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External Sector Openness Management: The Bangladesh Experience

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Abstract

Bangladesh has had impressive growth in exports, remittances and foreign exchange reserve in recent year. By analyzing the liberalizing regime from 1979 to this date by adopting a comprehensive approach, this paper concludes that there is significant evidence in the short run as well as in the long run of external sector openness and economic growth. The degree of country's openness in terms of exports plus imports of GDP increased to 47 per cent in FY2013 from 21 per cent in FY1979. The exports to GDP ratio increased to 12 per cent in FY2000 from 4 per cent in FY1980. It rose even further to 21 per cent in FY2013. With limited opening of the country's capital account, FDI inflows accelerated to USD 17.3 billion in FY2013 from only USD 383 million in FY2000. Along with the increasing trend of remittances inflows, the country experienced surplus current account balance since FY2002 except for a deficit recorded in FY2011 and FY2012; in FY2013 the current account surplus amounted to USD 2.53 billion. Nevertheless, the country's reserve rose to the comfortable level at USD 20.3 billion as on 4 June 2014 (equivalent of 6 months of imports payments) from USD 1.6 billion at the end of FY2000 (equivalent of 2 months of imports). These developments in the country's external sector were, however, free from the contagion effect of the recent global financial crisis. Presently, the economy is also cushioned because of its limited openness. Undoubtedly, the successes evidenced ensue from well- managed external sector related policies and reforms.

Key words: external sector, openness, financial liberalization, foreign exchange, capital account

Introduction

External sector openness entails both trade liberalization and capital account liberalization, the latter being one of the components of financial liberalization. The existing literature suggests that both developed and developing countries have gained by opening their economies. From the nineteen-nineties, Bangladesh embarked on a path of accelerated reforms for financial sector development and increased openness to global trade and financial flows, to spur investment and output growth. Starting from the mid eighties, Bangladesh had gradually introduced various liberalization measures. The process was initiated by liberalizing its international trade by gradually minimizing the number of items hitherto restricted for trade, by reduction of tariff level and tariff dispersion, by simplification and rationalization of the tariff structure, by deregulation of the import process as well as by providing various export incentives such as Export Performance Licensing, Export Performance Benefit Scheme, Special Bonded Warehouse Scheme, Back to Back LC System, Export Credit Guarantee Scheme, Export Development Fund, and by allowing retention of exchange earnings, etc. Joining WTO from inception enabled trade and tariff liberalization.

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In the arena of foreign exchange regime liberalization, full convertibility of Taka for current external transactions came about by the mid-nineties. The exchange rate of Taka was floated with market-based flexibility in 2003. The range of foreign exchange regulations that allowed residents' access to foreign exchange for current account transactions have been expanded. Although resident- owned capital is yet to be permitted to move abroad, a series of measures has been adopted to attract flows of foreign investment. In financial liberalization, market-based interest rate policy was replaced to allow for directed lending and dictated interest rate policies in the early nineteen-nineties. This was followed by a number of other related measures, including new loan loss provision system, prescribing guidelines in key areas, and adoption of Basel-I, II & III.

How these measures for the greater openness of the country's external sector affected the overall economy and extended it is the main objective of this paper. This paper also examines Bangladesh's external sector openness in Section II. Impact of different policy measures and the development of the country's macroeconomic scenario and external sector are analyzed in Section III. The paper reviews different reforms and management issues on external sector openness in Section IV while Section V offers concluding remarks. The paper has been prepared based on secondary data and regulations adopted by Bangladesh.

II. Measuring Bangladesh's external sector integration

It is evident that Bangladesh economy has become more open and has integrated with an extended degree with the global economy during the last decade by adopting different policy measurers.

Table 1: A Snapshot of Bangladesh's external sector

Policy Criteria	Status
Exchange Rate	Unified
Exchange Rate determination	Floating
Payment convertibility Current account Capital account	 Yes Limited
Import restrictions Import licensing QRs on imports State monopolies	 No No No
Tariff structure Top Rate, FY2013 Average Protective Rate FY2013 Tariff slabs (customs duty) Para-tariffs	 25 13.9 0, 3, 5, 12, 25 Supplementary Duties
Existence of high level of NTBs	No
Trade Openness (trade to GDP ratio) in FY13	47 %

Note: NTBs: Non-tariff barriers.

Indeed, the country is now recognized as a 'trade dependent economy' and is no longer seen as an 'aid dependent economy'. The country's openness indicator measured by total exports plus total imports in per cent of nominal GDP increased from 18.5 per cent in FY1990 to 30.0 per cent in

FY2000. Throughout the decade, the growth of the ratio increased remarkably to 47.1 per cent in FY2013 (Chart 1). In terms of openness indicator, the figures reveal that in FY2013, the Bangladesh economy was more open compared to other economies in the SAARC region. In India, total trade (exports earnings plus imports payments) to GDP ratio increased to 43.5 per cent in FY2013 from 35.4 per cent in FY2010. Likewise, the Sri Lanka and Pakistan economies experienced a fall in the ratio in the last couple of years. For instance, the openness indicator in Sri Lanka declined to 42.3 per cent in FY2013 from its highest level of 66.7 per cent in FY2004 and in case of Pakistan it came down from 35.5 per cent in FY2006 to 27.2 per cent in FY2013. A view of exchange arrangements and exchange restrictions on capital flows of the major economies of the SAARC region is offered in Appendix-I.

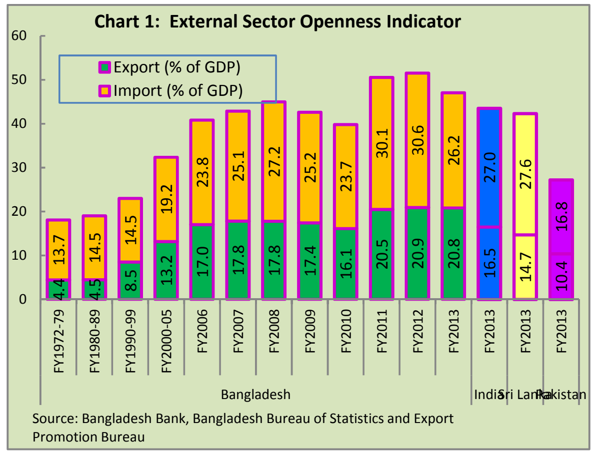


Table 2: Bangladesh Economy: Degree of Openness and Extent of Globalization

In million USD

Indicator	FY1972	FY1979	FY1989	FY1999	FY2009	FY2010	FY2011	FY2012	FY2013
Export (X)	356.8	618.8	1291.6	5312.9	15565.2	16204.7	22928.2	24301.9	27027.4
Import (M)	863.5	2459.0	3375.0	8006.0	22511.0	23738.0	33658.0	35516.0	34084.0
Remittances (R)	n.a	n.a	770.8	1705.7	9689.2	10987.4	11650.3	12843.4	14461.2
FDI inflows	n.a	n.a	n.a	394.1	960.6	913.0	779.0	1194.9	1730.6
Portfolio investment (net)	n.a	n.a	n.a	-6.0	-159.0	-117.0	109.0	240.0	287.0
Total globalization	1246.4	3605.8	6433.4	16279.7	49756.9	53315.1	70156.6	75635.2	78989.2
Trade balance (X-M)	-506.7	-1840.2	-2083.4	-2693.1	-6945.8	-7533.4	-10729.8	-11214.1	-7056.6
Current account balance (CAB)	**n.a**	**-331.4**	**-1386.0**	**-477.0**	**2416.0**	**3724.0**	**-1686.0**	**-447.0**	**2525.0**
Degree of openness	**18.5**	**21.1**	**17.8**	**29.1**	**42.6**	**39.8**	**50.5**	**51.5**	**47.1**
Extent of Globalization	**18.9**	**24.7**	**24.5**	**35.6**	**55.7**	**53.1**	**62.7**	**65.2**	**60.8**
X as % of M	41.3	25.2	38.3	66.4	69.1	68.3	68.1	68.4	79.3
CAB as % of GDP	0.0	-2.3	-5.3	-1.0	2.7	3.7	-1.5	-0.4	1.9
External Debt as % of GDP	0.0	21.9	37.7	32.5	23.3	20.3	19.7	19.0	17.5
Foreign Exchange Reserve	270.5	413.6	913.0	1523.0	7471.0	10750.0	10912.0	10364.0	15315.0
Reserve cover import (month)	4	2	3	2	4	5	4	4	5
GDP (current market price)	6604.4	14612.9	26224.8	45712.7	89359.8	100364.9	111943.8	116073.5	129862.0

Note: n.a= not available

Source: Bangladesh Bank, Export Promotion Bureau, Ministry of Finance.

