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EXCHANGE RATE CRISIS AND ITS IMPACT ON BANGLADESH ECONOMY

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Abstract

It is widely accepted that the exchange rate as a crucial factor in shaping both short- and long-term macroeconomic goals, such as growth and development of a nation. Exchange rate volatility and its impact on the economy of Bangladesh has always been an area of concern, particularly for past few years. Particularly, Bangladesh has been severely impacted by the foreign exchange reserves (FER) crisis, facing significant economic challenges since the COVID-19 pandemic, further exacerbated by the Russia-Ukraine war. Between August 2022 and January 2023, the country's foreign reserves declined from $39 billion to $32 billion, while the Bangladeshi Taka depreciated by 27%, falling from BDT 84 to BDT 107 per U.S. dollar. Given the growing concerns surrounding debt and dollar crises, this study explored the underlying causes of these recent financial disruptions and explored policy recommendations. Bangladesh Bank has taken a range of initiatives to ease the conditions. Particularly, apart from the currency exchange rate volatility mitigation policies, the overall monetary policy has been adopted to mitigate the crisis of the financial sector, but to what extent it would be curbing the inflationary pressure that the country is exposed to is still a question. Hence, to restore external resilience, near-term corrective policy actions would require reducing the reliance on the exchange rate as primary nominal anchor for monetary policy, further tightening the monetary policy stance, and maintaining fiscal discipline.

Key Words: Exchange Rate, Macroeconomic Policy, Foreign Currency Reserves, Currency Appreciation/Depreciation.

Introduction

Bangladesh has experienced unprecedented growth over the past decade. Bangladesh was able to navigate through covid-19 pandemic with its prudent macroeconomic policies and experienced a real GDP growth of

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about 7.22% in FY-22 (World Bank, 2023). Despite being able to grow through the support of domestic policies, it has been significantly affected due to external pressure. The ongoing wars especially the Ukraine Russia war had dropped a huge impact to sustain internal policies. There have been severe disruptions in supply, spike in fuel prices and other commodities at the international level. In addition to this rising inflation triggered by global factors, Bangladesh is also experiencing a volatile banking sector, financial account deficit, decreasing foreign exchange reserve wavering the country's stability (CPD, 2024).

Bangladesh's Inflation increased from about 6.1 percent in FY22 to an average of 8.7 percent in the first eight months of FY23 due to rise in international commodity prices and BDT depreciated. At the end of FY22 and for the first half of FY23 Bangladesh did adopt an accommodative constricted monetary policy. On the other hand, Banking sector was losing its liquidity, due loss of dollar of sales. Bangladesh Bank started selling its dollar from June 2021 to limit the depreciation of the taka which led to furthermore accelerated depreciation of BDT. This was catalyzed further due to differences between the rates provided by banks officially and by other foreign exchange markets locally.

Impact of Exchange Rate Movements on Economy

Economic literature highlights the exchange rate as a crucial factor in shaping both short- and long-term macroeconomic goals, such as growth and development (Ehikioya 2019; Alagidede & Ibrahim 2017; Iyke & Odhiambo 2014). Examining 75 developing countries from 1973 to 1996, Broda (2004) found that nations with fixed exchange rate regimes experienced greater vulnerability to trade shocks due to insufficient real exchange rate adjustments. Herrmann and Jochem (2005) analyzed the factors influencing current account deficits in Central and Eastern European (CEE) countries that joined the EU in 2004, concluding that most mitigated larger deficits through currency depreciation. Similarly, Aristovnik (2006) determined that real exchange rate appreciation and deteriorating trade conditions contributed to widening current account deficits. The findings indicated that countries with deficits exceeding 5% of GDP faced challenges in sustaining them.

Calderon, Chong, and Loayaza (2000) examined the empirical link between current account deficits and various economic factors documented in the literature. Their study, which analyzed annual data from 44

developing countries between 1966 and 1995, identified a statistically significant relationship between the real exchange rate and the current account deficit, aligning with the predictions of the Mundell-Fleming model. They highlighted the effectiveness of flexible exchange rate regimes in balancing payments. Similarly, Edwards (2004) found that countries with more flexible exchange rates were better equipped to absorb economic shocks.

