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Interpreting Recent Inflationary Trends in Bangladesh and Policy Options

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Centre for Policy Dialogue (CPD)
House No 40/C, Road No 11 (new)
Dhanmondi R/A, Dhaka-1209
Bangladesh
Tel: (880 2) 8124770, 9141703. 9141734
Fax: (880 2) 8130951
E-mail: cpd@bdonline.com
Website: www.cpd-bangladesh.org

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The Centre for Policy Dialogue (CPD), established in 1993, is a civil society initiative to promote an ongoing dialogue between the principal partners in the decision-making and implementing process. The dialogues are designed to address important policy issues and to seek constructive solutions to these problems. The Centre has already organised a series of such dialogues at local, regional and national levels. The CPD has also organised a number of South Asian bilateral and regional dialogues as well as some international dialogues. These dialogues have brought together ministers, opposition frontbenchers, MPs, business leaders, NGOs, donors, professionals and other functional group in civil society within a non-confrontational environment to promote focused discussions. The CPD seeks to create a national policy consciousness where members of civil society will be made aware of critical policy issues affecting their lives and will come together in support of particular policy agendas which they feel are conducive to the well being of the country.

In support of the dialogue process the Centre is engaged in research programmes which are both serviced by and are intended to serve as inputs for particular dialogues organised by the Centre throughout the year. Some of the major research programmes of the CPD include **The Independent Review of Bangladesh's Development (IRBD), Trade Related Research and Policy Development (TRRPD), Governance and Policy Reforms, Regional Cooperation and Integration, Investment Promotion and Enterprise Development, Agriculture and Rural Development, Ecosystems, Environmental Studies and Social Sectors.** The CPD also conducts periodic public perception surveys on policy issues and issues of developmental concerns. With a view to promote vision and policy awareness amongst the young people of the country, CPD is implementing a **Youth Leadership Programme**.

Dissemination of information and knowledge on critical developmental issues continues to remain an important component of CPD’s activities. Pursuant to this CPD maintains an active publication programme, both in Bangla and in English. As part of its dissemination programme, CPD has decided to bring out CPD Occasional Paper Series on a regular basis. Dialogue background papers, investigative reports and results of perception surveys which relate to issues of high public interest will be published under its cover. The Occasional Paper Series will also include draft research papers and reports, which may be subsequently published by the CPD.

As part of CPD's publication activities, a CPD Dialogue Report series is brought out in order to widely disseminate the summary of the discussions organised by the Centre. The present report contains the highlights of the dialogue on ***Interpreting Recent Inflationary Trends in Bangladesh and Policy Options*** held on 8 September 2008 at the BRAC Centre Inn Auditorium, Dhaka. The dialogue was organised under CPD’s IRBD Programme.

Report Prepared by: *Tazeen Tahsina*, Research Associate, CPD.

Assistant Editor: *Anisatul Fatema Yousuf*, Director (Dialogue & Communication), CPD.

Series Editor: *Professor Rehman Sobhan*, Chairman, CPD.

Dialogue Report on

Interpreting Recent Inflationary Trends in Bangladesh and Policy Options

The Dialogue

The dialogue on *Interpreting Recent Inflationary Trends in Bangladesh and Policy Options*, organised by the Centre for Policy Dialogue (CPD), was held on September 8, 2007 at the BRAC Centre Inn Auditorium, Dhaka. The main objective of this dialogue was to share some observations and analysis as regards the recent inflationary pressure in Bangladesh.

Professor Rehman Sobhan, Chairman, CPD presided over the dialogue while *Dr Salehuddin Ahmed,* Governor of Bangladesh Bank was present as the Chief Guest. *Dr. Mohammad Farashuddin,* former Governor of Bangladesh Bank and *Professor Wahiduddin Mahmud,* Former Advisor to the Caretaker Government attended the dialogue as *Special Guest and* Guest of Honour respectively. *Dr S R Osmani,* Professor, University of Ulster, United Kingdom and Visiting Professor, Department of Development Studies, BRAC University presented the keynote paper. Special Guest

The dialogue saw a broad representation of the civil society with participation of senior government officials and policy makers, economists, academicians, representatives of development agencies, and political leaders. The list of participants is attached in Annex A.

