Towards a more liberal capital account regime in Bangladesh

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By *Dr. Ahsan H. Mansur*

Bangladesh's economy faced several macro-financial developments, some of which are positive or virtuous and others are not so favourable, over the last fiscal year (FY) 15, namely: (i) the foreign exchange reserve hit a record high of US$25 billon in FY15 and continues growing; (ii) the main source of the inflow is the increased activity in the financial account while the external current account balance has turned to a deficit after several years of sizable surpluses; and (iii) lackluster foreign direct investment (FDI), alongside sluggish private domestic sector investment, has contributed to the virtual stagnation of investment against gross domestic product (GDP).

Real GDP growth rates have been reported to be hovering around 6.0-6.5 per cent rate officially, although there are reasons to cast doubt about these estimates against the backdrop of lacklustre export performance, static private sector investment, private sector credit demand etc.

Foreign currency reserves have increased by more than 120 per cent during FY11 to FY15, reaching a record high of USD 25 billion (Figure 1).

Current account's contribution to the reserve fell substantially in FY15 due to a deceleration in export growth and remittances. However, the financial account of the balance of payments (BOP), which is often the least understood part of the BOP in Bangladesh, was the major driver of reserve accumulation (Figure 2).

Historically financial account balance in Bangladesh has been generally negative or insignificant. However, from a deficit of more than $2.0 billion in FY11, it turned to a small surplus in FY12 and thereafter steadily increasing to a record surplus of $5.2 billion in FY15.

A number of benefits generally result from high level of foreign exchange reserves. High levels of reserves act as a self-insurance policy at times of BOP crises. This is important for a small open economy like Bangladesh where current account balances and foreign reserves are often vulnerable to terms of trade fluctuations and capital flight. Noteworthy examples include East Asian countries, which rapidly built up foreign exchange reserves to record high levels in the post-Asian Crisis period.

A large foreign currency reserve is also likely to improve the country's credit rating as the likelihood of repayment is greatly increased. This lowers the country's external borrowing costs as interest rate spreads for both sovereign and private borrowers over the London Interbank Offered Rate (LIBOR) would decrease. The decline in country risk may also encourage foreign investors in making FDI in labour intensive industrial and information technology (IT)-related sectors in Bangladesh. High levels of reserves will also improve government's capacity to finance large infrastructure projects like the Padma Bridge, elevated express ways, and major power projects currently planned for.

Furthermore, accelerated inflow of foreign assets creates a number of policy challenges including market pressures for exchange rate appreciation and complications for monetary management. Bangladesh Bank (BB) needs to incessantly buy dollars to prevent a nominal appreciation of the exchange rate of Taka against the dollar. However, buying dollars from the interbank exchange market has the side-effect of increasing money supply beyond the target level, undermining the inflation target. Any sizable sterilisation operation undertaken by BB in recent years to contain monetary growth within the intended limit entails quasi-fiscal costs and consequent reduction in the profitability of BB and its contribution to the budget.

Against this background, BB's reserve management strategy should undertake measures to stem the reserve growth through market mechanisms. The financial and capital accounts

should be liberalized further, which will create additional demand for foreign exchange. Export retention can be increased in steps and may even ultimately go up to 100 per cent (as in India and China). This will force commercial banks to manage foreign currency denominated assets and develop more products for their clients in consultation with BB. Commercial banks will be flushed with dollars and will be in a position to offer foreign currency-denominated domestic lending. There could be further liberalization of the current account transactions like the level of foreign exchange allowed for foreign travels, internet transactions for hotel bookings and purchases from abroad etc.

It is encouraging to note that BB is indeed moving in this direction. In July 2015, BB raised the Net Open Position (NOP) limit for commercial banks. This means that banks are now allowed to hold more foreign exchange reserve, up from $1.36 billion to $1.51 billion, helping them to better manage foreign currency transactions due to diminished pressure of buying or selling. Banks will also be able streamline foreign exchange loans as they will have access to more funds locally. However, banks will face exchange rate risks and will have to develop the expertise to manage and mitigate such risks. This measure follows a series of other measures by BB to liberalise the financial and capital account transactions.

However, Bangladesh remains significantly behind other developing economies, especially India, in terms of liberalisation of financial flows. This is particularly evident in the foreign exchange and capital account regulations which are greatly restrictive compared to other emerging nations.