Alagidede and Ibrahim (2017) emphasize that exchange rate volatility, characterized by persistent fluctuations, has become a key issue due to its impact on economic activities. Additionally, inflation remains a major challenge for many SADC countries, with conflicting views on its relationship with economic growth (Baharumshah et al. 2016). The combined effects of these challenges could have severe economic consequences, potentially spilling over into neighboring economies.

There is no consensus on how exchange rate volatility affects macroeconomic performance. Some researchers argue that instability in exchange rates drives economic growth (Ozcelebi 2018), while others suggest it hinders progress (Barguellil et al. 2018). Differences in findings may stem from variations in data, methodology, study periods, and country-specific factors. For instance, Chamunorwa and Choga (2015) and Ngondo and Khobai (2018) used different econometric models—GARCH and ARDL, respectively—to analyze the relationship between exchange rate fluctuations and export output in South Africa, both concluding that volatility negatively impacts output. Conversely, Katusiime et al. (2016), applying the ARDL model to Uganda, found that exchange rate shocks had a positive effect on GDP.

Foreign exchange reserves (FER) are a key component of a country's financial assets, managed by its central bank or monetary authority. These reserves typically consist of foreign currencies, government securities denominated in foreign currencies, gold, and, in some cases, Special Drawing Rights (SDRs). FER serves as a safeguard against external economic shocks and uncertainties (Bussière et al., 2015). Additionally, it plays a vital role in facilitating international trade and investments by supporting cross-border transactions. FER is especially important for developing countries, as their economies are more vulnerable to external shocks, heavily reliant on key exports, and have limited access to global

financial markets (Bordo et al., 2010; Krušković & Maričić, 2015; Augustine et al., 2017).

Many developing nations rely heavily on the U.S. dollar for various transactions, including purchasing essential goods, securing food supplies, and attracting foreign investments. Additionally, these countries often use dollar-denominated debt as a key financing strategy, making their economies highly vulnerable to sudden currency depreciation or devaluation (Tanjim, 2022).

As of April 2023, several developing nations, including Egypt, Pakistan, Ghana, Lebanon, Malawi, Ukraine, Tunisia, Sri Lanka, and Zambia, are experiencing a foreign exchange reserves (FER) or debt crisis (Reuters, 2023). According to Times of India (2023), the number of countries at risk of an FER crisis has risen significantly. Factors such as soaring inflation, rising borrowing costs, and a strong U.S. dollar have made it increasingly difficult for these nations to repay loans and secure funding, leading to widespread defaults and mounting debt (Matsumoto, 2022; Moore & Glean, 2016).

Bangladesh has been severely impacted by the recent foreign exchange reserves (FER) crisis, facing significant economic challenges since the COVID-19 pandemic, further exacerbated by the Russia-Ukraine war (The World Bank, 2022). Between August 2022 and January 2023, the country's foreign reserves declined from $39 billion to $32 billion, while the Bangladeshi Taka depreciated by 27%, falling from BDT 84 to BDT 107 per U.S. dollar (Business Standard, 2022). Similar short-term economic crises have also affected some developed nations, including the United States and European countries. Given the growing concerns surrounding debt and dollar crises, it is crucial to thoroughly investigate the underlying causes of these recent financial disruptions. Despite the increasing attention on debt crises, no prior studies have specifically examined the causes and consequences of sudden short-term FER crises in emerging economies.

Current Scenario in Bangladesh Foreign Exchange Market

Bangladesh's current account surplus saw a substantial decline in October 2023, plummeting to only $233 million, a reduction of four-fifths from the previous month (Modak, 2023). This sharp decrease is attributed to a surge in imports, sluggish export growth, and a negative trend in remittances,

according to the Bangladesh Bank. In September 2023, the country had boasted a more robust surplus of $1.2 billion.

There has been notable contract in the current account surplus which raises concerns about its potential impact on the exchange rate and foreign exchange reserves. The current account typically consists of the balance of trade (exports minus imports of goods), net income from abroad, and net current transfers, holds significant importance as a key component of the broader balance of payment.

The Current Account deficit narrowed considerably but overall; balance of payment balance deteriorated in FY23. LC margin requirements on the payments by banks and foreign exchange shortages have also further to contraction in imports on year-on-year basis by about 16%. Exports remained stable despite a slow growth with major trading partners (Figure1).

