

Active exchange rate policy and fear of appreciation

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BANGLADESH Bank has been very active in exchange rate interventions. The Daily Star recently reported that the central bank bought a record \$5.14 billion from the market in the just-concluded fiscal year to stabilise the exchange rate, in particular to halt appreciation.

The move was aggressive because the amount was only \$157 million in fiscal 2011-12 and \$316.50 million the previous year. BB's efforts helped raise the country's foreign exchange reserve to more than \$15 billion.

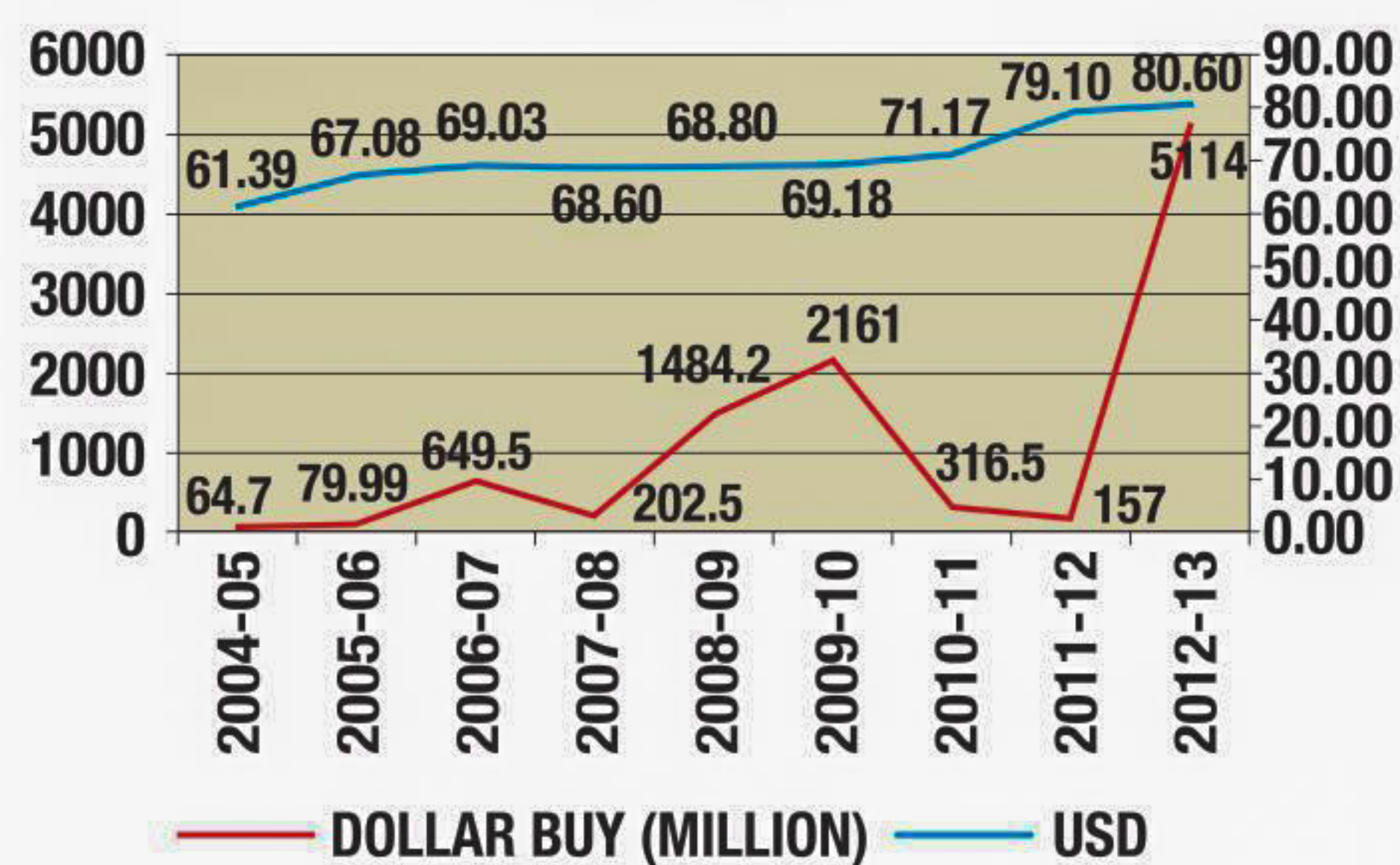
Exchange rate intervention in Bangladesh, the flipside of reserve accumulation, has been attributed more to the 'fear of appreciation' than that of depreciation, which is related to a mercantilist attempt to keep the currency undervalued (either to foster the competitiveness of exports or to detract from the competitiveness of imports). Ultimately, it contributes to a current account surplus, both allows the accumulation of foreign assets and preserves some slack on the external front.

