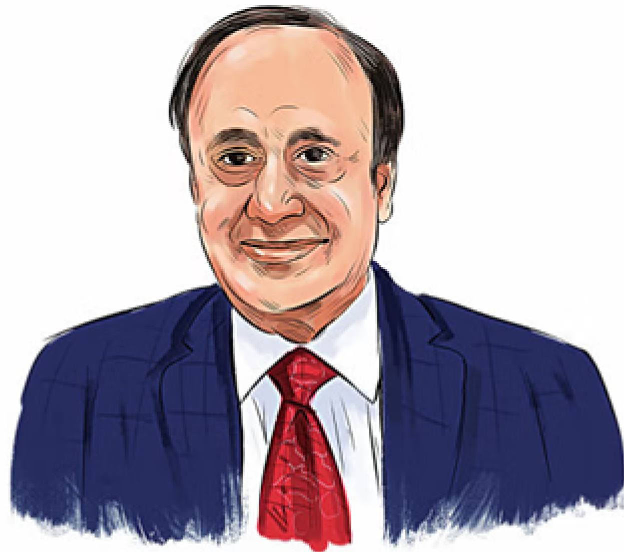

Fighting inflation sustainably

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Illustration: TBS

Persistent near double digit inflation is hurting consumers badly. There is near consensus in Bangladesh that fighting inflation is the topmost policy priority.

Why is inflation so persistent and what can be done to fight inflation comprehensively and sustainably?

There is considerable debate on these issues. A populist argument is that inflation is primarily due to the profiteering and greed of the "syndicates" who use their market power to continuously jack up prices. Some argue that inflation is caused by the large devaluation of the Bangladesh currency that is pushing up prices.

The syndicate theory of inflation is misleading. There is no evidence provided for this. It also begs the question why inflation was much lower between 2013 and 2022 despite the syndicates. Regarding devaluation, while there was substantial devaluation between January 2022 and September 2023 that exerted cost push pressure, the Bangladesh Taka has been relatively stable over the past 12 months. Additionally global commodity prices fell considerably after August 2022, which tended to offset the adverse effects of the Taka devaluation.

In a market economy prices are determined by demand and supply. While there are market

imperfections relating to information flows and efficient functioning of the supply chain, especially for perishable products, that can influence periodic price outcomes, on balance I believe prices in Bangladesh are based on forces of demand and supply. Just as prices rise when demand increases or supply falls, the rate of change of prices (inflation) is influenced by the rate of change of demand and supply. If aggregate demand grows faster than aggregate supply, the rate of growth of the price level (inflation) will increase. There are many factors that influence demand and supply. Fighting inflation sustainably requires policies to focus on ways to curb the growth of aggregate demand while pushing the growth of aggregate supply.

Demand Management Policies: In my book "Bangladesh Stabilizing the Macroeconomy " published in December 2023, I provided evidence that the fundamental factor that fueled inflation in Bangladesh since August 2022 was excess growth of domestic credit, mostly public sector credit, owing to the large stimulus packages of the covid-19 period (FY2020-FY2021) funded mostly through budgetary deficit and money creation, the continued financing of fiscal and quasi fiscal deficits (FY2022-FY2023) through money creation, and control over interest rates (July 2020 -November 2023) that pushed private sector credit growth and lowered the growth of bank deposits.

Monetary policy correction started in November 2023 when the interest rate was deregulated and financing of budget deficit through money creation was stopped. These policies were strengthened in May 2023 and further tightened during August-October 2024 period. The interest rate is now fully deregulated and monetary policy is strongly focused on inflation control. The monetary policy correction is a smart policy move and should be expected to have strong positive impact in lowering aggregate demand pressure on inflation.

I had also argued in my book that monetary policy alone cannot curb the demand pressure on inflation and requires strong fiscal correction. On the positive side, the fiscal deficit was reduced considerably in FY2024. But this correction happened through expenditure cutbacks and not through increase in revenues, The quality of fiscal adjustment is not good because relying solely on expenditure cutbacks will have adverse effects on the supply side through reductions in public investment and GDP growth. While the interim government is rightly focusing on the quality of spending by cutting waste and leakages, it is well known that many required public investment programs relating to human development and water management

are grossly underfunded. Focusing excessively on expenditure cutbacks to reduce aggregate demand is not likely sustainable and the effort must shift to greater revenue mobilization through tax reforms and reforms of the state owned enterprises (SoEs).

