

## **On Inflation and Macroeconomic Activity**

**By**

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With the inflation rate reaching a new high, debate surrounding the source of higher inflation continues. Some have succeeded in establishing sensible explanation for the cause behind higher inflation, while others have missed the point completely. Compared to the existing debate, the goal of this article is very modest. This article shed some light on three important issues that have received much attention in recent times. These issues are: (i) the decision to increase energy prices, (ii) remittance inflows and inflation, and (iii) the import syndication dilemma. These are discussed in turn below.

First, the issue whether government should raise energy prices has received considerable attention in recent days. Some support the notion, while many oppose it. Both imported oil and domestically produced gas are being sold at prices relatively lower than international levels. Bangladeshis still enjoy these precious commodities at the subsidized rates. This partly explains why government's revenue often falls short than its expenditure. Thus, at times when demand for these goods increases, government's budget deficit is likely to widen since subsidy expenditures are increasing. At the end of the day, government finances her deficit by borrowing money from Bangladesh Bank. This extra money growth is often treated as a source of inflation.

For developing countries like Bangladesh, time is never right for the government to raise prices of essential goods. But we have just seen that, the decision to keep prices unchanged could result in higher inflation. Of course, inflationary pressure can also arise (at least in the shorter-term) if government decides to raise prices of oil and gas at the first place. However, with domestic prices getting more aligned to the international level, domestic fiscal position is likely to improve. As such, underpricing causes economic inefficiency and tends to be unfair. In my view, this pivotal issue deserves further analysis in terms of benefits and costs associated with increasing prices of energy goods.

Second, the debate over the relationship between remittance and inflation has generated more heat than light. To begin with, it is important to know which way the direction of causality is running. A large body of research has shown that remittances tend to respond very strongly to prices, reflecting the need overseas Bangladeshis feel to increase family support when prices rise. This lends support that remittances, to a large extent, are spent on consumption. A study on Mexico found that a 1% increase in the CPI inflation is associated with a threefold increase in remittance volume.

In Bangladesh, remittance inflow is booming. Between FY 2005/06 and 2006/07, remittances from overseas Bangladeshis have increased from US\$4.8bn to US\$5.5bn – a 25% rise in one year. While it is possible to observe positive correlation between inflation and remittances in Bangladesh, it remains to be seen which is causing which. Empirical evidence regarding remittances affecting receiving country's inflation is scant

and varies widely across countries. To deal with the inflationary impact of remittances (if observed), the monetary authority could tighten the liquidity. This will likely to increase domestic interest rates and therefore increase the incentives for remittances to come in. However, the direct effect of remittances on inflation may be overshadowed by other factors such as exchange rate. More research is needed to find conclusive evidence as to whether remittance inflows spur domestic inflation.

Third and finally, a widespread believe is that import prices are higher due to collusion among importers. Perhaps as a response to this claim, the interim government has deployed law enforcers to curb rising food prices by selling government food stocks. Despite the government intervention, import prices are showing no sign of slowing down. What seems to be happening in the market? This point has recently been analyzed by Dr. A. K. Enamul Haque of East West University and Economic Research Group.

In a market without government intervention, importers import up to the amount so that it does not distort the market price. When government intervenes, for instance, by delegating TCB (Trading Corporation of Bangladesh) to import goods, it impedes the normal pace of market operations. TCB being a public-funded importer enjoys cost advantage over private importers. For instance, TCB could get an import loan easily and/or pays lower interest rate on its loan than private importers. As a result, private importers feel discouraged to participate in import competition. The upshot of this is lower import volume and higher prices.

Given the size, it would be impossible, if not unwise, to serve the domestic market via a government corporation. In fact, our markets are loosing competitiveness partly because the number of importers is limited and domestic banks have not been sensible enough to provide loans to new importers. In poorer countries, governments are omnipotent. Instead of slowing down the pace of the market, government should eliminate obstacles in order to creat competitiveness in the markets.

Inflation is a colmplex, dynamic process which cannot be comprehended simply through occasional debates or newspaper articles. Rigorous research is needed to understand inflation dynamics and its implications for monetary policy. Much of the responsabilites lie within the purview of local universities, policy institutes, and in particular the Bangladesh Bank.

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