EXCHANGE RATES, CAPITAL MOVEMENTS AND MONETARY POLICY: BANGLADESH PERSPECTIVE

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**A paper prepared for the Bi-Annual Conference of BEA
to be held during November 22 – 22, 2014 at Dhaka**

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1. Macroeconomic concepts like Exchange Rates, Capital Movements and Monetary Policy are very crucial to understanding the crisis like East Asian financial crisis of late 1990s, the Global financial crisis of 2008 and the most recent Euro debt crisis. The objectives what we want to achieve by practicing those macroeconomic concepts/tools all seem very desirable and it would have been excellent for an economy to have these all. However, the famous "Mundell's Trilemma" observes that a country can choose no more than two of the following three features of its policy regime: one, free capital mobility across borders; two, a fixed exchange rate, and three, an independent monetary policy. This phenomenon is also known as "Impossible Trinity".

Impossible Trinity

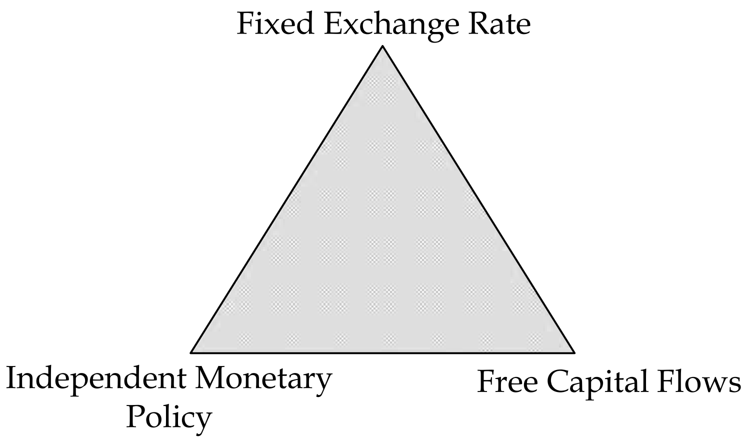

Figure - 1

2. The choices the world made under the impossible trinity varied over time. Under the gold standard, exchange rates were fixed and capital could move around, but central banks were forced to adjust interest rates to ensure they did not run out of reserves. This could lead to pressure on the real economy, and a lot of booms and busts. Under Bretton Woods, we had fixed exchange rates (with occasional adjustments) and independent monetary policy, but

capital mobility was highly restricted; The Bretton Woods system broke down under the weight of fixed exchange rates, and the world moved to largely floating exchange rates. Capital was allowed to flow freely round the world. In the post-Bretton Woods era, countries have made different choices. The most common case, typical across advanced economies, is to give up on a fixed exchange rate so as to run an open economy with an independent monetary policy. On the other hand, economies that adopt a hard peg give up on independence of monetary policy. Examples include the currency boards set up by Hong Kong and, for a time, Argentina.

3. Notwithstanding its real life validation, it is not that Mundell's 'Impossible Trinity' is inviolable. Many of the assumptions underlying this model do not often hold; indeed the new open economy macroeconomy models that build in price rigidities and monopolistic competition demonstrate policy dynamics quite different from those built in the Mundell-Fleming tradition. Therefore, in contrast to advanced economies which opt for corner solutions, emerging economies have typically opted for middle solutions, giving up on some flexibility on each of the variables to maximize overall macroeconomic advantage.

4. For example, India has opted for a middle solution on the "impossible trinity" whose contours are the following: (i) exchange rate has been made largely market determined, but intervening in the market to smooth excess volatility and/or to prevent disruptions to macroeconomic stability; (ii) capital account is kept only partly open; while foreigners enjoy mostly unfettered access to equity markets, access to debt markets is restricted; there are limits to the quantum of funds resident corporates and individuals can take out for investment abroad, but the limits are quite liberal; and (iii) because of the liberalization on the exchange rate and capital account fronts, some monetary policy independence is forfeited. What the middle solution also implies is that

a country can guard on all the three fronts with the relative emphasis across the three pillars shifting according to macroeconomic situation.

5. In this context, we may also share the Bangladesh experience. Our Governor, Dr. Atiur Rahman, in one of his paper, "Challenges to Central Banking in the context of the Financial Crisis", has explained how Bangladesh fared on the recent global financial crisis. Bangladesh financial sector remained virtually unruffled by the global crisis mainly because of regulated limited openness of Bangladesh to short term capital flows. A small net FPI outflow was far outweighed by sustained strong inflow of remittances from workers abroad. Competitiveness of our apparels and textiles sector kept overall FY 09 export growth in double digits. Import of capital goods for new investment activities weakened in the recessionary global environment and food grain imports remained low with good domestic harvests. Low outflows for imports from the surging inflows of workers' remittances and export proceeds kept the local financial markets awash with liquidity, in sharp contrast with most markets elsewhere facing liquidity crunch caused by large scale flight of FPI and non-resident deposits. Bangladesh Bank guided the financial sector in utilizing the liquidity glut in productive pursuits (lending in agriculture, SMEs, renewable energy and effluent treatment projects etc., sectors typically under-served by markets) that strengthened domestic demand by increasing employment and income. Export sectors affected by weak demand were extended fiscal support (modest subsidies, tax/fee waivers etc.) from the government, which also increased social safety-net expenditure for the weak and vulnerable population segments.

