

# Recasting the interest rate, exchange rate and inflation narrative

Sajjad Zohir  
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## **The magic perceived in high interest rates**

Many argue that the remedy to all woes in Bangladesh's financial economy lies in raising interest rates—be it in the name of repo, deposit rates, or lending rates. The arguments, if I understand the proponents, are as follows: An increase in interest rates will, firstly, increase the price of present consumption vis-à-vis savings (that is, future consumption).

The proponents possibly presume that this will increase deposits to banks, with less remaining in private hands to push prices of consumables up. Thus, an increase in interest rate works both to liquidate ailing banks by increasing deposits and to contain inflation.

Secondly, it will attract foreign private remittances, which will increase supply of foreign exchange, allowing an increase in the foreign exchange (FE) reserve as well as stability in exchange rates. The logic is often stretched further to argue that increased 'macro-stability' and adequate FE reserve will attract foreign direct investment (FDI), leading to increased employment and growth. With no good reason, some even hope to contain inflation in the medium to long term by following this route!

The first inference presumes that cash in private hands has only limited options: either spend on purchases of consumables or deposit in banks. This, however, is not true. People may hold on to cash in hand, which is especially true when sources of such funds are likely to be tainted.

People with cash savings in hand may also engage in self-financed (equity-based) investment, particularly on self-employed activities sought in distressed situations. While the last group may find high (deposit) interest rates attractive, diversion of funds away from micro and small investments adversely affects supplies, especially of food and other essentials, worsening the inflationary situation.

The second assertion regarding the inflow of private remittances is no less questionable. There was a time when foreign citizens of Bangladeshi origin (FCBOs) put their income from Bangladesh sources and savings sent from foreign lands to bank deposits (or Sanchay Patra) with high interest rates.

But several factors in the not-too-distant past prompted outward remittance by the same group. Those included a reduction in interest rate during FY2021-22, political uncertainties perceived to persist during 2025, and prevailing unknowns in post-tax net returns (especially for the FCBOs).

These lend little justification for raising the interest rate for attracting private remittances from FCBOs. Above all, the alleged size of private remittance from FCBOs (who constitute a segment of population that excludes non-resident Bangladeshis, the NRBs) is questionable.

It is understandable that people had often accumulated assets in the developed countries by transferring resources availing such means as under-invoicing exports, over-invoicing imports, or by availing hundi (that diverted earnings of genuine NRBs from points of origin).

It is also commonly understood that some such funds return under the guise of remittance from the US! To my knowledge, the size of such inward remittance is insignificant during normal years.

It is also possible that cross-border remittance flows through private financial institutions are being routed via New York or other financial centres, as has been the practice among many UN and multilateral lending agencies! Unfortunately, one is yet to see Bangladesh Bank come forward with an in-depth analysis on the mystery of private remittance flows between the US and Bangladesh!

In the absence of FCBO registration and a mechanism to record information on residency, it is apprehended that a short-term nominal inflow may be offset by large outflows of remittance in the not-too-distant future.

### **Demystifying inflation rates and their abuses**

Inflation rates are important in various decision-makings. Cost of living adjustment (COLA) in salary/wage fixation is commonly practiced in the organised sector, and published estimates on the inflation rate are an important determinant in such a fixation.

The real effective interest rate (REIR), a second relevant topic of interest for the present discussion, is arrived at by deducting the inflation rate from the nominal interest rate. A high inflation rate thus lowers the REIR and justifies a raise in the nominal interest rate.

A third variable of interest is the real exchange rate (RER) between two currencies (say, the US dollar and taka). If the nominal exchange rate is expressed as value of one unit of US Dollar in taka,  $e = \text{taka/US dollar}$ , the real effective exchange rate (taka/US dollar),  $RER = e \times P/P^*$ .

That is, the nominal exchange rate multiplied by the ratio of prices prevailing in the two countries,  $P^*$  (price level in the US) divided by  $P$  (price level in Bangladesh).

[The above formulation deviates from conventional expression, US dollar per unit of taka, since we are used to thinking in terms of taka per unit of US dollar.]

Given an initial nominal exchange rate ( $e$ ), when the general price level in Bangladesh ( $P$ ) goes up relative to the US (or the rest of the world), the real value of taka (captured by RER) actually diminishes further (which is equivalent to an increase in taka required to buy a unit of US dollar).

