Inflation: Are better times ahead?

Friday, Sep 19, 2008

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LIKE most other countries, Bangladesh has been suffering from inflationary pressures in recent months.
Although Bangladesh generally had a good track record on inflation, it could not insulate itself from the global
phenomenon due to both domestic supply shocks arising from two rounds of flood and the cyclone Sidr and
external shocks arising from global energy and commodity prices.
While inflation at about 10 percent is not out of line with our neighbouring and many other emerging
economies, the hardship it caused for the poor is real and, if continued for long, could seriously undermine
many of the social sector gains achieved in recent years. After months of oppressive inflationary pressure,
people in Bangladesh must be wondering about what lies ahead since domestic supply situation has improved
and international commodity and energy prices are on a declining trend.
On the domestic supply front, a strong rebound in agriculture and manufacturing sectors would definitely help
price stability. In the crop sector, record boro, potato, wheat, and maize outputs and the favourable outlook for
aus and aman have eased domestic supply situation. Bangladesh should be able to achieve its cherished
objective of self-sufficiency in rice this year. This favourable outlook, coupled with the sizable stock of rice that
the government has already built up, should enable it to insulate domestic rice prices from

their current high
international levels.
Rice stock has increased to about 1.2 million tons, moving closer to the government target of 1.5 million tons
and well above the level of 0.5 million tons last year this time. The crop outlook and the higher stock level have
also created the unusual phenomenon that in the lean September-October period, usually considered as the
seasonal high points for rice prices, we are observing a moderate decline.
Developments on the external front are also turning more favourable, after a broad-based price shock
experienced in the last 12 months. Most basic commodity prices surged to record highs globally in recent
months, following the surge in crude oil price. As the major economies of the world are currently slowing down,
commodity prices have started to retreat from their historic peaks, following the lead of crude oil prices which
has already come down by more than 30 percent since its peak in August.
Bangladeshi consumers are likely to gain in particular from the corrections in edible oil, wheat, sugar, and other
basic commodities. Price of palm oil has already come down to Tk. 71-75 per kg, the level it was a year ago.
Soybean oil prices are also coming down, albeit somewhat less than palm oil. Rice prices in Bangladesh,
although high by historical standard, are already well below the world market, and not expected to benefit from
the significant reduction in the international markets in recent months. Rice prices in the international market
have come down to about $650 per ton from the record highs of more than $1000 per ton. However, at this
level, it still remains (equivalent to Tk.45 per kg) well above the prices prevailing in local markets (Tk.31-40
per kg).
This dual effect of improved domestic supply and downward adjustments in commodity

prices globally will certainly help the domestic inflationary environment. If this outlook holds, we should expect a significant reduction in the rate of inflation in Bangladesh. By end of December, we may see that coarse rice prices will remain stable at the current Tk.31-32 levels, which are already at the floor implied by the government procurement price of Tk.29.50 (including subsidy of Tk.1.5 per kg to the millers).
Better quality rice prices may come down further from their current levels. Edible oil prices would also decline further, with palm oil prices below last December's level. Many other importable basic commodities (sugar, onion, etc) are also showing similar trends, and we should expect import-induced inflation to be very low or even negative.
Will that be enough to bring the overall inflation down significantly in Bangladesh? With basic food prices remaining stable and non-food inflation (point-to-point) at less than 3.5 percent in June 2008, inflation coming down to about 5 percent does not seem unrealistic. The outcome will however depend on the government's ability to contain domestic demand pressures and maintain exchange rate stability. We need to remember that countries like Pakistan, Sri Lanka and Vietnam, all currently experiencing very high inflation (25 percent), are essentially overheated due to strong domestic demand and excessive domestic liquidity expansion. The recent surge in Indian inflation to 12.5 percent is also largely attributable to these factors.
Bangladesh is not immune from similar demand pressures, which could originate from multiple sources. Fiscal policy is expansionary due to record increases in spending, and the overall deficit may be higher than budgeted because of shortfalls in achieving the ambitious revenue target. The 20 percent increase in public sector wages,

in addition to normal increases, is creating wage pressures in all other sectors. With elections coming and
remittances remaining strong (50 percent higher during July-August 2008), private sector spending will be
higher than usual. The early rush for Eid shopping across Bangladesh is an indication of this outlook.
Liquidity management will become increasingly challenging for the Bangladesh Bank (BB). In addition to
injections from high fiscal deficit, the net foreign assets (NFA) of the banking system are likely to become a
major source of liquidity expansion. Exports are growing at a rapid pace and are likely to remain strong.
Remittances are also likely to remain very strong, reaching a new record of about $10 billion in 2008.
At the same time, import payments are expected to slow down because of declining commodity and petroleum
prices, after record increases in 2007/08. The resulting strengthening of the balance of payments would entail
much larger external current account and overall surpluses compared with the surpluses recorded in recent years.
The potential surge in the NFA would certainly alleviate concerns about exchange rate depreciation. BB should
be able to maintain exchange rate stability and prevent a possible appreciation of the taka by accumulating
foreign exchange reserves. The resulting increase in monetary expansion, however, will create inflationary
pressure if not very actively contained by the BB. A buildup of reserves by $2-3 billion alone could contribute
to money supply by an additional 6-9 percentage points. Combined with strong credit demand from the private
and public sectors, limiting domestic liquidity to the required level will be very difficult.
Managing the liquidity impact of various combinations of factors noted above will not be easy, as evident from
the experience of India, Pakistan, Vietnam and China. Despite several rounds of increases in

central bank
intervention rates and cash reserve requirements, containing domestic liquidity and inflation proves to be very
difficult for these countries.
In addition to watching monetary developments carefully, BB must act preemptively to limit liquidity expansion
in order to translate the favourable supply situation to lower inflationary outcome in the coming months. BB
will certainly need a helping hand from the fiscal side, including possible expenditure cuts, without which the
task may prove to be even more difficult.