The power of a flexible exchange rate system

Friday, Jan 10, 2025

By *Dr. Sadiq Ahmed*

“Regarding concerns about the volatility of the exchange rate and fueling of inflation, it is too early to tell”

As a professional economist I have systematically advocated the adoption of a market-based flexible exchange rate system. My advice was ignored by the Bangladesh policy makers and many of my fellow economists also expressed their opposition.

The two main arguments against a flexible exchange rate system was firstly the fear that this will destabilise the exchange rate and secondly that this would create inflationary pressure by raising the domestic price of imports.

Armed with these contentions, since FY2011 Bangladesh basically pursued a fixed exchange rate system, even though the official stance was a managed float. As a result of this fixed exchange rate policy, the real effective exchange rate (REER), which provides incentives to exporters, appreciated by 57% between FY2011 and FY2022. The appreciation was particularly sharp after FY2014.

As was inevitable, the fixed exchange rate policy came under pressure in FY2022-FY2024

owing to global inflation, the Ukraine War, and the supply disruption effects of Covid-19. The misguided policymaking of the then government initially sought to protect the exchange rate by drawing down on reserves but soon found this a futile effort and eventually was forced to adjust the exchange rate downwards. The effort to protect exchange rate continued through a confusing system of multiple exchange rates and imposition of severe import controls that disrupted domestic production and hurt the growth of exports.

Only in May 2024, the unsustainability of a fixed exchange rate policy was officially recognised and there was a major reform of the exchange rate system. Bangladesh unified the multiple rates and adopted a crawling peg system as an interim arrangement with market-based flexible exchange system as an end game. The Interim Government that came to office in August 2024 enhanced the flexibility of the exchange rate, although it has not yet formally discarded the crawling peg system. De facto, though, the market has adjusted to the new reality of a flexible exchange system and adapted its behavior accordingly.

What has been the impact of this flexible exchange rate management? Firstly and most importantly, the flexibility of the exchange rate system has shown its power in augmenting the supply of foreign exchange even during the limited period since it came to existence. It has provided a strong incentive for both exports of goods and non-factor services as well as remittance earnings from the export of labour.

Before we proceed, an important caveat is in order. The annualised growth rates based on the first 6 months of FY25 are not strictly comparable with the 5-year average growth rate figures for FY14-19 and FY19-24. The 6-month growth rates may not be sustainable for a 5 year period. This is particularly true of remittances that have surged by 28% in the first half of FY25 as compared with the first half of FY24. Clearly, this pace of growth of remittances will not likely be sustainable over a 5 year period. Yet, the recovery of exports and the surge in remittances from the levels prevailing in FY23 and FY24 are a clear indication of the power of a flexible exchange rate in providing incentives for increasing the supply of foreign exchange. Most importantly, the weak performance of exports over the past 10 years is a strong reminder of the damage that a controlled exchange rate regime that allows a sharp appreciation of the real exchange rate can do to exports.

Secondly, the increase in export and remittance earnings has considerably eased the

pressure on reserves, which initially declined from $20 billion in August 2024 to $18 billion in November 2024 but has now recovered to $21 billion as of end December 2024. This has happened even though official and private capital inflows have fallen.

Thirdly, imports have gotten some breathing space. After declining by 25% in FY2024 from its peak level of USD82 billion in FY2022, imports have shown some signs of recovery in the first half of FY2025. Even though the growth in imports is muted owing to a difficult production and investment climate situation resulting from law and order concerns and political uncertainties, a reversal in the trend in imports is a welcome sign and if sustained it should help with the reduction in inflation and the recovery of GDP growth.

Regarding concerns about the volatility of the exchange rate and fueling of inflation, it is too early to tell. A priori though, one can argue that since the exchange rate flexibility has been combined with proper demand management policies, especially through the curb on credit growth, it is not likely that the exchange rate will become unstable. The limited evidence available so far suggests the exchange market has been behaving reasonably well. The exchange rate was unified at Tk117/USD in May 2024. At that time the kerb market rate was around Tk119/USD. Today the kerb market rate is around Tk127/USD. This amounts to a depreciation of the Bangladesh Taka by 7%. Although BB management has shown deep concern about this development, they should not. The Bangladesh inflation rate is around 10-11% while the US inflation rate is only 3%. The downward adjustment of the market rate for USD by 6-7% is a natural consequence of the inflation differential of 7-8%. Instead of setting unsustainable bands around an unsustainable peg rate and allow an appreciation of the real exchange rate as happened in the past, BB can explore viable options for stemming the fall in the value of the Bangladesh currency.

There are two policy measures to stabilize the exchange rate. First and most obvious is to bring down the rate of inflation close to the US and other major trading partner countries. Second, the government should make all out effort to reverse the downward trend of multilateral, bilateral and foreign private capital flows. The more capital flows it can attract, the lesser the pressure on the market exchange rate including the need for BB to buy foreign exchange from the market to build reserves.

Concerning inflation, the exchange rate is only one variable that affects inflation. Demand

management is very important. Additionally, sharp depreciation frequently happens in a fixed exchange rate regime when the exchange rate becomes unsustainable. With a flexible rate, the exchange rate changes are spread over a longer period. Empirically, there is no evidence that a country with a flexible exchange rate regime has necessarily a higher rate of inflation than a country with fixed exchange rate.

The current persistent inflation in Bangladesh is the outcome of poor demand management until very recently and a deep supply shock. Demand management has improved vastly since May 2024. There is little scope to tighten demand further without jeopardizing the recovery of GDP growth. Much of the policy action now needs to focus on managing the supply crunch. This supply crunch emanating from a $20 billion cut in imports between FY2022 and FY2024, a slide in manufacturing growth from 9-10% to 4-5%, and the adverse effects of the recent floods have destabilized the supply chain that must be restored to fight inflation sustainably. A reduction in trade taxes will also help lower inflation by reducing the cost of imports and domestic production.

Sadiq Ahmed is Vice Chairman of the Policy Research Institute of Bangladesh. He can be reached at sadiqahmed1952@gmail.com

https://www.tbsnews.net/economy/power-flexible-exchange-rate-system-1038456