

## EXCHANGE RATE POLICY OF BANGLADESH – NOT FLOATING DOES NOT MEAN SINKING

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*The question of operating a primarily fixed or primarily floating exchange rate regime has long concerned academics and policy makers alike. This paper draws upon the literature on the subject and the experiences of some of the countries in the Asian and Pacific region that undertook major changes in their exchange rate regimes, from the perspective of the current policy choices facing Bangladesh. The paper concludes that Bangladesh's experience with an adjustable basket peg policy has been broadly positive and moving to a floating rate regime is not called for.*

Media reports suggest that Bangladesh is under intense pressure by the International Monetary Fund (IMF) to change its prevailing exchange rate regime to one in which the nominal exchange rate will be determined primarily, if not solely, by the market forces of demand for and supply of foreign exchange. There are also indications that the Government is willing to comply once the foreign exchange reserve situation improves. In light of these developments, this paper seeks to examine if there exists any strong justification to opt for the change that the IMF has been apparently insisting upon.

The first section of the paper briefly describes the present exchange rate regime in Bangladesh. The second section draws upon literature on the subject to identify the general economic characteristics suitable for alternative exchange rate regimes and indicates the preferred option for Bangladesh in that light. The third section briefly reviews the experiences of some of the countries in the region that undertook major changes in their exchange rate regimes in recent years and the implications of these experiences for Bangladesh. The fourth section evaluates the performance of the present exchange rate regime of Bangladesh in terms of the key economic objectives that an exchange rate regime is expected to promote. The paper ends with concluding observations that summarize the key findings and their implications for the choice of the exchange rate regime in Bangladesh.

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### I. EXCHANGE RATE REGIME IN BANGLADESH

The exchange rate regime of Bangladesh can be characterized as one of an adjustable basket peg using a real effective exchange rate target. Given an existing nominal exchange rate, the corresponding real effective exchange rate is estimated. If it is observed that the real effective exchange rate (REER) as estimated on the basis of current par value significantly diverges from the desired or targeted REER, a corrective response is initiated in the form of changing the nominal exchange rate.

The estimation of REER involves three steps. The first is the calculation of the bilateral nominal exchange rates (NER) of the country under consideration, *i* (Bangladesh), with its trading partner country, *j*. In the case of Bangladesh, nominal exchange rates are usually announced in terms of the United States dollar (\$) and data on exchange rates of trading partners are also available in terms of the dollar. Thus, bilateral exchange rates are calculated by using the following formula:

$$NER_{ij} = \frac{NER_{i\$}}{NER_{j\$}} \quad \dots \quad \dots \quad \dots \quad \dots \quad \dots \quad (1)$$

Where  $NER_{ij}$  stands for the bilateral nominal exchange rate of Bangladesh with the trading partner *j*;  $NER_{i\$}$  for Bangladesh's exchange rate with the dollar and  $NER_{j\$}$  for the trading partners' exchange rate with the dollar.

The second step involves estimation of bilateral real exchange rates. This is based on the following equation:

$$RER_{ij} = NER_{ij} \frac{P_j}{P_i} \quad \dots \quad \dots \quad \dots \quad (2)$$

where  $RER_{ij}$  is the bilateral real exchange rate of Bangladesh with trading partner *j*;  $P_j$  is the price index of the trading partner and  $P_i$  is the price index of Bangladesh. REER is finally estimated as per following:

$$REER = \sum W_{ij} RER_{ij} \quad \dots \quad \dots \quad \dots \quad (3)$$

where  $W_{ij}$  stands for the share of the trading partners in Bangladesh's trade and  $\sum W_{ij}=1$ .

As already noted, if the actual REER is found to be substantially different from the desired or targeted level, NER would be changed to reach that level. Then, the question arises as to what level or REER is deemed desirable and targeted.

