The falling Bangladeshi currency

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There is a lot of talk these days about the falling value of the Bangladesh taka in terms of the US dollar. The dollar itself has been depreciating against other major global currencies. For example, between June 2010 and mid-July 2011, the dollar depreciated by 14 percent against the euro and 10 percent against the yen. So, the fall in the value of the Bangladeshi currency at a time when the dollar is weakening against the major global currencies and many other Asian currencies are appreciating against the dollar is viewed with a great deal of concern.

Some worry that this is a reflection of a lack of confidence in the Bangladeshi economy. Others worry that depreciation will increase the already high inflation rate. At the political level, Bangladesh Bank (BB) is coming under pressure to arrest the decline in the value of the Bangladeshi currency. While the debate is understandable, simply creating political pressure on BB without analysing the underlying factors creates a risk that wrong and inconsistent policy decisions might be taken. The objective of this article is to explain the reason for the decline and provide some policy options that might help stabilise the currency without creating problems for other economic targets.

In simple language, the exchange rate, measured as a number of units of local currency per unit of foreign currency, is the price of the foreign currency in terms of the local currency. Its inverse is the price of the local currency in terms of the foreign currency. Like any other price, the value of the foreign currency in the local market depends on its supply and demand. For simplicity, I will use the US dollar as the representative foreign currency for the Bangladesh exchange market.

Between fiscal 2007 and fiscal 2010, the price of the dollar was nearly constant at around Tk 69 a dollar. The price started rising in 2011, reaching Tk 75 in early July 2011. As is well known, there is also a kerb market for the foreign currency where the exchange rate is more flexible than in the official market. Consequently, the price in the kerb market and its trend are a better reflection of the true foreign exchange market situation. Usually, the differential between the official price and the kerb market price is small — around one taka. However, in periods of demand pressures the differential between the kerb market price and the official price tends to rise. Presently, the price of the dollar in the kerb market has reached Tk 78, creating an unusually large differential of Tk 3 per dollar.

Unlike in Bangladesh, currencies in China, Thailand, Malaysia, Korea, Singapore and India are all appreciating against the US dollar — implying that the price of the dollar is falling in these economies. For example, the price of the dollar fell from 6.8 Chinese yuan in 2010 to 6.5 yuan in July 2011. In India, the price of the dollar fell from 48.1 Indian rupees in March 2009 to 44.7 rupees in July 2011. In Thailand, the price of the dollar declined from 32.4 baht in 2010 to 30.4 baht in July 2011. The price of the dollar similarly declined in Malaysia, Korea and Singapore.

The rising price of the dollar in Bangladesh in both the official and kerb market, along with the growing differential in the two rates, is a clear indication that demand for dollar in Bangladesh is growing much more rapidly than supply. The rise in the price of dollar is a market correction to equilibrate demand and supply. As in any market, the price should play an important role to correct market disequilibrium. So in this sense, there is nothing wrong for the price of dollar to go up in order to bring supply and demand in harmony.

This raises three important questions. First, why is the demand for dollar growing faster than its supply? Secondly, can BB intervene and control the local price of the dollar? After all, the price was stable in 2008-10. Why can this not be done now? Thirdly, why is the price of the dollar falling in other Asian countries while it is rising in Bangladesh? The answers to these questions are inter-related and provide the analytical base for designing proper policy responses.

Between 2008 and 2010, Bangladesh experienced a remarkable period of rapid inflow of foreign currency measured in US dollars. The main contributors were growth in export earnings and the flow of remittances. Together, these two sources provided much more dollars than were needed for import payments and foreign debt servicing.

Consequently, Bangladesh experienced record surpluses in the current account of the balance of payments. The surplus was $2.4 billion in fiscal 2009 and $3.7 billion in fiscal 2010. Owing to these large surpluses, Bangladesh was able to finance the deficit in the capital account (around $260 million on average a year) and build up its reserve cover. Foreign reserves increased from a low of $6.1 billion in June 2008 to $10.7 billion in June 2010. Because of this very favourable supply situation relative to demand, the dollar price did not rise.

If BB had not built up the reserve base, the excess supply of dollars would have driven down its price and the Bangladesh currency would have appreciated in nominal terms. Building up reserves was the right policy decision because the reserve cover was low (measured in months of imports). Additionally, the taka was appreciating in real terms because the inflation rate in Bangladesh was much higher than in OECD countries. An appreciation of the nominal exchange rate would have further appreciated the taka in real terms and hurt exports.

