



Institute of Governance Studies

BRAC University

POLICY BRIEF

Dealing with Foreign Exchange Reserves

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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.

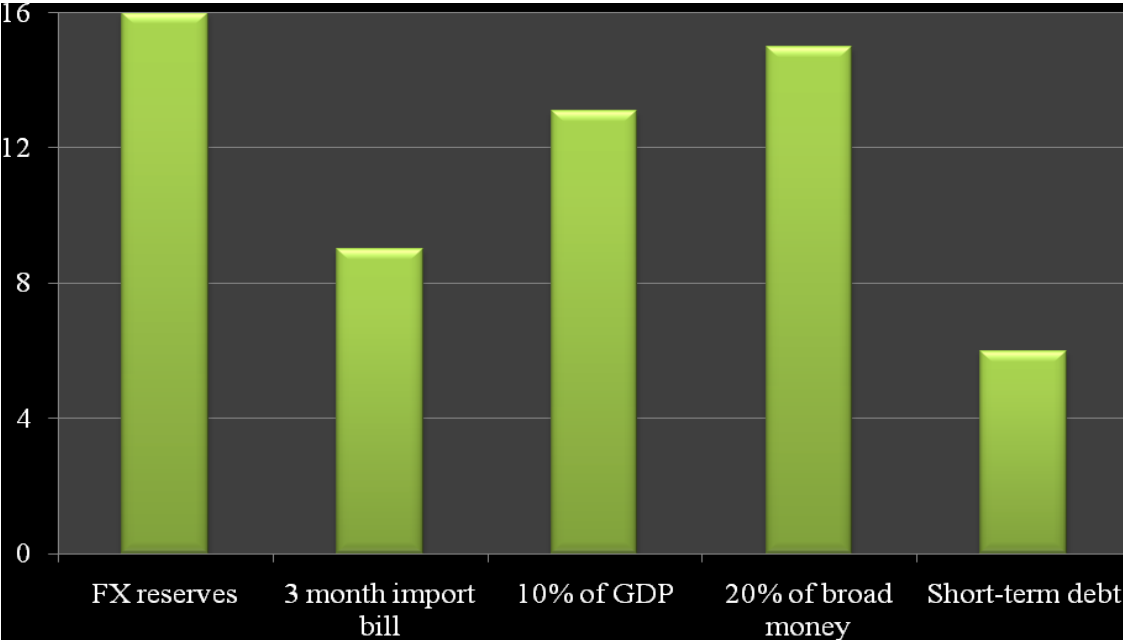
Bangladesh's current level of FX reserves seems excessive, although not markedly, based on key criteria that are relevant for the country. Reserves should account for at least three months worth of a country's import bills, a widely accepted measure derived from a trade-related approach to

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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.

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



Source: Author’s calculation based on Bangladesh Bank data

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.

The Institute of Governance Studies (IGS), established in 2005, is an institute of BRAC University, a private institution of higher education in Dhaka, Bangladesh. The University, established in 2001, has a goal to provide a high quality, broad-based education with a focus on professional development to equip students with the knowledge and skills necessary for leading the country with its quest for development.

IGS was established with the mission to identify, promote and support effective, transparent, accountable, equitable and citizen-friendly government in Bangladesh and South Asia. In pursuit of this mission, the Institute is dedicated to understanding the strengths and weaknesses of governance in Bangladesh and South Asia through research and academic pursuit. It aims to share the processes and path towards improving the foundations of governance in Bangladesh as well as regional and international forums.

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