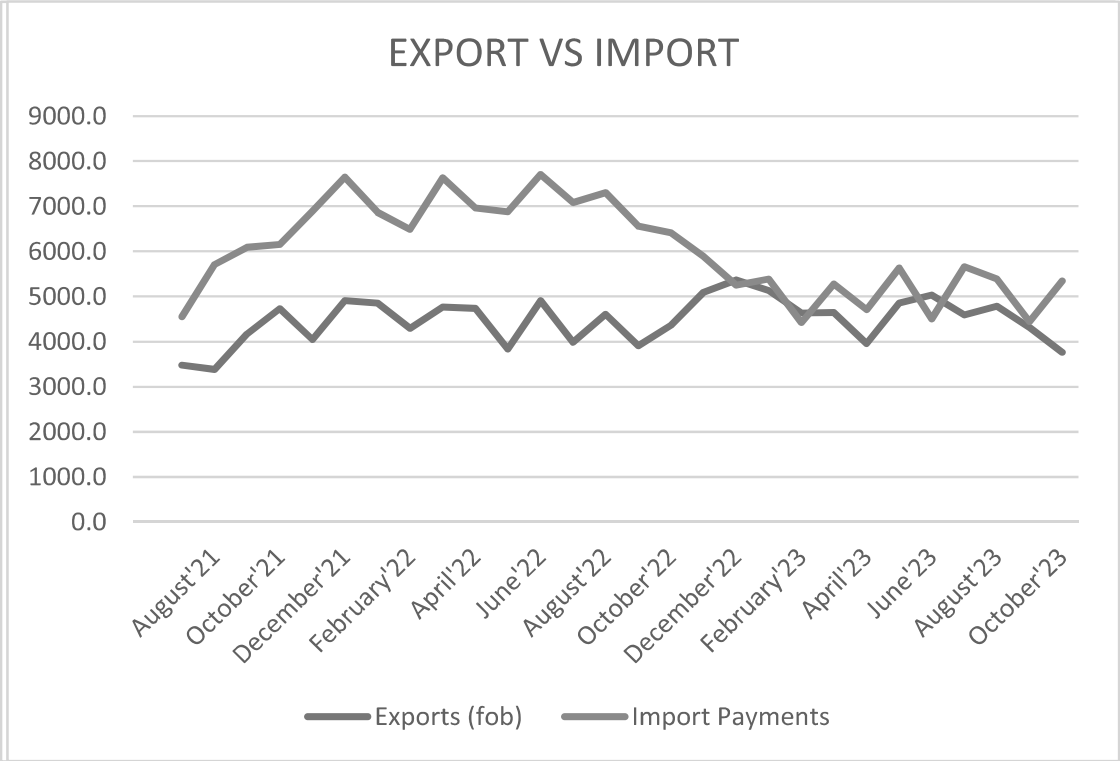


Figure 1: Export vs Import Scenario

Figure 1 shows from July 21 to October 22 imports were much higher compared to exports. There was surge of imports during this period leading to demand for higher foreign currency and thus leading to further depreciation. The trade deficit narrowed only modestly in the first half of FY23 which is quite evident from the Figure (1). The trade deficit remained

elevated in the first seven months (July-Jan) of FY23. Exports grew by 9.6 percent (y-o-y) with resilient demand and growing market share in major export markets, and import growth declined to 5.7 percent as numerous import suppression measures were adopted, reducing the issuance of letters of credit.

The Current Account balance improved significantly. However, the financial account experienced an outflow of 0.5 percent of GDP (US$2.1 billion) in FY23, compared to inflows historically averaging about 2.5 percent of GDP, signaling capital flight which is in light with the negative balance of trade and payment (Figure 2).

