



Managing the exchange rate in challenging times

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Frankly speaking, the exchange rate has not drawn much attention of policymakers for most of the last two decades. That is because after floating the exchange rate in 2003, complemented by modest interventions from the Bangladesh Bank, our balance of payments showed no sign of stress largely because exports and remittances were bringing in enough foreign exchange to foot the rising import bill. That has changed with the onset of significant shocks emanating from at least four adverse global developments: (a) post-Covid supply chain disruption, (b) Russia-Ukraine war, (c) food and energy price hike, and (d)

strengthening of the US dollar. These challenging developments has made the management of exchange rate a pivotal instrument of trade policy as well as macroeconomic stability.

For the longer term of course, it is important to recognize proper exchange rate management as a development strategy, as critical as the strategy of export led growth.

For a long time our exchange rate was all but dormant, changing sluggishly and by small amounts. For the man on the street that would indicate robustness of our economy. But is it? Since late 2017, the exchange rate, Taka per US dollar, was depreciating by barely 1 per cent each year, and stuck around Tk.84-85/\$ for almost two years until December 2021, while the economy was running modest but persistent current account deficits in the balance of payments (i.e. Bangladeshis were spending more than their income). During this time our competitors such as India, Vietnam, and many others depreciated their currencies significantly to stay competitive in the world market.

So export competitiveness is one critical factor determined by the exchange rate. Economists consider the real exchange rate (exchange rate adjusted for relative inflation between trading partners) rather than the nominal exchange rate as an indicator of competitiveness. A more sophisticated characterization by trade economists of the real exchange rate is that it reflects the relative price of tradables to no-tradables. Lets see what was happening in Bangladesh in recent times. While inflation in Bangladesh for the past several years was running at over 5-7 per cent annually, inflation in our major trading partners like European Union (EU) and United States of America (USA) was running at 2 per cent or lower. That means Taka was losing its value much faster than the US\$, which is our main payment currency for international trade. The result: our real exchange rate was getting over-valued making exports less competitive. Not surprisingly, between 2015-2020 exports were sluggish.

One of the essential conditions for the success of export-led growth strategy has always been described as the maintenance of a competitive exchange rate. Another facet of this trend is that an overvalued exchange rate makes imports relatively cheaper thus raising the incentive to import more, with detrimental impacts on the trade balance. Just as overvaluation hurts growth, undervaluation facilitates it. There is consensus among economists that proper management of the exchange rate is critical for ensuring export competitiveness and a superior export performance. In the Bangladesh economy where export is a key driver of

growth, misalignment of the exchange rate could be disastrous for economic growth. If the real exchange rate is over-valued, it serves as a major disincentive to exports by stifling profits. Such has been the case in the recent past.

Policy Research Institute of Bangladesh (PRI) research of the past five-plus years has shown convincingly that Bangladesh's real exchange rate was trending significantly towards over-valuation. When that happens it becomes imperative that the exchange rate be adjusted to neutralise the over-valuation. Since domestic inflation is stubbornly resistant to quick adjustment the onus of adjustment falls on the nominal exchange rate (Taka per US dollar). Holding on to a given exchange rate at a time when undercurrents of external disequilibrium was becoming evident (via persistent but modest current account deficits) could turn out to be a costly policy omission. As we have seen, BB's approach of shoring up the nominal exchange rate required depletion of foreign exchange reserves!

Exchange rate experts describe a situation like this as a case of "fundamental disequilibrium". The situation was aggravated by global developments which descended on the Bangladesh economy with a bang - post-pandemic supply chain disruption, Russia-Ukraine war, food and energy price hike. By close of fiscal year 2022 it was clear that maintaining the old exchange rate was no longer tenable. Finally, the dam broke. Bangladesh Bank let the exchange rate float but then put the brakes on when the bank rate reached Tk.95 to the dollar. But that is hardly the end of the story.

A bit of historical perspective might be useful here. In an overall scheme of trade liberalisation, Bangladesh moved from a "fixed" exchange rate system to a unified and flexible exchange rate regime in 1991-92. Then in 2003, a floating exchange rate regime was launched. However, it was a "managed" float, perhaps too intensively managed. The actual exchange rate regime seems to fit the description of a "crawling or adjustable peg" which recently took the shape of a rate that was too sluggishly pegged to the US dollar. Consequently, the principal advantage of a floating exchange rate, that is, equilibrating the balance of payments via smooth adjustment of the exchange rate was all but lost.

Recently, much to the surprise of trade economists more complexity has been added due to the formulation of a multiple scheme of exchange rates - a bank rate, a rate for exports, another for import settlements, still another for remittances. Trade economists are not great

fans of such multiple Exchange Rate (ER) systems. Few countries have actually resorted to multiple ER systems. Usually, in times of economic turmoil, it is a mechanism by which governments can quickly implement control over foreign currency transactions. Such a system can buy some extra time for the governments in their attempts to fix the underlying problem in their balance of payments. Bangladesh economy did face an external shock that gave BB some justification for resorting to this extreme measure; but suffice it to say that it is a highly complex and inefficient system for alleviating excess pressure on foreign reserves. Therefore, it should be transitional and short-lived, and disbanded sooner rather than later.

To restore balance in the Balance of Payments (BOP), and bring current account deficits to sustainable levels like before, the road is pretty straightforward: imports will have to be restrained for a brief period while exports and remittances (plus ODA and FDI) generate adequate flow of foreign exchange to keep official reserves accumulating rather than depleting. That will require a return to orthodox exchange rate policy, that is, moving as quickly as possible to a unified and flexible (or floating) exchange rate system for all international transactions. The move towards unified and flexible exchange rate need not be instantaneous, but can be done with incremental adjustment until such time as the external sector balance is restored. As the Chinese saying goes, if you don't know how deep the river is "you should cross the river by feeling the stones".

Make no mistake, restraining imports in an export-led economy will have its own setbacks, as Bangladesh imports are overwhelmingly (some 80 per cent) destined for the productive sectors of the economy. So the policy brakes on imports need to be as short-lived as possible leaving market forces to get back in charge. While exchange rate depreciation is dampening the demand for imports, on the one hand, it has added fuel to the fire of hike in import prices, on the other. So managing domestic inflation and managing exchange rate stability has become a dual-edged sword that honestly is not so easy to manage in these challenging times.

The challenge ahead should be daunting enough for the most talented members of the policy community in Bangladesh, if not for those in charge of global financial institutions. Global developments in the geopolitical as well as the geo-economics space seem to raise the spectre of a global slowdown that calls for a coherent global stability and growth strategy of the kind that was witnessed following the 2008 Global Financial Crisis (GFC). This time around

the Bangladesh economy appears far more integrated with the global marketplace and therefore more susceptible to adverse developments abroad.

Our external balances and the exchange rate in particular will have to be on the policy radar for some time to come as we grapple with the possibility of adverse external forces reaching our shores with the fury of a “perfect storm”, as the former US Treasury Secretary, Larry Summers, would like to describe it. Our hope is that calm minds prevail in managing the exchange rate such that the external sector is handled with the deftness it deserves in order to help resume the path of sustainable growth in imports, exports, remittances, and consequently, stability in the balance of payments. These external sector indicators are conjointly the most critical drivers of our macroeconomic stability and prosperity.

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