III. External sector openness and economic performance in Bangladesh

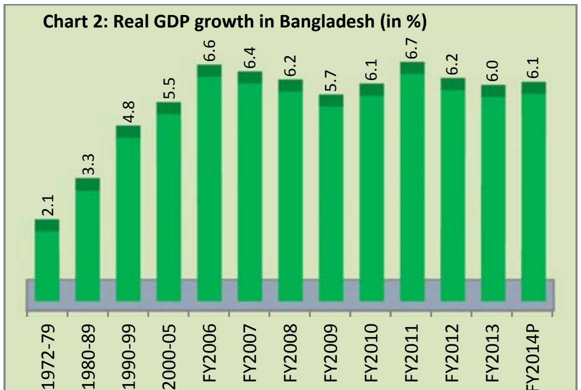
In fact, external sector openness is closely associated with the overall economic development of an economy as well as the process of movement of resources from a surplus country to a deficit country. In Bangladesh, strengthened policy frameworks and strong macroeconomic fundamentals along with current account convertibility and limited openness of capital account, significant increase of exports values and remittance flows have bolstered the country's economic growth. Moreover, external debts have become sustainable since they are largely concessional. Higher foreign exchange reserve has also been of comfort. The major economic indicators, such as real GDP growth, trade balance, FDI inflows and BOP are discussed in the following sections.

Global integration and economic growth

Macroeconomic performance in Bangladesh has been buoyant and momentum is indicative of real GDP growth: Signs of recovery of the 2008's global financial crisis in advanced economies are clear while some emerging market economies (EMEs) are also showing signs of a strong turnaround. The Bangladesh economy continues its buoyant performance. Since FY2004 it has achieved around 6.0 per cent annual growth, led by strong growth in industry, steady expansion in agriculture, and with major contribution from the service sector (which accounts for around half of the total GDP). The GDP growth has been driven largely by robust exports and strong increase in domestic demand. It is evident that increased capital flows have accelerated overall economic activities of the country.

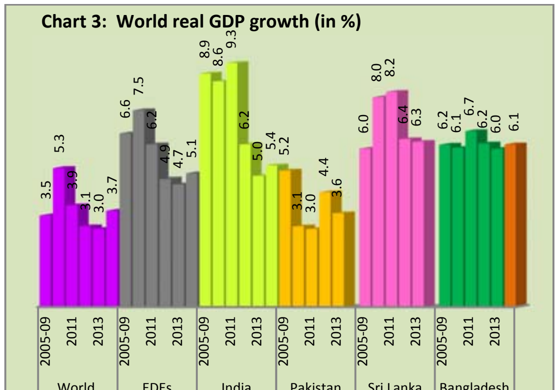
Outlays related to incentive packages from national budget have provided support to affected sectors and have extended the social safety net to uphold domestic demand and economic activities. Moreover, BB is maintaining a financial inclusion policy and growth-supportive monetary policy stance to maintain momentum in economic activities. As a result, the country's economy has evidenced 6.0 per cent real GDP growth in FY2013, although this is slightly lower than the 6.7 percent achieved in FY2011 (Chart-2). Although country-wide stoppages for political unrest occurred during the first seven months of FY14, very recently BBS has estimated 6.1 per cent growth of GDP for the year based on trends and performances of economic indicators. In contrast, the IMF has estimated 5.7 per cent growth for FY2014.

Chart 2: Real GDP growth in Bangladesh (in %)



Source: Bangladesh Bureau of Statistics (BBS)

Chart 3: World real GDP growth (in %)



Source: IMF World Economic Outlook (WEO), Update, January 2014

In Bangladesh, the data show that growth performance started to improve in the 1990s. During 1990s, the average GDP growth rate increased to 4.8 per cent from 3.3 per cent in 1980s. During FY2000 to FY2005, the average growth rate was above 5 per cent. Growth was achieved at 6.3 per cent in FY2004 and in the following years the growth performance remained over 6 per cent except in FY2009 when it declined to 5.9 due mainly to the adverse effect of 2008's financial crises and to political unrest in the country. Significantly, the structure of the economy has been transformed, with the share of agriculture shrinking from 58 per cent to 19 per cent and of industry expanding from 10 per cent to 32 per cent in FY 2013 from FY1973. Service sector contribution has also increased significantly and currently accounts for almost half of the GDP. The greater openness of the country's economy along with improved macroeconomic management have catalyzed economic agents and led to accelerated GDP growth.

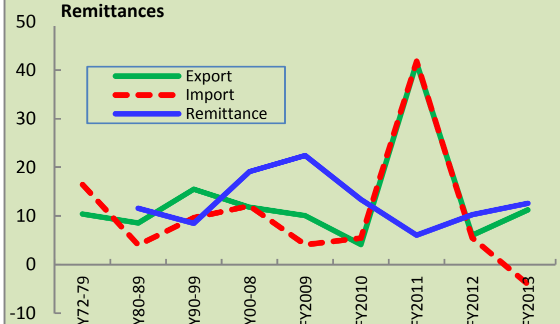
External sector developments

The external sector indicators— export, import, inflows of remittances, FDI and portfolio investment— have showed signs of improvement since late 1990s and over the years the trend has continued.

Merchandise exports: Steady and robust export growth has contributed to increase domestic production. Both the volume and value of exports have increased gradually in the last two decades. During 1980s, on average, Bangladesh earned only USD 0.44 billion from exports, which was only 4.0 per cent of nominal GDP. This has increased almost twenty times in the next three decades. The exports receipts recorded at USD 15.57 billion in FY2009 (17.4 per cent of GDP) and gradually increased to USD 27.03 billion in FY2013 (20.8 per cent of GDP). Except 41.5 per cent recorded growth in FY2011, exports growth has been moving on at almost around 10 per cent during the last couple of years (Chart 4).

Exports pattern has shifted to manufacturing products from agro-based primary products due to increased integration with the world economy. This is vastly different from the situation prevailing in the early 1980s. In that period jute and jute products of primary products category were the main export items. There has been a notable change in the composition of exports goods. During the 1980s the contribution of primary products in total exports was 30.0 per cent while manufacturing products contributed 70.0 per cent (of which readymade garments was 22.0 per cent). The scenario changed over the years; the contribution of industrial products increased significantly. In FY2013 manufacturing products accounted for 95.0 per cent of total merchandise exports of which the contribution of readymade garments (including knitwear) was 79.0 per cent; primary products accounted for only 5.0 per cent at this time.

