

WHY INFLATION IS NOT COMING DOWN FASTER IN BANGLADESH?

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As global commodity prices surged to its all-time peak in July last year, inflation in Bangladesh also followed a similar track. However, with the fall in commodity prices, most countries like India and China experienced a much sharper fall in inflation compared with Bangladesh. More specifically, while inflation in China entered into the negative territory and that in India is approaching zero inflation, the point-to-point inflation in Bangladesh remained at more than 6 percent since November 2008 (Fig: 1). While finding a definite answer to this issue is not easy, this note identifies some major differences in the underlying economic fundamentals that might explain this slower reduction in inflation in Bangladesh compared with India and China.

The background: Bangladesh suffered from inflationary pressures starting in 2007 due primarily to domestic supply shocks originating from two rounds of flood and the destructions caused by the cyclone Sidr. If we compare the inflation chart with that of commodity prices (Fig: 2), it is clear that the first round of inflationary pressure in Bangladesh starting in 2007 was not linked with global commodity price developments. In the period immediately preceding the global commodity price shock, inflation in both India and China were moderate despite some inflationary undercurrents originating from strong

domestic demand.

Commodity prices started its surge in early 2008 and the global index for commodity prices reached its peak in

July 2008, coinciding with the inflation rates recording their peaks in Bangladesh, India and China. Thereafter,

as the commodity prices declined by 53 percent during the July-January period, inflationary pressures also

receded rapidly in all economies across the globe. In India the inflation rate declined from its peak of more than

12 percent to 4.39 percent by January 2009 and thereafter further to 2.43 percent by end-February. In China, the

inflation rate dropped to the negative territory -1.6 percent and is likely to remain negative in the near term. In

contrast, although inflation in Bangladesh declined initially (during August-October 2008), it stabilized at more

than 6 percent level during November-January.

Can the differences in traditional macroeconomic indicators like monetary and credit expansion or the

stance of fiscal policy explain the difference in inflationary behavior? A cursory review of the usual culprits

however cannot help explain this relatively lesser decline in Bangladesh inflation. Monetary and credit

expansions in India [and China] were quite similar to the rate of expansion in Bangladesh.

Fiscal policy in these

economies was also no less expansionary than Bangladesh. In particular, in the aftermath of the ongoing global

recession both India and China rapidly moved to an easy money policy. Fiscal policy also became much more

expansionary with the acceleration of investment programs and adoption of fiscal stimulus packages in both

countries.

What could then explain this higher inflation in Bangladesh? Since inflation in many instances is a

barometer for domestic demand pressures, one plausible reason for Bangladesh's differential

inflation

performance could be that its economy has so far been impacted marginally by the global meltdown, in comparison to China and India. Economic recessions or depressions are usually accompanied by softening of inflation or price deflation (negative inflation), and a strong economic environment generally puts upward pressures on the price level. Thus, a significant weakening of domestic demand or foreign demand for domestic products, reflected through exports and imports data, would be good indicators for a weakening of domestic economic activity leading to lower inflation and in some cases even a decline in the price level, as happened in China.

China with highest export dependence has suffered the most. Exports have fallen by more than 25 percent in January and February 2009. India with similar exposure to the export market as Bangladesh, also recorded a significant fall in export receipts (15.9 percent in January). In comparison, while exports certainly slowed down in Bangladesh, export receipts still recorded modest growth in dollar terms (11.4 percent) [table: 1].

Bangladesh's import demand has been much more robust than in India and China. As the fastest growing economy in the world, China traditionally recorded the highest rate of import growth and 2008 was no exception until the beginning of the global meltdown. Since [December] 2008, China's imports in dollar terms nosedived to the extent that in January 2009 import payments declined by more than 43 percent over the corresponding month of the previous year. In India, the corresponding decline in January was 18.2 percent, while imports remained steady in Bangladesh in dollar terms (Table: 2). After adjusting for the drop in

commodity prices, imports in volume terms should have increased at a double-digit rate. The combined effect of all these various economic indicators have been reflected in the markedly slower overall growth performance of India and China. Real GDP growth rates of China and India in 2009 are projected by the IMF to be almost half of what both of these economies recorded in 2007. In contrast, Bangladesh's growth outlook remains fairly robust, down by only half a percentage point to 5.6 percent in 2009 (table: 3).

What is lesson for the policy makers? In the industrial countries bond market yield curves are generally viewed as precursor/predictor of the stages of economic/business cycle. Inflationary development is also a major indicator of the state of economic activity. The higher level of inflation in Bangladesh is essentially a reflection of its relatively robust domestic demand condition. The prevailing high asset prices in Bangladesh (both real estate and stock market), relative to other emerging economies also point to a strong domestic demand condition. In designing policy response to the global meltdown, we have to take this markedly stronger current domestic demand condition into account. While there is merit in supporting selected adversely affected sectors in a targeted and time-bound manner, there is still no case for implementing a general fiscal stimulus package in Bangladesh.

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