

## Managing forex reserves and inflation

In today's globalised economy, a clear understanding of the intricate strategy of managing forex reserves and exchange rate (XR) is imperative for both monetary and fiscal operations. For example, XR appreciation and depreciation directly affect the volume of exports and imports and hence, domestic economic growth, employment and inflation.

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THE increasing foreign exchange (forex) reserves holdings by Bangladesh Bank (BB) -- as reported on November 12 -- reaching an all time high of \$10 billion is certainly a milestone. Earlier, on November 10, BB raised concerns about inflationary pressure and declining exports posing a major challenge to the economy. We believe that unless these reserve pile ups are purposefully managed, inflation will be inescapable as the economy begins its full rally to a recovery.

In today's globalised economy, a clear understanding of the intricate strategy of managing forex reserves and exchange rate (XR) is imperative for both monetary and fiscal operations. For example, XR appreciation and depreciation directly affect the volume of exports and imports and hence, domestic economic growth, employment and inflation.

A country with a strong currency can monopolise more global resources. For example, the US has been consuming

25% of the world's oil supply despite having only 4% of the world's population. Today, China with its burgeoning forex reserves, can buy food and gold from outside with its dollar holdings and then sell them domestically, raising the value of its yuan whilst keeping the food prices down.

Forex reserves are maintained by countries all over the world to defend the value of the domestic currency, and hence, they act as a buffer against external shocks. They enhance a central bank's (CB) ability to manipulate XR -- usually to stabilise it and thus bring about more favourable business conditions for exports and imports. A large reserve also increases a country's creditworthiness to international lenders. However, maintaining large reserves isn't without costs, which are often unavoidable.

Take, for example, the case of forex reserves in US dollars (currency plus all dollar denominated assets) held by countries all over the world. At the end of 2007, a whopping 63.9% of the identified official reserves in the world were held in dollars and 26.5% in euros. Since the

dollar has recently been losing ground against other stable currencies, every nation with dollar reserves has been experiencing a loss in its purchasing power and, hence, a loss of wealth. Add to that the persistent devaluation of the money due to inflation. As a result, a CB must continually increase its reserves holdings so as to maintain its grip on XR manipulating power.

Although forex reserves can earn interests in foreign currencies, they're often not large enough to offset the loss of inflation induced devaluation over the same period -- effectively resulting in a negative return known as the "quasi-fiscal cost." One strategic tool to minimise this loss -- while leaving the XR unaffected -- is to transfer a significant portion of reserves in higher yielding default-free foreign assets.

For example, recently China started selling its US agency securities holdings (debt backed by Freddie Mac/Fannie May) in exchange for US Treasuries. Even though the reserves transfer leave the country's XRs unaffected, such operations exert a strong negative effect on whatever the CBs are buying and selling. When China started selling US agencies securities for Treasuries, the former crashed while the latter rallied. In the same vein, if China starts transferring reserves into gold or euros, the dollar would likely crash against whatever it buys.

Forex reserves positions can change in the process of conducting monetary policy. That has implications for both XR target and domestic inflation. Under

Table: Forex Reserves of selected Asian countries (2009)

Ranking and Country	Reserves (millions)	Inflation rate (year over year)
1. China	2,273 (Sept)	-0.80
2. Japan	1,053 (Sept)	-2.2
5. Taiwan	341,200 (Oct)	1.31
6. India	285,525 (Oct)	7.93
7. S. Korea	264,200 (Oct)	2.0
8. Hong Kong	240,100 (Oct)	0.5
11. Singapore	182,038 (Sept)	2.9
69. Bangladesh	10,000 (Oct)	5.04

fixed XR regime, an unsterilised forex operation causes an expansion or contraction of the domestic currency circulation, which directly alters the money supply and hence inflation. Therefore, XR and inflation target has to be set jointly.

Under floating rate regime, although XR is largely market determined and monetary policy instruments are the preferred tools to achieve inflation target, forex interventions by CBs are still used -- although sparingly -- to counter disruptive short-term XR volatilities.

In the process of maintaining the XR target, a country can accumulate forex reserves continuously. China has been doing just that. To accommodate increased domestic demand for yuan, China issued more yuan while buying up foreign currencies. That kept the value of the yuan down, resulting in increased money supply and the potential for higher inflation. In practice, the actual conduct of forex operations is more complex -- depending on many other factors. Note that the effect on inflation and some other key variables will show up only with

lags from months to years.

Examining the relevant Bangladesh data available from the BB, one will find that while reserves are increasing (mostly due to increased remittances), XR against the dollar is remaining fairly constant, and money growth is steadily declining, and so is the inflation rate (see DS-Nov.12: Are remittances inflationary?).