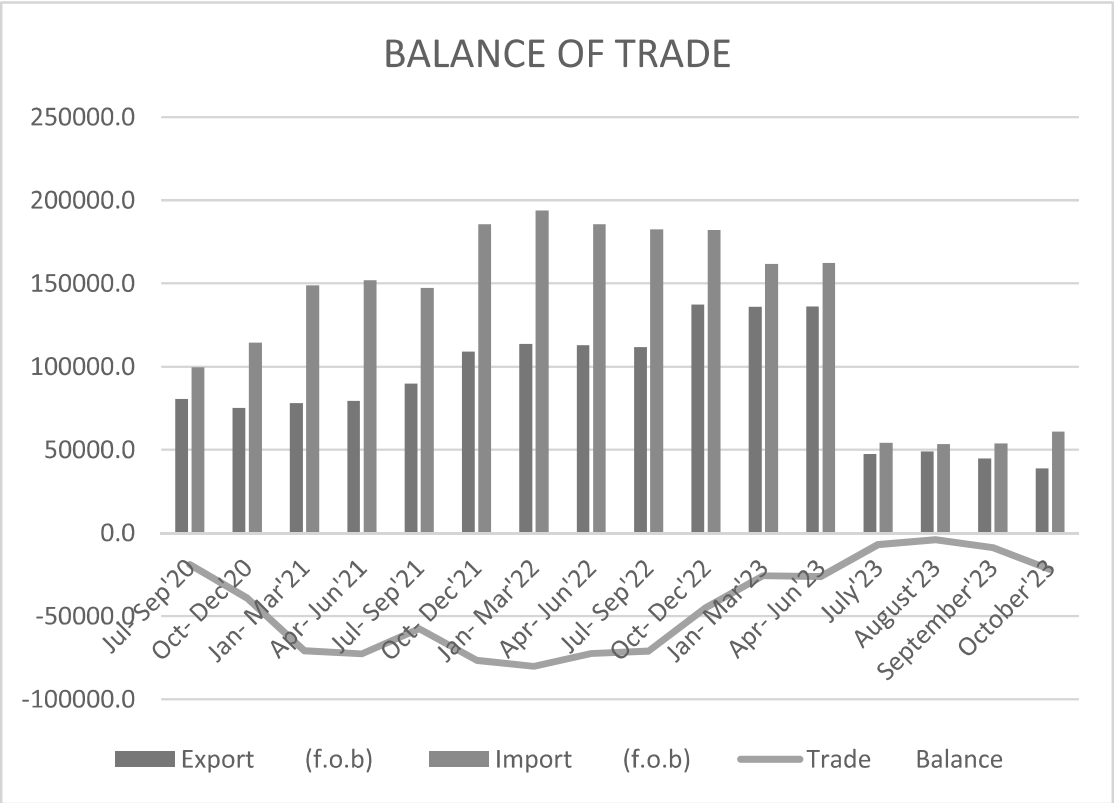


Figure 2: Bangladesh Balance of Trade.

Figure 2shows trade deficit have increased in the first quarter in the first half of FY23-24 to about -$22021.6 which had decreased in the last quarter of FY22-23 which was about -$6915 according to Bangladesh Bank data. Although the deficit trade balance has narrowed relatively due to slight increase in exports and decrease in imports, but it has been experiencing continued deficit for the last five years and more so in the recent year.