Chart 4: Annual growth rate: Exports, Imports and Remittances



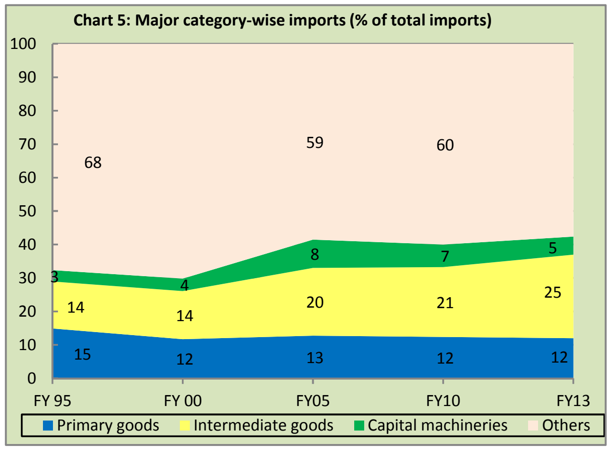
Source: Bangladesh Bank and Export Promotion Bureau

Table 3: Sector-wise exports (per cent of total)

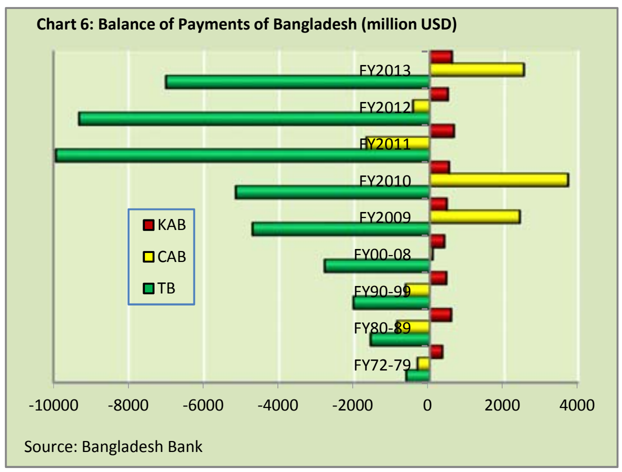
Sector	FY80-89	FY90-99	FY00-08	FY09	FY10	FY11	FY12	FY13
1. Primary products	29.9	13.4	7.2	5.4	5.6	5.5	5.7	5.2
2. Manufacturing products	70.1	86.6	92.8	94.6	94.4	94.5	94.3	94.8
of which Readymade Garment	22.0	61.9	75.3	78.5	79.3	77.1	78.1	78.5

Source: Export Promotion Bureau.

Imports payment: Imports of intermediate goods for domestic industries increased. The supportive measures to gear-up export-led growth, imports of raw-materials and capital machineries, increased over the periods that contributed to the increase of imports. In FY1972-79, year average imports payment (c&f) amounted USD 1.46 billion (13.5 per cent of GDP) and increased to USD 8.37 billion in FY2000 (17.8 per cent of GDP). With this continuous increase, imports payment stood at USD 34.08 billion in FY2013 (26.2 per cent of GDP). Imports of raw materials for manufacturing industries increased significantly to 25 per cent in FY2013 from 14 per cent in FY1995 due to emphasis on domestic industrial production. The share of imports of primary goods remained same at 12-13 per cent, except reducing the share of others sector to 58 per cent in FY13 from 68 per cent in FY95.



Current account balance: Improved current account balance is maintaining by the strong growth of exports and remittance earnings. Current account balance (CAB) of Bangladesh recorded a deficit accounted USD 326.8 million and clustered around 3.0 per cent of GDP in 1970s. The CAB deficit became wider in 1980s, in average accounted USD 869 million (4.4 per cent of GDP). During 1990s the deficit narrowed and improved. Following that the CAB recorded a surplus, amounted USD 157.0 million in FY2002 (0.3 per cent of GDP). The trends of surplus continued to FY2010 except a deficit accounted USD 518.0 million in FY2005. CAB recorded a surplus accounted USD 3724.0 million in FY2010 (3.7 per cent of GDP) (please see table 2). Next two years CAB became deficit and again in FY2013 it improved followed by a surplus amounted USD 2525 million.



Foreign Exchange reserve: Comfortable foreign exchange reserve continued. The foreign exchange reserve stood at USD 20.3 billion on 4 July 2014 (equivalent to about 6 months of imports). In Bangladesh, form its independence to FY1991, amount of foreign exchange was very small and below billion; it covered only 2 months of imports. The sign of improvements observed in FY1992. Reserve reached to a

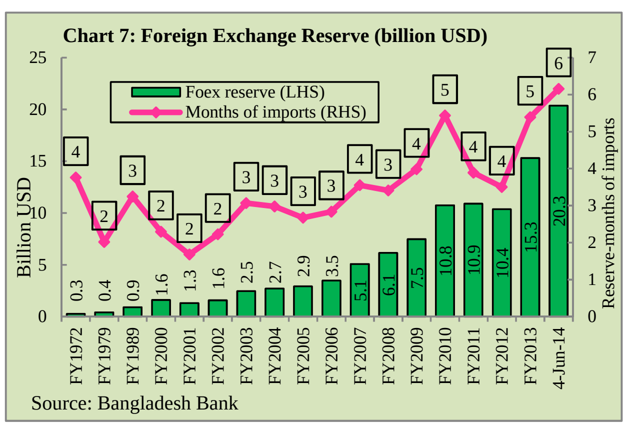
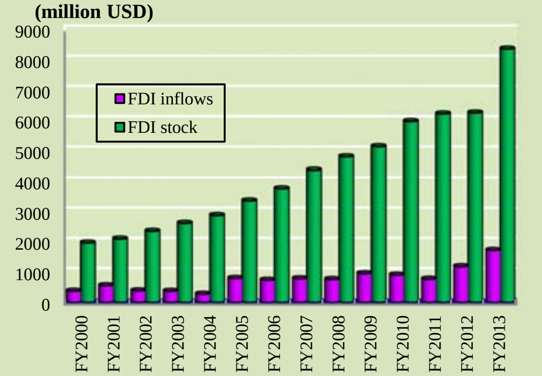


figure in billion accounted USD 1.6 billion in FY1992. Though the improvements continued to FY1995, further it became to fall during FY1996 to FY2001. However, reserve increased to USD 3.1 billion (equivalent to about 6 months of imports) in FY1995 that again came down to USD 1.3 billion (around 2 months of imports) in FY2001. Furthermore, the sign of improvement was shown in FY2003 and continued till date. During FY2010 to FY2012, the reserve position was above 10 billion. In end FY2013, reserve increased to USD 15.3 billion (equivalent of 5 months of imports) and further reached to USD 20.20 billion at end May 2014 (equivalent more than 6 months of imports). A strong export growth and remittance inflows contributed to build up the comfortable foreign exchange reserve.

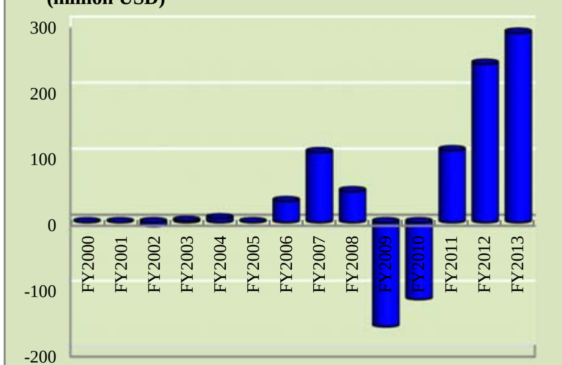
Foreign Direct Investment (FDI): Both foreign direct and portfolio investments showed increasing trend. Foreign direct investment (FDI) is a potent weapon for the development of any economy, especially in Emerging Market Economies (EMEs) by bridging the saving investment gap. It contributes to build up physical capital, create employment opportunities, develop productive capacity, enhance skills of local labor through transfer of technology and managerial know-how, and help to integrate domestic economy with the global economy. Capital flows not only enable recipient countries to achieve higher growth without sacrificing their current consumption but also provides befits foreign investors by earning higher returns on their capital investment. Over the last decades, almost all developing Asian economies including Bangladesh have progressively adopted more open policies toward FDI flows and this trend is likely to continue in the foreseeable future.