Ideally, targeted REER should approximate the equilibrium exchange rate. However, estimating the equilibrium exchange rate that ensures healthy external balance

as well as desirable levels of domestic economic aggregates is a complex and arduous task. This cannot be routinely done. It is learnt that the authorities in Bangladesh monitor the movements of the REER compared to some base year and also qualitatively take into account several other domestic and external sector variables in determining the targeted REER. The external variables include the level of international reserves, current account gap, trends of exchange rate changes in the local interbank foreign exchange market and trends in the exchange rates of major neighbouring trade partners (India and Pakistan). Domestic variables include the domestic inflation rate, credit growth in the private and public sector, and the growth of broad money and liquidity.

The exchange rate policy decisions, though notified in all cases by the Bangladesh Bank, are made on behalf of and in close consultation with the Ministry of Finance. Bangladesh Bank does not have independent stewardship of exchange rate policy.

The Bangladesh Bank supports the current parity of the taka through a continuous presence in the market in the form of announced readiness to undertake United States dollar purchases and sales at rates decided by itself within the declared rate band (currently of one taka width) any time an authorized dealer approaches. Any adjustment in the parity is implemented through the announcement by the Bangladesh Bank of a revised band for buying and selling rates following which the dealers adjust their rates for transactions with their customers and among themselves. Upto 24 May 2001, Bangladesh Bank used to announce specified buying and selling rates. From 3 December 2000 Bangladesh Bank adopted the practice of declaring a 50 poisha band within which buying and selling transactions will be undertaken; this band was widened to taka 1.00 from 25 May 2001.

Prima facie, Bangladesh pursues an active exchange rate policy. This activism is reflected in the frequency of nominal exchange rate changes announced by the central bank. From 1983 onwards, there have been as many as 89 adjustments in the exchange rate of which 83 were downwards and only six were upward. However, the behaviour of economic agents is influenced by the impact of policy changes on the real variables that affect them. In the present context, the relevant variable is the real effective exchange rate. Table 1 shows the relationship between the nominal exchange rate and the real effective exchange rate during the past twelve years

Data in table 1 suggest that up until 1998, the authorities were basically pursuing a policy of stable REER. Thus between 1991 and 1998, REER depreciated by a mere 5 per cent. The subsequent years were marked by stronger depreciations. The mild appreciation of REER in 1998 could be one factor that encouraged policy makers to be more active in the exchange rate policy arena. Another factor could be that some of the competitor neighbouring countries were apparently depreciating faster.

**Table 1. Indices of NER and REER (1991 = 100)**

<i>Year</i>	<i>NER</i>	<i>NER index</i>	<i>REER index</i>
1991	36.60	100.0	100.0
1992	38.95	106.6	100.2
1993	39.57	108.1	104.6
1994	40.21	109.9	102.2
1995	40.28	110.1	102.9
1996	41.79	114.2	103.8
1997	43.89	119.9	105.5
1998	46.91	128.2	105.4
1999	48.00	131.4	112.8
2000	52.00	142.1	116.2

*Source:* Based on unpublished data from Bangladesh Bank.

## II. CHARACTERISTICS SUITABLE FOR ALTERNATIVE REGIMES

It should be stressed at the outset that the task of identifying economic characteristics that dictate the choice of one regime or the other is enormously difficult. The difficulty arises due to several reasons. Much of the literature identifies these characteristics from the standpoint of two polar policy regimes. One of these can be branded as a regime of “hard peg” in which the value of the local currency is irrevocably fixed in terms of one or more foreign currencies. On the other extreme lies the regime of “free float” under which the exchange rate is allowed to fluctuate freely in response to the market forces of demand for and supply of foreign exchange. The actual practice of either of these regimes is rare. There is a host of other regimes which lie in between, variously labelled as “managed float”, “independent float”, “peg with sliding or crawling band”, “flexible peg” etc.

The second difficulty arises from the fact that no single exchange rate regime is appropriate for all countries in view of differences in levels of economic and financial development and other aspects of their economic situation. Moreover, the regime that is appropriate for a particular country may change over time (Mussa and others, 2000).

The third difficulty is that the sustainability of a regime is also conditioned by the capacity of a country to formulate and effectively implement other economic policies which can reinforce the beneficial impact of a particular regime and neutralize the negative consequences. In particular, the credibility and the flexibility of monetary and fiscal policies are of crucial importance.

