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Challenges to Central Banking in the Context of the Financial Crisis

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Panel II discussion session on international monetary system – some opening remarks by Governor, Bangladesh Bank

Session chairperson, fellow panelists, distinguished audience:

Let me begin with a brief recount of how Bangladesh fared in the recent global financial crisis and how the Bangladesh authorities responded to it. Because of regulated limited openness of Bangladesh to short term capital flows, her financial sector remained virtually unruffled by the global crisis. A small net FPI outflow (USD 159 million in FY 09) was far outweighed by sustained strong inflows of remittances from workers abroad, in part presumably transfers of their savings from jittery markets in host countries. Competitiveness of our apparels and textiles export sector kept overall FY 09 export growth in double digits, despite export decline in other commodities. Import of capital goods for new investment activities weakened in the recessionary global environment however, and food grain imports remained low with good domestic harvests. Low outflows for imports from the surging inflows of workers' remittances and export proceeds kept the local financial markets awash with liquidity, in sharp contrast with most markets elsewhere facing liquidity crunch caused by large scale flight of FPI and non resident deposits.

Bangladesh Bank guided the financial sector in utilizing the liquidity glut in supporting productive pursuits (lending in agriculture, SMEs, renewable energy and effluent treatment projects etc., sectors typically under served by markets) that strengthen domestic demand by increasing employment and income. Export sectors affected by weak demand were extended fiscal support (modest subsidies, tax/fee waivers etc.) from the government, which also increased social safety net expenditure for the weak and vulnerable population segments. Bangladesh Bank allowed temporary easing of bank loan rescheduling terms for affected exporters, besides allowing easy credit conditions to continue with supportive monetary policies. Growth of Bangladesh economy has consequently been impacted only modestly by the crisis, with 5.9 percent real GDP growth in FY 09 following 6.2 percent growth of FY 08. Current trends of economic activities indicate that real GDP growth is likely to be around six percent in FY 10; accelerating in subsequent years as export demand recovery gains firm traction. CPI inflation remains moderate (annual average 5.21 percent as of November 09), and is

projected not to exceed 6.5 percent by June 2010. Over the medium term Bangladesh is aiming at rapid poverty eradication with sustained strong and inclusive economic and social growth.

A few words now on each of today's discussion topics:

(i) Exchange rate policies and reserve accumulations: Export led large accumulations of foreign exchange reserves, aided by some extent of undervaluation of domestic currency, have for some years now been viewed as desirable buffers against regional or global instability. The global financial crisis has laid bare the limitations and costs of this approach. Undervalued currency attracts footloose speculative inflows (FPI, short term non-resident deposits) faster than can be absorbed in real sector investments; these inflows pile up in host country's foreign exchange reserves (fetching low returns in central bank's risk averse placements abroad) while the domestic currency equivalents of these inflows fuel price pressures in local asset markets. In hours of crisis these footloose funds exit quickly, leaving local markets in credit crunch and drawing down the reserves. Another effect of excessive reserve buildup is the heightened risk of fragility of central bank balance sheets, with huge exposures in the few reserve currencies, in some cases with exposures even in equity and commodity positions.

It may be appropriate therefore not to actively pursue continual reserve buildup once it attains a reasonably comfortable level, from then on avoiding deliberate undervaluation of domestic currency. Any incremental price pressure from domestic demand stimulated by this approach is likely to be offset by elimination of price pressures from currency undervaluation. Also, suitably channeling part of the current large reserve stocks to investments in regional bond issues financing real sector investments projects will be beneficial, with reserve resources supporting real output rather than ending up in speculative uses.

(ii) Management of capital flows: Over the past several years, persistent global imbalances have impaired orderliness of global capital flows, creating arbitrage opportunities for speculative capital movements. For advanced economies open in external capital account, avoidance of destabilizing capital inflow/outflow surges will be contingent on the expected reforms in global monetary order with adequate safeguards (including measures like the suggested 'Tobin Tax' on capital flows) against buildups of large imbalances. Pending global dialogs and their outcomes, spontaneous policy discipline in individual large economies aiming at balanced external positions will help progress greatly.