Chart 8: Foreign direct investment in Bangladesh (million USD)



Source: Bangladesh Bank

Chart 9: Portfolio investment (net) in Bangladesh (million USD)



Source: Bangladesh Bank

Bangladesh has a number of positive attributes to attract foreign investors from both developed and developing countries. Low wage rates compared to any other Asian countries, stable and single digit inflation, reasonably stable exchange rate, investment friendly custom regulations without any discrimination between foreign and domestic investors, tax holidays, and special investment zones with attractive incentive packages are available for foreign investors. Besides, tax-free access of Bangladeshi products in almost all developed countries such as EU, Canada and Australia and the benefit of double tax avoidance agreement with 28 countries, easy repatriation of profit and capital are also encouraging factors for FDI inflows. Nevertheless, Bangladesh could not attract significant amount of FDI inflows though the increasing trends of FDI inflows has continued. In Bangladesh, FDI stock rose to USD 8.36 billion at end FY 2013 (6.4 per cent of GDP) from USD 3.37 billion (5.6 per cent of GDP) in FY2005 (Chart 8). On the other hand, due mainly to the narrow capital market of

Bangladesh portfolio investment inflows and providing different incentives to attract portfolio investment inflows was also not notable (Chart 9).

Despite the country's sound macroeconomic fundamentals FDI inflow levels remain substantially lower in Bangladesh than in any peer group of countries. High cost of land, deficiencies of gas and power supplies and political instability are likely to be the main constraints to deter more FDI inflows. These constraints needed to be address to increase the kind of large FDI inflows aiming to attain the growth vision of the Government of raising the county's per capita GNI to the upper middle income country group by 2020.

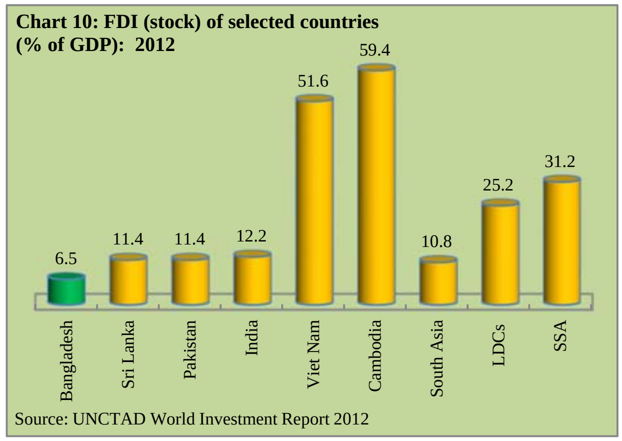


Chart 10: FDI (stock) of selected countries (% of GDP): 2012

Source: UNCTAD World Investment Report 2012

Government External borrowing and debt sustainability in Bangladesh: Significant reduction in debt ratios supports debt sustainability in the medium to long term. Bangladesh government possesses a favorable debt profile split between domestic and external debt to meet the deficit financing of the budget like some other countries. The Bangladesh Government's external debt to GDP averaged 37 per cent during FY1980 to FY2000, reaching an all time high of 45 per cent in FY1994. The situation has improved gradually since then because of the adoption of different policy measures to improve overall economic activities. From FY2001 to the present, the ratio was recorded at an average of 27 per cent. External debt to GDP ratio came down to 20 percent in FY2010 and further reduced to 18 per cent in FY 2013 (Chart 11). In the same way, government borrowing from domestic sources has remained constant around at 17 per cent of GDP during last decade.

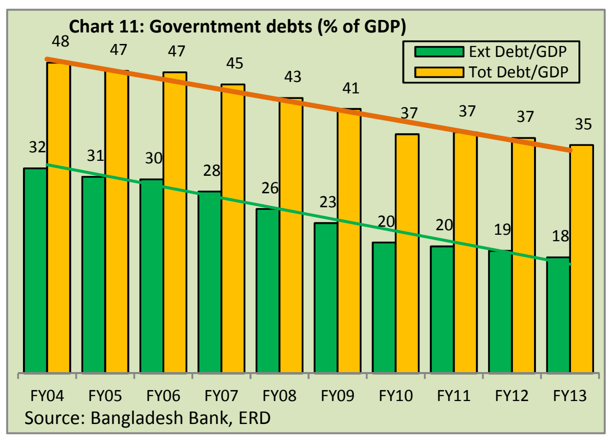


Chart 11: Government debts (% of GDP)

Source: Bangladesh Bank, ERD

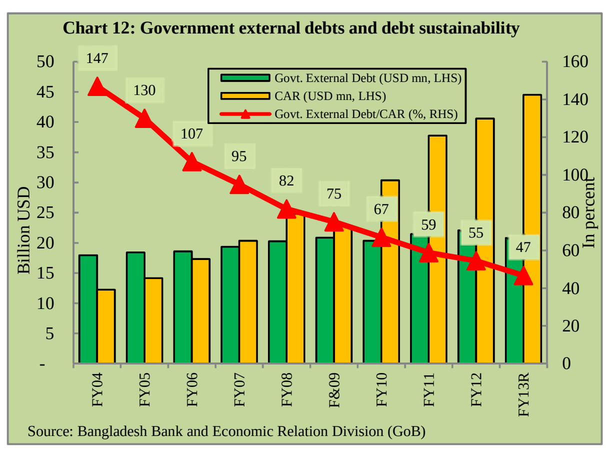


Chart 12: Government external debts and debt sustainability

Source: Bangladesh Bank and Economic Relation Division (GoB)

However, a closer look at the country's external debt reveals that most external debts of Bangladesh are from multilateral and bilateral sources and on concessional terms (they accounted for almost 81 per cent of the total external debt at end FY2013). The reports of the IMF, World Bank and other agencies reveal that the situation h is improving gradually and the level of debt stock is sustainable now. The result of debt sustainability analysis (DSA) based on major macroeconomic developments and borrowing needs updated on May 2013 indicates Bangladesh remain at low risk of debt distress.

In the same way, an assessment made by IMF has revealed that the current and projected structure of external financing does not raise external vulnerability concerns. The authorities should continue to seek maximum concessional base external financing and all non-concessional borrowing needs must be focused on high-impact projects, supported by improved investment selection projects. Such borrowings, however, should be closely scrutinized and monitored to ensure full transparency and sound governance. The debt service liability is modest at around 4.1 per cent of exports receipt. Moreover, debt to current account receipts (CAR= export earnings + workers' remittances + other foreign exchange receipts) ratio has showed a significant improvement in the last decade and the ratio decreased to 47 per cent in end FY2013 from 147 per cent in FY2004 (chart 12). Here, it is to be noted that that following the experiences of Sri Lanka, Bangladesh has taken an initiative to issue sovereign bonds aimed at reducing borrowing from the domestic banking sector. Yield of the bond will be determined by benchmarks facilities of private sector's issuance bond.