Supply Side Factors: Many observers are disappointed that despite considerable monetary tightening inflation remains stubbornly high at near double digits. There is also some skepticism whether monetary tightening has gone too far without favorable outcomes for inflation. This skepticism, however, is based on a partial view. A fuller analysis will show that the reason the full benefit of demand tightening for lowering inflation has not emerged is because of a large supply downturn that has happened over the past two years.

The depth of the supply crunch is indeed worrisome. The most immediate supply constraint factor is the sharp fall in imports. Between FY2022 and FY2024, imports fell by a whopping 22%, down from USD86 billion in FY2022 to USD67 billion in FY2024. Imports declined further in the first quarter of FY2025 by 1%. The import cutbacks are broad based. Food and consumer goods imports fell by 17%; intermediate goods by 24% and capital and other goods by 21%. In addition to contributing to domestic price escalation, these deep cutbacks in imports tell a rather sad picture of an economy in decline.

It might be argued that the surge in imports in FY2022 was largely the outcome of acceleration of global inflation. World inflation and commodity prices of key imports have fallen and stabilized since then. So, a fall in the value of imports is normal. However, looking at long term trend, the level of imports in Bangladesh consistent with a 7% GDP growth and 5-6% inflation rate should have grown from USD 61 billion in FY2019 to USD 86 billion in FY2024, whereas actual imports increased only marginally to USD67 billion in FY2024, reflecting the deep cuts in imports over the trend level. Exchange rate stability based on such deep cuts in imports is also not sustainable.

A second supply side factor is the slide in the growth of the manufacturing sector, which provides the large bulk of the domestic consumer goods outside agriculture. The manufacturing growth rate fell to 6.6% During FY2023-FY2024, down from an average of 12% in FY 2021-FY2022 and 14% in FY2018-FY2019. Unless the trend is reversed, manufacturing growth rate could dip further to 4-5% in FY2025. This deep slide in the growth of manufacturing output has contributed substantially to the slowdown in the growth of

aggregate supply. Although the sharp downturn in manufacturing output is disproportionately affected by the turmoil in the textiles and RMG sector, the growth reduction has spread to a wide range of activities affecting the supply of consumer goods owing to intermediate import cutbacks, energy constraints, and most recently by deterioration in law and order

Finally, the recent flooding created some short-term adverse effects on agro-food prices during the August-September months of 2024. There are now reports of better supply of vegetables in October easing inflationary pressures on these products. Continued monitoring and support to farm production is essential to manage inflationary pressures.

The Way Forward: Except for domestic resource mobilization, the demand management policies are mostly on track. Effort now needs to focus on improving the quality of the fiscal adjustment by raising domestic revenues through reforms of the tax system and through SoE reforms. The agenda is well known and documented in detail in my book on Stabilizing the Macroeconomy. Policy effort to control inflation on a sustainable basis must now shift to the recovery of the growth of supply, both from imports and domestic production.

Bangladesh is an import dependent economy for a wide ranging products and the smooth flow of imports is essential for both inflation and economic growth. From the inflation perspective, efforts are underway to enhance imports of essential food products and lower their cost by reduction of trade taxes. This is a sound policy move. More generally, there is a need to rationalize the trade protection regime with a view to sharply cutting trade protection, which will be beneficial for both inflation control and export growth. Furthermore, all non-tariff import restrictions imposed during 2022-July 2024 to reduce imports need to be re-examined and eliminated to facilitate the inflow of imports.

Regrading domestic production, farm output support mechanisms including supply of fertilizer and farm credit must be strengthened. Taxes on imported farm inputs should be lowered. Distribution system for farm products should be strengthened by removing all octroi/toll collection ports.

Concerted policy attention should be given to examining the constraints to manufacturing production and removing those constraints. In particular, the recovery of RMG sector is essential to increase exports, which will support the sustainable expansion of imports without

putting undue pressure on the exchange rate. For the manufacturing sector as a whole, the easing of supply of intermediate imports will help the recovery of manufacturing growth. Additionally, strong efforts are needed to ensure uninterrupted supply of electricity to the manufacturing units. Finally, greater attention to law and order is critical to the recovery of the manufacturing sector.

In conclusion, sustained reduction in inflation is a medium term challenge that requires strong policy actions to restore the expansion of imports, regain the momentum in manufacturing sector production, and ensure strong farm production. Alongside, prudent macroeconomic management consisting of market based exchange and interest rate policies, low fiscal deficits based on domestic resource mobilization, and sound public expenditure policies to support energy, agriculture, water, transport and human development services are necessary. In the short term, focusing on food imports with low or zero trade taxes and increase in social protection spending will help reduce the burden of high inflation for the poor.

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