government decided to allow such borrowing in the year 2008 only for the import of capital goods of new projects and modernisation, and other sectors defined in the country's industrial policy. Due to a healthy reserve position, outside lenders and others started making available a considerable volume of funds to Bangladeshi entrepreneurs. In the past six years, Bangladesh Bank has allowed private firms to borrow \$5.56 billion from foreign sources at lower interest rates of around 5.0 per cent-6.0 per cent. In its monetary policy for July-December FY15, the central bank set the private sector borrowing ceiling at

16.5 per cent for the second half of the year, with 2.5 per cent coming from foreign borrowing. This is an explicit recognition that foreign currency-denominated borrowing will continue to play an important role in the sourcing of private sector credit.

A sectoral classification of the approved foreign loan portfolio for the private sector during 2009-14 shows that, the telecommunication/ISP sector accounted for 42.6 per cent of the total. The second and third highest approved loan amounts were granted for the power and RMG-related firms, which accounted for 18.6 per cent and 12.5 per cent of the cumulative approved loans for the period. The highest recipient of foreign loans, the telecommunication/ISP sector, is exposed to relatively less risk since most of them are subsidiaries of large international parent telecom companies/conglomerates. In comparison, most of the power sector and RMG sector projects are owned domestically.

A study conducted by the Bangladesh Bank on foreign borrowing by the private sector indicates that while the amount of loans approved has increased significantly in the last five years, the amount of loan disbursed has in fact declined. The total loan approved for 2012 was \$1.58 billion of which only \$0.528 billion was disbursed. The amount disbursed in 2013 was \$0.393 billion while total approved loan was \$1.55 billion. The low disbursement rate of 35 per cent and 25.3 per cent for the two years is a cause for concern, as it indicates weakness on the part of the borrowers in terms of their ability to meet the financial standards set by international lenders in the context of granting such loans. Table 2 shows the net outstanding foreign currency-denominated loans was only \$1.52 billion in 2012 and \$1.74 billion in 2013.

A survey report of the Bangladesh Bank states that these loans were mostly used for importing foreign capital machineries, expansion of existing projects and establishing new ones. The report also states that 'some of the external loans have been used to pay off more expensive local loans and one company used the loan to settle its L/C payment obligations (Deferred L/C). The survey pointed to three major potential/actual difficulties in external borrowing:

n Exchange rate fluctuations: Companies, which are not export-oriented, do not earn in foreign currency. Hence unfavourable exchange rate fluctuations lead to losses in local currency when servicing their foreign currency-denominated loans.

n Borrowing from off-shore banking units: One company, which borrowed from the off-shore banking unit of a local bank, faced significant losses as the bank was unable to continue foreign exchange financing and switched to higher cost local financing.

n Lengthy procedure of loan approval: The loan application and approval process takes considerable time, which acts as hindrance for some companies which require financing urgently.

Dr. Ahsan H. Mansur is Executive Director of the Policy Research Institute of Bangladesh (PRI). ahsanmansur@gmail.com

<http://www.thefinancialexpress-bd.com/2015/02/01/78768>

Posted : 02 Feb, 2015 00:00:00

Liberalisation of access to foreign loans

Ahsan H. Mansur in the second of his three-part paper titled 'Foreign currency regulations and implications for private investment'

The main reasons for the private sector to seek foreign loan is the interest rate differentials between foreign currency-denominated (international) borrowing and taka-denominated borrowing from domestic banks. Interest rates charged on foreign currency-denominated loans provided to the private sector are generally set in the range LIBOR plus 3.0 per cent-4.5 per cent, the spread over LIBOR (at 3.0 per cent-4.5 per cent) being the combined mark-up charged by the facilitating domestic commercial banks and the counterpart foreign lenders. The domestic lending rates at present vary between [11 per cent-14 per cent] depending on the customer, which is still high and is acting as a deterrent for investment and

private sector borrowing. In terms of foreign rates, there are two main contributing variables — the level of LIBOR and the exchange rate between US dollar and Bangladesh taka.

[Liberalisation of access to foreign loans]

Despite this enhanced stability of the exchange rate of Taka against the US dollar in recent years, the market and the borrowers however still continue to expect the annual exchange rate depreciation of about 3.0 per cent or more while making their decisions to go for dollar denominated loans. Therefore, considering the LIBOR to be 0.55 per cent, an intermediation mark-up of 4.5 per cent, and additionally accounting for the exchange rate risk factor of about 3.0 per cent, the cost of borrowing (in taka equivalent terms) from the foreign lenders would be about 8.0 per cent (Mark-up 4.5 per cent+Libor 0.55 per cent+Expectation with respect to exchange rate depreciation of 3.0 per cent= cost of borrowing 8.0 per cent). This rate is still significantly lower than the rates charged by the domestic banks to domestic prime borrowers.