Keynote Presentation by *Dr S R Osmani,* Professor, University of Ulster, UK

At the beginning, *Professor Osmani* thanked CPD for organising the dialogue. He mentioned that the findings of his study would contradict a number of explanations provided by various groups of people previously and his presentation would only focus on the price situation of the recent past. He added that the objective of his paper was to examine the various hypotheses that had been put forward to analyse the recent inflationary trends and to offer a fresh and complete explanation. *Professor Osmani* identified two features of the recent inflationary experience. The first one was accelerated inflation in Bangladesh since 2000/01. The second feature was that the overall inflation had been driven mainly by acceleration in food inflation. Starting from a low level, food inflation accelerated much faster than non-food inflation during FY2001-2007. In his view, these two phenomena needed to be addressed while explaining inflation in Bangladesh.

Professor Osmani placed two groups of hypotheses: demand side and supply side for establishing his argument. Under the demand side hypotheses, he included growth of money supply, rising prosperity of people and growing flow of remittances as plausible explanation of inflation. Under the supply side hypotheses, he included the existence of a non-competitive market (syndicate) and global inflation in food prices.

While explaining the set of hypotheses, the presenter mentioned that the most popular explanation of the possibility of the existence of a syndicate was the least convincing argument as it would not work from an economic point of view. He identified that a mere existence of concentration in the market did not necessarily indicate towards price fixing. Oligopoly in some cases could behave like a cartel in some circumstances while they could be fiercely competitive in others. Even if it was assumed that non-competitive behaviour was prevailing, it did not explain the rising price phenomena as inflation was about rising price not the level of price. If there existed some kind of a syndicate, price would have already been set high above the competitive level. In order to establish such an explanation for inflation, one would have to argue that not only market power existed but that it had been following an increasing trend and at an increasing rate. But no direct evidence on the existence of a non-competitive price had been produced yet.

While elaborating on the money supply hypothesis, *Professor Osmani* explained that excessive growth of money supply caused rising inflation by generating excessive pressure of demand in the economy and there were some evidence that money supply had accelerated in recent years. Since 2003, rising inflation had been associated with accelerated growth of M2 (broad money). He explained with the help of a diagram that from 2001 onwards, rising money supply had been associated with falling rate of inflation and falling money supply growth had been associated` with rising inflation. Therefore, over the short run no systematic relationship could be derived between money growth and inflation. However, a positive relationship did exist over the longer term, admitted the speaker. But this could not be invoked to claim a short run causal relationship as no systematic relationship existed in the short run. More importantly, no evidence had been found that Bangladesh Bank followed a cheap money policy by inducing falling interest rate. Another instance when such things happened was when the central bank needed to finance the country's budget deficit. But during the recent years, budget deficit remained low and slightly declining. The speaker suggested that monetary expansion was not irrelevant for understanding the process of inflation in Bangladesh. Rather, it acted as a means of accommodating inflationary pressure emanating from the supply side.

While explaining the prosperity hypothesis, the speaker noted that the argument that rising prosperity of the people resulted into the demand pressure and led to inflation was invalid. Growth in national income meant growth in national output as well. Since additional demand was matched by additional output, there would be no pressure of excess demand to cause inflation. Moreover, it could not explain the rising price of food either. Professor Osmani recalled that according to Engel's law, rising prosperity should be associated with falling relative price of food. Though in principle, diminishing returns in agriculture could offset the effect of Engel's law, but in practice Engel's law triumphed everywhere helped by technological progress in agriculture. When income goes up demand for food as well as non-food has to go up. Proportionately, demand for food had fallen and non-food had risen. Therefore, relative price of food declined. The speaker further elaborated that an even greater difficulty arose from the "small open economy" argument. Bangladesh is a small open economy. However, most of the food items in Bangladesh have become tradable (importable), whereas a large part of non-food items are non-tradable. According to theory, the prices of tradables are given by the world price. Under this circumstance, rising prosperity must induce a decline in the relative price of food vis-a-vis non-food, regardless of whether Engels' law is offset by diminishing returns or not.

Moving onto the remittance hypothesis, the speaker highlighted the fact that growing remittance certainly added pressure from the demand side. But it could not serve as an explanation for overall inflation as extra demand was matched by extra availability of goods. Nor could it account for rising relative price of food in a small open economy. Professor Osmani pointed out that the hypothesis of rising world food prices was the most plausible explanation of food price inflation in Bangladesh. In a small open economy, facing given world food prices, the relative price of tradable food must fall with growing income, other things remaining the same. The speaker said that for the relative price of tradable food to rise in a small open economy, two conditions must hold - rising world food price and there should exist little or no excess demand in the economy to push up non-food prices. Both these notions were supported by empirical evidence. Both absence of excess demand and rising world price of food had been identified. However, the speaker argued that world food prices could not alone explain the recent inflationary experience in Bangladesh. Such explanation needed to consider the monetary policy and the exchange rate policy.

