Orderly transition to a stable macroeconomy

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The global food-fuel price-led inflationary episode since March 2022 has destabilised the Bangladesh economy and threatens to disrupt the ongoing recovery from the adverse effects of Covid-19. On top, the surge in inflation in Bangladesh is hurting people and has become a major socio-economic concern.

The government is acutely aware of the need to take appropriate and forceful policy measures to restore macroeconomic stability.

The key challenge here is to adopt the right mix of policies in order to ensure an orderly transition to a stable macroeconomy. This orderly approach is important to minimise the transition costs and ensure that the long-term growth path is not jeopardised.

The government has responded by taking several policy measures. It has decided in principle to free the exchange rate and let it be market determined. It has adopted a new budget that aims to maintain fiscal discipline by raising tax revenues and energy prices. It has taken several measures to discourage imports by raising tariffs. It is also seeking to reduce import by slowing down the issuing of letters of credit. It is hoping to lower inflation through a combination of electricity, gas and fertiliser subsidies and price controls over essential food items.

How effective are these policies? While the full impact of these policies will take time to work, several observations can be made.

The freeing up of the exchange rate is a smart policy move and if applied properly can help stabilise the balance of payments in an orderly fashion. The problem though is that the policy is yet to be properly implemented.

Presently, there are multiple exchange rates that has complicated the management of the balance of payments. Especially, the artificially fixed inter-bank rate of Tk94.5 per dollar has heavily penalised exporters contrary to the objective to boost exports through a market-based exchange rate. The most recent initiative to unify the exchange rate through the joint efforts of the commercial banking system and the Bangladesh Foreign Exchange Dealers Association (Bafeda) ends up by offering three exchange rates: a lower rate for exporters (Tk99/$), a higher rate for remittance earners (Tk108/$) and a weighted average of these rates for importers. While these rates are closer to the market rate, it is puzzling how a 3-tier rate system is regarded as a uniform rate. Most importantly, it still continues to penalise exports.

The national budget FY2023 has good intentions but the revenue targets will not be achieved as in past several years. The results of FY2022 budget implementation shows a tax revenue shortfall of Tk380 billion. Thus, compared with the FY2022 budget target of Tk3,460 billion (8.7% of GDP), actual tax collections stood at Tk3,080 billion (7.7% of GDP).

This shortfall happened despite a revenue boost from the import surge. For FY2023, the

Budget puts a tax revenue target of Tk3,880 billion (8.6% of GDP). In the absence of any major tax reform, the best estimates are a tax collection of Tk3,500 billion (14% growth and 7.8% of GDP) in FY2023.

The revenue shortfall will require a reduction in public spending, which usually falls disproportionately on development and social protection spending. It may also compromise the budget's target to contain the fiscal deficit at 5.3% of GDP. So, the demand management effects of the FY2023 Budget will likely be constrained by continued weak tax performance.

Tariff hikes and import controls through slowdown of LC openings will lower the growth of imports as intended and will reduce the current account deficit. But this is a blunt instrument with high adjustment cost. These policies will certainly constrain the expansion of investment, exports and GDP growth. Already, the textile industry has expressed a major concern about the shortage of raw materials owing to slower LC openings.

Seeking to dampen inflationary pressures through subsidies and price controls is fraught with risks and sustainability concerns. The government does not have adequate budget space to finance the estimated energy subsidy amounting to 2% of GDP. It was already forced to raise fuel oil prices. There is also growing pressure on gas and electricity subsidy bill.

For the time being the government has avoided raising these prices by resorting to power supply cutbacks. But these cutbacks will adversely affect investment and GDP growth. Regarding price controls on essential food items, there is plenty of global evidence that price controls do not work and lead to rationing of supply at the fixed prices and a flourishing black market. The government has already seen an example of this from its efforts to defend the artificially low exchange rate.

In summary, the current policies will likely reduce the growth of imports and lower the current account deficit but will impose a high adjustment cost in terms of lower growth of exports, investment and GDP. There is also a risk that the adverse signal effects of a controlled economy will dampen private investment and FDI that could jeopardise the long-term growth path. Lower GDP growth will reduce employment and income that will eventually bring down inflationary pressure. It is not obvious that this muddle through policy scenario is the best possible outcome.

A more orderly approach would be to reduce BOP and inflationary pressure with reduction in aggregate demand based on a combination of exchange rate, fiscal and monetary policy corrections. Reduction in aggregate demand will also reduce GDP growth in the short term, which is inevitable irrespective of the choice of instruments. But demand management through the use of proper policy instruments will be more efficient and help lower the transition costs. Importantly, it will help an orderly transition to the long-term growth path without jeopardising this path.

In this orderly transition to the restoration of macroeconomic stability, the exchange rate should be unified at a single market-determined rate for exports, remittances and imports. This policy will also lower the fiscal pressure by enabling the government to withdraw all export and remittance subsidies.

The most direct and sustainable way to lower inflation is to raise the interest rates. The government should immediately remove the “6/9” interest cap and instead use its normal monetary policy instruments to guide the interest rate.

The reduction in demand through interest rate hikes is the most commonly used policy instrument globally to lower inflation and the Bangladesh Bank should educate the political powers that this is necessary to reduce inflation at this time.

It is true that the increase in interest rates will hurt growth in the short term but so will import and price controls. The adjustment through interest rate will be more orderly because it will allow consumers and investors to only finance the most efficient and high-return projects. It is also sustainable while inflation control through subsidies and price controls is unsustainable.

Additionally, demand adjustment through interest rate hike will lower the pressure on import demand and stabilise the exchange rate.

A missing link in this scenario is the use of fiscal policy. In the short run where revenue mobilisation options are limited, the best use of fiscal policy would be to lower subsidies to sustainable limits and increase spending on social protection to protect the incomes of the poor and the vulnerable population who are hurting badly from the surge in food price inflation.

Starting with the next year’s budget the government must tackle the tax policy debacle by making some bold and far-reaching tax reforms. This could be complemented with the much-needed reforms of the state-owned enterprises.

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