Notwithstanding the above difficulties, it is worthwhile to examine the economic characteristics that point to the appropriateness of a particular regime as benchmarks. These can be useful indicators for the choice of a regime in Bangladesh.

There is a vast literature on the choice of exchange rate regime.<sup>1</sup> The conditions that generally point to the appropriateness of some form of pegged exchange rate regime are briefly discussed below.

- The degree of involvement with international capital markets is low. This condition ensures that the exchange rate will not be subject to large fluctuations in response to volatile inflows and outflows of short-term capital. Bangladesh clearly satisfies this criterion with a wide range of controls on capital and money market instruments, credit operations of the commercial banks, and transactions related to foreign direct investment and real estate.
- The share of trade with the country/countries to which its currency is pegged is high. As has been explained in the preceding section, this condition is fully met in Bangladesh as it follows the policy of a trade-weighted basket peg.
- The shocks it faces are similar to those facing the country/countries to which it is pegged. With stringent capital controls in place, the external shocks to the Bangladesh economy are transmitted primarily through the trade channel. In light of the point made above, this condition also holds for Bangladesh.
- Exchange rate based stabilization is considered attractive for the country. Given that there are lots of endogenous pressures from political and economic interest groups in Bangladesh to be lax in the conduct of monetary and fiscal policies, maintenance of some sort of a pegged exchange rate which forces monetary and fiscal discipline appears to be a desirable nominal anchor for Bangladesh.
- The country is willing to give up its monetary policy independence and largely follow the monetary policy of the partner country. This condition is specially relevant for countries which pursue a policy of hard peg vis a vis a single currency. Since Bangladesh follows a policy of basket peg and the peg itself is adjustable, Bangladesh does not have to sacrifice its monetary policy independence entirely and blindly imitate another country's monetary policy stance.
- The country has high international reserves. This is an important requirement for a pegged exchange rate regime that Bangladesh does not adequately meet. However, the rationale for high international reserves under a pegged exchange rate regime arises from the fact that should the exchange rate come under pressure the authorities

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<sup>1</sup> See, for example, Mussa and others (2000); Velasco (2000) and the references cited in note 18 of the publication by Mussa and others (2000).

must have adequate foreign exchange to intervene effectively in the market to maintain the pegged rate. This condition does not appear to be an indomitable constraint for the present exchange rate policy in Bangladesh as the authorities can exercise two options, in addition to domestic policy instruments, to ease off pressure in the foreign exchange market. First, the exchange control regime can be tightened subject to obligations under Article VIII of the IMF Articles of Agreement. Second, the peg itself can be adjusted, as has been done many times over the years

The above discussion already suggests that some sort of a pegged exchange rate regime may be the preferred option for Bangladesh. At this point it is worthwhile to examine how does Bangladesh figure in terms of the economic or institutional requirements of a floating exchange rate regime.

The literature on the subject clearly highlights the need for a credible alternative nominal anchor for the conduct of monetary as well as fiscal policies as the exchange rate fails to provide such an anchor under the floating regime. The alternative anchor that is most often suggested is inflation targeting. Under the inflation targeting system, a country is committed to keep inflation within a predetermined target rate. Monetary and fiscal policies have to be tuned to ensure that the target is not violated. This in turn requires an independent central bank which can refuse accommodation to the Government if it is apprehended that the latter's fiscal stance is likely to cause inflation beyond the targeted rate. Furthermore, the central bank should have the independence to conduct monetary policy in such a manner that constrains the Government from financing its deficit through the commercial banks and other ways which may have inflationary consequences. Apart from the requirement of legal independence, the central bank also needs to be staffed by highly competent professionals who can predetermine an appropriate target rate of inflation, monitor the actual behaviour of inflation and implement systematic adjustments in monetary policy instruments to ensure that the target is realized in practice. No one would seriously doubt that these institutional imperatives for the success of inflation targeting are unlikely to be met in the near future in Bangladesh. Another major problem that Bangladesh is likely to face in this area is that, to a large extent, inflation is most likely caused in Bangladesh by supply shocks. In particular, the natural calamities have an important bearing on food prices, a major component of inflation in Bangladesh. This complicates the task of predicting the behaviour of inflation and also of controlling it through monetary policy instruments.