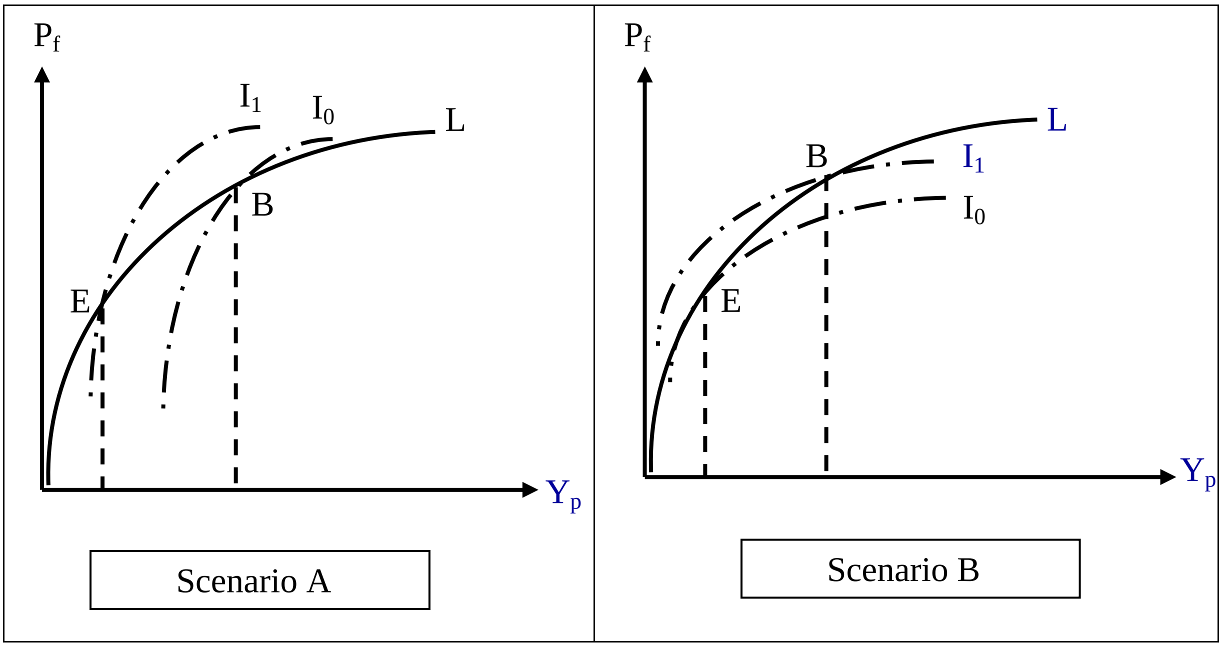
The speaker considered monetary policy to be more acceptable since Bangladesh is a small open economy and could not avoid the impact of rising world price level. Since inflation is about overall rise in the price level, for a relative price to increase and to rise into inflationary pressure, monetary policy needed to be accommodative. In other words, the change in relative price could lead to overall inflation only if an expansion of money supply allowed prices of both food and non-food items to rise. The accommodating monetary policy was embodied in the "monetary programming framework" used by the central bank. This practise allowed immediate past inflationary pressure to be reproduced in the subsequent period at more or less the status quo level, and thereby made it self-perpetuating. The speaker then explained the difference between an accommodating and an expansionary monetary policy. An expansionary monetary policy causes inflation by creating excess demand while an accommodating monetary policy merely validates inflationary pressure caused by some supply side factors. According to the presenter, accommodating policy has helped Bangladesh Bank to prevent collapse of the non-tradable sector that would have occurred otherwise. He explained it further by saying that in the absence of accommodation, rising tradable prices would have entailed a sharp decline in price of non-tradables. Since nominal wages would not adjust immediately, especially as food prices were rising, production would have collapsed in the non-tradable sector.

