Exchange rate system

Finance, Financial Analysis

The objective of this paper is to investigate the exchange rate volatility and its effects on international Trade in Bangladesh during May 2003-Dec 2008. The concept of the study is taken from one off the working papers of Bangladesh Bureau of Statistics (BBS), Bangladesh Bank, Centre for Policy Dialogue (CPD) and leading English and Bengali Dailies in Bangladesh. INTRODUCTION The depth and intensity of exchange rate volatility and its impact on the volume of international trade was recognized during 1970s when the world economy shifted from fixed exchange rate to free floating exchange rate. The hypothesis may be that if the exchange rate volatility is higher then it will generate uncertainty of the future profit from export trade. To mitigate the uncertainty, investors can go for currency hedge and minimize the uncertainty related to international trade in short time.

Exchange rate volatility may also affect trade indirectly by influencing firm's investment decision in the long run. In Bangladesh free floating exchange rate was adopted since May 31st. 2003. At the initial stage of the exchange rate, the fluctuation was very nominal. However, exports evolved largely in line with total world imports. Bangladesh's share in world imports was more or less stable after adopting the floating exchange rate. In 2003, the total amount of export of Bangladesh was US$ 6548.

44 million and in 2008 gradually it has increased to the amount of US$ 16333. 04 million and the growth is almost 2. 83 percent. On the other hand exchange rate was (US$1= Tk 50. 31) in 1990 and in 2008 it was (US$ 1= Tk 68. 50), which was increased by 1. 36 percent in 18 years.

A PREVIEW OF EXCHANGE RATE EXCHANGE RATE SYSTEMSExchange rate systems normally fall into one of the following categories: i. Fixed Exchange Rate ii. Floating Exchange Rate iii. Managed Float Exchange Rate iv. Pegged Exchange Rate i. Fixed Exchange Rate: In a fixed exchange rate system, exchange rates are either held constant or allowed to fluctuate only within very narrow boundaries. If an exchange rate begins to fluctuate too much, governments arbitrate to maintain it within the level of tolerance.

In consideration of the gravity of situations, a government may devalue its currency while in other cases it will revalue its currency against other currencies. Advantages: Multinational Company’s are able to engage in international trade without worrying about the future exchange rates. They reduce the risk of doing business in that country too. Disadvantages: The government is in a position to manipulate the value of the currency. Also, a fixed exchange rate system may make each country more vulnerable to economic conditions in other countries. ii. Floating Exchange Rate: Also known as a clean float.

In a freely floating exchange rate system, exchange rate values are determined by market forces without intervention by the governments. Advantages: A major advantage of this system is the insulation of a country from the inflation or unemployment problems in other countries. An additional advantage of this system is that a central bank is not required to constantly maintain ER within specified boundaries. Disadvantages: A country’s economic problems can sometimes be compounded by freely floating ER. Under such a system, MNCs would need to devote substantial resources to measuring and managing exposure to ER fluctuations. iii. Managed float exchange rate system: Also known as a dirty float.

It is similar to a freely floating system in that exchange rates are allowed to fluctuate on a daily basis and there are no official boundaries. It is similar to a fixed rate system in that governments can and sometimes do intervene to prevent their currencies from a sharp fall. Advantage: It prevents a crash in the value of the currency, should it happen. Disadvantage: Some criticize such a policy as it seeks to protect the home currency at the expense of others. iv. Pegged Exchange Rate: Under such a system, the value of the home currency is pegged to a foreign currency. The pegged currency moves in line with that currency to which it is fixed against other currencies.

Some currencies such as the Argentine Peso or the Chinese Yuan are pegged against a single currency (US dollar) while some others are pegged against a composite of currencies such as the composite of European currencies. Advantage: If a country conducts most of its trade with another country then pegged system yields benefit to both these countries as it virtually eliminated the exchange rate risk. Disadvantage: The risk associated with depreciation of that currency to which it is pegged. HISTORICAL OVERVIEW OF EXCHANGE RATE SYSTEM OF BANGLADESH Exchange rate regime of Bangladesh can be characterized mostly as a fixed rate system imposed and influenced by the government. Given an existing nominal exchange rate, the corresponding real effective exchange rate was estimated. If the real effective exchange rate (REER) as estimated on the basis of current par value significantly diverged from the desired REER, corrective response was initiated by changing the nominal exchange rate. The exchange rate policy decisions, though notified in all cases by the Bangladesh Bank, were made on behalf of and in close consultation with the Ministry ofFinance.

