Urgent need to stabilise macroeconomy

Friday, Jun 3, 2022

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Macroeconomic stability has been a hallmark of Bangladesh's development strategy. This has served the country well, especially in terms of providing a solid enabling environment for the private sector.

Relatively low inflation (long term average rate of 6.1 per cent over the 1990-2021 periods) has also been helpful in preserving the gains in nominal income for the poor and the fixed-income group. Periodic episodes of imbalances were quickly reversed through deft macroeconomic management involving relevant reforms.

The combination of Covid-19 global supply disruptions and the food-fuel supply crisis related

to the Ukraine war has created serious global inflationary pressures. Over the past 12 months, the inflation rate has increased from 4.2 per cent to 8.3 per cent in the US, 1.5 per cent to 9 per cent in the UK, 2 per cent to 7.4 per cent in Germany, 3.4 per cent to 6.8 per cent in Canada, 4.2 per cent to 7.8 per cent in India, 5.5 per cent to 33.8 per cent in Sri Lanka, and 11.1 per cent to 13.4 per cent in Pakistan.

Bangladesh being an open economy is no exception. Although official CPI data show a much lower inflationary pressure (from 5.6 per cent to 6.3 per cent), this has met with scepticism in many quarters given the depth of global inflation. More importantly, individual commodity prices relating to food items show substantial increases over a 12- month period.

For example, Dhaka retail prices suggest the following increases: rice 15 per cent; atta 30 per cent; cooking oil 43 per cent; sugar 29 per cent and lentils 15 per cent. These are hurting consumers at large but especially the poor and the fixed-income group. Additionally, the import bill has surged, creating huge excess demand for foreign exchange at the official rate, thereby exerting substantial pressure on the exchange rate.

The government has responded with several policy measures, including lowering of import duties on several food items, moderating the increases in the prices of energy, keeping the fertilizer price unchanged by absorbing the international price pressures through budgetary subsidies, partially devaluing the official exchange rate, depleting foreign reserves to reduce the pressure on the exchange rate, imposing trade restrictions (supplementary/regulatory duties on 135 items deemed as luxury imports; slowing down the opening up of import lines of credit), and slowing down the implementation of import-intensive development projects.

The government measures relating to the reduction of import duty and providing subsidy cover to the energy and fertilizer imports can have some dampening effects on domestic inflation. Similarly, trade controls and expenditure switching can play a temporary role in reducing pressure on the balance of payments. But these are not likely to be adequate.

They can also have unintended adverse effects on the budget (large subsidy bills crowding out high priority development spending and/or putting pressure on the fiscal deficit), promote inefficient import substitution (trade controls), and hurt development by slowing down project implementation of large infrastructure projects that tend to be capital and import intensive.

Import and trade controls can also discourage private investment, especially foreign direct investment (FDI) inflows, by giving wrong signals about the government's move towards a controlled economy, a feature that badly served Bangladesh in the 1970s and the 1980s.

What are the good and sustainable policy options?

The macroeconomic imbalances emerge from three sources: inflationary pressure; fiscal pressure and the balance of payments pressure. Addressing these issues requires the use of at least three policy instruments that best relate to each of these areas: use of monetary policy instruments to ease inflationary pressure; exchange rate policy to ease the balance of payments pressure; and tax/ expenditure policy measures to ease the budgetary pressure. Their combined use as a coordinated set of policy measures can help avoid the bluntness of any single instrument and reinforce the effectiveness of each of the policy measures.

MONETARY POLICY

Nobel Laureate Milton Friedman famously stated that inflation is always a monetary phenomenon. This is a truism because without monetary impulse, changes in individual price items cannot create inflation.

The debate about this extreme monetarism concerns the worry that using monetary policy instruments only can be blunt and hurt economic growth. For temporary inflationary pressure, one can ignore the need to use monetary policy. But for a prolonged period of inflation, as presently, it is too risky to avoid the use of monetary policy instruments.

Finance ministers and central bank governors across many countries, including the US, the UK, Canada, Australia and India have recognised this challenge and have raised interest rates to reduce aggregate demand. The European Central Bank is also poised to hike interest rate in July. The increases are being calibrated to have the desired effect of lowering inflation while moderating the adverse effect on economic growth.

For Bangladesh, the monetary policy challenge is to modify what has come to be popularly known as the "6/9" policy, whereby the deposit rate can't exceed 6 per cent and the lending rate can't exceed 9 per cent. This played a positive role during the Covid-19 years (2020 and

2021) and along with other supportive policies helped the current post-Covid economic recovery.