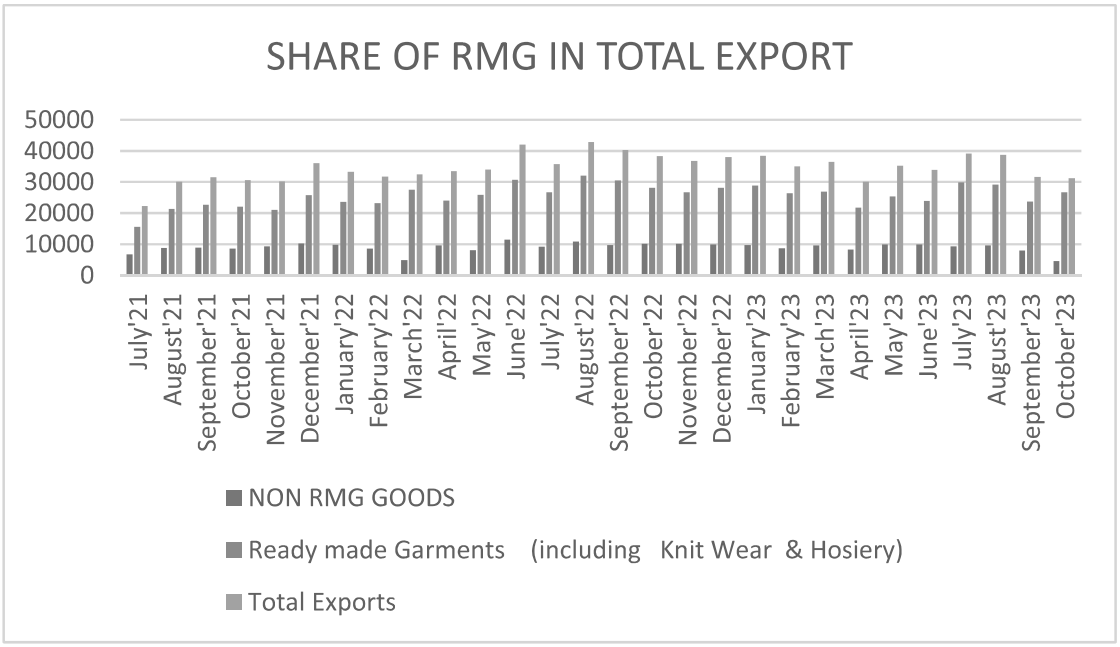


Figure 3: Share of RMG Sector Export

Merchandise exports rose by 33.4 percent in FY22 supported by resilient global demand for RMG products and rising market share due to the diversion of orders from China. According to Bangladesh Economic Review (2023) exports remained highly concentrated, as RMG accounted for 81.8 percent of total merchandise exports. The United States (20.0 percent of exports) and the European Union (44.6 percent) remained the main export destinations. However, in the first half of FY23-24 Bangladesh has experienced slow growth in RMG exports.

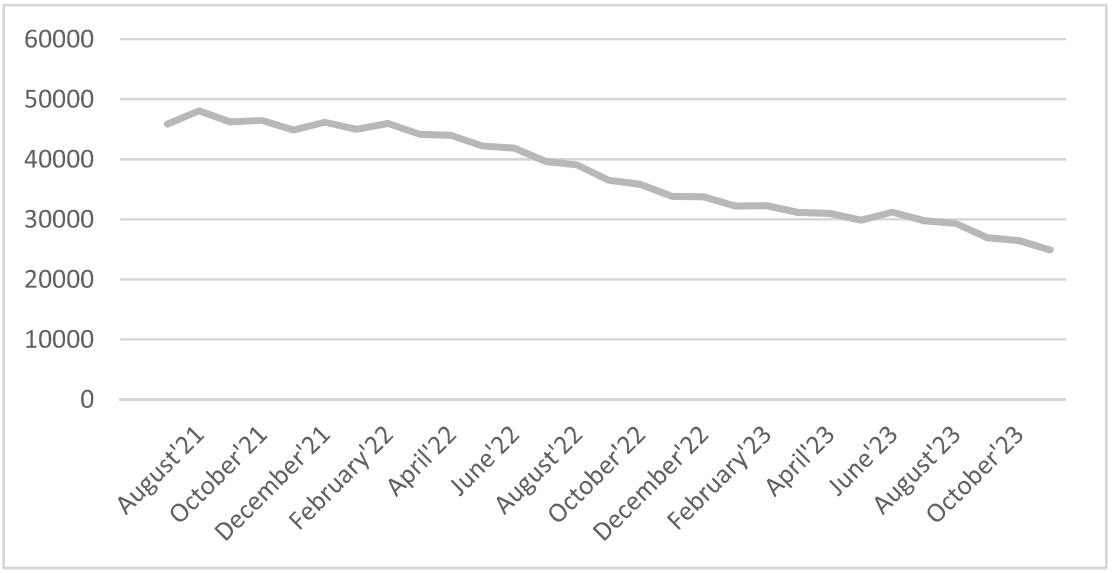


Figure 4: Bangladesh Foreign Exchange Reserve

Gross Foreign Exchange Reserves declined rapidly (Figure) as the BoP moved into deficit and BB sold reserves to support the value of the taka. Gross FX reserves declined to US$ 31.3 billion as of March 15, 2023, down from US$ 44.2 billion one year prior. BB sold a record US$ 7.6 billion in FY22 and an additional US$ 9.9 billion in the first seven months of FY23. Without a market clearing exchange rate, BB FX sales are the primary source of dollar liquidity in the banking system (World Bank, 23)

