Taming the imported inflation bug

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The inflation genie is out of the bottle. It will take time and effort to put it back in.

Official statistics indicate point-to-point inflation at 9.1% in September this calendar year, although the 12-month moving average CPI index is about 7%. That is the highest in a

decade or more.

The poor are hurting most. Fixed income earners are finding it difficult to make ends meet. Something needs to be done, but this inflation is different.

The spike in domestic price level is not the result of a crop failure in our agriculture or disruption in industrial production.

It was external events that caused it.

It can be described as “imported inflation” because its roots are to be found in recent external developments: post-Covid-19 supply chain disruption, Russia-Ukraine war, hikes in food and energy prices and, eventually, global inflation.

Practically all products that Bangladesh imports have seen a rise in prices, though international food and energy prices have recently abated somewhat.

Consequently, our economy has experienced a rise in the prices of traded goods as well as non-traded goods (services, transportation, and the like).

Clearly, this inflation is import-induced.

In the past fiscal year, we have seen an import surge of 35% which was associated with an export surge of 34%.

The import surge resulted in merchandise imports of $82 billion in FY22 against total imports of $60 billion in the previous year.

The rise in imports was partly due to rise in global prices of imported goods but largely due to the import-export linkage that occurs when an economy primarily exports manufactured goods.

The rise in imports was not matched by the inflow of foreign exchange from exports and remittances resulting in a record current account deficit of $18.7 billion or 4% of GDP.

This put pressure on the Taka-US dollar exchange rate which could not be held at the old rate of Tk86/US$ even after disgorging some $10 billion from the official foreign exchange reserves of Bangladesh Bank.

Quite rightly, the central bank had to let the exchange rate float resulting in a depreciation of over 20% in a matter of weeks.

Coincidentally, this matches the appreciation of the US dollar by some 20% over the past year.

If the Taka did not depreciate, the exchange rate would have been overvalued by 20% for just the reason of dollar appreciation.

So, domestic prices of imports have risen on two counts.

First, global inflation that saw the rise of food and energy prices with spillover effects on all other traded and non-traded goods and services.

Second, the exchange rate depreciation raised the landed price of imports by the extent of the depreciation.

Contiguously, as the domestic price of imports rose, so did the price of import substitute products domestically produced.

All this translates into a rise in the domestic price level – inflation.

Bear in mind that 80% of our imports comprise raw materials, intermediate inputs, and capital goods, all of which are destined for the productive sectors of the economy.

This contributes to what is called a "cost-push" inflation that was transmitted from across the border.

Observations

In the circumstances, I will argue that this inflation might not be tamed by the standard demand-side management that we see in most developed economies today.

Those economies were engaged in monetary easing for almost 12 years since the outbreak of the global financial crisis (GFC).

This was at a time when inflation was running at below 2 percentage points and interest rates were even lower.

They have now reverted to a course of monetary tightening (restraining credit demand) to deflate the rise in prices on account of the post-pandemic supply chain disruption and the Russia-Ukraine war.

Interest rates have risen in order to tame inflation by retraining demand.

That is unlikely to work in the Bangladesh scenario.

Quashing inflation has to start at the border.

One phenomenon already mentioned is the 20%+ exchange rate depreciation that was implemented within a matter of a few weeks.

Quite apart from the transmission of price effect to the domestic market there are three simultaneous impacts of note.

First, a 20% depreciation of the Taka-US dollar is the equivalent of a 20% spike in tariffs across-the-board.

This comes from the fact that the assessable value (on which import taxes are assessed by customs) of all imports are up by 20%.

Therefore, any ad valorem (according to the value) tariff now goes up 20%.

Simply put, a 10% tariff on Tk100 worth of imports will now yield Tk12 revenue on import

value that has risen to Tk120.

This is a windfall tariff hike for NBR, without the need for any legislation.

Second, applying the principle of uniform tariff protection, a 20% exchange rate depreciation has the effect of raising the effective rate of protection by an equal 20%, as it raises the tariff-induced price of output and inputs by the same percentage point.

That means import substitute industries get a boost from the exchange rate depreciation as well.

Caveat: since domestic import substitutes are imperfect substitutes of imported products output prices may not rise as much as the tariff spike.

A rise in effective protection may not exactly match the rate of depreciation, but there will be a rise nevertheless.

Third, exporters get an extra 20% from every dollar of exports — we may call it a subsidy that is different from the cash subsidy they receive which comes out of the government budget.

Quite apart from the fact that consumer goods prices have risen, since 80% of imports are destined for the productive sector, costs of production in the industrial, agricultural, and services sector have increased to push up output prices as well resulting in a point-to-point general inflation rate of 9.1% in September 2022.

In large part this uptick in inflation is import-induced.

Remedies

One effective instrument to quash this import-induced cost-push inflation is to use the tariff handle.

Since NBR finds itself benefiting from an unanticipated 20% spike in tariffs it is well placed to

make some downward adjustment in tariffs that could help quell domestic inflation without any loss of revenues.

Even a modest reduction in tariffs will have a noticeable impact on reducing inflation.

One low-hanging fruit is the regulatory duty (RD) that is applied to 3,400 tariff lines (about 45% of all tariff lines).

About 95% of the RD is applied at 3% with a small number of products identified for higher rates (unknown selection criteria).

RD is not a permanent feature of the customs tariff but needs to be legislated every year.

Removing the entire RD in one stroke can take some shine out of inflation.

This could be just the beginning.

Brave hearts can do more to curb inflation.

There is no issue of revenue loss to NBR because it comes out of the windfall.

Domestic lobbies favouring import substituting protection have no reason to complain as the RD is being taken out of the 20% extra protection from exchange depreciation.

The fact is larger the neutralization of the price effect of exchange rate depreciation greater will be the downward impact on the current import-induced inflation.

The RD removal could be a simple innocuous experiment that could also have a lasting impact on tariff rationalization that is currently being examined by a study team constituted under the directives of the Prime Minister’s Office (PMO).

It could also be a win-win for both the consumer and producer.

To conclude, at a time when the interest rate handle has been effectively frozen so credit

restraint (i.e. demand restraint) is no longer possible through raising interest rates, the tariff handle remains as a potentially lethal instrument to stifle imported inflation.

Current tariff levels are undermining dynamism of the Bangladesh economy besides discouraging foreign direct investment (FDI) at a time when multinational corporations (MNCs) are scouring the globe to find new grounds to park their investments.

By all accounts, Bangladesh tariffs are at levels significantly higher than its peers.

This has become a stumbling block to our strategy for boosting exports and their diversification.

The sharp depreciation of the Taka-Dollar exchange rate presents a scope for using the tariff handle to tame the bug of imported inflation.

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