What are the reasons behind the appreciating trend of the exchange rate? Excessive liquid dollar asset in the market is mainly due to a decline in imports and increase in remittances. This ultimately triggers a slack in domestic demand or ineffective domestic demand management.

This also points to inconsistencies in monetary policies. On the one hand, the BB has been pursuing contractionary monetary policy in order to keep inflation low. On the other hand, it has been injecting money into the market by buying dollars, although it claims that part of the injected money was sterilised through issuing bonds.

Partial sterilisation may not help keep inflationary pressure in control. As a result of contractionary monetary policy, domestic demand gets squeezed, which was reflected in lower import demand. Excess liquid taka in the banking sector also supports this claim.

Another aspect of buying dollar from the market is to strengthen the reserve position. How does it help the economy?



International reserves are basically used to finance international transactions, to serve as a buffer against unexpected payment difficulties and to allow implementation of monetary and foreign exchange rate policies.

Recently, international reserves in Bangladesh exceeded the \$15 billion mark. Such high reserves have been welcomed at all levels with great satisfaction, thanks to remitters as well as active intervention. The reserve accumulation has happened in Bangladesh mainly due to record high remittance growth, constant purchase of dollar from the local currency market and low imports as a result of sluggish investment demand.

The pertinent questions are: Is accumulation of international reserve a case of 'more is better? Will the current level of reserve sustain in the future? What are the costs and benefits of such reserve accumulation?

Generally, a country should maintain international reserve at a level with which it can meet import payments for at least three months. With \$15 billion in reserves, Bangladesh can meet import payments for six to seven months.

In this context, this is a case of satisfaction. Having international reserve more than the standard level (equivalent to nine-month import payments) could work as a safeguard against any currency crisis.

However, there is no such sign of crisis that may occur in the near future for which a healthy reserve would be needed. This is rather a cause of concern for many reasons.

For example, an accumulation of reserves over time may entail risks and costs like inflationary pressure, over-investment, asset bubbles and complications in the management of monetary policy. Persistent reserve accumulation suggests a strong external sector with significant current account surpluses, which is certainly true for Bangladesh. It has consistently been registering current account surpluses for the last few years. While a persistent current account surplus can be interpreted as a sign of high remittance growth without any clear implication to rising productivity or falling costs, it can be interpreted as a sign of an inherently weak domestic economy.

According to the absorption approach to interpreting balance of payments statistics, the current account balance is the difference between national income and domestic absorption, where absorption is defined as the sum of private consumption expenditure, investment and government expenditure. A current account surplus, thus, suggests there is a weak domestic demand, and that there is a glut of domestic savings. As such, more international

reserves do not necessarily mean better, and a large stockpile should not be mistaken as a sign of economic resilience. Besides, an accumulation of reserves entails risks and costs.

The persistent growth of remittances as well as international reserves may pose policy challenges for macroeconomic management, exchange rate policy and financial sector supervision, if it is not managed properly. Capital inflows could accelerate the growth of domestic credit, create economic overheating, including inflation, and cause the real exchange rate to appreciate, thus affecting macroeconomic performance in a way not consistent or compatible with domestic policy objectives, such as sustainable economic growth with price stability.

Unsterilised intervention partly contributes to liquidity overhang in the money market, and possibly to a surge in inflation too. Increase in remittances and net foreign assets could lead to a stock price boom and a bubbly sentiment in the stockmarket.

Another concern for high international reserve is that it may create a problem like the 'Dutch Disease'. This is a combination of factors, such as overvaluation of taka, loss of competitiveness and shrinkage of the manufacturing sector due to persistent large capital inflows. The phenomenon of de-industrialisation in the presence of rich natural resources, which happened in the Netherlands in the 1960s, is called the Dutch Disease. In Bangladesh, the impact of remittance inflows can lead to such a problem.

Therefore, international reserves can act as a double-edged sword for an economy. While a low level of reserve is not good for an economy, it is also not good for an economy to have a high level of reserve. Although there is no credible estimate on the optimal level of reserve for Bangladesh, it still appears not to be a cause of serious concern.