Bangladesh Bank did not have the sole authority over determining the exchange rate policy. Up to 24th May 2001, Bangladesh Bank used to announce specified buying and selling rates. From 3rd December 2000 Bangladesh Bank adopted the practice of declaring a 50 paisa (0. 50 Taka) band within which buying and selling transactions were to be undertaken; this band was widened to Taka 1. 0 from 25th May 2001. Even during the fixed regime, as mentioned earlier, Bangladesh pursued 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. REASONS FOR CHANGING THE FIXED RATE SYSTEM TO FLOATING ? Balance of Payments disequilibrium can automatically be restored to equilibrium. When the economy experiences a balance of payments deficit, there is excess demand for the foreign currency and the exchange rate of the local currency depreciates. This may have the effect of automatically restoring equilibrium. In such case, the value of local commodities falls from foreigners’ perspective making them more attractive abroad hence increasing export and value of foreign goods increases from domestic perspective making them less attractive locally. Both could lead to an improvement in the balance of payments situation. Floating Rate may decrease inflationary pressures and improve international competitiveness.

A floating exchange rate can reduce the level of inflation in LDCs like Bangladesh. Allowing the exchange rate to float freely should ensure that exports do not become uncompetitive. The basic idea comes from the Purchasing Power Parity theory. A high rate of inflation tends to make the exports uncompetitive. ? To keep pace with the other markets in South Asia where India (in1998), Pakistan (in 2000) and Sri Lanka (in 2001) have already introduced the floating rate system. Donors had also been putting pressure on Bangladesh to go for the floating exchange rate system and reportedly, obtaining foreign assistance from them also depended somewhat on introducing the new floating exchange rate system. Hence, it can be argued that pressure from the IMF and the World Bank was an important factor behind the regime change.

? Involvement of the government would stop under the new system where market forces determine the actual price of taka rather than the finance ministry or the central bank. CURRENT EXCHANGE RATE SYSTEM OF BANGLADESHThe Bangladesh Bank (BB) set foreign currency exchange rate band free from any regulation on May 29, 2003. It came into effect, officially from June 1, Saturday, when banks started to fix buying and selling rates of dollar and other currencies according to supply and demand situation under the free-float system. The BB however said that it would keep an eye on the market and intervene inmoneymarket and US dollar selling and purchase transactions whenever needed. The BB also said that it would deal with banks on dollar on a case-to-case basis. Though the official change came on May 29, BB was effectively pursuing the freely floating rates and did allow the banks to determine the rates for the past one year. The observed volatility was not significant during this period, which encouraged the BB to take this long awaited step.

The attraction of a floating exchange rate system is, that at least in theory it provides a kind of automatic mechanism for keeping the balance of payments in equilibrium. Besides, progressive devaluation of the Bangladesh currency, arising out of the fixed exchange rate, has been a regular feature during the last three decades. The devaluations and their effects on the economy subjected the governments to regular criticism by those affected by the same. Under the floating rate system, the need for such official devaluation of the currency will cease. However, the finance minister indicated that the new exchange rate system will not be totally devoid of official influence. The Bangladesh Bank is likely to resort to buying and selling of foreign currency from time to time to indirectly play a stabilizing role in exchange rate operations. A STUDY OF INTERNATIONAL TRADE IN BANGLADESHThe study evaluates the impact of exchange rate over international trade of Bangladesh in different points of concentration.

The study level includes the following aspects and elements of foreign trade: Exchange Rate More than a decade Bangladesh pursued a flexible exchange rate policy. Beforehand, the exchange rate of Taka used to be attuned from time to time to keep it competitive based on the rate of inflation and movement of exchange rates as well as trade weights with partner countries.

Introduction of free float exchange rate since May 2003 did not fetch in any major instability in the economy so far. Although, the US dollar linger stronger against Taka during the period of late 2003 through April 2004 but the situation after that did not aggravate and the value of Taka remained stable between May 2004 to August 2004. Since August 2004 Taka showed stability and from August 2004 to March 2005 Taka showed some resilience against US Dollar. Despite the rapid development of private sector with increasing credit flow; much higher growth in import of capital machinery and primary goods due to devastating flood and hike of the oil price in international market were mainly responsible for the fluctuation of exchange rate. Due to constant monitor and supervision by the central bank of Bangladesh and booster of greenback into foreign exchange market the exchange rate remained stable.