Another requirement for a floating exchange rate regime is that the country should have a deep and competitive foreign exchange market. If the market is thin and controlled by a small number of operators, free float will inevitably lead to a large degree of volatility. This is likely to inhibit trade as well as investment

(both local and foreign) due to greater exposure of economic agents to exchange rate risks. In principle, it can be argued that such risk can be hedged. In practice, this possibility would be of limited relevance for Bangladesh, given the facts that (a) the foreign exchange market of the country is pretty thin even for spot transactions and (b) no organized markets for currency futures and options exist. In the circumstances of Bangladesh where non-residents are unwilling to hold local currency exposure, there will be no net capacity to shift foreign exchange risks abroad at a reasonable price. Therefore, any hedging under a floating exchange rate would basically involve shifting of exchange rate risks of one domestic economic agent to another domestic agent.

A well-regulated, well-supervised and financially sound banking system is also a crucial requirement for a floating exchange rate regime, particularly so if one of the objectives behind the adoption of a floating exchange rate regime is to substantially open up the capital account. With the opening of the capital account, banks play a critical role in intermediating short-term capital flows. If the inflows are not invested appropriately, the exchange rate may come under indefensible speculative attack with disastrous consequences for the economy, as was the case with the East and South-East Asian economies in 1997. Appropriate investment of short-term external capital inflows has to satisfy at least two conditions. First, maturity mismatch has to be prevented. This means the time profile of the income stream generated by investment has to broadly correspond to that of the repayment obligations. Second, currency mismatch has to be avoided. There arises a currency mismatch if most of the income from investment is generated in local currency with repayment obligations inevitably denominated in foreign currency. One need not belabour the point that the banking system of Bangladesh would be simply incapable of meeting the stringent requirements of an open capital account.

Finally, the requirement of high international reserves under the pegged exchange rate regime is of no less relevance to the floating exchange rate regime either. The reason is that the authorities cannot remain as idle onlookers when the exchange rates fluctuate wildly. The experience of developing countries worldwide (in some cases even developed countries) shows that authorities cannot avoid intervening in foreign exchange markets under floating regimes in order to maintain a reasonable degree of stability in the exchange rate. The need for intervention may be even stronger for Bangladesh with its thin foreign exchange market which typically implies greater fluctuations. This is precisely the reason why the Finance Minister has pronounced many times that he would consider the adoption of floating exchange rate only after the country acquires a high level of reserves.

The upshot of the above arguments is that the ex-ante requirements for the adoption of a floating exchange rate regime are not satisfied in Bangladesh. Thus, the justification for a change in the present exchange rate regime is by no means obvious.

### III. EXPERIENCES OF OTHER COUNTRIES

The experiences of some countries in the region which implemented major changes in their exchange rate regimes in recent years can provide useful lessons for Bangladesh. This section begins with a brief review of the experience of the five East/South-East Asian Countries (Indonesia, Malaysia, Philippines, Republic of Korea and Thailand) all of which adopted independently floating exchange rate regimes following the Asian crisis in the second half of 1997 with the exception of Malaysia which resorted to a fixed exchange rate policy<sup>2</sup>.

The review here is concerned primarily with the comparison of exchange rate volatility before and after the crisis. It is well known that, before the crisis, these countries were basically pursuing pegged exchange rate policies though their regimes (with the exception of Thailand which officially had a pegged rate) were officially branded as managed floats. The post-crisis period is defined as the 24 month period beginning January 1999 and the pre-crisis period is defined as 24-month period ending in June 1997. Thus the period of extreme instability resulting from the crisis is left out of account. The magnitudes of exchange rate variations are captured in the following table.