Finally, exchange rate management should not be against the wind without making proper assessment in the light of real effective exchange rate movement.

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Indian rupee falls to near lifetime low

AFP, Mumbai

INDIA'S rupee fell to near its lifetime low on Friday, prompting the central bank to intervene in currency markets to drag the ailing unit up, dealers said.

The rupee hit an intraday low of 60.59 rupees to the US unit -- near its record low of 60.76 hit on June 26 -- as Indian importers bought dollars.

The Indian currency later pared some of its losses, helped by intervention from the central bank, dealers said, to close at 60.22 rupees to the dollar.

"Possibly there was intervention from the Reserve Bank around the 60.58/59 level, which helped the rupee to recover," said Hemal Doshi, a currency strategist at Geojit Comtrade, according to the Press Trust of India.

The central bank does not normally comment on whether it has intervened in the market but dealers reported there were signs of intervention to prop up the rupee.

The reported intervention came a day after the central bank's governor said the Reserve Bank of India did not have an exchange rate target.

The rupee has skidded lower as overseas funds pull out of emerging markets on investor expectations of a scaling down of the hefty US monetary stimulus and as India's domestic economic woes mount.

The Reserve Bank of India is believed to have intervened several times in the market in recent weeks, but governor Duvvuri Subbarao said the priority was managing volatility.

"We employ all instruments available to us to manage volatility, and we do try to manage volatility. But we do not have an exchange rate band," Subbarao told reporters in the southern city of Chennai on Thursday.

The Indian currency, which has fallen more than 10 percent in 2013, is the worst performing currency among major Asian countries.

Analysts believe the central bank lacks the financial firepower needed to manage the rupee and prevent it from falling further.

Its tumble raises import prices of everything from oil and fertilisers to food staples such as pulses, stoking already high consumer inflation and causing hardship for India's poor millions.

Business leaders have been hoping that the RBI would cut interest rates when it meets on July 30 in an effort to spur growth, which is at a decade low of 5.0 percent, but the falling rupee makes this more difficult.

The RBI has lowered rates three times this year.



Shipyard workers hold a banner reading "Europe listen, shipyards fight!" during a demonstration against the repayment of state aids for Spanish shipbuilders in Vigo, northwestern Spain, on Thursday.

Spanish shipyard faces uncertain future

AFP, Vigo, Spain

GIANT cranes stand idle in the shipyard in the bay of the Spanish city of Vigo due to a loss of orders blamed on the threat that the European Union may force shipbuilders to pay back billions of euros in disputed state subsidies.

"There is no boat coming out of the shipyard, it is completely paralysed," said Manuel Simon, spokesman for the metalworking section of the Vigo branch of the CIG union.

The Metalships shipyard is working at half of its capacity, thanks to an order from a US client to build a ship for an oil rig -- making it a lucky "exception" according to the company's boss Alberto Iglesias.

"Four or five years ago, if we wanted to sign five contracts at the same time, we could," he added.

Spanish shipbuilders are struggling since the European Union in 2011 ordered the end of state subsidies for the sector, he said.

The threat that Brussels may demand that the bulk of the three billion euros (\$4.0 billion) which the sector received in aid between 2005 and 2011 be paid back is adding to the sector's woes and

frightening off business.

The sector has lost contracts for 50 ships due to concerns over the commission's enquiries into the state aid, according to the PYMAR association which represents Spain's shipbuilders.

Six Spanish shipyards have already closed in recent years, leaving just 19 standing which employ 87,000 people directly or indirectly.

Brussels will rule by July 17 if the state aid needs to be repaid.

The decision is anxiously awaited in Vigo, where the shipyard is a major employer along with a Citroen plant and Pescanova, a major Spanish fish company which in April filed for insolvency.

The city of around 300,000 people on Spain's northwestern coast of Galicia already has an unemployment rate of 27 percent.

"Three years ago 12,000 people worked in the shipyards, today barely 900," said Ramon Sarmiento, the head of the naval sector of the CCOO union who works at the Barreras shipyard in Vigo, just like his father and grandfather did.

The Barreras shipyard has not signed a new contract in two years. During boom times it worked on up to six ships at the same time.