The main reason behind the exchange rate fluctuations is usually the inflation rate differential between Bangladesh and its major trading partners. As we know it very well, domestic inflation rate in Bangladesh is much higher than the inflation rates of its trading partners. Additionally, if borrowers are concerned about the uncertainties associated with the exchange rate depreciation induced increase in cost of fund, they may hedge their risk in the forward foreign exchange market which would give them additional security.

Liberalisation of access to foreign loans will definitely create pressure on the local banks to reduce their lending rates in order to compete with foreign lenders. Since 2012, there has been a steady decline in private sector credit demand as private sector credit growth came down to a 13-year low of 11 per cent at the end of November 2013 and banks' loan-to-deposit ratio declined to around 71 per cent in December 2013. While this deceleration has been primarily caused by a slowdown in the economy and a lack of investor confidence due to the political instability in the country, the growing presence of foreign lenders has also been a factor. It is interesting to observe that domestic average lending rate charged to the private sector has seen a modest decline of 1.0 percentage point — from 14.69 per cent in December 2012 to 13.68 per cent in June 2014. This coincides with the period during which borrowing from foreign lenders picked up significantly. While this decline in the domestic

average lending rate is a positive sign, the interest rate differential vis-à-vis foreign currency borrowing is still too large to ignore and the domestic lending rates must come down further for the domestic currency lenders to be able to compete with foreign currency denominated lenders.

[Liberalisation of access to foreign loans]

The slower growth in domestic private sector credit expansion, sluggish domestic private sector investment outlook and increased completion from foreign currency denominated lending, are likely to keep pressures on for further lowering of domestic lending rates. Faced with these intensifying pressures, domestic banks are also pushing down the interest rates on taka-denominated bank deposits. The average private commercial bank (PCB) deposit rate has already declined from a recent peak of 9.3 per cent in April 2013 to about 8.1 per cent at the end of June 2014. This declining trend in both deposit and lending rates is likely to continue in the near term, in particular, if the inflationary pressures decelerate further in the coming months.

[Liberalisation of access to foreign loans]

ARE LOWER INTERNATIONAL BORROWING RATES STIMULATING COMPETITION WITHIN THE BANKING SYSTEM? It is generally believed that despite the presence of a large number of banks operating in the domestic market, interest rates in Bangladesh (both deposit and lending) have always been considered (particularly the business community) to be much higher than what they should be. It is also observed that the spread between lending and deposit rates has always been much higher than many of Bangladesh's comparators and regional countries.

As mentioned above, the domestic lending rates are already on the decline due to the increased competition from foreign lenders. The deposit rate has also declined from 9.04 per cent to 8.13 per cent from June 2012 to June 2014, which indicates an increase in spread. The spread in Bangladesh is also relatively higher than other comparator countries like China, Malaysia and Thailand, shown in figure. In a well managed and relatively efficient banking

system the level of spread could be as low as below 3.0 per cent, compared to 5 per cent or more for Bangladesh. The higher spread in Bangladesh is a manifestation of structural weaknesses or inefficiencies of the banking system as a whole. This increase in spread may be explained by the increase in loan loss provisions due to provisioning requirements associated with increased classified loans in the banking system. In particular, the recent series of loan scams and defaults have left many commercial banks, especially public sector ones, in a precarious position. The very high corporate tax rate applied on pre-tax profits of commercial banks (at 42.5 per cent) may also partly explain the greater spread in Bangladesh.

[Liberalisation of access to foreign loans]

However, the weak credit demand and increased external borrowings by the private sector have led to the swelling of excess liquidity in the country's banking sector. Bankers said the local banking industry is now sitting idle on surplus liquidity – more than BDT 800 billion – because of non-utilisation of funds. The excess liquidity of the country's banks increased by BDT 240 billion or 40 per cent during January-September 2013 and stood at BDT 840 billion from BDT 600 billion in January 2014, according to Bangladesh Bank data.

Bangladesh Bank is in positive mood to approve foreign loan applications as the policy decision has positive implications on the domestic banking sector such as put pressure on banks to bring down the lending rate by raising competition. Big entrepreneurs are more interested in taking foreign loans as they can borrow at lower rates which are as low as 6.0 per cent. However, these entrepreneurs will become interested in taking loans in local currency if the trend of lowering the lending rates continues and the interest rate in the international capital market picks up with the US economy gaining momentum.