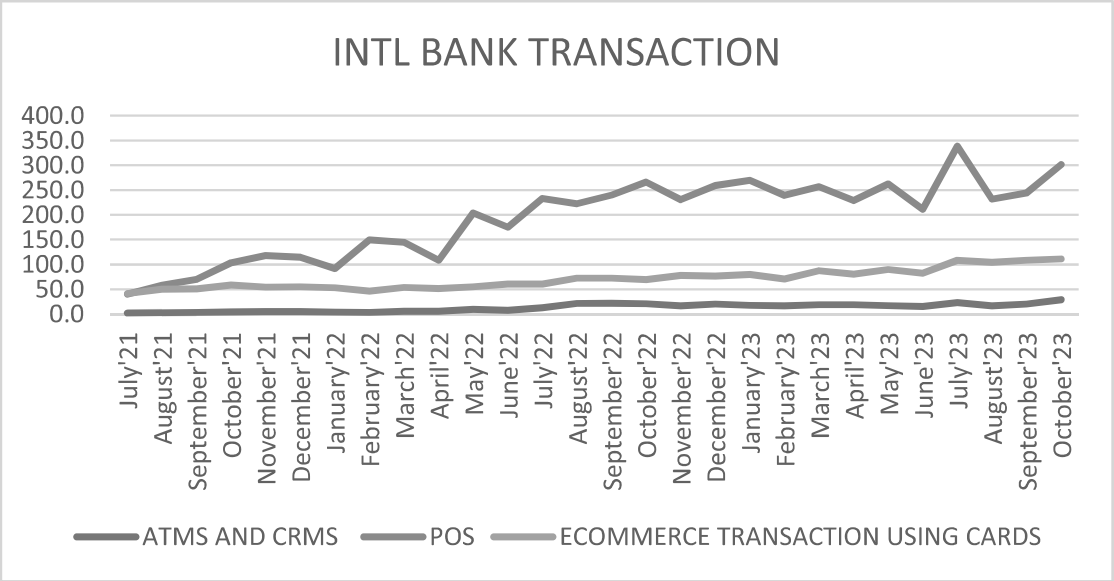


Figure 5: International Banking Transaction

In the world of global connectivity, Bangladesh has experienced a surge of international transaction. According to Bangladesh Bank data there have been an increasing number of outflows of USD through international card transaction. POS transaction internationally have been increasing at an accelerating rate (Figure: 5). Ecommerce transactions have been increasing at a steady rate. Looking at the time period increasing international transaction has also expedited the decrease in foreign exchange reserve.

Policy Analysis and Recommendations

To navigate the current crisis Bangladesh should step up to take certain policies. Bangladesh is faced with a two-edged sword. On one side the liquidity crunch of the banking sector and on the other side soaring exchange rate depleting the foreign exchange reserve. With such background a careful analysis of the current policies and potential recommendations are discussed below:

1. Bangladesh Bank have increased policy rate which will make it expensive for banks to make money (Hasan et. el. 2023). However, this could put Bangladesh at crossroads of attracting more foreign capital but then this could also impede the growth of private sector when it is already in a sluggish state. Though the main goal of the central bank is to control inflation with this policy, however, a cap in the lending rate may act as a barrier. A higher policy rate with a lending cap will only end up with a tightened net interest margin for the banks. In order to making borrowing costlier, banks should also be allowed to increase lending rate.
2. To curb the accelerating depreciation of BDT, Bangladesh has plan to shift from multiple exchange rate policy to crawling peg system which perhaps may stabilize the exchange rate (Hasan M. M. 2024). This is a good initiative which works as a base policy measure while moving towards a full flexible market driven policy. However, it can be observed that the central bank directed peg-range and the curb market rate differs significantly. This disparity actually depletes the benefit of the pegging system. It was documented that the kerb market rate jumped to more than TK120/$ whereas the official bank rate was around TK110/$ in September 2023 (Modak, 2023). Allegedly, many banks were also trading USD at a higher rate than that of the official rates (Modak, 2023). The recent data also shows that there are substantial discrepancies (around TK12/$) between the official rate and the kerb market. Usually, kerb market rate motivates trader to move to unofficial channel (e.g. money laundering) to remit funds and also the financial institutions fail to realizing foreign inflows fighting with the kerb market. In one hand, importers struggle to access foreign fund at official rate, and on the other hand, exporters are discouraged to realize their foreign funds through official channel. Hence, a tight control is needed to ensure the entire foreign exchange market comply to official pegging rate and, at the same time, the Central Bank may need to continuously adjust the pegging rate considering the market conditions. Otherwise, such foreign exchange rate discrepancies will trigger market inefficiencies and policy initiatives will fall apart. Hence, the BB (Bangladesh Bank) may set its exchange rate policy reflecting the market condition and interbank rate (Khatun, 2023).