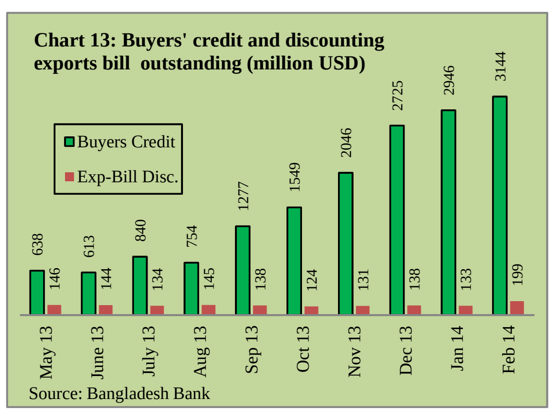
Corporate sector borrowing from abroad: Borrowing from abroad by corporate sector has been allowed very recently. Corporations established in Bangladesh are allowed to borrow on medium and long terms from abroad with prior permission of the Board of Investment. Proposals for such borrowings are being evaluated in terms of cost and viability by a high-powered committee headed by the Governor of Bangladesh Bank. Trends of corporate borrowing from abroad has been increasing gradually because of lower cost of fund and stable exchange rate; nevertheless, this amount is still not significant (2.1 per cent of GDP at end FY2013). External borrowings by the private corporate sector is well-managed and under full observation of the administration to eliminate the risk of unnecessary and costly borrowing and piling up of external debt burden.

Table 4: Corporate borrowing from abroad (in million USD)

Year	FY09	FY10	FY11	FY12	FY13
Private Sector Ex Debt	1605.5	1651.8	1584.5	1552.5	2731.1
As % GDP	1.80%	1.65%	1.42%	1.34%	2.10%

Source: Bangladesh Bank.

In addition, Bangladesh Bank is allowing buyers' credit for banks since 2012. Also banks are permitted to obtain short-term credit line from abroad for discounting export bills. Both initiatives have attracted enterprises. Evidence shows that the stock of short-term borrowing from abroad stood at USD 3.14 billion at the end of February 2014. Such substantial short-term borrowing (almost 16 per cent of foreign exchange reserve) is a signal to the authorities to take precautions since it may pose a risk to external liquidity as well as the exchange rate.



Though as a resource-scarce country, corporate borrowings from external sources can potentially provide liquidity support for Bangladesh it may also bring risks for the financial sector. There have been many instances where a country struggled to pay its total foreign borrowing. Such a situation depreciates local currency as well as strains foreign exchange reserve. To avoid any risk policy makers are more concerned for financial sector stability.

IV. Management of Bangladesh's External Sector Openness: Reforms and measures

Trade liberalization

At the beginning of independence, Bangladesh followed a public sector-led, import-substituting industrialization strategy. Bangladesh started to take various reform measures from the early 1980s introducing the New Industrial Policy (NIP) in 1983 with the aim of improving competitiveness, enhancing economic efficiency, dismantling state enterprises' interventions, increasing participation of the private sector, and promoting export-led growth. As a continuation of the process, significant reforms have been implemented in terms of external sector openness, trade liberalization and relaxation of foreign exchange regulations. Both tariff and non-tariff barriers have been reduced while quantitative restrictions (QRs) on imports and deregulation of import procedures have been reduced. Throughout the1990s and afterwards, the liberation process continued with the objective of achieving adequate export growth, reducing trade gap, and increasing FDI inflows, all of which impacted directly on GDP growth. Throughout the last decade, Bangladesh economy achieved around 6 per cent GDP growth compared to the 4 per cent recorded till 1996.

In Bangladesh trade liberalization deepened in 1990s and was further accelerated after 2000. Under the liberalization program, different types of customs duty and number of tariff lines were reduced (Table 5). The maximum tariff rate which was as high as 350 per cent in FY1991 came down to 37.5 per cent in FY2000. The rate came down even further to 25 per cent in FY2005 and onward and it has now been fixed at 25 per cent.

Bangladesh government has also taken pragmatic initiatives to reduce average import duties in order to ensure availability of different kinds of raw materials, machinery and equipments to promote industrial outputs. Higher tariff rates for finished goods stand while the rates for intermediate goods and raw materials and machineries are relatively low and are even zero for importing export-oriented products.

Table 5: Tariff Structure of Bangladesh

Year	Number of Tariff Bands	Operative Tariff (%)	Maximum Tariff Rate (%)	Import Unweighted Average Rate (%)	Import Weighted Average Rate (%)	MFN Unweighted Average Rate (%)
FY1991	18		350.0	88.6	42.1	n.a
FY2000	5	0,5,15,25, 37.5	37.5	22.4	13.8	n.a
FY2005	4	0, 7.5, 15, 25	25.0	16.3	9.6	16.5
FY2010	5	0, 3, 5, 12, 25	25.0	13.7	6.5	15.0
FY2011	5	0, 3, 5, 12, 25	25.0	13.6	6.1	14.9
FY2012	5	0, 3, 5, 12, 25	25.0	13.6	5.8	14.8
FY2013	5	0, 3, 5, 12, 25	25.0	13.8	n.a	15.0

Source: National Board of Revenue (NBR). Note: n.a= not available

Since the early nineteen-eighties to increase the access of Bangladeshi product into the global market, the process of publishing import and export policy has been continued on a regular basis (i.e. Import Policy 2012-2015, Export Policy 2012-2015). The import policy is devised to rationalize and simplify the trade regime by lowering tariff rates, phasing out the quantitative restrictions (QRs), and streamlining import procedures and tax reforms. Following the policies there has been a substantial reduction in the number of banned and restricted items. Whereas the total QR was 315 in FY1990 it has now been reduced to 63 in FY2006 and 18 in FY2013.

The government has attempted to promote exports through various measures. The policies adopted have emphasized the need to diversify the export base, make available raw material for exportable products, expand export destinations, stimulate higher value added-exports, improve the quality of exports, encourage the use of sustainable and environment-friendly technology, develop back-warded and forwarded linkage industries, ensure the best utilization of computer technology, facilitate e-commerce and undertake vigorous marketing efforts. Incentives are being provided to exporters in the form of reducing tariff and taxes for imports of raw materials, establishing export processing zones (EPZs), introducing Export Development Fund (EDF), considering special sectors, cash incentives, and duty drawbacks and through a number of other methods.

External sector liberalization

Since the early 1990s, Bangladesh has entered into the global gateway by taking different policy measures on the issues of exchange rate, foreign exchange regulations, foreign financial flows, etc. Such continued efforts have substantially increased the integration of Bangladesh economy into the global economy. The important policy measures and developments in this regard are discussed in the following section.

Legal Framework of Foreign Exchange Transactions

The Bangladesh Bank is empowered as administrator to regulate and manage foreign exchange transactions by the Foreign Exchange Regulation Act of 1947. In accordance with the Act, BB issues full 'Authorized Dealership (AD)' licenses for dealings in foreign exchange to scheduled banks. Non-bank financial institutions or other non-bank entities are not considered eligible as ADs for foreign exchange transactions. ADs are the only resident entities with general authorization to hold foreign exchange both in Bangladesh and abroad. Their holdings in foreign currency are subject to open exchange position limits prescribed by BB on consideration of their capital bases which is now 15 per cent of their total capital.

Besides ADs, licensed money changers are allowed to transact foreign exchange with customers but this is limited to purchase of foreign currencies from incoming tourists and selling foreign currency against travel entitlement to outgoing Bangladesh nationals. Some hotels, restaurants and shops are permitted to receive foreign currencies from foreign tourists against sales of their goods or services. Foreign currency receipts of these limited money changers are required to be sold to ADs against payment in Taka.