6. During the post crisis period, it is over the question of capital mobility that the biggest change can be seen. The global financial crisis (and also the Asian Financial Crisis of 1997) showed the dangers of unrestricted capital movements. Booms were unsustainably boosted into bubbles much greater than they otherwise would have been, while the inevitable crash was made

far worse by capital flight. Capital mobility was destabilising economies and making them more extreme. Economists are beginning to reconsider their using and advocating some limited use of them. Paul Krugman and Joesph Stiglitz are leading the change and over 250 economists signed an open letter calling for capital controls. Studies of banking crashes have found that they are often preceded by a large influx of capital and followed by capital outflows. It is therefore, concluded that capital controls are useful in preventing banking crashes. Even neo-liberal institutes such as the World Bank and the IMF acknowledge that there are occasions when capital controls are beneficial.

7. The current evidences from different studies support the stands of most developing economies on having controls on capital flows in the presence of managed floating exchange rate management systems. The welfare gains are also evident in the above mentioned studies. The policy has also worked in protecting a number of developing countries (including Bangladesh and India) to save themselves from the negative waves of crises that translated mainly through capital volatility and sudden change in exchange rates.

8. The global financial crisis has changed the theology of central banking in a fundamental way. The orthodoxy of central banking before the 2008 crisis was: single objective - price stability; single instrument - short-term interest rate. Although most central banks deviated to different extents from this minimalist model, yet, the crisis came as a powerful rebuke to central banks for having neglected financial stability in their single-minded pursuit of price stability. A consensus has developed around the view that financial stability has to be within the explicit policy calculus of central banks, although opinion is divided on the precise nature of institutional arrangements for maintaining financial stability.

9. Some central banks of developing countries like Bangladesh Bank has opted to deviate from the mainstream monetary policy approach of developed economies. These central banks have been following monetary and financial policies towards supporting inclusive and sustainable growth. BB's monetary policy approach attempts to serve Bangladesh economy in upholding growth and stability and have been experiencing macro financial stability amid domestic shocks and external turbulences, including the last global financial crisis. Thus, the outcome so far has been positive and encouraging in regard to maintaining financial stability in the country. Monetary policy approaches of many other developing economy central banks have variants of similar inclusiveness and sustainability-supportive aspects. Based on the experiences of several developing countries, it can be stated that price stability, the primary objective of monetary policy, does not occur in isolation rather financial stability is an important requirement for ensuring price stability.

10. As central banks are grappling with balancing the demands of price stability and financial stability, there is now yet another powerful assault on central bank orthodoxy arising from the euro zone sovereign debt crisis. The argument, in its essence, is that if a central bank is committed to financial stability, it cannot ignore the feedback loop between financial stability and sovereign debt sustainability, and by extension therefore, it has to be mindful of sovereign debt sustainability concerns. In this context, Subbarao (2012) argues, is the new trilemma - the simultaneous pursuit of price stability, financial stability and sovereign debt sustainability - a new impossible trinity? Possibly not. There is no theory which says that these objectives are inconsistent with one another. It can even be argued that the three objectives reinforce each other, and that together they sustain growth, thereby constituting not an impossible trinity, but actually a holy trinity of objectives.

Holy Trinity

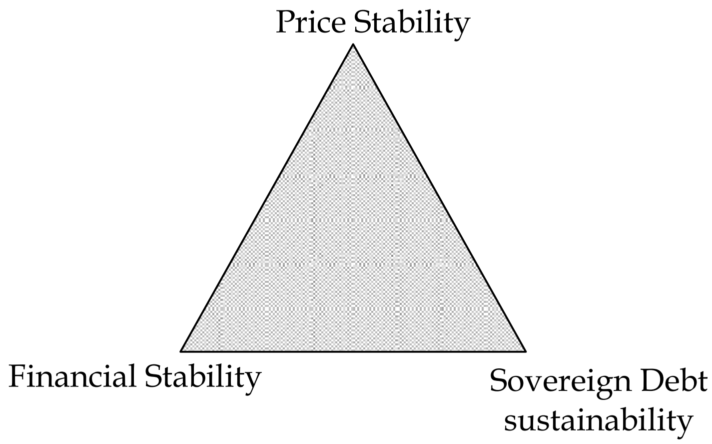

Figure - 2

That does not by any means imply that the holy trinity of objectives can always be achieved simultaneously, or once achieved, can be maintained as such indefinitely.