While describing the possible effect of exchange rate, the presenter raised that while Bangladesh Bank's monetary policy accommodated the inflationary pressure generated from outside, it's exchange rate policy that might have exacerbated inflation. Most of the discussion that took place in Bangladesh about inflation concerned Indian food price and ignored the differences in exchange rate within the two countries. The speaker emphasised that rather than world food price inflation, we should try and elaborate on the situation in Indian food price since Bangladesh did not depend on the developed countries for food import. The problem thus arose as a result of depreciation of taka against US dollars whereas the exchange rate in India remained stable against US dollar (even appreciated during the previous five months by as much as 10 per cent). This resulted in significant depreciation of Taka against Rupee. This explained the worsening food price situation of Bangladesh compared to India.

According to the presenter, such depreciation of Taka against the US dollar was not outside the control of Bangladesh Bank. Rather, the bank soared its foreign exchange reserve during the period. This was contradictory to the idea of having excess demand of dollar. The booming export and remittance also indicated towards an opposite scenario. Thus, it could be apprehended that the central bank had contributed to this by buying dollar from the market or by not selling the excess dollar when required. However, the presenter expressed his concern that depreciation of taka, even though, could explain faster rise of relative price of food but the reason behind the faster rise in overall price level could not yet be explained. Here again the accommodating monetary expansion mechanism had been held responsible. Thus, on one hand accumulation of reserves caused Taka to depreciate adding an upward pressure on the relative price of food. On the other hand, it added to the reserve money by expanding the foreign assets holding of Bangladesh Bank leading to faster growth of money supply. Though theoretically, such growth of reserve money could have been offset by sterilisation but it was not viable in a less developed money market like Bangladesh.

The presenter concluded that the most convincing explanation behind Bangladesh’s rising inflation was the rising world food prices. If the Bangladesh Bank did not pursue accommodating monetary policy in response to rising relative price of food, people’s earning from the non-tradable sector would have suffered. Although the exchange rate policy exacerbated inflation, the speaker argued that depreciation helped the country to boost its exports and enhanced the income of the poor workers employed in the export sector. Increasing the flow of remittances was another possible route through which depreciation might benefit the poor. Conscious appreciation of Taka would have harsh consequences on the country’s export.

Professor Osmani, mentioned that depreciation could have two opposite effects on the poor; a positive effect in terms of income and a negative effect via higher cost of food. The presenter analysed the trade off between the two with the help of a model involving the ‘price-income locus’ and the ‘iso-poverty frontier’. Through identifying a price-income locus, *Professor Osmani* portrayed that rather than staying at the equilibrium exchange rate, Bangladesh Bank’s policy took the economy to such a stage where the poor earned a higher income and paid a higher price of food compared to the market equilibrium level. In order to identify which of the two situations would be better for the poor, the presenter drew an upward sloping iso-poverty curve showing the combinations of per capita real income for poor and relative price of food that would yield the same level of poverty. With positive relationship between poverty and relative price of food and negative relationship between poverty and their per capita real income, an upward sloping iso-poverty curve had been drawn.



The speaker presented two different scenarios to explain the situation. *Scenario A* presented Bangladesh Bank's exchange rate policy as pro poor (B in on a lower iso poverty curve) while in *scenario B,* the policy stance reached the higher iso-poverty curve meaning the policy is anti-poor. The speaker pointed out that which of the points (B or E) was better from the point of view of the poor would depend on the relative slopes of the price-income locus and the iso-poverty curves. These slopes in turn depended on a set of parameters like price elasticity of exports, labour intensity of the export sector, wage determination process of the export sector, exchange rate and income and price elasticities of demand for food. It would, therefore, be the responsibility of the policymakers to consider all these factors and ensure that the pursued exchange rate policy is beneficial for the poor.

Remarks by the Discussants

After the presentation, the floor was opened for discussion. Participants of the dialogue from various sectors provided their comments that have been discussed in details below:

Inflationary Trend

Dr Mohammad Farashuddin, Professor and Chairman, Department of Economics, East West University highlighted that the phenomena of food inflation taking over non food inflation was not always accepted by policymakers and could not be explained only through monetary policy. The discussant agreed with Professor Osmani's observation that for a small economy like Bangladesh, consideration of global price level could be misleading; rather the Indian context would represent the global picture for relative weighing of food inflation in Bangladesh.

Dr Mustafa K Mujeri, Professorial Fellow, BIDS stated that the present inflationary pressure gave worrying signals because it was not triggered by a natural disaster like flood. The complexity arose because the price spiral was not due to one kind of shock rather it was caused by a mixture of shocks.