Interbank foreign exchange market

BB has been attempting to develop an active interbank foreign exchange market since the 1990s. In the interbank market, ADs are allowed to buy and sell on spot and forward basis freely within their prescribed "open position" limit. They can contract forward transaction with their non-bank customers against underlying needs only. They are free to undertake Taka-foreign currency swap for fund management. Cross-currency forward and swap not backed by underlying are also allowed subject to implementation of foreign exchange risk management guidelines prescribed by BB. No other hedging instrument like future or option exists. Though efforts to develop vibrant interbank foreign exchange market has continued, the volume of transaction in the market is not yet very significant but are as follows for the last few years:

Table 6: Interbank foreign exchange transaction (billion USD)

Year	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013
Volume of transactions	19.9	20.3	19.15	3.57	4.4	6.9	15.2	29.69	18.57

Source: FRTMD, BB.

BB buys and sells foreign currency from/in interbank foreign exchange markets directly to create a competitive foreign exchange market and to ensure sufficient liquidity. Presently, it is buying significant volume from these markets only to restrain appreciation of Taka against USD as well for building a large foreign exchange reserve.

Table 7: BB's role in interbank foreign exchange market (million USD)

Year FY	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013
Buying	70.1	-	649.5	-	499.2	2161	316	157	4539
Selling	459.5	-	-	533	-	-	1279	781	-

Note: - nil, Source: FRTMD, BB.

Developments of foreign exchange market

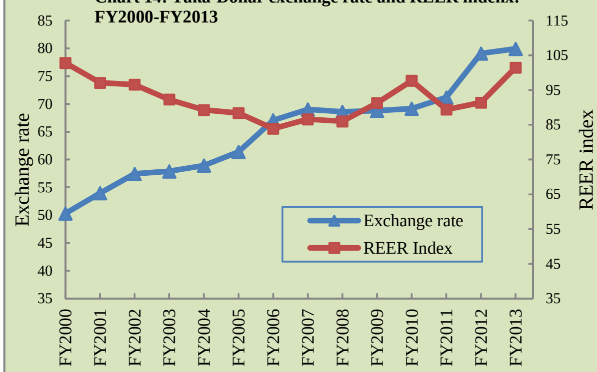
To activate an effective and efficient interbank foreign exchange market, BB has taken a few steps since the mid-1990s. Among them are: (i) adopting market-based floating exchange rate system; (ii) rationalizing Bangladesh Bank's intervention in the foreign exchange market; (iii) allowing transactions in USD only by Bangladesh Bank with other banks; (iv) fixing minimum amount of transactions with Bangladesh Bank; (v) permitting banks to quote freely both with bank and non-bank customers; (vi) allowing prescribed banks to use two-way quotations in interbank deals; (vii) abolishing foreign exchange holding limits (viii) prescribing Core Risk Guidelines in Foreign Exchange (ix) enabling formation of Bangladesh Foreign Exchange Dealers Association (BAFEDA) (x) establishing FC Clearing arrangement with BB; (xi) enhancing gradually open position limits of banks (xii) and introducing "Online Monitoring of Foreign Exchange Market".

Exchange rate experience

Since the adoption of floating exchange rate system from May 2003, the exchange rate is being determined on the basis of market demand and supply of the respective currencies. All scheduled banks are now free to set their own rates for interbank and customer transactions. However, BB continues to intervene to maintain orderly condition in the foreign exchange market.

Bangladesh started its exchange rate practice by pegging the exchange rate with Pound Sterling as the intervention currency on 1st January 1972; this system continued till July 1979 with several adjustments upon significant appreciation/depreciation of Sterling against other currencies. The period saw Bangladesh experience high double digits unstable inflation, unstable growth rate, and weak external position because of continuing deficits and very low reserve accretions. To reduce the average fluctuation of Taka against other foreign currencies important for the country's trade settlements, the single currency peg was discarded in August 1979 in favor of pegging to a currency basket comprising major 11 trade partner countries' currencies weighted according to their relative shares in the trade settlements of Bangladesh. However, sterling continued to be the intervention currency at this time. Because the settlements-weighted currency basket could not directly take into account the changes in relative position with some important trade partners (India, Pakistan) whose currencies were absent in the basket, a trade-volume weighted currency basket was adopted from January 1983 (8 countries' currencies) with new inclusion of Indian and Pakistani Rupee. The US dollar was then adopted as the intervention currency in view of its growing importance in international settlements.

Chart 14: Taka-Dollar exchange rate and REER indenx: FY2000-FY2013



Source: Bangladesh Bank

To take advantage of changes in inflation differentials with trade partners, the Purchasing Power Parity (PPP) based index of Real Effective Exchange Rate (REER) was brought into use in 1985. Bangladesh moved to the floating exchange rate system in May, 2003. Although some countries faced trouble in adopting floating exchange rate as exchange rate system, in Bangladesh, the early stage of the floating exchange rate regime was almost stable with low volatility and minimal depreciation of the taka against major trading partners' currencies due to adequate preparatory steps taken by Bangladesh Bank and the low inflationary environment at home and internationally. From FY04 to FY2010, the Bangladesh Taka remained stable against USD except for the substantial depreciation experience during FY05-FY06. The BDT, however, depreciated sharply during July 2010 to January 2012. Thankfully, it has showed an appreciating trend recently. Strong growth of remittance from wage earners abroad and flow of foreign aid with rationalization of import payments and moderate export growth has helped to keep Bangladesh taka competitive during the last couple of years. BB has remained vigilant in the foreign exchange market in line with its monetary policy goal of ensuring stability in the foreign exchange market. A trend of Taka-Dollar exchange rates for a decade is shown in chart -14.

The IMF in its country report on Bangladesh, December 2013 notes that the real effective exchange rate (REER) is around its fair value and is broadly in line with fundamentals. REER appreciated significantly in FY2013, supported by strong current account surpluses, large capital inflows, and faster price increases than in competing countries.

Current account liberalization

External liberalization process has been enhanced with the support from IMF under SAF from 1988 to 1990, ESAF from 1990 to 1993, PRGF/PRSP from 1993 and ECF from 2012 to onward.

The most significant measure adopted is the acceptance of current account convertibility in 1994. The declaration symbolized a turning point in the country's exchange management and exchange rate systems. Thereafter, restrictions have been being gradually removed for current account transactions and extensive powers have been given to the ADs to deal with current account transactions. ADs do not require prior approval from BB to conduct current account transactions within the indicative limit as set by BB. Major reform measures undertaken on current account convertibility are given below.

- **Repatriation requirement on earnings abroad and extent of permitted retention in foreign exchange:** Resident entities other than ADs are not entitled to retain funds outside Bangladesh and must repatriate to Bangladesh export receipts, factor income and any other earning abroad. Retention in foreign exchange with ADs in Bangladesh is allowed for exporters of goods and services, residents retuning from abroad, and for local shipping lines, airlines & licensed freight forwarders handling transportation of cargos for exports and imports.
- **Provisions in respect of funds of foreign nationals and non-residents:** Foreign nationals and non-resident Bangladeshi (NRB) can maintain foreign currency (FC) accounts with ADs in Bangladesh and have been permitted to convert foreign currencies so that they can send them abroad and vice versa.
- **Extended travel quota:** ADs are free to sell/issue foreign exchange for various needs such as personal visits or business visits abroad by residents, medical treatment or education or training abroad, etc. Residents of Bangladeshi and NRBs are allowed to endorse foreign currency up to the equivalent of USD 5000 for SAARC countries and Myanmar and USD7000 for non-SAARC countries under travel quota. They are also permitted to carry BDT 5000 while leaving or entering Bangladesh.
- **Settlements against trade and trade related services:** ADs are free to settle payments for all imports in conformity with the permissive import policy. Payments for invisible transactions related to authorize business transactions are generally not restricted.
- **Short term external borrowing for trade:** Importers can avail short term suppliers' credits/buyers' credit from abroad for tenure up to one year. Recently BB has allowed foreign owned/controlled industrial enterprises in Bangladesh to access interest free loans for working capital other than input procurements from parent companies/shareholders abroad for up to one year without any prior approval. Besides, exporters are allowed to access short- term foreign currency for import of inputs from Export Development Fund (EDF) on sight basis through ADs for up to 180 days. Export bills relating to direct and deemed exports of Bangladeshi products on usance basis, can be discounted in foreign exchange by the concerned AD of the exporter.
- **E-commerce abroad**: International credit/prepaid card can be used for hotel booking or online purchase of goods and services from abroad, subject to compliance with tax rules.

