Dealing with foreign exchange reserves

M. Shahidul Islam

With $16 billion (and counting) foreign exchange (FX) reserves, Bangladesh has the second highest reserves in South Asia after India. Although this is an incremental statistics and growth of reserves have been steady for years except for fiscal year (FY) 2011 and FY 2012, the record reserves are widely seen as the current regime's success.

However, accumulation of FX reserves in excess of optimal level could do more harm than good. That buildup of reserves comes at economic and social costs Bangladesh Bank's goal should be centered on the optimal level of FX reserves. More worryingly, accretion of reserves largely banking on remittances that makes non-tradables expensive (for instance, land) poses a danger for the long-term structure of Bangladesh economy, which is least understood in the country's policy discourse.

Before we delve into these issues, it is imperative to examine if the current FX reserves are significantly higher than the required level. There is no "one-size-fits-all" rule to measure the optimal reserves for all countries. Nevertheless, there are some criteria that help in understanding if a country has adequate reserves or is holding more.

Bangladesh's current level of FX reserves seems excessive, although not markedly, based on key criteria that are relevant for the country. Reserves should account for at least three months worth of a country's import bills, a widely accepted measure derived from a trade-related approach to the balance of payment. This is one of the key benchmarks that most countries follow when they calculate optimal reserves. With the current level of reserves Bangladesh can meet approximately 5 months of its import bills.

Other indicators such as reserves to GDP ratio (benchmark 10%) and reserves to money supply ratio (20%) suggest that the central bank is holding more reserves than what the economy requires.

While many Asian countries led by China and petrodollar economies have stockpiled staggering amount of reserves owing to mercantilist motive (to limit exchange rate flexibility), some economies have accumulated reserves to insure themselves from the impact of a 'sudden stop' in capital flows. For these countries reserves to short-term debt ratio is an important yardstick when they calculate reserves. Bangladesh's short-term debt is relatively low. Nevertheless, in many instances, both mercantilist and precautionary motives prompt reserves build-up.

In fact, accumulation of FX reserves, mostly in emerging and petrodollar economies, has created huge imbalances in the global economy, what the Federal Reserve Chairman Ben Bernanke dubbed 'the global savings glut' (excess intended saving), leading to a fall in global real long-term interest rates.

There is no denying that there are certain benefits in holding of higher reserves -- it reduces the probability of financial distress, lessens sovereign default risk and lowers real exchange rate volatility, inter alia. However, these benefits have to be weighed with costs of holding reserves.

When a central bank receives excess capital flows such as remittances they could potentially destabilise the concerned economy's domestic monetary and macroeconomic stabilities -- by increasing monetary base, appreciating currency and raising prices. Consequently, central monetary authorities have to sterilise the capital flow. They purchase foreign exchange by selling domestic currency (thus resulting in a reserves accumulation) to resist currency appreciation that generally offsets by open market operations (issuing bonds, treasury bills, etc.) in the domestic market.

Such actions (sterilisation) counterbalance its impact on domestic interest rates and inflation. Central banks generally invest FX reserves in short-term securities, predominantly in US Treasury securities and its agency bonds that offer very low returns.

Nevertheless, such sterilisation mechanism is sometimes difficult to operate and can potentially be self-defeating. In extreme cases, mounting fiscal costs could prompt central banks to abandon the sterilisation effort. Even stability in the domestic economy through sterilisation comes with a price. There is an associated fiscal cost (direct cost) of sterilisation which is on the rise following the drastic fall in yields on the US Treasuries. This could worsen central banks' operating losses and could expose the sterilisation instruments into credit risk.

While the existing level of FX reserves seems excess, albeit not markedly, it is imperative to see if the trend is sustainable. The rise of reserves in recent months following slow growth in FY11 and FY12 is largely due to three reasons: decline in import demand, steady growth of exports and double digit growth of remittances. Moreover, credit for oil import and better aid disbursement has also helped in developing a favourable balance of payment position.

All these developments have been of help in attaining macroeconomic stability. However, the excess supply of foreign exchange forced the central bank to intervene in the market, arresting rapid appreciation of the local currency vis-à-vis the US Dollar and other key currencies. Bangladesh Taka has appreciated against almost all the major currencies, including 5% appreciation vis-à-vis the US Dollar and 15% against the Indian Rupee in the past year.