On June 30, 2004 the official and interbank market exchange rate of Taka-Dollar remained firm, whereas, the value of Taka was 59. 30 and 61. 50 correspondingly. Even though, in open market the dollar was charged comparatively more than interbank market exchange rate. However, on June 30, 2004 the exchange rate of dollar was moving upward slightly from Tk. 61. 0 to 62.

20 in this market. The exchange rates of Taka per US Dollar during the last decade is presented in the graph. Foreign Exchange Reserve The development of export earning and significant rise of remittance from the expatriate of Bangladeshis resulted in the voluminous stock of forex reserve in the country. In June 30, 1999 the foreign exchange reserve was US$ 1523

million, which was lower than the previous year by 12. 42 percent but it was increased in next year by 5. 17%more than the same date of previous year. After introducing the free floating exchange rate in Bangladesh on May 31, 2003 the reserved of foreign exchange was US$ 2470 million.

Further movement of reserve is depicted in the chart below. Export The study of the country wise export shows that USA is the major target market of Bangladesh to export merchandise. In 2004-05, Bangladesh exported largest volume of merchandise and commodities to US and held the top position inrespectof importing Bangladeshi commodities. YearTotal ExportGrowth rateExport as percent of GDP 2003-04437, 09829. 13. 1 2004-05532, 83121. 914.

37 2005-06691, 95029. 916. 63 2006-07850, 30922. 8918. 19 2007-08985, 93115. 9518. 19 During this period, goods worth of US$ 2, 412.

05 million were exported to the US, which was 27. 87 percent of the total export of the country. The major commodities exported to US were frozenfood, home textile, knitwear and woven garments. According to the commodity wise Bangladesh exported 45. 12 percent of woven garments, 14. 28 percent of knitwear and 40. 79 percent of shrimps of the total export to US in 2004-2005.

After US, Bangladesh exported most of the commodities to Germany and UK respectively. ImportBangladesh economyis more dependable on import as the largest portions of the products are coming from outside the country to full fill the domestic demand. However, apart from the basic commodities now a days Bangladesh imports the luxurious commodities as well to satisfied the social needs. YearTotal ImportGrowth rateImports as percent of GDPImports as percent of revenue receipts 2003-04630, 363 24. 518. 9174. 3 2004-05769, 954 22.

1420. 8196. 4 2005-06962, 345 24. 9923. 214. 48 2006-071, 118, 664 16. 2423.

9226. 12 2007-081, 496, 722 33. 827. 6247. 24 Balance of Trade Balance of trade of country defines the result of export import business of the country against rest of the world. Since the independence of the country, we have negative trade balance in the foreign trade. Main reason for trade deficit for Bangladesh is dependency on international country as well as international aid agency.

As a developing country, in many sectors especially for capital machinery and technological support, we have to depend on developed countries. According to the central bank data, the country's overall trade deficit stood at 113 million U. S. dollars in July period from 320 million U. S. dollars of the corresponding period of the previous fiscal. The country's import payment was 1, 555 million U.

S. dollars in July this fiscal year 2009-10 (July 2009-June 2010) while earnings from exports stood at 1, 442 million U. S. dollars during the same period. Balance of Payment A country’s balance of payments is commonly defined as the record of transactions between its residents and foreign residents over a specified period. Each transaction is recorded in accordance with the principles of double-entry bookkeeping, meaning that the amount involved is entered and each of the two sides of the balance-of-payments accounts by Koray, F. , and Lastrapes, W.

D. (1989). Boosted by a surge in remittances, Bangladesh's overall balance of payments surplus reached 694 million U. S. dollars in July, the first month of the current 2009-10 fiscal year, the central bank data showed Monday. The overall balance of payments (BoP) surplus of the South Asian country was 217 million U. S.

ollars during the same period of the previous fiscal year 2008-09 (July 2007 - June 2008), according to the statistics of the Bangladesh Bank (BB). For robust growth in remittances, the BB data showed, the current account surplus surged to 609 million U. S. dollars in July compared to 264 million U. S. dollars of the same period a year ago. It showed flow of net foreign direct investment, which stood at71 million U.

S. dollars in July against 100 million U. S. dollars of the corresponding period of previous fiscal, also contributed to keep current account balance remain healthy. But the central bank data showed the financial account balance stood at a deficit of 32 million U. S. dollars in July against the deficit of 221 million U.

