FOREIGN EXCHANGE REGIME AND ECONOMIC DEVELOPMENT IN BANGLADESH

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CHAPTER I

INTRODUCTION

A. Statement of the Problem

The acceleration of economic growth and development is an overriding policy objective of national authorities in all developing countries. Exchange rate policy is one of the most important policy measures which the authorities can take recourse to for the realization of this objective.

The currency realignment in the early seventies and the introduction of a more generalized floating following the 1973 "oil shock" have made it almost impossible to discuss the stabilization and structural adjustment problems of developing countries without addressing the exchange rate issues. The growing difficulties in the balance of payments accounts of these countries, and the "stabilization programme"[1]

1The "stabilization programme" is better known as the International Monetary Fund (IMF) "conditionality". Chief components of conditionality have been reviewed and analysed in Tony Killick, "IMF Stabilisation Programme," The Quest for Economic Stabilisation: The IMF and the Third World, ed. Tony Killick (England: Gower, 1986).

which has been specially tailored for containing such difficulties have lent further prominence to these issues.

Exchange rate issues emanate from a country's particular foreign exchange regime. There are three types of foreign exchange regime: fixed exchange regime, flexible exchange regime, and exchange-control regime.

The fixed exchange regime is a convertible currency system. In this system, individuals are free to undertake their desired transactions at prevailing prices, and the government buys and sells foreign exchange in order to maintain the exchange rate. The flexible exchange regime is also a convertible currency system; however, the exchange rate is market determined.

The exchange-control regime is an inconvertible currency system. The government sets the exchange rate and does not necessarily let individuals carry out their desired transactions. In this system, foreign exchange is sold only under certain conditions, and citizens who make payments abroad are legally required to buy foreign currency from the exchange-control authority at the official rate of exchange.[2]

2The official rate of exchange is the rate which is registered with the IMF and is referred to as the nominal exchange rate in the literature.

Furthermore, individuals are generally required to sell any foreign exchange they may have to the exchange-control authority.

The major issues under a country's foreign exchange regime depend on the type of the particular regime. Under fixed exchange regime, major issues are about the circumstances that can lead to deficits or surpluses in payments. In a flexible exchange regime, major issues pertain to the determinants of exchange rate and changes therein.

Some special features of exchange-control regime warrant a different analysis of the relevant major issues.[3] One such feature is the emergence of a parallel or "black" market of foreign exchange. A related feature involves issues that arise with regard to the estimation of an equilibrium exchange rate and the use of a crawling peg.[4]

3Some special features of exchange-control regimes have been analysed in Anne O. Krueger, Exchange-rate determination, Cambridge Surveys of Economic Literature (Cambridge: Cambridge University Press, 1983).

4An equilibrium exchange rate is the rate that would clear the market were exchange controls removed. Estimation of this rate is warranted for purposes both of shadow pricing and of estimating the magnitude by which policymakers might alter the exchange rate. On the other hand, under a crawling-peg system exchange control is maintained, but the exchange rate is altered periodically by small amounts in order to maintain the price-level differential between the country and the rest of the world constant. Ibid., p. 182.

Irrespective of the differences of major issues under alternative exchange regimes, foreign exchange regimes have been found to play an important role in implementing trade and development strategies in many developing countries. This can be evidenced by the inclusion of exchange rate actions as a major component of IMF conditionality for a sustainable economic growth and balance of payments position in these countries.

IMF conditionality includes elements to ensure greater flexibility in developing countries' exchange rate policy. The target of such conditionality elements is either external competitiveness or other forms of flexibility.[5] Two important components of a typical conditionality package are: (i) abolition or liberalization of exchange control and restrictions; and (ii) devaluation of the official exchange rate.

The viability and the effectiveness of this policy package, in recent years, have attracted a growing body of literature. This study is an addition to this body of literature. It examines a particular country case - the case of Bangladesh.

5Peter J. Quirk et al., "Floating Exchange Rates in Developing Countries: Experience with Auction and Interbank Markets," Occasional Paper, no. 53 (Washington, D.C.: International Monetary Fund, 1987).

The post-liberation economic history of Bangladesh is one of slow growth, high inflation, and chronic deficit in balance of trade account.

The war of independence in 1971 left a devastated economy.[6] Restoration of the economy required about $3 billion.[7] At the beginning of 1972, agricultural production declined by about 25 percent while the level of commercial, industrial and other activities probably declined as much as 50 percent below the lowest figures of 1970.[8] The government had no foreign exchange reserve and no overseas credit facilities; the domestic financial resources were wholly inadequate to bear the excessive costs of restoration. To top these all, authorities inherited an overvalued currency - the Pakistan rupee - and a complex system of exchange control.[9]

6An estimated $1200 million material damage was inflicted by the war. United nations, Relief Operations in Dacca, <u>A Survey of damages and Repairs</u> (Dhaka: n.p., 1972).