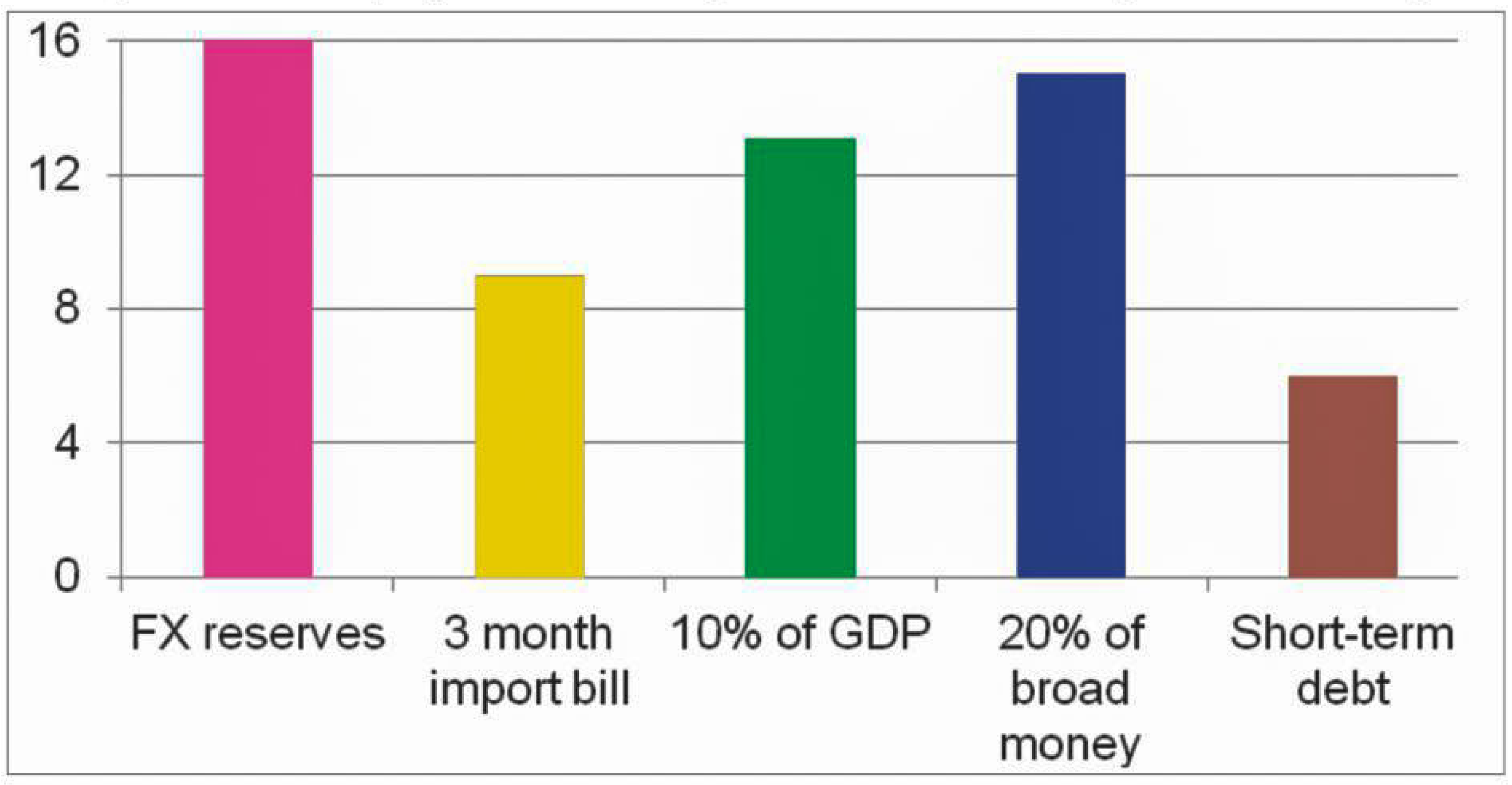
The fall in import growth in two consecutive years, including negative growth (-5.6%) in FY 2013, underlies that growth in investment demand decelerated markedly reflected in slowdown in private sector credit growth resulting in reserves build-up. This also signifies that owing to poor economic governance there is not much headway in investment growth keeping economic growth significantly below than the target level outlined in the 6th five year plan.