COMPARISON OF BANGLADESH CAPITAL ACCOUNT REGIME WITH INDIA AND CHINA:

Bangladesh's capital account transactions in terms of inflows are generally liberal for FDI inflows, portfolio equity investment inflows, portfolio bond investments. However, outflows of capital by residents for investment purpose — be it for FDI, portfolio equity investments, and portfolio bond investments — are not permitted. Foreign investors are not allowed to invest in Bangladesh money market and in financial derivatives. Resident Bangladeshi's are also not allowed to invest in money markets abroad and Authorised Dealers (ADs) are allowed in a

very limited way to acquire hedging instruments abroad against exchange rate risk or price risk for commodities on behalf of their customers.

A review of the Indian and Chinese capital account control regimes however indicates much higher degree of openness, particularly in terms of outflows by the resident Indian and Chinese institutions and persons. Indian companies and registered partnerships may invest up to 400 per cent of their net worth abroad without approval. No limits apply for investment using funds earned in foreign currency or out of funds raised through ADRs/GDRs. Conditions may apply for unregistered partnerships and proprietorship firms. In the case of China, companies may purchase or transfer foreign exchange for outward FDI subject to registration only and can also use renminbi in countries that accept such settlement.

While there are some restrictions on what percentage of Indian and Chinese companies' shares may be purchased by foreign institutional investors (FIIs) or qualified FIIs (QFIIs in the case of China), investment by qualified domestic institutional investors (QDIIs) in the case of China and by residents in the case of India are quite liberal. Resident corporations in India may invest up to 50 per cent of their net worth in shares of listed companies abroad. Indian mutual funds are permitted to invest abroad within an overall cap of US\$7.0 billion. In China, QDIIs' can invest abroad in portfolio bonds subject to overall ceilings and regulatory limits on the type of security. In India, only resident individuals may invest in debt securities abroad subject to a yearly limit of US\$200,000. As regards investment in money market abroad, Indian residents may purchase instruments without Reserve Bank of India (RBI) approval following prescribed norms. Only QDII in China can invest abroad in money market instruments subject to their respective foreign exchange quotas and regulatory limits. Indian commercial banks and resident companies may purchase/use such derivatives for asset management or hedging against commodity price and foreign exchange debt exposures.

Private sector external borrowing from abroad is allowed liberally in India through automatic and approval routes. The borrowing limit under the automatic channel is US\$20 million for loans up to three-year maturity and the limit is up to US\$750 million for a minimum of 5-year maturity. However, external borrowings are subject to all-in-cost ceiling, which is adjusted automatically, and also subject to end-use restrictions. In China, private sector borrowing is subject to individual limits and subject to approval for maturities longer than one year.

In the case of Bangladesh, lending abroad by the residents is not allowed. In the case of India and China lending abroad are generally subject to approval, except for trade credit and lending to foreign subsidiaries. On repatriation of export proceeds, all three countries have repatriation requirements ranging from four months (Bangladesh) to one year (India). In China, export proceeds may be deposited in foreign exchange with domestic banks or abroad. Depositing of proceeds abroad are regulated based on balance of payments and foreign exchange management needs.

The summary comparisons presented above indicate how much behind is Bangladesh compared to India and China. As a matter of fact, India started its liberalisation process in early 1990s as part of its broader economic transformation and moved quite speedily in the opening up process. Even during the recent economic and BOP (balance of payment) crisis, RBI and the Government of India did not impose very many restrictions and all of them have been withdrawn within a short time.

Can Bangladesh afford to liberalise its capital account like India and China?

Ahsan H. Mansur concluding his three-part paper titled 'Foreign currency regulations and implications for private investment'

International experience indicates that capital account liberalisation is most successful when the process is continued in a good macroeconomic and strong BOP (balance of payment) environment. Our preliminary assessment is that, based on traditional indicators for strengthened external position, Bangladesh compares quite well with India, China, Vietnam and Malaysia all of which have much more open capital account regimes than Bangladesh. Traditionally countries try to build up a respectable level of foreign exchange reserve to self-insure against BOP pressures and fend off unanticipated sudden surge in outflow as part of its opening up of capital accounts in phases.

[Can Bangladesh afford to liberalise its capital account like India and China?]