For countries like Bangladesh that are maintaining capital controls, opening up will be cautiously gradual. As of now, inflows and outflows of non-resident owned direct and portfolio investments are free of restrictions in Bangladesh, but short term Taka

money and Treasury bill markets are not open to non-residents. Outflows of resident owned capital for investment abroad are restricted; and aside from usual trade credit, residents can borrow abroad only for industrial projects, for medium or longer terms. Because of such cautious stance, Bangladesh had bop current account surplus even at the height of the global financial crisis. Gradual further consolidation of external sector strength will hopefully enable phased easing of the capital controls. Opening up of short term Taka money market to non-residents will help development of forward exchange market, but this may need to be accompanied by some sort of countercyclical taxation on FPI and other short term capital flows to discourage sudden destabilizing surges. External borrowing by resident owned businesses will be eased gradually with gains in the country's debt sustainability and credit rating. Investment outflows of resident owned capital will be opened up in the final phase, as domestic financial institutions and markets acquire strength and expertise to absorb and withstand the strains of large capital flows. Other developing economies will also presumably adopt broadly similar gradual approach in opening up to global capital flows.

(iii) Future of the global reserve system: USD and Euro are now the two major reserve currencies, a few other fully convertible currencies are also in limited use. Laxities originating from the persistent US imbalances that culminated in the recent global financial crisis have called into question the dominant role of USD as a reserve currency. Emerging imbalances in some EU member economies, unless sorted out, will eventually pose risk for overall external balance of the EU, with implications for reserve currency role of Euro.

In theory, a fully convertible currency of any economy maintaining external sector balance qualifies as reserve currency. In practice, speculators exploiting global imbalances render it potentially destabilizing for smaller economies to have ballooning buildups of non-resident balances in their currencies. For stability the global reserve system needs a handful (perhaps around four to six) of fully convertible currencies of fairly large individual economies /regional monetary unions in the discipline of a global order effectively maintaining imbalances at a minimum. Currencies of the larger fast growing emerging market economies like China, India and Brazil have potential for reserve currency role over the medium term. Currencies of new regional monetary unions would have been preferable given the typically stronger commitment of monetary Unions to balance and stability; but these can only be longer term prospects; it takes several years of sustained patient co-operation and integration to bring a successful monetary union into fruition.

For the global reserve system to function well it will need to be underpinned by a reformed global monetary order effective in maintaining balance and stability. This would need some mechanism tethering growth in global liquidity to the growth in real global output. A possible option mooted in Bangladesh sees a reformed IMF in a new role as the apex global monetary agency, annually issuing (or recalling) SDR allocations in line with actual or potential growth in global output; with liquidity issues in national or regional currencies by members needing to be fully backed by IMF SDR allocations, a mechanism in likeness of gold standard, with global output growth substituting for gold.

Numerous small developing economies like Bangladesh presently have little or no voice in global dialogs on issues affecting them, even though in aggregate they represent a substantial segment of the global population. Ensuring their meaningful, substantive representation in global dialogs needs to be seen as a priority.

(iv) Reforms in the IMF: Current basic quota (voting power) allocations in IMF are legacies of past dominance of North America and Europe; these need revision to reflect current realities. Here again, the reallocations for smaller developing economies need to take into account the significant percentage of global population they represent, beside their current minor shares in global economic output.

Under its current mandate the IMF has not succeeded in preventing buildups of large global imbalances from actions of its major quota holder members. The mandate for IMF in a new global monetary order will need to have adequate safeguards against laxities of members leading to persistent large global imbalances.

(v) The potential for developing regional monetary arrangements: Successful regional monetary unions require high levels of regional political and economic cooperation and integration attainable only by years of sustained, patient work. The European monetary union realized this way is an example inspiring others including us here in South Asia already operating a limited clearing union for trade settlements. Two monetary unions are operating in East and West Africa. Political will for developing new regional monetary arrangements will strengthen with beneficial results from co-operation and integration initiatives in trade, tariff and other policies preparatory to eventual monetary union. The reform agenda for IMF and the global monetary order may include discussions and analytical work on how best to support and promote regional efforts and initiatives towards regional monetary unions; because successful well functioning regional monetary unions are likely to better ensure global co-operation and stability than numerous individual economies of various sizes acting individually.

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