11. The monetary policy stance of Bangladesh Bank aims to preserve the country's external sector stability. As part of that overall capital flows are under close monitoring of the central bank and concerned policy makers. Capital account of Bangladesh is not fully convertible. As in a number of developing countries, outflow of capital has been generally restricted whereas inflows are permitted. Strategy of incentivizing foreign direct investment inflows is not very different in the country from the strategies of a number of developing countries. Bangladesh receives FDI from both developed and developing countries across the globe. The major investors come from 36 different countries of which 21countries are from developing and transition economies and Bangladesh received 70 per cent of total FDI inflow from only 11 countries (Unnayan Onneshan, 2012). It is nice to see that FDI inflows changed from import-substitutes to export oriented manufacturing. In terms to attracting FDI inflows, manufacturing and service sectors are playing important role. After entering into the WTO (World Trade Organization), Bangladesh opened the service sector and made a competitive policy framework which contributed flow of FDI in service sector. According to BB MPS Statement (2014), the capital and financial account shows that the

estimated foreign direct investment in FY14 was 1550 million concentrated in three largest sectors - telecommunications, power and textiles. New foreign firm entry was limited given recent domestic uncertainties.

12. A stable Taka-Dollar exchange rate and the slump in share prices lured foreign funds to the Bangladeshi stock markets in recent times. According to the available information, foreign portfolio investments increased remarkably in recent months. The rise in foreign investments boosted the confidence of the local investors; however, any sudden rise should be monitored. [The Jul-Dec period of the 2013-14 fiscal saw inflow of USD 310 million foreign funds in the stock markets. It was USD 116 million during the same period in the previous fiscal. The 2012-13 fiscal saw USD287 million foreign portfolio investment in the markets, while during 2011-12 it was USD240 million-http://news.priyo.com/2014/02/01/stock-markets-piled-foreign-investments-99314.html]. Stable exchange rate for quite some time is believed to be factor that attracted foreign funds. It is to be mentioned that there were almost no foreign funds in the market following the stock market difficulty of 2009-10. Difficulties in the stock markets in the world also contributed in attracting foreign portfolio investors.

13. In Bangladesh, the industrial enterprises in the private sector incorporated under the Companies Act 1994 and registered with Board of Investment (BOI) are eligible for obtaining credit from recognized lenders. However, in order to obtain loans from foreign sources a private company in Bangladesh needs approval from the BOI. As in most developing countries, policy makers of the country had very conservation in allowing these loans. Practically, following the East Asian financial crisis in 1997, the importance of monitoring and regulating the external debt position of a country, and specifically the rate of build-up of private commercial borrowing received due attention to the policy makers.

14. Private debts to Bangladesh remained insignificant in early twentieth and increased only in recent years mainly due to the change in the approach of the policy makers. In the country, the main rationale for the recent borrowing

from foreign sources was the lower interest rate compared to domestic sources; and also because most local banks could not finance large projects due to their limited capital base. In terms of the loan use most companies used borrowed fund mainly to import capital machineries either to start new projects or to expand the existing one. A recent survey by Bangladesh Bank (2014) observed that that the loans were generally used productively. Alongside allowing domestic corporates to facilitate cheap fund it is expected to create downward pressures on the loans rates offered by the banks. Another important observation in connection with import finance (BIBM Trade Review 2014) is the huge increase in the buyers' credit (discounting through OBU/correspondent bank) under deferred payment credit popularly known as UPAS. In between April 2013 and April 2014, the volume increased from around USD 520 million to USD 3355 million (BB information). This is over 60 percent of the total import finance and around 30 percent of the total trade finance volume of the country. It can be observed (in 2014) that Bangladesh Bank has already addressed the issue by allocating the liabilities on quarterly basis to minimize the potential impact of sudden high outflows of foreign currency in near future.

15. Avoiding excessive exchange rate volatility remains a key objective of the monetary policy authority of Bangladesh. As stated in the most recent MPS, BB (2014) continues to support a market-based exchange rate while seeking to avoid excessive foreign exchange rate volatility. BB's interventions in the foreign exchange market have protected exporters by slowing the appreciation of the Taka in recent time. Moreover by opening up working capital borrowing at lower interest rates from foreign sources to exporters in FY13, and increasing the Export Development Fund size, as well as expanding the sectors eligible for the Fund, BB is actively promoting export competitiveness. The practice of intervention by the Bangladesh Bank in the foreign exchange market is well recognized though officially a floating arrangement was adopted in 2003. Current exchange rate arrangement of Bangladesh, termed as 'managed floating' by IMF, has been effective in having required controls on external balances.

16. Practically, 'Mundell's Trilemma' has never been the case for most developing countries considering the status of monetary-fiscal coordination. Though the situation improved, dominance of fiscal policy and accommodation of the monetary policy remained the case in most of these countries. In regard to the monetary policy in Bangladesh, the autonomy status improved however independence remained limited. The strategies as part of monetary policy of Bangladesh Bank to maintain 'external sector stability' remain effective, and the combination of managed floating and controlled capital movement are working well in the context of the country.

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