7Charles Peter O'Donnell, <u>Bangladesh: Biography of a Muslim Nation</u> (Boulder: Westview, 1984), p. 110.

8Ibid., p. 111.

9The exchange-control system in Pakistan discriminated against East Pakistan - now Bangladesh. The centralized foreign exchange allocation policy effected a transfer of resources from the poor majority province of East Pakistan to the richer minority province of the West - now Pakistan. Nurul Islam, <u>Foreign Trade and Economic Controls in Development: The Case of United Pakistan</u> (New Haven: Yale University Press, 1981), p. 264.

Only a massive aid could rescue the new nation from sinking of its own weight. A generous amount of aid from the United Nations (UN)[10] did save the situation for infant Bangladesh.

More than one and a half decade after independence restoration of the economy remains an ongoing process. External financial resources still finance more than 90 percent of the Annual Development Programme (ADP) expenditures.[11] A chronic deficit characterizes both internal and external balance accounts. Despite several adjustments in exchange rate, the Bangladesh currency[12] virtually remains overvalued. Furthermore, exchange arrangements continues to be controlled despite concerted efforts to rationalize them since the early eighties.

Very recently, the economy of Bangladesh was in a shambles.[13] Foreign exchange reserves were hardly

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10The aid was estimated to be about $1.3 billion at the end of 1973. O'Donnell, p.113.

11Bangladesh Bank, Annual Report 1987-88 (Dhaka: Department of Public Relations &Publications, Bangladesh Bank, n.d.), p. 137.

12The Pakistan rupee was renamed taka (T) in January 1972 and was made the Bangladesh currency. Taka was devalued by about 66 percent from T11.43 to T18.9677 per pound-sterling immediately after its establishment.

13"Bangladesh Economy in a Shambles," Business Times (Kuala Lumpur), 7 March 1990, p. 5.

sufficient to cover one month of imports. Reserves dipped to $450 million - the lowest in last eight years - at the end of February, 1990 from $1.06 billion in February, 1989. Officials at Bangladesh Bank - the central bank - attributed the fall to a higher consumer and construction imports and a lower foreign aid.[14] However, Dr. Wahidul Huq, the minister for finance, held the surreptitious funneling of millions of dollars abroad through over-invoicing of imports responsible.[15] The crisis alongwith the controversies surrounding it possibly led to Dr. Huq's resignation on the 16th March on "totally personal grounds".[16]

A number of steps were taken by Bangladesh Bank to mitigate the crisis. Commercial banks were advised to ask for a 100 percent margin against a Letter of Credit (LC) for commercial imports in the second week of February. However, pressures from import lobbies forced a downward revision of LC margins to 50 percent

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14Ibid.

15"Dhaka Forex Reserves Depleted by Capital Flight," Business Times (Kuala Lumpur), 7 March 1990, p. 12.

16Mahfuz Chowdhury, "Arthamantri Dr. Huq chole gelen arthaneetir dai rekhe" (Finance minister Dr. Huq left the economy's liability), Bichitra (Dhaka), 23 March 1990, p. 10.

for both industrial raw materials and commercial imports during the fourth week.

The central bank then devalued the national currency by 4.99 percent on the 4th March. This was done in response to a growing pressure from the IMF which had been pressing for a 15 percent devaluation of taka.[17]

For the past few months, the multinational donor agencies have become critical of the management of Bangladesh economy. The country was denied grants and loans totalling $275 million from the World Bank in December, 1989 because national authorities failed to meet some conditions set by the Bank. While revealing this the Deputy Governor of Bangladesh Bank claimed that reserves dwindled to $14 million in 1974, and that a fresh tranche of foreign aid expected in April, 1990 could resolve the crisis of depleted foreign exchange reserves.[18]

17Ibid.

18Business Times, p. 5. The Deputy Governor was stressing that Bangladesh's current low reserves were no cause for panic. His statement was part of a public campaign aimed at restoring confidence. The campaign also included a news conference by the President of Bangladesh on the 24th March and a press conference by Bangladesh Bank Governor and 3 secretaries holding charge of economic ministries on the 12th April. Jamal Uddin Ahmad, "Economic Crisis Deepens," Bangladesh Observer (Dhaka), 19 April 1990, p. 5.

The foregoing discussion highlights the relevant issues of the problem under study. At the outset, there is the necessity for stabilization and structural adjustment of the economy of Bangladesh. The prime issue here is a chronic imbalance in internal and external accounts, and a stagnation of output growth.

Equally important are the issues of existing exchange control arrangements and exchange rate policy in Bangladesh. Like many other developing countries, Bangladesh has adopted an exchange control regime. The foreign exchange control act requires a surrender of all foreign exchange receipts to Bangladesh Bank. Both imports and exports are regulated by the Chief Controller of Imports and Exports (CCIE), and need licences from the CCIE.[19]

In exchange rate policy, Bangladesh maintains dual markets involving multiple exchange arrangements. The official rate of exchange is determined by Bangladesh Bank on the basis of a "basket of foreign currencies".[20] In addition, there exists a special

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19Bangladesh, Bureau of Statistics, Statistical Pocket Book of Bangladesh 1986 (Dhaka: n.p., 1986), pp.51-52.