Table 2 makes it abundantly clear that all the countries experienced much greater volatility in their exchange rates as they switched to floating regimes. And this happened despite the fact that they did not refrain from intervening in the foreign exchange market as well as using domestic policies to stabilize the exchange rates.

**Table 2. Monthly exchange rate percentage changes**

<i>Country</i>	<i>Period</i>	<i>Range</i>	<i>Standard deviation</i>
Indonesia	Pre-crisis	.033	.007
	Post-crisis	.230	.063
Malaysia	Pre-crisis	.027	.007
	Post-crisis	.000	.000
Republic of Korea	Pre-crisis	.043	.011
	Post-crisis	.066	.017
Philippines	Pre-crisis	.012	.003
	Post-crisis	.068	.017
Thailand	Pre-crisis	.016	.004
	Post-crisis	.070	.018

*Source:* Hernandez and Montiel, 2001.

<sup>2</sup> This review draws heavily from Hernandez and Montiel (2001).

Greater volatility and sharper depreciation have also been the experience of South Asian countries which adopted some sort of floating exchange rate regimes in recent years. India adopted a unified exchange rate system in March 1993 in which the exchange rate is determined by the supply and demand condition in the interbank foreign exchange market. The country's exchange rate remained fairly stable till August 1995, but then there was a sharp depreciation against the dollar by 12 per cent by the end of 1995. There was again a sharp depreciation by about 15 per cent between September 1997 and July 1998. By November 2001, there was a further depreciation by about 13 per cent and the rupee/dollar exchange rate was 48.0.

The adoption of a floating/flexible regime has not freed the Reserve Bank of India (RBI), the central bank of India, from intervening in the foreign exchange market. In fact, taking note of the fact that the thinness of the foreign exchange market as well as some large transactions can cause excessive volatility, RBI pursues an explicit policy of intervention in the spot market and also undertakes both forward and swap transactions in support of its exchange rate objectives.

Pakistan can be considered to have adopted a sort of floating exchange rate policy since July 2000 when the exchange rate band was abandoned. Between November 2000 and 2001, the exchange rate depreciated from Rs 57.5 to Rs 60.9 per US dollar. Exchange rate volatility was relatively high between mid-1998 until October 1999 when the fixed peg was adopted for a brief period. With the adoption of the floating system, volatility increased again to pre-peg level.

The State Bank of Pakistan also intervenes in the foreign exchange market. The interventions take the form of outright sales/purchases of foreign exchange, swap transactions and provision of foreign exchange to banks to cover certain bulky imports.

Sri Lanka adopted a free float on 23 January 2001. Immediately after the float, there arose considerable volatility. The currency fell drastically in two days following the float to as low as Rs 98/\$ compared to Rs 79/\$ in November 2000. This forced the authorities to intervene in support of the currency and introduce stringent control measures so as to restore the currency to Rs 87/\$ by about March 2001. By November 2001, the rupee had depreciated to Rs 93/\$.

The volatility and the sharp depreciation in Sri Lanka occurred inspite of putting in place precautionary foreign exchange regulations in conjunction with the float. Those regulations, *inter alia*, imposed limits on banks' daily net foreign exchange exposure; enjoined banks to ensure settlement of export credit by using export proceeds within 90 days (later extended to 120 days) and to impose penalties for overdue settlements; introduced restrictions and deposit requirements for banks' forward sales of foreign exchange and prohibited prepayment of import bills. The country also has a set of detailed guidelines for dealing in the foreign exchange market and for conduct of intervention by the central bank.

#### IV. HAS THE EXCHANGE RATE REGIME OF BANGLADESH PERFORMED POORLY?

This section examines the performance of Bangladesh in terms of certain key objectives that an exchange rate regime is expected to promote. The relevant objectives are: (a) the prevention of any major misalignment of exchange rate and, in particular, the prevention of appreciation of the real effective exchange rate which can hurt exports; (b) the promotion of exports and containment of the current account deficit; (c) moderation of inflation; and (d) enhancement of remittances – a matter of special concern for Bangladesh, given that the remittances financed a significant portion of the country's trade deficit throughout the 1990s (Islam, 2002).