- **Recognition of service exports**: Service exporters (like freelancers, exporters of software, data processing, data entry, business services, consultancy, research works, etc.) can collect export proceeds easily and quickly through banking channels with very limited formalities where formal contract or LC is not mandatory.
- **Receipts of proceeds from invisible exports through OPG:** BB has allowed receipts of small value export proceeds against business process outsourcing, including information technology-related services through online payment gateway besides TT or draft.
- **Short term borrowing by ADs:** ADs may obtain short-term loans and overdrafts for a period not exceeding 7 days at a time from overseas branches and correspondents.
- **Establishment of Off-shore banking units (OBUs):** BB has permitted establishment and operations of OBUs in Bangladesh, allowing free foreign exchange transactions by 100% foreign-owned companies of Export Processing Zones and with persons who are non-residents in Bangladesh.

However, exchange regulations require residents to repatriate export proceeds and other foreign earnings, as also to file proof of arrival of goods against import payments within specified periods. Exchange regulations necessitate some extent of documentation requirement and bona fide checks on current transactions as well. For instance, travel-related foreign exchange needs, and royalty/technical fee payments abroad at higher than specified usual rates attract prior bona fide check before authorization.

Capital account liberalization

In the foreign exchange regime, to increase capital flows in the form of equity or loans, Bangladesh Bank has undertaken the following measures towards capital account liberalization:

- **Free inflows in both FDI and PFI:** Both foreign direct and foreign portfolio investment in Bangladesh are allowed except in a few reserve sectors. Investments in few sectors require permission. Foreign investors are free to buy and sell debt/equity securities from/to stock markets in Bangladesh. They are also allowed to buy shares of companies not listed in the stock exchange. Besides, NRBs are also allowed to invest and sell Bangladesh Government Treasury Bonds (BGTBs) at any time. Recently the government has withdrawn mandatory lock for a period for foreign investors.
- **No ceiling for Investment:** in Bangladesh, there is no ceiling on foreign private investment. Foreign investors are allowed to establish enterprises in full ownership although some countries allow foreign investment on joint venture basis only. Investors are permitted to repatriate their dividend/profit and proceeds of liquidation of investment.
- **Short term/long term borrowing from local banks:** Foreign owned/foreign controlled companies are allowed to borrow in short term or long term from the local market on banker- customer relationships. They are also allowed to avail working capital from the banks.
- **External Term borrowing:** External term and medium borrowing are also allowed, subject to approval of the Board of Investment where there is no discrimination between locally owned and foreign-owned companies.

- **Investment abroad by Bangladeshis:** Outflows of resident-owned capital for investment abroad remain restricted since domestic savings are inadequate for the economy's own investment needs. Sparingly granted exceptions permit (i) domestic banks to set up exchange houses abroad for attracting inflows from workers abroad; and (ii) business houses to set up offices abroad for export promotion and inputs sourcing.
- **Short term capital inflows:** Access of non-residents to Taka money market securities is still restricted to avoid speculative /volatile inflow and outflow surges of short-term funds.

External Sector Openness and economic shocks

In the last three decades, a number of countries have opened up their economies in terms of both current and capital account openness. Some of them have benefited from the initiative since they utilized and managed properly the in-flowing foreign capital for their economic development and growth. On the other hand, some countries had to face severe financial crises since they could not manage capital flows efficiently; the recent crisis in India was caused by its failure to manage foreign capital flows adequately. Experiences from both sides have given remarkable lessons for countries like Bangladesh. Exchange rate policies of the crisis-ridden countries were not suitable since their currencies were overvalued so that foreign investors were able to leave local currency denominated assets.

The world economy has experienced several crises during last three decades. Interestingly Bangladesh was not affected remarkably by any of that crisis, including the recent global financial crisis due mainly to limited financial openness with the global economy. The currency turmoil of 1997 in East Asia caused substantial depreciation of exchange rates of East Asian currencies and also of currencies of neighboring India and Pakistan which were major trade partners of Bangladesh. In contrast, the depreciations of the currencies of those trade partner countries of Bangladesh helped the economy rather than hurt it because of cheaper imports because the Taka had appreciated against their currencies as Bangladesh has a huge trade deficit with them. However, financial markets and institutions in Bangladesh have remained free of the toxic assets and contagion afflicting the global financial markets over the past couple of years, because of the limited, regulated external exposure of our economy.

V. Concluding Remarks

This paper has came up with the following findings and recommendations in regard to adoption of different regulatory/policy reforms for smooth functioning of foreign exchange market and capital inflows, widening international trade and integration with world economy along with the impacts of the changes policies on overall economic activities of Bangladesh.

We find that in line with a number of developing economies, Bangladesh has undertaken measures such as simplification and rationalization of trade and tariff structure and deregulation of import process. It has been providing incentives for exports, and had adopted floating exchange rate, full convertibility of Taka, and limited openness of capital account, and has undertaken initiatives of FDI flows to boost the country's domestic production through the integration with the world economy. These reform measures and efficient macro-prudential policies have extended the country's external sector with the global economy in terms of total trade (exports earnings plus Imports payments) in per cent of GDP. The trade to GDP ratio rose to 47 per cent in FY23013 from 18 per cent in FY1990.

This paper has also concluded that the Bangladesh economy has seen a stable exchange rate, single digit inflation rate, deepened and stable financial sector, increased remittances and FDI inflows, surplus CAB and comfortable foreign exchange reserve along with improved GDP growth. FDI inflows increased but yet significant. High cost of land, shortages of power and gas, lack of developed infrastructure and political instability are the main barriers for large FDI inflows. However, government efforts continue to achieve the goal of making Bangladesh an upper middle- income group country.

The question of whether Bangladesh should go for full convertibility of capital account is still being debated. We find that liberalizing measures such as current account convertibility, floating exchange rate, opening foreign investment both in the form of FDI and PFI have not posed any threat to the economy. Till now Bangladesh has not experienced any significant shock in its external sector but disasters may be experiences in the future. Full capital mobility is thus one of the important concerns to authorities in Bangladesh. Accordingly, a roadmap has been designed. Success of such a roadmap will depend on overall macroeconomic conditions as well effectiveness of the coordinated efforts of BB and other related Government organizations. Before embarking on full liberalization, preconditions must be met. In this context, a phased approach is workable but in each phase a package of reforms must be implemented to ensure that conditions for success are built in. Very recently, India has experienced a crisis in its external sector. Therefore, the experiences of the emerging market economies regarding full capital mobility and its shocks may provide effective lessons to Bangladesh in adopting proper policies to attain optimum benefits and to tackle difficulties on the way to full capital account convertibility in future. This paper therefore would like to end by stressing that full capital account convertibility is not an end in itself and should be treated only as a means to realize the potential of the economy to the maximum possible extent at the least possible cost.