These inferences reaffirm that BB is effectively conducting a "managed float" (not completely market determined) in its foreign exchange operations with sterilisation activism to control growth and inflation.

The data in the table displays the six largest Asian forex reserves holding countries preceded by their world ranking with corresponding inflation rates. We see no clear evidence of a positive nexus between the burgeoning forex reserves with high inflation (except India).

Using quarterly data over the 1981-2003 period for the five East Asian economies (see Table), Lin and Wang (2005) analysed the relation between forex reserves and inflation rate. The study's

theoretical prediction is that with increasing forex reserves, inflation is expected to rise when the exchange rate effect is stronger than monetary surprise effect. And the inflation rate will decrease when the monetary surprise effect is powerful and the weight placed on output stability is not large.

The empirical evidence shows that the relation between changes in forex reserves and inflation rates is negative for Japan, positive for Korea and Taiwan and statistically insignificant for Hong Kong and Singapore. Not surprisingly, these empirical observations are consistent with the raw data in the table.

Finally, some analysts advance the possibility of a competitive domestic currency appreciation because of spiking food prices globally (due to global shortages and money printing). Such a competitive currency appreciation could potentially be triggered by China selling its reserves to counter rising food prices.

As and when China begins appreciating the yuan, food shortages and prices everywhere else will leap upward, threatening social unrest. Countries with massive dollar reserves will start selling off their reserves. In response, China will sell even more of its reserves and so on. The big victim in this war will be the US dollar and all countries ambivalent to such a slowly developing spectacle.

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## New national pay scale: Some observations

The significance of awarding pay hike to the public employees lies in the fact that job-holders in the middle and fixed income deciles have been badly hit by inflation and depreciation of the national currency.

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THE government has finally announced the much-awaited new national pay scale for the public servants considering the need for reasonable pay hike and enhancement of job benefits for them. Of course, a 52% increase, on average, of the basic pay in the seventh national pay scale is certain to maximise satisfaction of the service holders in general. Better late than never. The significance of awarding pay hike to the public employees lies in the fact that job-holders in the middle and fixed income deciles have been badly hit by inflation and depreciation of the national currency.

It goes without saying that the immediate past caretaker administration announced 20% dearness allowance to offset the double-digit inflation that sent commodity prices skyward. Later, in September 2008, the seventh pay commission was formed. After the commission submitted its report in April a secretariat level committee was formed to revise the report. The Pay Commission recommended fixing of the highest basic pay at Tk.45,000 and the lowest at Tk.4,000. The proposed basic at the highest level was increased to Tk.40,000 and the lowest basic was increased to Tk.4,100.

According to the new pay scale, Grade-

1 salary will now be Tk.40,974 (74% increase), Grade-2 Tk.33,500 (74%), Grade-3 Tk.29,000 (73%), Grade-4 Tk.25,750 (72%), Grade-5 Tk.22,250 (62%), Grade-6 Tk.18,500 (68%), Grade-7 Tk.15,000 (67%), Grade-8 Tk.12,900 (62%), Grade-9 Tk.11,000 (62%), Grade-10 Tk.8,000 (57% increase), Grade-11 Tk.6,400 (56%), Grade-12 Tk.5,900 (59%), Grade-13- Tk.5,500 (57%), Grade-14 Tk.5,200 (58%), Grade-15 Tk.4,900 (58%), Grade-16 Tk.4,700 (57%), Grade-17 Tk.4,500 (58%), Grade-18 Tk.4,400 (69%), Grade-19 Tk.4,250 (70%) and Grade 20 Tk.4,100 (71%).

Finance Minister A.M.A. Muhith announced the new pay scale at a press briefing on November 11 at the Prime Minister's Office (PMO) after the cabinet approved it. "All government officials and employees will get their salaries under the new pay scale from July this year, but they will get all other benefits from July next year," the minister reporters.

All the public servants under the 20 grades will get all other benefits at the rate of 30% of their basic pay. The finance minister said that the pay scale would be implemented in two phases in line with the proposal made by the pay commission. The pay scale will be applicable for civil servants, the armed forces, educational services and judicial service with effect from July, 2009.

### Some observations

• The new pay scale came as a boon to the service holders when they were suffering due to artificial price rise. The endeavour of the government speaks of its sincerity and commitment. All the concerned policy actors are instrumental in finding a way to mitigate the sufferings of the middle and fixed income groups and to help them come out of the situation.

• The most commendable part of the newly announced pay scale is the 70% rise. Yet, such a marked rise seems to be more apparent than real. With deduction of 20% dearness allowance, the figure does not look impressive. Even then the government deserves thanks for its concern for the people and for approving the enhanced pay scale within its financial limitation. Something is better than nothing. The arrear benefit arising out of the new pay scale to be effective from July is more than redeeming.