With regard to investment inflows, Bangladesh’s FDI regime is very liberal, in comparison to China and India. Bangladesh has no restriction on ownership or holding period of the intended venture, which is similar to that of India. Profits can be repatriated without any obstacles. In China, however, there is a mandatory holding period of three years for foreign strategic investors.

In contrast, Bangladesh imposes strict restrictions on outflow of FDI as residents are not allowed to invest abroad. Only foreign firms which are listed in the stock market are allowed to automatically remit proceeds of their share sales out of Bangladesh. In all other cases of outward remittance, prior permission from BB is required for the approval, obtaining which is not easy.

Bangladesh compares poorly with China and India regarding other aspects of the capital account regime. For many types of investment purposes, inflow of funds is allowed while any outflow is heavily regulated or entirely prohibited. This includes portfolio equity investment, portfolio bond investment, foreign loans and domestic currency accounts of Non-Resident Bangladeshis (NRBs). Inflow of funds in the above areas is also often subject to restrictive regulations including portfolio equity investment and foreign loans. By contrast, China and India provide very generous regimes for inflow of funds in all of the above capital account transactions.

Bangladesh has barred virtually all forms of outflow of funds including portfolio equity investment, portfolio bond investment, money market investment, derivatives and foreign loans. However, Bangladesh permits repatriation of sales, capital gains and dividends originating from portfolio investment through a Non-resident Investor's Taka Account (NITA). The export retention limit for low value added sectors was increased by 5.0 percentage points (to 15 per cent) and for high value added non-readymade garment (RMG) sectors was increased by 10 percentage points (to 60 per cent) in May this year. Export proceeds are required to be repatriated to Bangladesh within four months, which is significantly shorter than that of six months in China and one year in India. In both countries export earnings may be retained as foreign currency in their entirety and may be deposited in domestic accounts. In addition, China and India permit outflow in all forms of the above investment areas.

As can be seen, the current policy regime views inbound foreign exchange transactions favourably while considering any type of outbound transactions as inherently undesirable. This is akin to the "Mercantilist" view between the 16th and 18th century Europe which intended to avail positive trade balances in accumulating monetary reserves. This outdated policy of "restrictive" capital account regime has many problems and it is no surprise that European nations today adopt policies that are totally contrary to the Mercantilist view.

A restrictive capital account regime is neither conducive to increasing the level of investment in relation to GDP nor it prevents capital flight. Stagnating investment is identified as a limiting factor for Bangladesh not being able to break out of the "6.0 per cent growth trap" over the last few decades. In particular, a restrictive regime on foreign exchange outflows also poses problems in attracting foreign and NRB investors to Bangladesh, especially in transactions not involving FDI. Foreign investors may be particularly wary of the difficulties in

recouping and/or repatriating their investments back to their host country.

An inflexible capital account regime also precludes Bangladeshi residents to take advantage of investment opportunities abroad. Restrictions and uncertainty over foreign exchange regimes may also delay, hamper or deter importation of technology which is crucial to investment and industrialisation in a small developing country like Bangladesh. This may be due to complications with regard to foreign currency transactions and retaining export proceeds for further investments. Restrictive capital account regulations such as low export proceeds retention may also encourage delaying of repatriation of proceeds and money laundering to finance importation and other foreign exchange liabilities.

BB has eased regulations in recent times in its quest to achieve financial and monetary liberalisation in Bangladesh. This includes an increase in the export earnings retention threshold and in the NOP limit. These are steps in the right direction but more needs to be done to achieve the goal of financial and monetary liberalization. Bangladesh may also permit on a selective basis outflow of investment, especially FDI, to help domestic investors to take advantage of lucrative investment opportunities abroad. Such investments schemes initially should require prior consent of BB and priority must be given to domestically established and successful firms which are better equipped to compete and survive in foreign markets.

Whether we like it or not, Bangladesh may have to live with the situation where hot money or “carry trade”-induced inflow of foreign exchange will continue to be an issue. The incentive for such inflows is the relatively much higher rate of return on financial instruments (particularly higher interest rates) in Bangladesh in an environment of exchange rate stability. Since Bangladesh’s money and derivatives markets are not mature enough to withstand the associated volatility of foreign investment we need to develop these areas. In addition, it would be necessary to establish proper regulatory and economic environment which discourages flow of “hot money” into Bangladesh.