As shown in the cross-country Table (Table 4) for such indicators, Bangladesh's current reserve coverage of seven months of import payments, reserve level at — per cent of M1 (cash in circulation and demand deposits) and — per cent of broad money, and reserve levels

at 14 per cent of GDP (gross domestic product) are quite respectable to protect itself from external shocks or contagion effect. In terms of almost all indicators, Bangladesh outperforms India, while Bangladesh capital account is much less open compared with the Indian capital account regime.

IMPERATIVES FOR A PHASED CAPITAL MARKET LIBERALISATION AND MANAGING THE ASSOCIATED RISKS: Capital account liberalisation has its well-known benefits and that is precisely the reason every developed country maintains an open capital accounts regime and all emerging and growing developing countries tend to liberalise their capital account transactions and better integrate with the international capital market. As the economies grow domestic savings may not keep pace with domestic investment growth and financing of the higher level of investment from domestic sources alone would not be possible. Capital account liberalisation is believed to be a major way to alleviate financing constraint through inflow of foreign capital into the domestic economy in various forms.

The fast growing economies in Asia like Korea, China, Indonesia, Malaysia, Vietnam and India have used external private financing quite extensively in achieving higher investment and growth in recent decades. Bangladesh, on the other hand, did not try to exploit this channel for securing additional financing effectively. Bangladesh public and private sector have very little presence in the international capital market except some foreign currency-denominated borrowing by some private and public sector entities. Bangladesh has not issued any sovereign bond despite favourable external environment, and Bangladesh corporate sector has very limited exposure to the international capital market through issuance of bonds or borrowing from other sources.

The limited access has also limited private sector's ability to access funds from the cheapest sources and undermined their competitiveness by increasing their cost of doing business. The higher domestic interest rates are partly attributable to the lack of competition and inefficiencies in the domestic financial system in an environment of captive/closed market. Like every other market price of capital would ultimately depend on supply and demand for capital in the financial sector. Increased funds made available for lending would contribute to lower interest rates and increased portfolio investment from abroad would contribute to support equity/stock prices and enhance market discipline and performance.

WHAT KIND OF RISKS AND REWARDS THIS TYPE OF LENDING POSES FOR THE VARIOUS ACTORS: Bangladesh Bank has to be aware of the potential risks of liberalising external sector borrowing. Most importantly, the default risk in foreign loans always has to be kept under strict observation to prevent crisis of confidence. The main thing that all actors need to be aware of is the risk of financial liberalisation leading to a financial crisis, somewhat like the Asian Crisis of 1997.

Many developing and transition countries opened up financially by the early 1990s and became “emerging markets” attracting foreign loans and investments. In developing East Asia, short-term commercial bank loans were the dominant form of capital inflow (Asian securities markets were underdeveloped). At first, this caused domestic booms and asset market inflation. But later, as the market sentiment turned for the worse and foreign investors pulled their money out, the balance of payments came under a severe pressure. Speculative attacks rapidly depreciated Asian currencies, and the illiquidity problem – inability to rollover the short-term bank loans since foreign banks demanded immediate repayment – occurred. The domestic banking sector froze up and domestic demand fell sharply, causing a serious recession that lasted for one to two years.

This macro shock was amplified by the balance-sheet vulnerability caused by the weaknesses of Asian banks, nonbanks and corporations. Firms in developing East Asia were highly dependent on indirect finance such as bank loans for working and investment capital and had high debt/equity ratios. Moreover, the local banks and nonbanks were exposed to two kinds of balance-sheet mismatches. They borrowed in USD and lent to domestic projects in local currency (currency mismatch). In addition, they borrowed in short-term loans but lent to long-term domestic projects (maturity mismatch). When the currency depreciation began, the balance sheets of these financial institutions were immediately hit and bad debt increased. When foreigners demanded repayment, they had no foreign cash. This started as a liquidity problem, but as the crisis deepened, it created insolvency as well.

The Asian crisis was primarily caused by the wrong speed and sequencing of external financial liberalisation. Countries liberalised capital accounts too quickly and without preparation, which caused over-borrowing by the private sector and asset price bubbles. Furthermore, the governments did not properly monitor what was happening or unwilling to stem the inflows. The lesson therefore is that countries must open up their financial sector

gradually and in the right order/sequence. The pace of financial liberalisation must match the pace of strengthening of the domestic financial sector and the monitoring capability. The government must make utmost effort to improve domestic banks and securities. It is important to note that Bangladesh's corporate banking sector is still at an early stage of its learning process and therefore, it will take some time to come up to the desired form. Large-scale liberalisation would be dangerous and irresponsible.