• In the pay scale recommended by the first National Pay Commission, the ratio between the highest and the lowest scale was 1:16. In the newly introduced scale this ratio is 1:10 as it was in the previous one, where the highest scale was Tk.23,000 (fixed) and the lowest scale was Tk.2,400, while in the new seventh pay scale the highest and the lowest are Tk.40,000 and Tk.4,100 respectively. To establish an egalitarian democratic society and to ensure social justice by reducing discrimination between the highest and the lowest scale holders, this ratio should be decreased as far as possible. In Canada for example this ratio is 1:6.

• The new pay scale failed to do justice in reducing the prevailing discrimination



A welcome step.

• The mid-level officers and employees belonging to scales between 10 and 17 would be less benefited compared with scales 1-4. For instance, in the case of the former scales the rate of increase is minimum 72% while in the case of latter it is only 56%, which seems to be a gross injustice to the class 11 level officers and UD clerks/ assistants, even though they constitute the bulk of the public sector. Needless to say, these people are the worst sufferers due to price hike and a majority of them live from hand to mouth.

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that exists between the public and private sectors in terms of remuneration for similar qualification and fitness and similar kind of work. In Japan, the ratio between the public and private sectors is 1:1.3, and in Singapore it is more or less equal. Taking into consideration the attraction of meritorious students to the private sector along with MCNs, and the rampant corruption prevailing in the public sector, this discrimination should be done away with as soon as possible to attract meritorious students and combat corruption in the public sector.

However, the present government deserves appreciation for the NPS and the time it chose for announcing it. During this time, the prices of essential commodities should not increase because the aman crop is about to come and most vegetables are available in the market. As a result, the fear of inflation, which normally takes place at an enormous rate immediately after the declaration of NPS, seems to be much less.

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## Reducing traffic congestion

In this regard, a few suggestions are put forth here that can be implemented within a minimum time frame, at an efficient cost with the country's own resources, and during the tenure of the government.

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THE Honourable Prime Minister Sheikh Hasina said that her government planned to construct elevated and underground railways, flyovers, orbital waterways and circular roads around the capital to ease traffic congestion and solve the transport problem.

Understandably, this is a very ambitious and time-consuming program, some aspects of which may not be implemented during the tenure of the present government. In this regard, a few suggestions are put forth here that can be implemented within a minimum time frame, at an efficient cost with the country's own resources, and during the tenure of the government.

• Circular waterway: A waterway is the cheapest means of communication and should be given top priority. In the present proposed waterway system

stable navigable channel around the year. An alternative solution for this problem is to construct navigable locks at appropriate locations to retain monsoon high water level during the low water stage to help uninterrupted movement of both passenger launches and cargo vessels. Examples of such locks are available in many countries. The required steel gates can be fabricated locally.

• The government has already

ordered that the river must be kept clean of industrial effluents and garbage. This should be strictly implemented.

(d) The government desires that beautification of the river banks should be ensured with construction of walkways and planting of beautiful trees to attract both tourists and local inhabitants.

• Railway: Railway is the cheapest communication means next to waterway. So this should be expanded and utilised

through all possible means. In this regard the following suggestions may be helpful:

(a) The existing single rail line passing through the metropolitan city and terminating at Narayanganj should be converted immediately into a double line, which would allow two-way travel. The number of trains should be increased to ensure availability of transportation at an interval of 15 minutes with 3-minute stopping time.

The number of stoppages should be increased to enable traveling passengers to get a train within walking distance. At appropriate locations, underpasses should be constructed to enable passengers to cross the line to catch trains headed to their desired destination.

(b) While the engines will have to be imported, passenger carriages can be manufactured locally.

(c) Feeder roads should be constructed to enable people to catch trains easily from any location.

(d) A circular rail line along the periphery of the metropolitan city can also be constructed in the same manner.

Needless to say, the construction of a rail line and its maintenance is much

cheaper than the construction of metalled roads and their maintenance.

(e) Underpasses should be constructed under the existing rail crossings that are adding to the congestion problem.

(f) The same rail line will also be used to carry goods wagons to their destination siding line for loading and unloading, and thus, will not cause interference to the passenger trains.

(g) The above plan, if implemented quickly, will relieve the present situation. Also, it will not pose any problems for the proposed construction of any elevated railways, express highways, etc.

(h) With one engine pulling many wagons, fuel cost will be saved, and the air pollution problem will be reduced.

• Public transport: An adequate number of large-capacity city buses should be provided, instead of using small vehicles that contribute to the traffic congestion problem.

It will be appreciated if the government of Bangladesh seriously considers the above suggestions for the greater interest of the country.

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