



The case for compensated depreciation

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Countering potential inflationary impacts in Bangladesh

The exchange rate is once again on the economic policy radar. The other day, at the second annual economic conference sponsored by daily Bonik Barta, current and former governors of Bangladesh Bank (BB) took turns to highlight how the BB steered the course of the Bangladesh economy and paved the way to reach the lofty heights it has reached at 50 years of independence. In particular, former governor Dr Farashuddin, in his impressive remarks via

video, touched upon the issue of the exchange rate and made a strong case for depreciation in light of emerging global challenges and opportunities and as a strategy for superior export performance in the post-pandemic recovery. BB has acted and modestly depreciated the exchange rate by 1.41 per cent on 10 January, 2022. As reported, the strategy is to gradually depreciate the exchange rate in phases. The fear of inflation, we are told, is what prevents a sharp depreciation.

To put it simply, the nominal exchange rate (e.g. Taka 86= US\$1.0) is the price of foreign exchange. This price rises and falls with changes in the demand and supply of foreign exchange. The demand for foreign exchange is a derived demand, stemming from the import demand for goods and services. Likewise, the supply of foreign exchange is generated through the export of goods and services. Lately, with the strong economic recovery under way, there is an exceptionally strong pick up in import demand which could hit a record \$75 billion in FY2022 compared to \$60 billion in FY2021. Predictably, this is putting a lot of pressure on the exchange rate which would have depreciated automatically under a floating exchange rate regime. But as we know it, ours is a regime of managed float and the BB had to disgorge some \$2.5 billion out of its reserves to keep the exchange rate from depreciating significantly and causing market instability. If the exchange rate were allowed to be determined by market forces, rise in import bill in excess of export supply would have caused the rate to depreciate, causing import demand to fall and prevent a fall in official reserves. In a managed float regime, there is reluctance to let the exchange rate depreciate too fast for fear of causing imported inflation.

On the other side of the coin, even though supply has also been picking up thanks to a resurgence in exports, the latter (exports) has historically trailed imports leaving an excess demand on the market. But the supply side of export-generated foreign exchange must include the inflow of remittances (export of factor services). Policy Research Institute of Bangladesh (PRI) projections indicate exports to top US\$ 46 billion supplemented by another US\$ 22-23 billion of remittances. Note that remittance inflows tapered this year after a record jump of 36 per cent last year; yet it will exceed FY19 figure of US\$ 1.0 billion by over 20 per cent. Exchange rate pressure could be further relieved by inflows of foreign aid money. On that count there are optimistic expectations of net inflows (aid minus debt servicing) of about \$5 billion based on, among other things, new commitments of budget support from the World Bank and other multilaterals. Exports, remittances, and aid could bring in up to \$75 billion,

nearly matching the \$75 billion import bill. The balance of payments (BOP) could still be in overall balance at the end of the year or modestly in deficit (estimated at 2.6 per cent of GDP).

Be that as it may, one can visualise mounting pressure on the exchange rate to depreciate in the near term (signalled by the excess of curb rate over bank/official rate), unless exports and aid flows materialise as projected. Imports could also taper off by end of fiscal year for various reasons. Leaving exchange rate unadjusted would result in appreciation of the real effective exchange rate (REER) which undermines export competitiveness.

Economists focus on the real effective exchange rate as the indicator of export competitiveness. The latest REER (REER is the nominal exchange rate adjusted for inflation differences between Bangladesh and its major trading partners) trends estimated by BB seem to suggest an appreciation trend until FY2020 than declining moderately as the nominal exchange rate hovered around Tk.85/US\$. Overall, the REER trend over the recent past has not been good news for our exporters (Fig.1) as REER appreciation undermine export competitiveness and serve as a disincentive. Even a modest depreciation of the nominal exchange rate could reverse this trend and give exporters some relief.

Export growth can be stimulated through various policies of which a proper exchange rate management is crucial. Without pushing the case for an under-valued real exchange rate, there is no justification for letting the REER appreciate for any amount of time.

THE POLICY DILEMMA: Exporters would love to see the nominal exchange rate depreciate significantly (i.e. yielding more Taka per dollar of exports) to compensate for sluggishness in export price or rising cost of imported inputs. But Bangladesh Bank has avoided letting the exchange rate slide too much for the fear of fuelling inflation. With comfortable foreign exchange reserves selling off \$2.5 billion may not be a problem but, as pressure mounts from surging imports, this approach would be untenable. Is there a way out?