The next point to ponder is should the government use a part of FX reserves in infrastructure and other investment vehicles, as suggested by some economists? China, Singapore and many petrodollar economies developed sovereign wealth funds (SWF) channeling a part of their reserves. This could be a risky venture for Bangladesh on two grounds. First, foreign exchange reserves are extremely liquid assets and any turnaround in import growth could increase the demand for US Dollar decelerating the growth of reserves as we have seen in the past. Secondly, and more fundamentally, to manage SWFs there is a need for a strong managerial capacity that Bangladesh lacks.

Finally, there is no denying that the rise of reserves largely banking on remittances reversed the balance of payment position. However, it is high time to revisit our development policies regarding remittances. Over-reliance on remittances could make Bangladesh Asia's next Philippines. One key difference between Bangladesh and China (or similar countries that accumulated huge reserves) is that the latter uses reserves to support its mercantilist (undervalued) exchange rate policies to defend its export-led growth, although Beijing is now revisiting the model. In the case of Bangladesh higher growth in remittances appreciates local currency making land and other non-tradables expensive that could eventually discourage industrialisation.

To sum-up, while FX reserves are necessary to maintain macroeconomic stability, the central bank's goal should be maintaining an optimal level of reserves, disallowing politicians taking mileage from it. The current level of reserves should also worry the policymakers as they are partly accumulated due to slowdown in import growth, in turn slackening of economic activities. More importantly, the country's policy priority concerning remittances should be revisited as their excess growth could make non-tradables expensive and discourage its long-term industrialisation, turning Bangladesh the next Philippines of Asia.

Figure: Reserve adequacy measures for Bangladesh and excess reserves (in billion US dollar)



Source: Author's calculation based on Bangladesh Bank data

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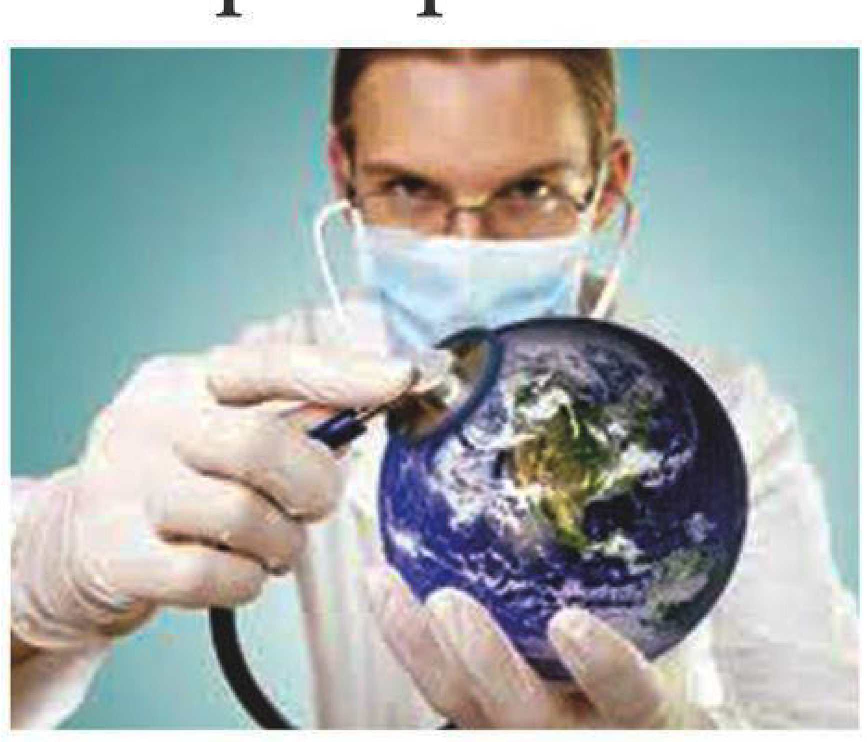
'Can the US get serious on climate change?' A different perspective

Abdullah Shibli

I read with interest the observations made by my friend Dr. Saleemul Huq in the recent article "Can the US Get Serious on Climate Change?" (The Daily Star, August 7). The fundamental issue for us engaged in the climate change debate is not whether "US can get serious on climate change?" as Saleem asks, because US administration has been serious since the '90s, rather can we present a coherent and logical view of the science and economic policy to the public and the Congress? And sadly, my conclusion is that we have failed to do so.

