



Inflation control requires reduction in fiscal deficit

Tuesday, Jul 2, 2024

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After nearly a two-year gap, the government finally got its act together and on 8 May it put the foreign exchange system and monetary policy on track. This bold policy decision, if implemented well, should help lower inflation and stabilise the exchange rate.

The next step in the adjustment process is to enhance the effectiveness of these policy reforms with fiscal policy adjustments. The fiscal policy reform is particularly important to reduce inflation.

The need for fiscal adjustment is easy to see. Reduction in domestic demand is necessary to reduce inflation. This calls for a reduction in the growth of total credit. Although the total

demand for credit is dominated by the private sector, over the years the public sector has also emerged as an important player in the credit market.

Monetary policy correction has increased the lending rate and thereby lowered the private sector's demand for credit, which will help reduce the demand pressure on both domestic inflation and the exchange rate.

But the public sector's demand for credit depends fundamentally on the budget deficit and the way it is financed. The lower the level of fiscal deficit and the higher the shares of foreign and non-bank private financing, the lower is the demand for bank credit by the public sector.

The FY25 budget sets a fiscal deficit target of 4.6% of GDP. Of this, some 1.7% of GDP will be financed through foreign borrowing and 0.4% of GDP will be financed through non-bank private borrowing. This leaves 2.5% of GDP for bank financing.

Detailed calculations show that given the limit on total credit growth set by the monetary policy target for inflation control, this level of bank financing of the fiscal deficit will substantially crowd out bank borrowing by the private sector. Interest rate will shoot up as the private sector competes with the budget for the limited supply of credit that is consistent with inflation control.

So, something will need to give. Private sector's political pressure will likely force the Bangladesh Bank to relax the credit growth target and thereby compromise the inflation control strategy. That would be most unfortunate.

To be fair to the private sector, it is bad economic management to put all the adjustment pressure on the private sector that serves as the engine for GDP growth. It is, therefore, imperative for the government to lower the fiscal deficit to a level that is consistent with inflation control.

The calculations referred above suggest that for FY25 a maximum safe level of bank borrowing to finance the budget deficit is about 1% of GDP. Along with other financing, this sets a safe level of fiscal deficit of about 3% of GDP for FY25. This level can go up in the future years when inflation is normalised at around 5-6% per year.

The 1.6% of GDP gap between the proposed fiscal deficit for FY25 (4.6% of GDP) and the inflation control safe limit for fiscal deficit (3% of GDP) can be easily reconciled through three fiscal policy measures.

First, while the government is reluctant to take bold actions on the tax front that involves rocking the boat by taxing the rich and powerful, it can resort to some basic reforms of the state-owned enterprises that will help increase the rate of return on government investment in these enterprises. I have provided a detailed paper to the Finance Ministry on how this is possible.

Second, the government can eliminate subsidies on fossil fuel, electricity, exports and remittances that will save the budget about 1.2% of GDP. By freeing up the exchange rate, subsidies on exports and remittances are redundant. Subsidy on fossil fuel is inconsistent with the government's commitment to reduce carbon emission.

In the power sector, the mistakes made on IPP and rental power contracts must be corrected instead of financing the excess cost through subsidies. Power generation must move back to the least cost sources to lower cost. Power prices then must reflect the true cost of power production with no subsidy.

Third and finally, the government should reassess the size of the FY25 ADP to a lower and more realistic level. It must also increase allocations for education, training, health, water and social protection and lower the allocations for long-gestation mega infrastructure projects. This reallocation will protect GDP growth and poverty reduction better than long-gestation mega transport infrastructure projects that would yield benefits only over the longer term.

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