3. Central bank has taken certain praiseworthy initiatives such as LC margin requirement to curb imports. However, care should be taken to ensure that the export sectors that also depends on importing raw materials from abroad should not be negatively affected by that policy. A flat policy implementation for the sectors will harm certain export sectors such as RMG that depends on cotton import, accessories etc. Furthermore, it is to be noted that he the export sector may need to import capital machineries which needed to be accommodated as well. In a roundtable discussion organized by The Business Standard on 3rd December 2023, highlighted that how the export sector is currently facing problems to manage their raw material imports and, hence stressed on the fact that, if the situation persists then it will drive away their foreign buyers (TBS, 2023a). Also, the importers who already have outstanding LCs are facing increase in costs as the exchange rate has depreciated significantly. It is reported that, in many cases, when the banks declines to honor LCs, then the burden is shifted towards the clients (TBSa, 2023). With such situation, LC margin requirement or direct quota restrictions can be implemented mainly for luxury items or items that have substitutes locally. Government can incentivize local producers to give support to the export sectors by establishing backward linkages where applicable. In a crisis situation where foreign currency shortages persist, the idea should be to lessen the dependencies on the foreign currencies as much as possible.

4. To handle the dollar crisis BB has adjusted the Export Orientation Quota (ERQ) at different rate for various sectors. Such as, for the RMG sector the ERQ is reduced to 7.5% from 15%, whereas for IT sector the ERQ has been lowered down to 35% from a massive 70%; for merchandise exporters ERQ is reduced to 30% from previous 60% (TBSb, 2023). It is true that the new ERQ policy would boost USD circulation in the market and easing the exchange rate but this policy may further hamper the operations of the export sector as the export-oriented businesses use the retained USD to purchase raw materials from abroad for sustain their operations or to support back-to-back LCs. Hence, care should be taken in order to suffice such curtail of ERQ rates with supporting LC facilities, where import is justified.

5. BB may take measures to diversify its foreign currency reserves and trade. This initiative has already been taken in July 2023 where it was agreed between India and Bangladesh to do trade through Rupee (Hasib, 2023). The Rupee was set as means of transaction for bilateral trade as India dominates the balance of payments with Bangladesh. Such initiative is praiseworthy and BB may consider such avenues with other countries as well. It is important to develop a basket of currencies for foreign transactions.

Conclusion

Experts argue that, soon the market will settle as the uncertainties regarding the political instability has been cleared. Moreover, recent large influx of remittances is also playing a positive role to ease the market condition to certain extent. With current developments, BB has announced that it will not further devalue BDT, rather it depreciated USD. But, according to the REER (Real Effective Exchange Rate), an exchange rate of 115TK/$ in January should be in place but the actual official rate (advised by the BB) is still much lower (Alo & Abedin, 2024). Besides, BB's monetary policy formulated for the late FY24, intended to bridge the gap of the deficit of the current account balance from USD 2billion (as of June 2023) to mere USD 332 million (Alo & Abedin, 2024). In any case, we cannot be complacent with few short run incidents/solutions, the BB must be continuing with its policy initiatives in order to reach to a longer run macroeconomic stability of the economy. Furthermore, it is not only about the adoption of policy, rather aligning all the actors in the foreign exchange market is crucial. The recent monetary policy has been adopted to mitigate the crisis of the banking sector, but to what extent it would be curbing the inflationary pressure that the country is exposed to is still a question. Hence, to restore external resilience, near-term corrective policy actions would require reducing the reliance on the exchange rate as primary nominal anchor for monetary policy, further tightening the monetary policy stance, and maintaining fiscal discipline.

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