In an interestingly abstract world of circular arguments, a higher inflation rate will be interpreted to result in a higher price level in the Bangladesh market that subsequently reduces the real exchange rate, and the latter may be used to justify further devaluation of the taka!

Needless to mention that a devaluation of local currency in an import-dependent economy expectedly leads to inflation in prices quoted in local currencies!

Once the importance of the construct called 'inflation rate' is appreciated, one may assess the current practices in estimating it. Inflation, by definition, is a rate of change in prices. In a setting of multiple goods and services, general price levels captured by price indices (such as CPI) are considered.

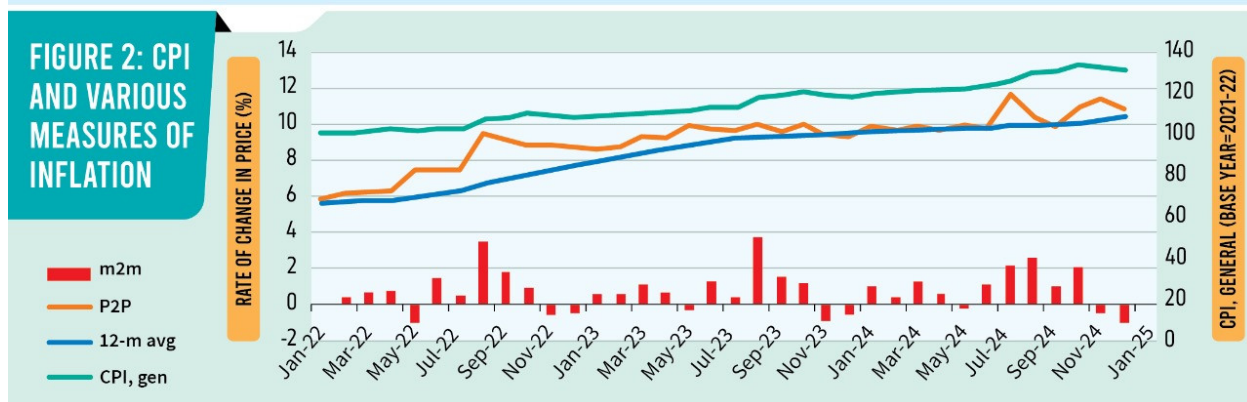
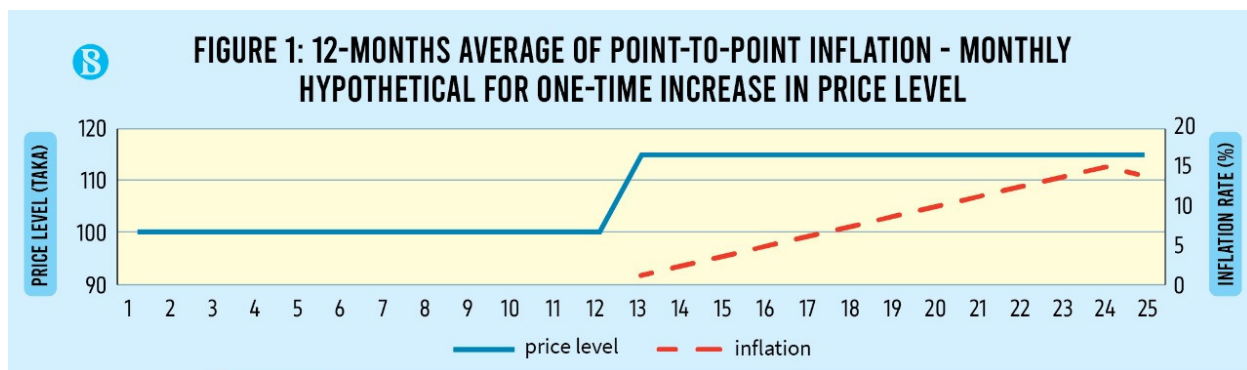
Even after skipping the distinction between Laspeyre's and Paasche's indices, one finds different ways of measuring inflation (rate). Point-to-point inflation normally considers months as 'points', and variation in monthly prices is the focus.

One may construct a percentage change in the current month's prices over the prices of the previous month. Alternatively, one may construct a percentage change in a given month's prices over prices during the same month in the previous year.