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Appendix-I

Comparative picture of reforms on capital account transactions in major SAARC economies [Based on Information Provided in AREAER, IMF, 2013]

<table>
<tr><th rowspan="2">Issues</th><th colspan="4">Present Status of Exchange Arrangement and Exchange Restrictions</th></tr>
<tr><th>Bangladesh</th><th>India</th><th>Pakistan</th><th>Sri Lanka</th></tr>
<tr><td>FDI Inflows</td><td>Free except few reserve sectors, some sectors require prior Govt. Permission. There is no ceiling on percentage of equity to be held by foreign investors.</td><td>There are two routes, govt. route or permission route and automated route. There are restrictions on some sectors, some countries and level of equity to be held by foreign investors.</td><td>Inward investment is permitted except for a few areas where prior approval is required.</td><td>Foreign investment is allowed based on the type of business. There are ceilings on percentage of equity to be held by foreign investors.</td></tr>
<tr><td>Controls on liquidation of FDI</td><td>No prior permission is required for sale or transfer of shares. Sales proceeds of shares are freely remittable if the company is listed with any stock exchange; otherwise requires prior permission from Bangladesh Bank.</td><td>Generally free. RBI permission requires only for sale of shares when preconditions and norms are not met. Repatriation of after tax profit is allowable provided non-condition of non-repatriation was imposed when the original investment was approved.</td><td>No control</td><td>Proceeds from the sale or liquidation of approved investments along with capital gain may be remitted in full.</td></tr>
<tr><td>Dealing with Capital market securities in local markets by non-residents</td><td>Non residents are allowed to invest in the securities of both private and public limited companies. There is no ceiling on % of ownership.</td><td>Allowed subject to registration with the Securities and Exchange Board, India (SEBI) also there are ceilings on % of ownership and some other regulations.</td><td>Investment both in equity and debt securities are allowed.</td><td rowspan="2">Except for local purchases by non-residents of shares or other securities of a participating nature, all capital market securities and money market instruments are controlled.</td></tr>
<tr><td>Sale/purchase by non-residents in the money market</td><td>Not allowed</td><td>As above</td><td>No controls apply</td></tr>
<tr><td>Outflows of resident owned capital</td><td>Subject to prior approval of Bangladesh Bank</td><td>Allowed through automated route and permission route</td><td>Equity based inv abroad allowed with SBP permission. Portfolio investment abroad not allowed.</td><td>Residents may by shares/bonds issued abroad up to certain limit as set by Govt.</td></tr>
<tr><th>Issues</th><th colspan="4">Present Status of Exchange Arrangement and Exchange Restrictions</th></tr>
<tr><td>Money market instruments-purchase abroad by residents</td><td>Not permitted</td><td>Allowed subject to compliance with prescribed norms.</td><td>Not permitted</td><td>Not permitted</td></tr>
<tr><td>Money market instruments-sale or issued abroad by residents</td><td>Not permitted</td><td>Require RBI approval</td><td>Require approval of SECP</td><td>Not permitted</td></tr>
</table>

Borrowing from abroad other than short term	Subject to prior permission of Board of Investment	May be raised from abroad under the automated route subject to RBI Guidelines.	Allowed up to 12.5 yrs.	Up to USD 30 mil for three years ending Dec 2015. Higher amounts require permission.
Sale/Issue of share, bond or debt instruments abroad by residents	Requires prior approval of BSEC and Board of Investment for equity and debt instruments respectively.	Allowed through automated route subject to ceiling.	Residents are allowed to issue bonds/other debt securities with SECP approval.	Approval is required.
Issue of shares or debenture locally by non-residents	Not allowed	Issuance of collective inv securities by non-residents in India is permitted under some conditions.	With permission of SECP	Not allowed
Financial credits by residents to non-residents	Credit to non-resident individuals requires prior BB approval. However, banks may extend Taka credit facilities to non-resident controlled companies incorporated in Bangladesh.	Allowed in some cases	Not allowed, However, ADs may extend rupee ODs to foreign nationals.	Banks may extends rupee credit facilities to non-resident controlled companies incorporated in Sri Lanka

Appendix-II

Roadmap for liberalization of the foreign exchange towards full capital account openness in Bangladesh

Under the technical assistance from IMF, BB recently has framed a road map for further liberalization of the foreign exchange regime towards greater capital account openness. Under this program, 17 action agenda i.e. measures have been identified for being implemented within the next five years (by September 2017). The actions will have to be implemented in different phase's viz. short, medium and long term. The roadmap was aimed at creating 'a better environment for trade and investments' as part of a phased approach, easing resident business environment abroad to promote global integration. As per the said roadmap, the authority is supposed to withdraw restrictions on the capital account inconvertibility by 2017 to help Bangladeshis to invest abroad. The roadmap envisages the outflow of capital owned by Bangladeshis for investments abroad, short-term foreign investments in the currency market and bringing about reforms to minimize regulatory and administrative bottlenecks centering on FDI implementation. Other areas falling under the roadmap include review of a number of policies such as access of foreign-owned businesses to domestic borrowing, reporting system on import and export, simplification foreign direct investment procedures including net asset valuation rules, the repatriation of divestment from unlisted firms and procedures for short-term inflows from non-resident Bangladeshis. The roadmap also plans to set up a multi-stakeholder high-profile consultative body for recommendations on phased opening of capital account and draft of associated rules and regulations.

The authors broadly agree with the actions and their sequence of implantation as stated in the said roadmap and would like to suggest further liberalization toward greater capital account openness as mentioned in the road map. Based on the action agenda to be implanted in different phases authors would like to suggest further liberalization towards capital account convertibility may be follows:

Phase -1: Short Term (To be implemented by 2014)

- Reviewing the existing foreign exchange regime for all current account transactions
- Reviewing reporting routines for all current transactions
- Revision of Foreign Exchange Regulation Act 1947
- Devising communication strategy for effective dissemination policy;
- Setting up multi stakeholder high profile consultative body;
- Setting-up BB-Authorized Dealers Forum for regular dialogues fostering understanding of Fx policies;
- Review of operational modalities for money changers to enhance their viability and usefulness.

Phase II: Medium (To be implemented by 2016)

- Develop mechanisms and instruments to manage capital flows, safeguarding stability.
- Initiate Fx Transaction capacity enhancement programs in banks, including risk management.
- Review and simplify rules/procedures for short term inflows, especially from NRBs.
- Review FDI procedures, including the NAV valuation rule repatriation of disinvestment from unlisted firms, for feasible modification.

Phase III: Long Term (To be implemented 2018)

- Permit selective outflow of resident-owned capital for money market investments abroad.
- Follow up consultative committee suggestions on phased opening of foreign investment by residents
- Open up for short term money market inflows, subject to prudential regulation.

Preconditions for Moving into Full Convertibility-

Several studies have suggested that to move into full convertibility, some preconditions must be met, of which followings are more significant:

- Maintenance of strong Macroeconomic Fundamentals,
- Strengthening the domestic financial sector through internal financial liberalization,
- Ensuring adequate prudential regulation and supervision,
- Strengthening the capital market including market for the govt. bond,
- Adoption of appropriate exchange rate policy and intervention,
- Maintenance of appropriate time, sequence and pace,
- Financial structure of nonfinancial corporations ,
- Capacity building of the foreign exchange market including risk management,
- Political and regional considerations,
- Information base with monitoring key variables,
- Formation of a Monitoring Committee.