A way out is : compensated depreciation. A policy of ‘compensated depreciation’ could be an option for policymakers to consider. This involves an exchange rate depreciation that is counterbalanced by downward tariff adjustments. Such a measure could be:

- (a) an incentive to all exporters,
- (b) maintain protection level for import substitute producers,
- (c) have neutral effect on the price level, and
- (d) be revenue neutral.

Here is how it works. In principle, a 5 per cent depreciation of the exchange rate (say, from Tk.86 per dollar to Tk.90) is equivalent to a 5 per cent subsidy on all exports, a 5 per cent increase in tariffs as well as a 5 per cent increase in effective protection on import substitutes (because a 5 per cent increase in import values is like a 5 per cent raise in all tariffs, on output and inputs equally). By raising the Taka value of imports by 5 per cent it could yield extra revenue. But this would also affect prices of imports and import substitute products upward by 5 per cent, which is what leads to the fear of currency depreciation fuelling inflation. That is where the compensation principle kicks in. If tariffs are then reduced by 5 per cent, the price effect of the currency depreciation would be neutralised. The net result is a 5 per cent uniform (i.e. non-discriminatory) incentive to all exports (thus eliminating some anti-export bias) while all other impacts are neutralised. Effective protection and revenues will remain unchanged.

To summarise the steps:

- (a) 5 per cent depreciation is equivalent to 5 per cent export subsidy (not coming out of the exchequer);
- (b) 5 per cent depreciation is like a 5 per cent rise in tariffs resulting from 5 per cent increase in import values, thus potentially fuelling inflation;
- (c) Reducing existing tariffs by 5 per cent will neutralise the effect in (b) leaving exports with 5 per cent subsidy, giving a boost to exports.

This example uses a 5 per cent hypothetical depreciation in order to explain the principle of compensated depreciation in the Bangladesh context. The actual applicable rate will have to

be determined after careful simulation of exports, imports, and revenue impacts, something that has been done under PRI research.

A better export performance is an absolute imperative if the targets of the 8th Five-Year Plan (8FYP) on industrial and GDP growth are to be achieved and the post-pandemic recovery is to be sustained. Whereas cash subsidies on exports can create budgetary pressure and risk violating the rules of the World Trade Organization (WTO), a depreciation under a floating exchange rate regime would be a WTO-compliant trade measure that could stimulate exports for an economy that is a price-taker in the world market and, theoretically speaking, faces limitless markets for its exports, if it can produce competitively. That is what explains the fact that the world market for readymade garments is still open and Bangladesh's share could be much higher than the 6.2 per cent that it currently commands.

IMPLEMENTATION ISSUES: Regarding compensated reduction in tariff, in principle, it is possible to uniformly shave off 5 per cent from all tariffs. Simply removing the 3 per cent Regulatory Duty (RD) in one stroke could essentially do the trick — neutralise inflationary effects of a 5 per cent depreciation of the exchange rate, leaving no effect on revenue or protection. Eliminating RD reduces current average nominal tariff of 26.4 per cent in FY21 to 25 per cent, a reduction of 5 per cent.

Expert advice is locally available on how to rationalise the tariff structure to counterbalance any rate of depreciation without undermining customs revenue or existing rate of effective tariff protection. Our proposal is somewhat radical in approach but we believe the 'compensated depreciation' principle should take the wind out of the sails of any protectionist opposition.

CONCLUDING REMARKS: There is consensus among economists that proper management of the exchange rate is critical for ensuring export competitiveness and a superior export performance. In an economy where export is a key driver of growth, misalignment of the exchange rate could have deleterious effect on economic growth. The nominal exchange rate is what everybody notices and talks about. But economists are more concerned about trends in the real exchange rate which factors in relative changes in inflation rates between trading economies. If the real exchange rate is over-valued, it serves as a major disincentive to exports by stifling profits. Holding on to the nominal exchange rate in times of import surge

would lead to appreciation of the real exchange rate which is harmful to exports. Indeed, cross-country evidence reveals that economies that have successfully promoted export-oriented growth policies have not only avoided a real appreciation but instead have pursued policies of under-valuing their exchange rates at one time or the other. According to Dani Rodrik of Harvard University, China is the most recent example of an economy that under-valued its currency for several decades to reap the benefit of accelerated export and GDP growth. As a policy, the least Bangladesh Bank can do is to never let the exchange rate become over-valued.

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