S. dollars in the same period in last fiscal year. The BB data showed the country's remittance inflow grew 8 percent to 886. 39 million U. S. dollars in July, which also helped offset the impact of the trade shortfall. Sequent, the sums of the two sides of the complete balance-of-payments accounts should always be the same, and in this sense the balance of payments always balances.

However, there is no bookkeeping requirement that the sums of the two sides of a selected number of balance-of-payments accounts should be the same, and it happens that the (im) balances shown by certain combinations of accounts are of considerable interest to analysts and government officials by Cushman, D. O. (1988). It is these balances that are often referred to as “ surpluses” or “ deficits” in the balance of payments. The balance of payment of Bangladesh during the time period of 1990-00 to 2006-07 is shown in the table. EXCHANGE RATE MANAGEMENT IN BANGLADESH 1. Depreciation of currency entails several types of effects on the economy.

First, depreciation directly affects the rate of inflation through the level of the pass-through. Many studies including a recent one by the Bangladesh Institute of Development Studies (BIDS) found a high pass-through effect of depreciation of taka in Bangladesh. Since Bangladesh is an import dependent country, any change in prices in the international market will eventually transmit to domestic prices. Second, depreciation also affects output growth through different channels including the balance sheet channel. Third, usually a larger depreciation entails a smaller increase in interest rates and this has effect on the credit channel. Therefore, the overall impact of depreciation depends on the trade-off between these effects. 2.

Caught in this dilemma, the monetary authorities perhaps have chosen to keep the exchange rate nominally fixed or almost fixed for last two years, by intervening in the foreign exchange market. However, to manage floats or to maintain a long-term value of the currency, Bangladesh Bank must have to acquire a good stock of international reserves. Recent increasing trends of remittance and net foreign assets give us an indication of bright prospects of acquiring large stock of international reserves, which is now stood at round $7. 5 billion by which Bangladesh can meet up three to three-a-half months import cost. In the face of current account surplus with increasing remittance with low import demand, the taka is likely to face constant market pressure to appreciate. Market analysis also reveals the fact that the taka is now under the pressure of appreciation, but Bangladesh Bank maintains an undervalued taka through huge purchase of US dollars from the market to maintain export competitiveness. 3.

Occasional intervention in the foreign exchange market brings some positive benefits, particularly for developing countries like Bangladesh if the intervention is targeted to achieve some economic objectives such as stable inflation or trade competitiveness. A word of caution is in order if nominal exchange rate moves along a continuum for long time-it may create distortions in the market, such as macroeconomic symptoms of irrational exuberance, which include strong growth, accelerating inflation, rising international reserves, and gradual overvaluation (the loss of international price competitiveness). This is a troublesome situation and if it continues for long time, there might have the risk of possibility of crisis. 4. In this context, the concern is whether Bangladesh Taka is overvalued and to what extent. At the same time, it is of policy concern as to how the real effective exchange rates (REER) are managed. To analyze the macroeconomic consequence of exchange rate, the most popular approach is to look at the REER and its equilibrium position.

During 2007/08, the REER showed a depreciating trend, but it started appreciating from the last quarter of 2008. While depreciation indicates the competitiveness of our export sector, appreciation indicates the loss of competitiveness. With nominal exchange rate being fixed, REER showed depreciation in 2007/8 because of falling dollar against major currencies as well as high domestic inflation. From the last quarter of 2008, the REER shows appreciating trend because of globally declining trend of inflation and of rebound dollar. This gives us a mixed-bag feeling about the exchange rate management policies of Bangladesh Bank. Virtually we are not doing anything except keeping exchange rate fixed to a certain level. Looking at the REER movement, it was, in my assessment, possible to depreciate taka to a certain percentage in the latter half of 2008 in order to give boost to the ailing export sector due to adverse effect of global recession.

However, such depreciation would not have significant impact on inflation, as imports and the prices were declining at that time. On the other hand, since from the first quarter of 2009, exports have started gaining momentum and inflation is on a somewhat rising trend, a certain percentage appreciation of taka would likely to give a favourable twist to the economy. Instead of such dynamic approach, Bangladesh Bank takes the policy of maintaining a fixed rate system. This indicates that our exchange rate policy lacks dynamism and it is maintained on an ad-hoc basis. EMPIRICAL APPROACH AND DIFFERENT THOUGHTS Researchers found that the exchange rate volatility has a significant negative impact on the volume of exports in each of the G-7 countries. They also investigated the impact of exchange rate volatility on exports in four East Asians countries (Hong Kong, South Korea, Singapore, and Thailand). Their results indicated that exchange rate volatility has negative impacts on exports in both the short run and long run periods.