##### (a) *Misalignment of exchange rate*

The prevention of misalignment implies that the actual exchange rate should correspond to the estimate of the equilibrium exchange rate. It is not easy to either define the equilibrium exchange rate or to estimate it. That would be a complex exercise in itself and is beyond the scope of the present paper. However, a recent study has undertaken such an exercise for Bangladesh (ADB, 2002a). The study concludes that the misalignment between the actual and equilibrium exchange rate for the period 1997 to 2001 has been small and has progressively narrowed since 1998. During 2001, the misalignment was only 2.2 per cent.

It will also be recalled from table 1 that the exchange rate policy certainly succeeded in preventing appreciation of the real effective exchange rate throughout the 1990s. In fact there has been more or less consistent depreciation of REER, the index rising to 116.2 in the year 2000 with 1991 as the base year. There was only one year, 1994, in which there was any noticeable appreciation and in that year the index fell to 102.2 compared to 104.6 in the preceding year.

It can thus be concluded that the exchange rate regime has avoided any major misalignment in the exchange rate.

##### (b) *Exports and current account balance*

Table 3 provides the perspective on export performance of Bangladesh in comparison with the other major South Asian economies.

It is evident from table 3 that Bangladesh has performed better than the other major South Asian countries. However, improved export performance cannot be the sole objective of exchange rate policy. What happens to the overall current account balance is an important consideration. Table 4 presents data on current account deficit.

It is quite clear that Bangladesh's achievement in terms of containing the current account deficit is by no means unsatisfactory. It has done consistently better than Sri Lanka, and better than Pakistan in all the recent years excepting 2001. The

**Table 3. Average annual growth rate of export of goods and services**

Country	Period	
	1990-1999	2000-2001 <sup>a</sup>
Bangladesh	13.2	10.3
India	11.3	9.3
Pakistan	2.7	8.9
Sri Lanka	8.4	3.5

Sources: World Bank (2001) and ADB (2002 b).

<sup>a</sup> Relates to merchandise exports only

**Table 4. Current account deficit as percentage of GDP**

Country	Years				
	1997	1998	1999	2000	2001
Bangladesh	2.1	1.1	1.4	1.0	2.1
India	1.3	1.0	1.1	0.6	0.5
Pakistan	6.4	3.2	4.1	1.9	0.9
Sri Lanka	2.6	1.4	3.6	6.5	3.4

Source: ADB (2002 b).

only country with which Bangladesh compares somewhat unfavourably is India, but that should not come as a surprise even to a casual observer in view of India's high savings rate and level of industrialization.

### (c) *Inflation*

Experience shows that countries have developed with different degrees of inflation. Nevertheless, a consensus has emerged that high and unstable inflation rates are not conducive to development. High inflation reduces returns to savers and thus acts as a disincentive to save and invest. In particular, saving in financial form is likely to be discouraged. This complicates the task of mobilizing savings for productive investment. The viability of financial and capital market institutions which act as crucial intermediaries between savers and investors is impaired. High inflation is also likely to distort the pattern of investment in favour of real estate, gold or other forms of property as hedging devices without adding much to an economy's productive capacity. The international competitiveness of the economy is badly eroded by inflation. It generally encourages capital flight, exacerbates income distribution, gives rise to inequities in income distribution and aggravates poverty. Last but not the least, a high rate of inflation seriously undermines the popularity of the government.

The discussion of inflation in the context of the exchange rate regime becomes relevant because of two major considerations. First, a change in the exchange rate is almost certain to cause a change in the domestic prices of tradables. Second, the prices of non-tradables are also likely to be affected because the non-tradables often use tradable inputs and the demand switch generated by an initial change in the exchange rate may not elicit a corresponding supply response from the non-tradable sector to leave prices unchanged.

In the backdrop of the above arguments, it is useful to look at the performance of Bangladesh in respect of inflation. The relevant data are presented in table 5.

