Inflation and politics: Issues not to be overlooked

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SINCE Bangladesh has been passing through a period of high inflation, "bringing down high prices" is a
legitimate political slogan. High prices caused by inflation, identified as the primary concern of the Bangladeshi
voters, forced political parties to include it as the number one item in their manifestos.
"Bringing down prices to levels affordable to the common people" is clearly stated in the manifestos and
underscored again in the televised speeches to the nation by the heads of two major political parties. What is not
explained is how they are planning to achieve a substantial reduction in the price of basic commodities like rice
and edible oil.
In the absence of a credible and publicly spelled out economic strategy, the economic statements of our political
parties may end up being empty slogans or execution of ill-designed populist measures causing more harm than
benefit to the economy and people in general.
In the absence of any further elucidation from the political parties, this column focuses on some general and
Bangladesh specific considerations, which future policy makers should take into consideration. The most
important factor that needs to be taken into account is that this recent inflationary episode was caused by supply
shocks of domestic (floods and Sidr) and international origins.
Economic theory tells us that when inflation is caused by supply-side shocks there is very

little that the central
banks can do to contain inflation through monetary policy. The best approach to overcome the problem is to
increase domestic supplies through supply-side measures, hope for the unwinding of the global shock, and
undertake targeted measures to provide food and income support to the poor and vulnerable.
Looking at the inflation picture globally and in the South Asia region, one can easily observe the global nature
of this inflation episode.
There was very little that governments and central banks could do to contain inflation across all of these
countries. Even India, which has vast domestic resources and which did not experience the kind of massive
domestic supply shocks experienced by Bangladesh, recorded similar or higher inflation than Bangladesh.
The inflationary pressure came like a tsunami across the globe, and is also receding fast with the collapse of
global commodity prices caused by the intensifying global financial crisis (Figures 1 and 2). Since petroleum
and other commodity prices peaked in July/August, commodity prices declined sharply across the board,
following a collapse in petroleum prices. Inflation in Bangladesh also tumbled from its peak of more than 12%
in July to 6 percent in November. Most regional countries also experienced similar reductions.
Is this significant gain on the inflation front attributable to government policies? Objectively speaking, as much
as the government was not responsible for the surge in inflation and could not do much to fight against it, it does
not deserve much credit for the rapid reduction in inflation.
The areas where the government policies were effective included input subsidies (fertiliser and fuel) and other
administrative interventions to improve supply (distribution of fertilizer and seeds) and alleviate hardships

caused by inflation through widening of the safety-net programs. Certainly, the relatively better inflation performance of Bangladesh was in part attributable to the government's intensified efforts to generate strong supply response from the boro crop.

Looking forward, we expect a further significant reduction in inflation in the near term, given the expected strong domestic supply response and the outlook for a more prolonged global recession. Inflation (point-topoint) coming down to 2% or even below in 2008/09 would not be surprising, given the current global outlook.

The politics of inflation generally refers to the high level of prices and the affordability of basic commodities by the ordinary people. This concept is fundamentally different from the economic concept of inflation, referring to the rate of change in the price level and not to the level itself. Thus, even with inflation coming down to a low single-digit level, since price levels for basic commodities like rice may remain high, political commitment to reduce basic commodity prices may lead to a deflationary situation with associated negative impact on economic activity and employment.

In particular, if rice prices are brought down to levels below the current cost of production, it will either lead to a sharp drop in rice production or a sharp increase in subsidy and fiscal deficit, contributing to higher inflation or unsustainable public debt.

Since inflation is coming down sharply on its own due to supply-side developments (Figure 3), the next government should let it happen through market forces and by containing domestic demand and wage pressures through prudent macroeconomic management.

While intensifying positive supply-side efforts (continued supply of subsidized inputs like fertilizer, electricity and diesel and extension services) to increase productivity and thereby reduce prices, the

new government must
avoid any direct intervention and other market distortion in the context of fulfilling election promises.

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