20The basket comprises of pound-sterling, U.S. dollar, yen, and West German deutsch mark. Ibid., p. 52.

Import Permit (IP) rate based on the rate obtaining at local auction of home remittances.

The evolution of the foreign exchange regime in Bangladesh is as important an issue as the existing exchange regime. A historical overview of the regime may reveal significant policy shifts which might have affected the pervasiveness of exchange controls and the attempts to liberalize foreign exchange from time to time.

The most important issues of the problem under study revolve around Bangladesh economy's recent encounter with a foreign exchange crisis. The encounter and the policy initiatives, both the ones adopted by the authorities and the ones prescribed by the donor agencies, to mitigate it require an assessment of the exchange-control regime in Bangladesh with reference to the regime's role in national development. This assessment is necessary, especially, if the viability and effectiveness of related policy prescriptions were to be acknowledged.

The analysis then calls for both backward-looking and forward-looking approaches. The backward approach explains how past exchange rate policies, together with other economic policies and with the changing exogenous circumstances, have brought the economy to its present position. The forward approach involves specification of the underlying adjustment mechanisms that follow a hypothetical exchange rate action.[21] Within this framework of backward-looking and forward-looking analyses, relevant considerations of policy for stabilization and sustained growth of Bangladesh economy can be evaluated.

A significant devaluation of taka is the prime policy consideration in this respect. Liberalization of exchange controls, export promotion, and privatization are other relevant policy questions in our discussion on foreign exchange regime and economic development in Bangladesh.

B. Objective of the Study

This study attempts to analyse the nature and consequences of the foreign exchange regime in Bangladesh. It also aims to draw specific policy recommendations which will foster the development of Bangladesh economy. The following objectives are pursued in the course of this study:

21The backward and forward analysis are methodologically independent of one another, but conceptually one is the extension of the other and they can be mutually reinforcing. Ahsan H. Mansur, "Determining the Appropriate Levels of Exchange Rates for Developing Economies: Some Methods and Issues," IMF Staff Papers 30 (December 1983), pp. 785-86.

i. an examination of growth and structure of Bangladesh economy;

ii. a description of the nature and evolution of foreign exchange regime in Bangladesh;

iii. an examination of the consequences of exchange control regime in Bangladesh;

iv. an analysis of the real impacts of exchange rate devaluation and liberalization of exchange controls on the economy of Bangladesh; and

v. the arrival at specific policy recommendations concerning devaluation, liberalization, export promotion, privatization, and consideration for the Fourth Five Year Plan (1990-1995) of Bangladesh.

Although not a stated objective, a overview of some relevant issues in literature on the problem under study will also be presented in the main body of the thesis.

C. Methodology

This study is an empirical investigation into the experience of the economy of Bangladesh under exchange-control regime. The focus is entirely on the ex-post experience under exchange control rather than on the ex-ante expectations about its consequences for a developing country like Bangladesh.

The analysis draws mostly from observed data, and, rarely, from our own account of Bangladesh economy. Published sources are relied upon for both quantitative and qualitative information. Sources for data range from national and international statistical yearbooks to newspaper articles. The data sources are varied; accordingly, sources are described as they become relevant in the main body of analysis.

The measurements of data are as varied as the sources of data. In many instances, published data from original sources are transformed into figures which are more suitable for the specific purpose at hand.

The period under study comprises of the post-independence years. Bangladesh became independent on the 16th December, 1971. The fiscal year 1972-73 was therefore the first full year for the economy. Availability of published data allows only an analysis with annual data and, in many exercises, for the 1973-1986 period.

In carrying out the study, two alternative techniques of analysis are used. The most widely used one is the non-parametric approach of tabular analysis because it allows one to examine each piece of information, thereby permitting an in depth analysis of magnitudes, turning points, et cetera of the data.

The study also makes use of parametric techniques, particularly the regression analysis, when there is a need to detect causality among variables, because the non-parametric approach of tabular analysis make such detection harder.

Finally, because of lack of data availability and general inconsistencies inherent in the problem under study, we adopt a multidirectional partial equilibrium approach in carrying out the analyses.

D. Scope and Limitations

Except the time frame, our coverage has three further qualifications. Firstly, the study focuses entirely on the macroeconomy. The relevant microeconomic phenomena are left out of the scope of analysis because these phenomena are difficult to quantify and are not adequately covered by published data sources. Secondly, even within the context of macroeconomy, the study focuses only on some overall indicators of relevant macroeconomic phenomena. In particular, the supply-side variables are almost