**Table 5. Inflation in Bangladesh and selected South Asian countries**

Country	Years					
	1996	1997	1998	1999	2000	2001
Bangladesh	6.6	2.5	7.0	8.9	3.4	1.6
India	4.6	4.4	5.9	3.3	7.2	4.7
Pakistan	10.4	11.3	7.8	5.7	3.6	4.4
Sri Lanka	14.6	7.1	6.9	5.9	1.2	11.0
South Asian average	5.8	5.2	6.3	4.2	6.2	4.6

Source: ADB (2002 b).

It is obvious from the data that Bangladesh has done reasonably well in terms of the inflation criterion. During the past decade, its inflation rate never reached double-digit level. In every year except 1999, the inflation rate in Bangladesh has been comparable to or lower than the South Asian average.

**(d) Remittances**

As noted before, remittances by Bangladeshi workers employed abroad play an important role in moderating the country's trade deficit. The country's performance in respect of remittances can be gauged from the table below:

**Table 6. Number of persons going abroad for employment and remittances**

<i>Year<sup>a</sup></i>	<i>Number of persons</i>	<i>Remittances (Millions of US dollars)</i>
1991	96 691	763.91
1992	185 106	849.66
1993	237 779	944.57
1994	192 263	1 088.72
1995	199 925	1 197.63
1996	181 462	1 217.06
1997	227 584	1 475.42
1998	242 811	1 525.43
1999	270 390	1 705.74
2000	248 291	1 949.32
2001	213 339	1 882.10
2002 (July to March)	139 000	1 811.10

*Sources:* Bangladesh Bank (2002) and Ministry of Finance (2002).

*Note:* FY 1990-91 is defined as 1991.

Table 6 shows that remittances in dollar terms have maintained an uninterrupted upward trend. There was only a minor blip in 2001.

The discussion in this section makes it abundantly clear that the performance of Bangladesh in terms of certain key objectives that an exchange rate regime is expected to promote has been quite satisfactory. In the minimum, therefore, it can be stated that the present exchange rate regime of Bangladesh has served the country reasonably well.

## V. SUMMARY AND CONCLUSIONS

The principal findings of the paper and their implications are summarized below:

- Bangladesh pursues an active exchange rate policy in the framework of a regime that can be characterized as one of adjustable basket peg.
- By and large, the country satisfies the conditions which justify the adoption of some sort of pegged exchange rate regime.
- In contrast, the economic and institutional prerequisites of a floating exchange rate regime are not met in Bangladesh.
- The experiences of other countries in the region show that a floating regime generates greater volatility in exchange rates. The attendant uncertainty is likely to affect adversely the overall trade and

investment climate which is already afflicted by many unfavourable elements in Bangladesh.

- The experiences of other countries also show that a floating regime does not eliminate the need for intervention in the foreign exchange market. Given the thinness of the market in Bangladesh, the need for intervention may be even greater in Bangladesh as the authorities cannot remain silent spectators when the exchange rate gyrates wildly.
- The present exchange rate regime in Bangladesh has served the country quite well. No major misalignment of the equilibrium exchange rate has occurred and the real effective exchange rate has not been allowed to appreciate. There has been satisfactory performance in terms of certain key macroeconomic indicators such as export growth, current account deficit, inflation and remittances by non-resident Bangladeshis.

Finally, it is instructive to bring to the attention of the readers the conclusions of a recent study by IMF economists (Mussa and others, 2000). According to this study, it can be safely stated that many developing and transition economies, especially those lacking a well-developed financial infrastructure including sophisticated financial institutions and broad and deep markets for foreign exchange (Bangladesh certainly belongs to this category), do not satisfy the requirements for a successful float.

In a different context, another IMF study specifically devoted to Bangladesh stated: "Given such pros and cons, the choice of exchange rate regime is not clear-cut. What matters is a set of sound economic policies that remain consistent with any chosen exchange rate regime" (Hossain, 2002, p. 23).

At a strictly philosophical level, one can argue that the exchange rate is a price and like any other price, it should be fully flexible. But to compare the price of foreign exchange which affects virtually all sectors of the economy with, let us say, the price of a pair of socks is both an intellectual absurdity and a practical folly.

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