With sustained inflationary and balance of payments (BoP) pressures, the policy should be modified to let the interest rate be market-determined along with increases in the policy rate managed by the Bangladesh Bank. Without a change in the 6/9 policy, attempts to increase the policy rate will be largely futile.

Creating a secondary market for T-bills will help increase the effectiveness of the monetary policy. The policy rate, reserve requirements and open market T-bill operations can all be used to moderate increases in the interest rates

EXCHANGE RATE MANAGEMENT

The Bangladesh Bank (BB) is well aware that the taka has been appreciating in real terms steadily against major currencies like the US dollar and the euro and also against the basket of currencies used by the BB to calculate the real effective exchange rate (REER).

The REER trend shows that the value of the taka appreciated in real terms by 71 per cent between FY2011 and FY2020. This was clearly unsustainable, as has become evident now. So, the depreciation of the taka was long overdue. Therefore, instead of throwing all its futile energies to artificially preserve a highly overvalued exchange rate through multiple currency practices, trade and exchange controls and moral suasion, the BB exchange rate management should be modernised to adjust to the realities of the market trends.

More flexible management of the exchange rate than in the past to allow the exchange rate to play its role in export growth and the reduction of imports will be a sound policy. Along with the flexibility of the exchange rate, monetary and fiscal policies should be used to moderate the demand pressure on imports.

FISCAL POLICY

Fiscal policy pressure has been mounting for a while due to the slow growth in tax revenues. The Bangladesh tax-GDP ratio is one of the lowest in the developing world and has basically

stagnated at 7-8 per cent of GDP.

Much has been written and known to the government about the need to modernise the tax structure with a view to increasing tax efficiency, tax buoyancy and revenue growth. Unfortunately, no significant tax reforms have happened. Without a strong political signal, this will not be possible. So, realistically, at the present time, expenditure management is the only feasible fiscal instrument.

As noted, the government is already using two important expenditure policy moves to dent inflationary and bop pressures. First, the subsidy is being used judiciously to try to reduce the inflationary impact of global energy and fertilizer price increases. Second, the government has decided to slow down the implementation of import-intensive development projects to lower the demand for imports. Both have some merit when used cautiously.

Regarding subsidy policy, the main concern is its fiscal sustainability.

Fiscal subsidies are estimated to reach Tk 62,500 crore in FY2021-22, which is 1.6 per cent of GDP, and surge to Tk 85,000 crore, including the subsidy to Bangladesh Petroleum Corporation, which is 1.9 per cent of GDP, in FY2022-23, if no energy and fertilizer price increases are allowed.

The total revenue (tax and non-tax) amounted to 9.3 per cent of GDP in FY2021 (7.6 per cent tax to GDP ratio and 1.7 per cent non-tax revenue to GDP ratio), which is not likely to grow much in FY2022 and FY2023 in the absence of tax and state-owned enterprise reforms. Assuming some revenue growth from higher-than-budgeted imports and the increase in trade taxes, one could envisage that the revenue base could grow to a maximum of 10 per cent of GDP.

In this scenario, subsidy alone will eat up 20 per cent of total revenues. Given other fixed spending items: wages and salaries (2 per cent of GDP), pension (0.8 per cent of GDP), supply and maintenance (1 per cent of GDP), transfers to local governments and state-owned enterprises (1.4 per cent of GDP) and interest cost of debt servicing (2 per cent of GDP), there will be very little fiscal space for spending on social protection and high priority development spending on health, education, and infrastructure even with 6 per cent of GDP

fiscal deficit. Therefore, a better policy would be to keep the fiscal deficit at 5 per cent of GDP and allow step-wise price increases of energy products and fertilizer to keep the subsidy bill for these items under control.

Subsidies for exports and remittances should be eliminated through the depreciation of the exchange rate.

Expenditure switching will only make sense for projects that are financed from domestic resources. Foreign-funded projects provide foreign currency loans to finance-related capital goods imports. So, care will have to be taken to slow down or postpone only domestically-funded import-intensive projects.

Since inflation hurts the poor and the low-income group relatively more than the rich, an important and positive fiscal policy measure would be to put priority on spending on health, education and social protection to support the income of the poor and the vulnerable.

Acceleration of income-transfer programmes to the poor and vulnerable will be a strong policy move to protect the poor from the adverse effects of inflation. So, instead of subsidising energy for all consumers, a combination of the energy price increase and re-channelling the saved resources as income transfers to the poor and vulnerable through the social protection system is a better policy option.

In health, the most urgent reform is the introduction of universal health care through government-funded health insurance schemes for the poor.

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