

Is the taka in free fall?

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The value of the Bangladesh taka in terms of the US dollar



has been declining since July 2010. The fall has been steady but at a moderate pace until August 2011. The rate of decline has picked momentum since then, and especially after November 2011. Today the taka is trading at 86 per dollar in the kerb market as compared with Tk 70 in July 2010 and Tk 76 in July 2011; in the inter-bank transactions the taka is trading at 84 per US dollar as against Tk 69.4 in July 2010 and Tk 73.6 in August 2011. This amounts to a whopping 23 percent depreciation of the Bangladeshi currency in the past 18 months, which is among the fastest pace of depreciation since 1982.

This rapid rate of depreciation has alarmed the business community as well as the general public. I have received many phone calls from business circles and journalists enquiring about this development and asking the inevitable question: is the Bangladeshi currency heading for a free fall?

At the request of The Daily Star I wrote a piece “The falling Bangladeshi currency” that was published on July 22, 2011. In that article I explained the reasons why the Bangladeshi currency was depreciating and provided a number of policy responses that might arrest the decline in the value of the currency. I do not want to repeat the arguments here and would direct the readers to that article to understand the fundamentals underlying the decline of the Bangladeshi currency. The only point I will re-emphasise is that the underlying reasons for a more rapid decline in the value of the Bangladeshi currency that is happening now are still the same: the demand for foreign currency (dollar) is growing even faster now relative to the growth of supply than previously.

On the demand side, imports have grown by 22 percent in the first five months of the current fiscal year (FY2012). As compared to this, on the supply side, exports have grown by a moderate 14.6 percent in the first six months. Given that the trade deficit in Bangladesh is substantial because imports are much larger than exports, the trade gap has further widened. This widening trade gap has not been offset by significantly faster growth of remittances (growing by a modest 8 percent in the first five months) or by capital inflows (the capital account remains substantially negative). It is hardly surprising that the value of the currency is declining rapidly.

Will there be a free fall? As always, the answer is it depends on a host of factors. If the present import and export growth trends continue, if remittances do not show faster growth and if the negative capital account does not become significantly positive, the Bangladeshi currency will continue to fall. In the absence of a full-fledged quantitative model, it is not possible to put a number on what could be the likely value of the US dollar in terms of the taka by the end of the fiscal year under a status quo scenario, but I can say with conviction that it will be lot higher (substantially more depreciated than now).

But this need not be the case. While the negative developments in the external environment in terms of rising food and fuel prices and the debt crisis in Europe are hurting Bangladeshi

balance of payments, blaming it all on these factors is not very reasonable. On the compensating side, Bangladesh has also gained quite a bit from the changing external environment whereby cost increases in China and India have benefitted the Bangladeshi garment industry. Additionally, we know from economic history that when external factors become adverse agile governments respond by strengthening economic policies.

Indeed, there is quite a lot that the government can do to stabilise the currency. On the demand side, as I had argued in my earlier article, the excess demand for dollar is partly fuelled by rapid monetary growth and high domestic inflation. In recent months the Bangladesh Bank has tried to slow down the growth of money supply (defined as M2 or broad money) from the 22 percent rate of growth. There are signs that monetary expansion is slowing down but there is a risk that this may not be sustainable owing to fiscal policy failures. Inadequate tax reforms combined with huge energy subsidies have played havoc on the FY2012 budget. In the absence of adequate alternative financing instruments including foreign financing, the resulting budget deficit has been financed largely through borrowings from the Bangladesh Bank.

While monetary tightening effort is still evolving, the brunt of the monetary tightening so far has been placed on the private sector. The growth of private credit has slowed substantially, from 26 percent in FY2011 to 19 percent (annualised, month-on-month basis) in the first five months of FY2012, but credit to public sector has expanded dramatically, from 34 percent to 51 percent over the same period. The slowdown in the growth of private credit is also reflected in rising domestic interest rates.

But this uncoordinated policy response is neither necessary nor desirable for managing the balance of payments or for lowering inflation. It is not necessary because monetary tightening could be combined with better fiscal management to reconcile domestic and external stability targets with the growth target. It is not desirable because the crowding out effect of uncoordinated monetary tightening with loose fiscal policy could push interest rate up to an extent that might reduce the expansion of private investment and hurt economic growth.

The Bangladesh Bank and the treasury should work cohesively as a team under the leadership of the finance minister to help reduce monetary growth while also preserving the

proper distribution of domestic credit between public and private sectors through a prudent fiscal management. This requires strengthening tax reforms, reducing subsidies and tapping alternative sources of budget financing.

On the supply side, actions must be taken to increase the growth of exports. Bangladesh's exports basket lacks diversification and remains heavily reliant on readymade garments (RMG). The solid performance of RMG has been a boon for Bangladesh. There are still prospects for doing better, especially as cost increases in competing countries (China, India and Vietnam) open up more markets. Bangladesh is also moving up the value chain with increasing presence in higher-end brand name RMG products. Yet, the risks of over-dependence on a single source of export are obvious from global developments including the most recent European debt crisis.

Endowed with abundant low-cost labour, Bangladesh can and should develop export competencies in other areas. The most potent way of doing this is through strategic partnerships with international investors including participation in the global vertical manufacturing chain. A range of policy reforms is needed to facilitate this including better macroeconomic management, reforms of the trade policy to lower trade protection, improving infrastructure, improving trade facilitation and strengthening regional cooperation.

Much of the actions to increase exports noted above will yield result in the medium term. In the short term, the supply of foreign exchange can be augmented by a coherent strategy for mobilising official and private foreign resources. In a number of my writings I have pointed out that Bangladesh is a rare example of a developing country that has a negative capital account balance. India, for example, has a significant current account deficit but it has a large surplus in the capital account that not only finances the deficit but also allows a buildup of foreign reserves, which helps stabilise the foreign value of the Indian rupee. The lack of a coherent foreign resource mobilisation strategy is one of the major policy failures in Bangladesh that needs to be quickly addressed to avoid a continuing slide in the value of the Bangladeshi currency while preserving the growth momentum.

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