Let me start with some important observations Saleem presents in his op-ed piece about the public mood on climate change and the political realities in the USA. The US public, as he correctly states, has not been "convinced by the scientists" on the evidence linking climate change to human behaviour. This has not been helped by the scandal that showed that some of the earlier findings of IPCC were flawed, and biased. As a Bangladeshi economist living in the USA, I also have noticed that in recent years public mood has further soured for two additional reason, (a) the alarmist tone projected by the scientists involved in the earlier rounds of IPCC and (b) recent hype within some elements of the media who try to link every recent weather-related disaster -- "droughts and hurricanes" -- to climate change. As can be expected, a rational and sceptical public will ask: if climate change is a long-term phenomenon, as we all seem to agree on, why are such natural disasters happening now? Is it possible that Hurricane Sandy and the recent weather patterns in the Rocky Mountain area are just outliers?

As for the political leadership, of course there are some groups, particularly in the Republican-dominated House of Representatives, who are opposed to any measure that has the flavour of a tax increase, for example carbon tax; on the other hand, even the power and automobile industry, two of the largest sources of greenhouse gas, are in favour of cap-and-trade. In the Obama first term, there was a decent chance that Congress would pass the cap-and-trade legislation; unfortunately, the president lost the initiative and redirected his energy on getting the HealthCare Law through Congress instead. Nonetheless, cap-and-trade still has some powerful supporters in the Republican Party, including Senators John McCain and Lindsey Graham. In cap-and-trade, a market based solution, which has been tried in some European countries and in the USA on a limited basis, each power plant, for example, gets a permit to



discharge a fixed amount of carbon. However, those who emit less than the amount allowed in the permit can sell the rest of the "right to emit" to another plant which has exceeded its quota. Thus, this trade benefits both plants and keeps the total amount of carbon emissions in check.

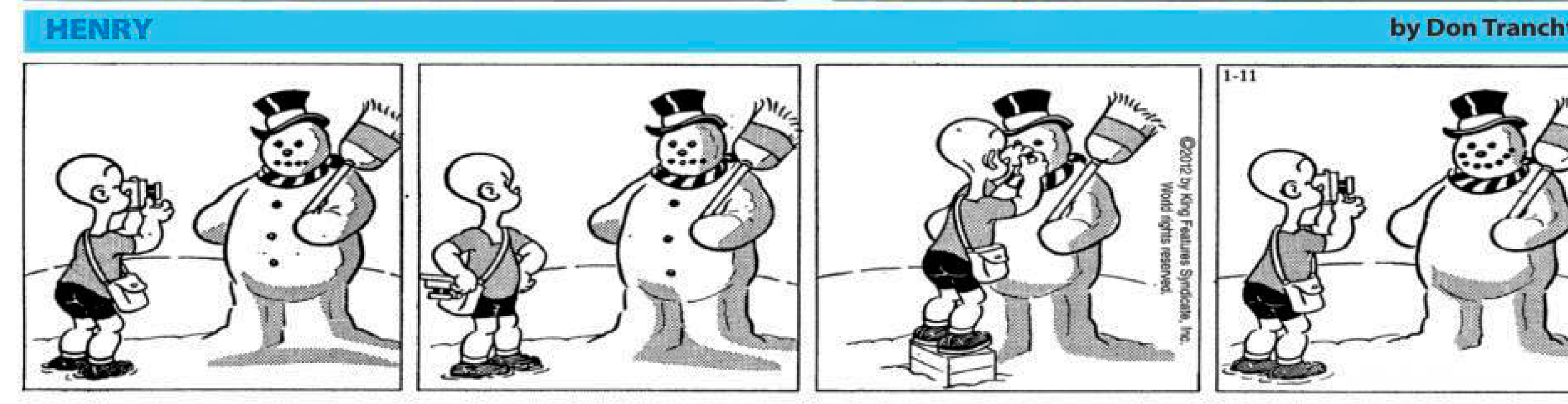
Is carbon tax then a lost cause? The short answer is no. In recent months, many advocacy groups have been mobilising public opinion on carbon tax. In Massachusetts, where I live, a non-profit named Committee for a Green Economy (CGE) is planning to place a ballot initiative for this tax. According to the proponents of this initiative, the state will levy a carbon tax on petroleum, heating oil, and other fossil fuels based on the amount of carbon dioxide they generate. However, before they are able to get to that point, the initiative must pass certain constitutional requirements. As one can surmise, even if public opinion is in favour of carbon tax, any new tax measure must overcome the checks and balances that are in place in a functioning democracy like the USA.