China, India, Vietnam, Myanmar and Cambodia were not affected by the Asian crisis as much as Korea and ASEAN economies (Thailand, Indonesia, the Philippines, and Malaysia). This was not because productivity and financial institutions of the first group were superior. In many ways, their domestic systems were much worse than Korea or the ASEAN Four. They were not directly hit because they did not open up financially at that time.

KEY FINDINGS: Bangladesh has just started its journey to access international capital market by allowing resident corporations to borrow abroad in foreign currency terms on a case by case basis. Most other emerging economies in Asia and Latin America are way ahead of Bangladesh in terms of integration with the international capital market. With strengthened BOP – as reflected through surplus external current account and overall balances in most of the years – Bangladesh has gained the capacity to liberalise its capital accounts both in terms of inflows and in selected cases for outflows.

Recent experience with foreign currency borrowing has been generally favourable and has contributed to lowering of the domestic interest rate structure. Although \$5.5 billion worth of loans have been approved by the High-Powered Committee Chaired by the Governor of Bangladesh Bank since 2008, the outstanding stock of such debt is only about \$2 billion, slightly over 1.0 per cent of GDP or less than 4.0 per cent of export and remittance receipts. In most other comparator countries the corresponding figures are several times higher than Bangladesh, and accordingly Bangladesh has the capacity to go a long way in terms of foreign borrowing to support domestic investment, including infrastructure development. Bangladesh Bank should continue with its monitoring mechanism to avoid any bulging of payments to external creditors.

POLICY RECOMMENDATIONS:

- * The linkage with international capital market should be deepened further in order to attain greater access to foreign financing at lower interest rates. As is the case currently, the initial emphasis should be on policies which would facilitate enhanced market access for Bangladeshi investors and issues related to outflow should be considered in a properly sequenced manner.
- * Establish an automatic approval process for loans up to a certain limit. Given the positive outcomes so far, it would be desirable that Bangladesh Government like its Indian counterpart considers a two-track approach for approval of request for foreign loans: an automatic window for borrowing up to a certain limit; and for higher amounts approval on the basis of current case by case approach.
- * Fight against inflation must be intensified. Domestic inflation should be brought down to less than 5.0 per cent. Bangladesh interest rate structure will never come close to the dollar or Euro interest rate structures as long as Bangladesh inflation remains significantly above the inflation rates of its major trading partners. The only sustainable approach to reduce the spread over industrial country interest rates would require a steady reduction of the domestic inflation rate and bring that closer to the inflation rates of industrial countries. The best example of this is China with inflation rates ranging between 2.0 per cent-3.0 per cent and more recently, the anti-inflation stance of the RBI (Reserve Bank of India) which helped bring down inflation to 4+ per cent from very high levels.
- * Exchange rate stability is paramount for deeper capital market integration. Exchange rate stability, which entails a corresponding reduction in exchange rate risk, is an important precondition for the private sector to be able to borrow from abroad in foreign currency. The reduced exchange risk would encourage foreign lenders and investors to lend and invest in Bangladesh. As long as Bangladesh inflation remains significantly above the inflation rates of its major trading partners, there is no way that Bangladesh Bank can prevent an appreciation of the REER (real effective exchange rate) and an eventual depreciation of the nominal exchange rate.
- * More clarity is needed in the regulations for hedging against exchange and interest rate risks. For large investors hedging is very important, and without proper exchange rate and interest rate hedging they are not likely to invest in Bangladesh. Currently some aspects of

regulations governing hedging are subject to different interpretations, particularly with respect to the underlying transaction (such as anticipatory or current contract). Exchange rate hedging for foreign currency-denominated borrowing is hardly applied in Bangladesh, whereas in India it is mandatory.

* Tax treatment of return on investment needs much more clarity. Return on investment may or may not be subject to taxation and the applicable rates or exemption status (as appropriate) needs to be very clearly specified. Provisions of bilateral avoidance of double taxation treaties also need to be clearly spelled out for investors to be assured about their post-tax investment return.

* Capital account liberalisation must be steady, properly sequenced and non-reversible. Bangladesh has a long way to go in its future march toward a more liberal capital account regime. The liberalisation process should be carefully sequenced, closely monitored, and the changes should be irreversible. Every emerging economy has travelled through the liberalisation process that Bangladesh needs to travel. Bangladesh cannot fall much behind its comparators and deprive its private sector the benefits of lower interest rates, exchange rate stability and price stability through lower inflation.