

The challenge of controlling inflation

Monday, Oct 8, 2012

By *Dr. Sadiq Ahmed*

Sadiq Ahmed in the second of his three-part article on the Sixth Five Year Plan

The fiscal stance in fiscal year (FY)11 was moderately expansionary with overall deficit (including grants) estimated at 4.4 per cent of GDP (gross domestic product). This deficit was below the budget target of 5.0 per cent but higher than the budget deficit in FY10 (3.7 per cent of GDP). Revenue performance was good, exceeding the budget estimates and registering an impressive 27.8 per cent growth (figure 2). As a result the tax to GDP ratio reached the double digit mark in FY11 for the first time in Bangladesh.

✘ On the spending front, increase in subsidies to agriculture, power, fuel, foods and exports contributed to a surge in non-development expenditures. Subsidies and current transfers including grants and pensions increased as well, amounting to 3.7 per cent of GDP in FY11. However, despite increasing pressure of current spending, total public expenditures in FY11 remained below the budgetary target due to underutilisation of Annual Development Programme (ADP) allocations. On the financing front, foreign aid disbursement has been slowing down. The declining trend in external financing over the last few years has intensified reliance on domestic borrowing to finance the budget deficit. A particularly worrisome development was the increase in net borrowing from banking sources, which jumped to 2.6 per cent of GDP in FY11 from (-) 0.3 per cent of GDP in FY10 (figure 3). The progress with improved tax performance has been maintained in FY12. The outlook is that the tax to GDP target of 10.4 per cent of GDP for FY12 will be achieved. But continued pressure on account of food, fuel and electricity subsidies, coupled with a further slowdown in the availability of foreign funding, has challenged fiscal policy management in FY12. In the first four months of FY12, the Government borrowed TK 150 billion from the domestic banking system, which was 80 per cent of the target for the entire fiscal year. Since then the borrowing rate has declined

somewhat. For FY12 as a whole, the bank financing is estimated at 3.2 per cent of GDP, which is substantially higher than the 2.0 per cent of GDP target in the FY12 national budget. ADP implementation has also been slow and a combination of capacity and financing constraints has reduced the ability to implement the planned ADP expenditure in FY12.

On the whole, while the tax target for FY12 has been achieved, the investment target for FY12 has been missed. The fiscal deficit is contained at around the stated target of 5.0 per cent of GDP, but much of the deficit financing has come from borrowings from the Bangladesh Bank (BB) with adverse consequences for the growth of credit to the private sector. Inflation outturn and monetary policy: Bangladesh has been facing growing inflationary pressures since FY01 (figure 4). The average yearly rate of inflation climbed from a low of 2.0 per cent in FY01 to a peak of 10.6 per cent in FY12.

✘ More recently, the rate of inflation on a point-to-point basis crept up steadily since July 2009, rising from a low of 2.3 per cent in June 2009 to a peak of 12 per cent in September 2011. The inflation rate declined slowly after that and stood at 8.6 per cent in June 2012 (Figure 5). Increase in the overall Consumer Price Index (CPI) was initially driven by high food prices, but non-food prices have been soaring in recent month. Increases in food prices reached a peak at 14.4 per cent in April 2011, but declined after that, falling to 8.0 per cent in June 2012. Non-food prices fell during the first half of FY11 reaching a low of 3.3 per cent in December, but then increased rapidly climbing 14.0 per cent in March 2012. It then declined to 12 per cent in June 2012.

✘ Inflation in Bangladesh can be explained through both supply and demand side factors. Soaring international commodity prices was the main source of food inflation. Meanwhile, an accommodating monetary policy boosted domestic demand, creating serious upward pressure on non-food prices. Larger-than-planned budgetary borrowings in FY11 and FY12 also contributed to monetary expansion and inflation. Despite the intention to restrain monetary growth, during FY10 and FY11, Bangladesh Bank's monetary targets were exceeded in practice due to growth in credit to public and private sector (Table 4). In FY11, monetary growth was high partly because of the monetisation of the fiscal deficit through government borrowing from Bangladesh Bank (BB). The stock of government borrowing from BB at end-June, 2011 was 43.6 per cent higher than that at end-June, 2010. The FY12 monetary policy statement (MPS) for the first half aimed to restrain domestic credit growth

by selectively containing the growth of credit for wasteful, unproductive and speculative uses. The MPS also sought to ensure adequate credit flows for all productive pursuits in manufacturing, agriculture, trade and other services. However, achieving this balance required coordinated fiscal policy management that keeps borrowing from Bangladesh Bank to a minimal level. In the event, this has proven difficult owing to larger-than-budgeted energy subsidies.

✘ Controlling inflation has, therefore, been a major challenge in the first two years of the Sixth Plan. The good news however is that efforts since the second half of FY12 to tighten domestic credit and money supply has yielded positive results. Building on the success of the implementation of the MPS for the second half of FY12, the MPS for the first half of FY13 aims to continue and build on the progress made in the second half of FY12. In summary, the estimated average inflation rate for FY12 is 10.6 per cent, much higher than the Sixth Plan target of 7.5 per cent. For the future, monetary and fiscal policies need to be coordinated so that the Treasury borrowing from Bangladesh Bank is restrained and the monetary growth rate is consistent with the Sixth Plan's inflation target. Proper implementation of the MPS for FY13 is of critical importance for achieving lower inflation. Note: The article was originally planned to be printed in two installments. It has now been divided into three parts.

The writer, Dr Sadiq Ahmed, is vice-Chairman, Policy Research Institute of Bangladesh. This write-up was presented by him at a recent seminar in Dhaka, organised by the PRI. pri.bangladesh@gmail.com

<http://www.thefinancialexpress-bd.com/index.php?ref=MjBfMTBfMDhfMTJfMV84N18xNDYyMDg=>