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Standard & Poor's cuts Nokia rating

AFP, Helsinki

Rating agency Standard & Poor's cut its notation of fallen mobile phone maker Nokia on Friday, because of the cost to the company of buying out a joint venture with German firm Siemens S&P cut the Finnish group's long-term debt rating by one notch to B+ from BB-.

Nokia has agreed to buy the shares held by Siemens in joint venture Nokia Siemens Networks (NSN).

Nokia said on Monday it would buy 50 percent of telecom equipment maker NSN for 1.7 billion euros (\$2.2 billion), allowing it to take full control of its most profitable business.

This initially pushed up the depressed price of shares in Nokia, since NSN performs strongly whereas Nokia as a telecom-equipment group is struggling.

But the acquisition will cut into the mobile maker's cash reserves, and this led S&P to lower its estimate of net cash at the end of this year to 1.3 billion euros, less than half a previous estimate of three billion euros (\$3.9 billion).

"Nokia's strong balance sheet, which we view as an offsetting factor to Nokia's cash burn and supportive to the rating, will weaken following the acquisition," the credit rating agency wrote.

On Wednesday, Moody's said it had placed the company's Baa3 rating on review for downgrade.

Once the star performer on the Helsinki stock exchange, Nokia has seen its market value plunge by 30 percent in the past two years.

Energy price reforms no quick fix for India's blackouts

REUTERS, New Delhi

INDIA is betting a gas price hike will boost supply and help fix the country's chronic power shortages, but the plan may falter unless the debt-laden industry can pass on higher energy costs to consumers or win government subsidies.

The government last week set out a formula that could double gas prices from next April to around \$8.40 per million British thermal units (mmBtu), bringing them nearer to globally traded prices in a bid to lift imports of liquefied natural gas (LNG) and spur investment in local output.

The move follows similar steps in coal and is the latest effort to reform India's troubled power sector. Massive blackouts in Asia's third-biggest economy have hampered growth, which is at a decade-low. A third of the 1.2 billion population has no access to electricity.

India wants to double the proportion of gas in its energy mix by 2020 from 10 percent now. It uses coal for nearly 56 percent of its needs. Oil, mostly imported, accounts for 26 percent.

But the success of the latest plan lies in determining who will pay. Generators and distributors remain mired in debt and passing on politically unpopular electricity prices will prove difficult, particularly in an election year.

The price hike is a win for producers, such as privately owned Reliance Industries which operates one of India's biggest gas fields with international partner BP in the KG basin, where production has declined sharply.

The companies have long argued that a higher gas price would support investment to reverse the fall.

"It is a very positive and encouraging decision which will really incentivise oil and gas companies to pursue exploration activities," said SK Srivastava, chairman of state-run energy producer Oil India.

Better supplies should help power companies. Gas fuels only about 7



A Kashmiri boy reads a book while sitting next to his grandmother during a power-cut due to curtailment, at their house in Srinagar.

percent of power stations, but many plants lie idle or operate at low capacity because there is not enough fuel available to keep their turbines running.

"There are a lot of projects which have been idling and they have been desperately in need of gas supplies," said Dipesh Dipu, a partner at Jenissi Management Consultants.

Lanco Infratech, a power producer mired in losses and debt because its plants are running at a fraction of their capacity, has cut operations at one 366 MW unit to just four percent of capacity for lack of gas.

It may take at least two years to boost fuel supplies as investments in output and import facilities bear fruit, but even then the key to the plan may lie with cash-strapped distribution companies.

The state-owned distributors - known as discoms - will have to stump up funds to buy the more expensive electricity from power stations. But passing on too much of the costs to consumers will be politically unpopular and the discoms may opt instead to simply halt supply.

Utilities are already rationing electricity supplies to consumers in an effort to improve their finances to qualify for a \$32 billion government bailout package that aims to address massive losses racked up through years of corruption, populist pricing policies and mismanagement.

To balance their books, eight-hour stoppages could even double as the discoms try to rein in their losses, said Vinayak Chatterjee, head of Feedback Infra consultants.

"The discoms don't have enough money to buy the power, therefore they are resorting to power cuts," T Adibabu, chief operating officer of Lanco, told Reuters.

"Unless the discoms' financial health is improved, the power situation cannot improve suddenly."

Finance Minister P Chidambaram has already conceded that the government might need to cushion utilities from the gas price increase, which would effectively mean subsidising them.

That is a practice India, which is trying to narrow a bloated fiscal deficit, can ill-afford and it leaves power sector reform still at the starting gates.