Some results indicated that the significant reduction in exchange rate uncertainty in the Brazilian economy during the crawling peg period might have contributed as much as the changes in prices toward the greater openness of the economy after 1968. Other studies were conducted thoroughly in the context of developing countries. The same negative results were achieved regarding the import volumes of a number of Southeast Asian countries. Estimation concluded that the increase in exchange rate risk has a significant negative impact on import volumes. However, researchers concluded that the cost efficiency by lowering price might not boost up the export demand significantly. Bangladesh export supply is a function of relative prices of its exports and the capacity output of the tradable sector. They have estimated the demand and supply models of exports with annual data and found that Bangladesh’s export is highly sensitive to the income growth of its trading partners and estimated that a 10% rise in a foreign income would raise the demand for Bangladeshi exports by 23%.

RECOMMENDATIONS AND POLICY STAND It may not be a good idea for Bangladesh to let everything to the market; however, it is also not a good to keep exchange rate fixed for a long time. There must have reconciliation between these two extremes and alternative policy options must be spelledout. It is necessary for Bangladesh Bank to pursue some pragmatic policies in managing the exchange rate through continuous monitoring of relevant indicators such as the REER, NEER, Export, Import, Inflation, Exchange Market Pressure, net foreign assets and domestic assets. In my opinion, a managed floating exchange rate system with a policy of short-term stability and medium to long-term flexibility might be appropriate for Bangladesh. Exchange rate can be allowed to move along the market trend to a certain extent and intervention can be done in order to smooth out the pace of depreciation/appreciation. More importantly, the REER index needs to be properly constructed and constantly monitored. For managing floats, an active intervention in the foreign exchange market requires the accumulation of a sufficiently large stock of reserves.

Therefore, exchange rate stabilization policies based on frequent and small adjustments is desirable. IN FINALE The exchange rate management in Bangladesh can be rated as good as it has not faced any crisis yet. However, still there are scopes to improve the exchange rate management by taking timely decision/correction. For which, the capacity for exchange rate management needs to be improved to reap the maximum benefits of a managed floating system. Even exchange market pressure in Bangladesh is likely to increase soon if the global economy starts recovering in a full swing. In that case, it would not be easy to keep the exchange rate fixed without proper monetary stance to maintain low or stable inflation. Therefore, for better management of exchange rate under a managed floating regime, Bangladesh Bank should work more on institutional development, bringing efficiency in the foreign exchange market and financial sector along with its own capacity building.

SOURCES OF DATA To do the analysis of the study the data has been used from May 2003 to Dec 2008. Total export and import of Bangladesh and country wise export and import data has been taken from various issues of Foreign Trade Statistic of Bangladesh issued by Bangladesh Bureau of Statistic (BBS). The exchange rate data has been gathered from Bangladesh Bank and The World Bank Group during that period. The systematic and objective process for gathering, recording and analyzing data has been used in this model. It has been tried to identify the issues, avoiding distorting effect of personal bias to find out the result of the hypotheses. At the end of selection and evaluation of the course of action analyzed based on the secondary data. REFERENCES Ahmed, M.

, Haque, N. , and Talukder, S. I. (1993), “ Estimating Export Demand Function for Bangladesh: An Application of Co-integration and Error Correction Modeling”, The Bangladesh Development Studies, 21, 89-104. Arize, A. (1995), “ The Effects of Exchange Rate Volatility on U. S.

Exports: An Empirical Investigation”, Southern Economic Journal, 62, 34-43. Asseery, A. , and Peel, D. A. 1991), “ The Effects of Exchange Rate Volatility on Exports”, Economic Letters, 37, 173 -177. Bailey, M. J.

, Tavlas, G. S. , and Ulan, M. (1987), “ The Impact of Exchange Rate Volatility on Export Growth: Some Theoretical Consideration and Empirical Results”, Journal of Policy Modeling, 9, 225- Kabir, R. (1988), “ Estimating Import and

Export Demand Function: The case of Bangladesh", The Bangladesh Development Studies, 115-127. Thursby, M. C.

, and Thursby, J. G. (1987), " Bilateral Trade Flows, Linders Hypothesis, and Exchange Risk", The Review of Economics and Statistics. 69, 488-495.