For smoothing out irregularities, it is a common practice among statisticians to take moving averages, and one such construct considers the average of point-to-point monthly inflation rates of 12 months as the inflation rate assigned to the last month of the 12-month period.

All available sources suggest that the inflation rates reported by the Bangladesh Bank are based on end-period constructs and, under the present circumstances, magnify the price inflation observed.

A simple illustration may be provided on the last statement. Consider a period of 12 months, say, July to June, when price remained constant at Tk100. Suppose the prices jumped by 15% to Tk115 on the 13<sup>th</sup> month (July), as shown by the solid line in Figure 1. The corresponding inflation rate, as calculated by 12-month averages of point-to-point inflation, as expected, continues to increase even when price level remains flat, till the end of a 12-month period.



In this infograph (Figure 1), with no further increase in prices, the inflation rate starts to decline, as shown in the broken line. The infograph shows that reported inflation rates may increase or decrease even when the general price levels remain constant!

Moreover, simultaneous reporting of point-to-point inflation and 12-month average inflation (assigned to last month) is sufficient to fool the general public about high inflation!

Figure 2 below captures the real data from BBS (and cross-checks with the Bangladesh Bank data). One may note that the general price levels declined in November as well as in December 2024. And yet, point-to-point and 12-month inflation rates exhibited increases due to the influence of lags in the calculation.

It is obvious that calculations based on 12-month averages will carry a one-time shock (increase in prices) for a maximum period of 12 months, and the decline in inflation rates beyond such periods need not necessarily be attributed to an increase in interest rate, as has been claimed in a recent statement by the BB Governor. The illustrations also reveal why (calculated) inflation will 'take a year to come down'!

### **Tale of two economies and the need to rethink policy**

Many tend to believe that Bangladesh's economy has gone into a long pause and the way forward remains unclear. Abstracting from the geopolitics and economic contracts tied to the strategic importance of Bangladesh, one may envisage several shades of Bangladesh's future, most of which are likely to tilt towards a remittance-dependent country.

Breaking away from a narrow view associating remittance with only the overseas workers of non-resident Bangladeshis (NRBs), a remittance-dependent economy is considered to be one where all labouring activities, be they carried out abroad or at home, are meant to produce goods and services for outside markets.

There are several variants of such labouring activities: (i) persons engaged in temporary works outside Bangladesh; (ii) export of goods; and (iii) export of services, where the latter is commonly tied to in-sourcing of services. Ironically, the literature often terms it as outsourcing, which is more appropriate from the perspective of agencies in developed countries whose services are in-sourced by countries like Bangladesh.

Under both the second and third options, FDI-supported investments in largely isolated geographic pockets called economic zones may shape the future economic landscape of Bangladesh. In such a setting, one may find corridors for labour movements between two 'economies'/territories, and some such instances in other parts of the world did not end in peaceful settlements!

The essence of this extremely remittance-dependent setting is as follows: All or most primary earnings of the national economic actors are in FE, and thus the income of the local workforce in those activities is also rooted in FE. Alternatively phrased, sustenance of those activities depends on assured access to the external markets, be it labour or goods & services.

Though the second set of activities under (ii) allow for partial formation of local institutional capital, Bangladesh clearly failed to translate some of the country's riches into building an ecosystem conducive to retention and expanded reproduction of that capital.

In such a trajectory, inflation is likely to be a regular companion unless the FE flows, especially utilisation of remittance earnings, are appropriately managed.

Unfortunately, high interest rate policy will aggravate the problems of transition by downsizing the local economy and turning the local society into a reserve pool of labourers whose services will be sold to the international market or to the enclaves of economic zones.

Surely, there will be a set of secondary income-earning activities to meet the demands of the labouring people, and that may also be in the grip of global retailers unless alternative measures are taken.

Generally, such economies increasingly slide down on the science and technology scale and drift away from the mainstream. Avoiding the Gaza syndrome and creating a different trajectory for the non-discriminatory model of two economies requires a major shift in the mindset of policy drivers. This note is only a preamble to a deep dive into those larger issues that demand serious attention.

**Sajjad Zohir is the Executive Director of the Economic Research Group. He can be reached at: [sajjadzohir@gmail.com](mailto:sajjadzohir@gmail.com).**