

Inflation untamed: Only hard choices remain

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INFLATION, like the floods, has a habit of returning. On a point-to-point basis, June inflation has reached 9.0 per cent, with food inflation hitting double digits. Inflation hurts the poor more than the rich; food inflation hurts the poor even more. Given the composition of our consumption basket, the current inflation is hurting the rural population more than their urban counterparts. Consumers are hurt more than producers or business people. To top it all, there is the scourge of floods upon us. So inflationary pressures continue unabated.

First, the diagnosis. Much has been said about what caused this inflation. Perhaps there is more agreement on that score, but less agreement — even sharp divergence of views — on how to address the problem. To our advantage, inflation is a widely studied phenomenon in economic science. Its causes and solutions are also fairly well known. It is the context that might be different each time. But that need not detract from fundamental principles. In the short-term, supply shocks or demand shocks can generate forces that push up prices. In the long-term, inflation is a monetary phenomenon, argued Nobel Laureate Milton Friedman. There are no two things about it. It is true for developed countries. It is just as true for developing countries. Simply put, if too much money in the economy is chasing too few goods and services, inflation is bound to happen. By inflation, we mean a rise in the general price level, not an increase in the price of any specific product in any specific market.

Like many other economic problem, there is a lot to learn from past episodes of inflation and the prescriptions emerging from theory and empirical evidence around the globe. More pertinent for our purpose of course is our own experience and the evidence from developing countries. The last episode of high inflation in this country was experienced in the wake of August-September floods of 1998 when nearly half the country went under water. By November, inflation had crossed 12 per cent, but, thanks to a bumper Boro harvest in 1999,

came down below 8.0 per cent by June, and to under 3.0 per cent by December 1999. That was a pure flood-induced supply-shock inflation that literally cured itself as a result of a bumper harvest that typically follows the rejuvenation of the soil due to alluvial deposits left by the floods. Furthermore, there was no oil price shock or global inflation to talk of.

What is less known is the fact that prudent monetary management at the time did much to keep the inflation genie in the bottle. During 1998-2000, annual money supply growth (M1) averaged only 9.0 per cent. To oil the wheels of the economy, money supply has to grow in tandem with economic activity. The trick is to let money supply growth keep pace with the growth rate of nominal GDP (Gross Domestic Product at market prices). Restraining money supply growth below the growth of nominal GDP would restrict the economy's growth potential, while letting money supply go ahead of the economy's output growth will fuel inflation. Sound monetary policy therefore implies that growth of money supply in the economy should be commensurate with the growth of nominal GDP — averaged 10-11 per cent during FY98-FY00; 12-12.5 per cent during FY05-FY07

Inflation this time is a lot different from the last episode just discussed. This time around the supply shock in the market has come from both internal and external sources. Bangladesh is heavily dependent on oil imports. It, along with the world's leading economies, has been reeling from the rise in oil prices since about 2003. Lately, world food prices of our staple foods — rice and wheat — have also shown upward trends due to shortages in the exporting economies. Domestically, adjustments of fuel prices, political turbulence followed by ad hoc market interventions, have generated upward price shocks. The onset of floods now has introduced additional pressures to the inflation phenomenon.

The government has been active in firefighting this latest episode of inflation with all the economic instruments at its disposal. Barring some misplaced ad hoc interventions in the city's kitchen markets, the approach taken in terms of economic policy has been largely in the right direction. Supply shocks have to be addressed by creating conditions that ease the supply of commodities whose prices are on the rise. Thus lowering or eliminating duties on essential imports like rice, wheat, onions, and edible oils is appropriate. The pronouncement for building rice and wheat stocks in the public silos for distribution in times of need should also ease price pressures currently and in the near future. The pre-announcement for duty-free imports of essentials during Ramadan is also helpful. Since the floods are upon us,

vigorous efforts must be made to meet the needs of the distressed during the floods followed by proactive post-flood VGF/VGD and food for work programs. All these could ease price pressures in the economy, but not for long, if monetary management is not supportive of these actions.

That brings us to the fundamental proposition about the relationship between money supply in the economy and prices. During the 1998 floods which pushed up prices, money supply growth was moderate in the early stages; so there was space to accommodate the post-flood demands for higher credit in agriculture and industry. Not quite so at the present time. Money supply growth has been averaging 20 percent during the past two years and was running at 18 per cent in May 2007, well ahead of the growth of nominal GDP of 12-12.5 per cent in FY06-FY07. As mentioned earlier, if money supply is growing ahead of output, inflation cannot be far behind. If inflation is to be tamed, money supply growth must be contained to levels commensurate with nominal GDP growth. As such, there is no option but to reign in the money supply with whatever monetary policy instruments are available. Unfortunately, this would require constraining liquidity in the banking system and cooling credit demand.

India recently did just that. By February 2007, Indian inflation had reached 7.0 per cent. The Reserve Bank of India effectively tightened money supply by squeezing liquidity out of the banking system to control credit growth. The result has been impressive. Inflation is down to just over 4.0 per cent in June and appears stable.

For Bangladesh today there are no easy choices. With money supply already running ahead of nominal GDP, there is hardly any room for expansion of credit to meet post-flood demands. If the Bangladesh Bank were to tighten money supply it would have to put a squeeze on private credit growth — quite unpalatable to the business community that seeks more, not less, credit to meet demands for working capital and new investment. A modest slowdown in economic activities could result from such action. What could ease the situation somewhat if government borrowing from the banking system could be contained by strengthening revenue mobilisation to meet rising public expenditures. One unknown is which way the floods will go. If they take a turn for the worse it would be tough to keep the fiscal house in order.

All in all, one sees only hard choices and no easy solution. If inflation is to be tamed — to

ease the burden on the poor and fixed income earners — monetary management has to be tightened, but that implies credit squeeze that will be hard on the business and industrial community. For now — though not for long — it is a choice between growth and price stability; between easing the burden on the poor and fueling the wheels of the economy. As often happens, economic policy finds itself caught between the rock and a hard place! But policymaking is about making hard choices and striking trade offs keeping the national interest in mind.

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