The balance of payments situation changed dramatically in fiscal 2011. While exports of goods and services measured in nominal dollars grew even more rapidly than in the past, registering an expansion of 37 percent over the level in fiscal 2010, imports of goods and services increased at an unprecedented pace of 41 percent. As a result, the trade balance widened by 56 percent — from $6.4 billion in fiscal 2010 to $10.0 billion in fiscal 2011. As compared to this, remittances grew modestly by 5.5 percent.

Consequently, the large positive balances in the current account during the past few years virtually disappeared. The deficit in the capital account has also prevailed. BB initially tried to accommodate the rising demand for dollars by releasing funds from its reserve base. But it soon recognised that this surge in the growth of imports is not sustainable and must be lowered. As a first step, it let some of the pressure go the exchange market. The price of dollar started rising. This increase in the price was aimed at reducing the demand for imports and providing more incentive for exports.

Although allowing the exchange rate to correct the excess demand pressure in the foreign currency market is a correct policy move, letting all the adjustment fall on the exchange rate may not be the right policy, especially because a drastic fall in the exchange rate would come in conflict with the objective of inflation control. A review of the underlying factors contributing to the huge growth in imports suggests that they comprise of two forces, one positive and one negative.

The positive force constitutes demand emerging from growing real income, investment and exports. The negative force relates to demand emerging from excessively rapid growth in money supply (22 percent a year in the past two years) contributing to growing inflation (more than 10 percent on a year on year basis between June 2010 and June 2011 as compared with 3.5 percent in the USA).

It is obvious that the correction of the excess demand in the foreign currency market must also involve actions to reduce overall demand in the economy by lowering monetary growth. A lower rate of monetary growth will reduce domestic inflation and demand for imports. Very recently, BB has taken action to reduce the rate of growth of money supply.

The combination of a reduction in monetary growth that reduces demand by increasing the interest rate and the rising price of dollar is indeed the right policy approach in the present situation. Both policies will lower demand for imports and help stabilise the balance of payments. Indeed, the monthly import flow data suggests a downward trend in demand for imports since May 2011. Other policy actions that will help the balance of payments include policies for boosting exports, supporting the growth of remittances and the mobilisation of foreign capital. The positive role of foreign capital is illustrated by the experience of dynamic Asian economies.

The Asian countries that have experienced an appreciation of their currencies have an overall surplus in their balance of payments, with some combination of surpluses in the current account or capital account or both. For example, China registered large surpluses in both current and capital accounts. The yuan ought to have appreciated much more rapidly due to these large net flows of foreign exchange. China instead has influenced the exchange rate by accumulating huge reserves ($3.2 trillion as of the end of June 2011) in order to preserve the incentive for exports. Indeed, this policy intervention has served China well, but has come in serious conflict with the OECD countries who argue that this policy is creating a bias against their exports.

Malaysia, Thailand and Korea similarly have significant current account surpluses and are accumulating reserves, which explain their appreciating currencies.

India on the other hand has a significant current account deficit but still its currency is appreciating against the dollar. The reason for this is the surplus in the capital account, owing to a huge inflow of direct foreign investment and portfolio investment, which exceeds the deficit in the current account. As a result, the total supply of foreign exchange exceeds demand.

The experience of the Asian countries provides another policy option to manage the exchange rate — through foreign capital flows. This policy can also reconcile the objective of securing higher investment and growth while maintaining balance of payments and exchange rate stability. Financing of infrastructure and investment in large manufacturing units through direct foreign investment is a hugely attractive policy action for Bangladesh. This will allow a financing of larger volume of imports without exerting pressure on the exchange rate.

Over the longer term, the most important policy for preserving the value of the Bangladeshi currency is to keep inflation under control. If the inflation rate in Bangladesh continues to be substantially higher than the US inflation rate, demand for dollar will continue to exceed its supply and the price of the dollar in taka terms will continue to rise over the long term.

This is illustrated by the fact that the taka depreciated against the dollar by about 4 percent a year on average over the past 21 years, between 1990 and 2011. During the same period, the average inflation rate in Bangladesh was 6.1 percent as compared with an US inflation rate of 2.8. Much of the long-term depreciation of the Bangladeshi currency is explained by a substantially higher inflation rate in Bangladesh, compared to the US inflation rate.

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