Finally, while it is true that we still have a long way to go, the clean environment movement in the USA is gaining strength and the newer generation is more conscious of the environmental costs of big cars, coal-burning power plants, and other wasteful practices. However, going forward, the US public can be swayed to act more forcefully to reverse climate change if the policy makers and politicians have the right mix of facts and actionable intelligence.

The writer is an economist who lives and works in Boston, USA.

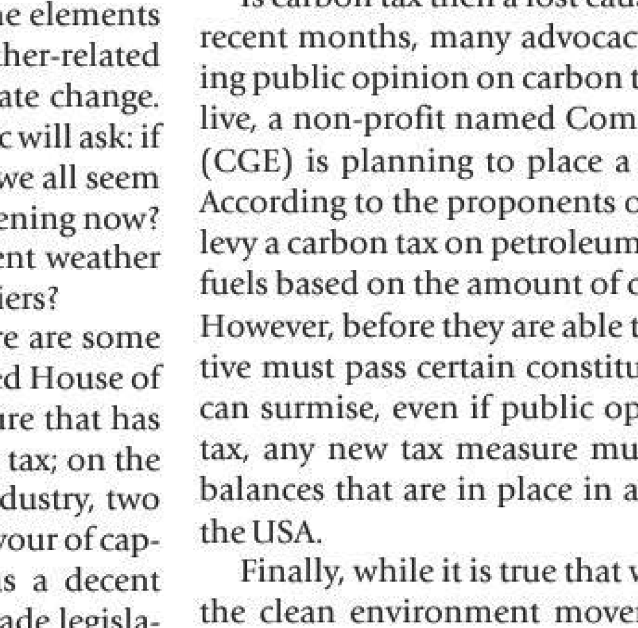
BEETLE BAILY by Mort Walker

HENRY by Don Tranchte



ACROSS
1 Med. watchdog org.
4 Baseball's "Georgia Peach"
8 Church section
12 Long. crosser
13 Finished
14 Polynesian figurine
15 Commotion
16 Conduit of a sort
18 Phi Beta —
20 Pair
21 Singer Guthrie
24 Perfumery compound
28 Entree
32 Carryall
33 Illustrations
34 Arrangement
36 "CSI" evidence
37 BBQ sauce option
39 Dawn or Joy
41 Improvise
43 Moby-Dick's pursuer
44 Common bit of Morse code
46 Nonclergy
50 Afternoon TV entry
55 Raw rock
56 Ginormous
57 Shakespeare's river
58 Goose egg
59 Latin list-ender
60 Tailless cat
61 Bribe

DOWN
1 Criticism
2 Word from the nursery
3 On
4 "— die many times before their deaths"
5 Lab eggs
6 Stake
7 Raised
8 Maximally
9 Actress Zadora
10 Tackle moguls
11 Aachen article
17 Regret
19 Skillet
22 Committed perjury
23 Town at the mouth of the Tiber
25 — list
26 Sicilian volcano
27 Harvest
28 2-Down's counterpart
29 Saharan
30 "— never work"
31 "Quiet!"
35 Troop group
38 Scatter
40 Govt. lender
42 Greet the villain
45 Junk email
47 Molecule parts
48 Small band
49 Business-review website
50 That woman
51 No longer chic
52 — Khan
53 Mendes or Longoria
54 Director Howard



Solution time: 21 mins.

Yesterday's answer 7-3

CRYPTOQUIP

F O C J A C L A M C O I H C H C W B X T I M M A I M T X I J R Z N J S C W X, F O I G K L V M R B L V K I M M G O C T ? X M N S O G L Z O I J R.

Yesterday's Cryptoquip: BECAUSE I CAN CRAFT VERY CLEVER PUNS ABOUT FENCING, I MUST SAY I'M GOOD AT SWORDPLAY WORDPLAY.

Today's Cryptoquip: A equals P

QUOTABLE *Quotes*

"Education is an admirable thing, but it is well to remember from time to time that nothing that is worth knowing can be taught."

Oscar Wilde