Regional Inflationary Scenario

Highlighting upon the experiences in other countries within the region, *Dr Salehuddin Ahmed*, Governor, Bangladesh Bank mentioned that inflation in India, Pakistan and Sri Lanka were 4, 8 and 17 per cent respectively. While discussing the Indian scenario the Governor mentioned that India increased its interest rates rapidly which was not a possible measure for Bangladesh. In his view, Bangladesh Bank took up rather a pragmatic policy stance. Bangladesh's real sector was not as productive as that of India and a vast sector in Bangladesh was demonetised. Sensitivity of interest rate was also lower compared to India. The transmission mechanism from micro to macro economic level was also weak.

The Bangladesh Bank Governor elaborated that Pakistan had an even tighter monetary policy than Bangladesh while Sri Lanka was also accommodative to inflation. The Governor went on discussing that although broadly monetary aggregates were the same, the four different countries held four different scenarios.

Monetary Policy and Inflation

Agreeing with the fact that over the short run there is no systematic or monotonic relationship between monetary growth and inflation, *Dr Zahid Hossain*, Senior Economist, World Bank disagreed with the deduction that monetary growth did not cause inflation in Bangladesh. Referring to the work done by the Policy Analysis Unit of the Bangladesh Bank and the International Monetary Fund (IMF), the discussant emphasised that the findings of the report showed that the effect of monetary growth occurred with lags that may be as long as 12 months long. *Dr Hossain* claimed it to be misleading to look for contemporaneous co-movement of inflation and monetary growth. According to him the evidence provided by *Dr Osmani* to support the conclusion that there was no systematic relationship in the short run was not robust compared to the Error Correction Model estimated by Bangladesh Bank which found a statistically significant and positive impact of both narrow and broad money growth on inflation.

Dr Hossain also disagreed with *Dr Osmani's* claim that there was no evidence that Bangladesh Bank was following a cheap money policy by inducing falling interest rates. Average nominal commercial lending rate had declined from 13.02% in FY02 to 12.7% in May 2007. There were ups and downs in between, but it had not even been reverted to the FY02 level. In real terms, interest rate declined much more.

Dr Farashuddin stated that *Professor Osmani's* presentation validated the notion that a monetary expansion in support of a fiscal policy in an unemployment/underemployment scenario could result in a WIN WIN situation leading to instances like high GDP growth, impressive growth in food production, significant job creation and a downward inflationary pressure with relatively low food inflation. Agreeing with *Dr Osmani's* argument that there was no basis for the explanation that monetary expansion had exerted demand pull inflation, he also reminded that minimising or eliminating budget deficit or maintaining higher reserves were not necessary or even desired in all circumstances.

Dr Mujeri discussed that the conventional stabilisation approach under the orthodox development strategy claimed that inflation control was the most important objective of monetary policy since low inflation helps to improve resource allocation, fosters market development, private investment and rapid and stable growth. Since inflation is due primarily to monetary factors, low inflation should be achieved through aggregate demand control by means of contractionary monetary and fiscal policies. But the question lied on whether this strategy would be compatible with sustained growth, macroeconomic stability and the achievement of pro-poor outcomes in the context of Bangladesh.

Dr Mujeri referred to some recent cross country experiences that showed that contractionary policies frequently stifled growth, transferred income to the financial sector and the rich and tended to conflict with the goal of pro-poor macro policy. He also mentioned that several studies specifically concluded that even though high inflation could harm the poor, excessively low inflation and conventional stabilisation policies could have the same result. It was important for Bangladesh to examine the theoretical structure and the policy rationale underpinning the unduly contractionary orthodox policies that were prescribed by the international financial institutions, particularly the World Bank and the IMF, he added. *Mujeri* observed that stable and moderate inflation might have little adverse macroeconomic or distributional consequences; and that orthodox obsession with low inflation could be bad for poor because it was associated with slow growth, high unemployment and high interest rates for long periods. He added that the whole idea of moderate inflation was very much country specific. The choices needed to be made considering the country's socio-economic conditions. *Mujeri* noted that these arguments did not mean inflation to be 'good' rather it highlighted the fact that choices were to be made about the priority to be given to inflation control and by how much to control. He suggested that Bangladesh in this connection could bring in the policy of "cautious expansionism" that would help test the limits of growth especially if the cost of inflation was not very high.

Dr Salehuddin Ahmed, Governor, Bangladesh Bank explained that *Professor Osmani's* explanation did not stand alone; there were a number of other factors that influenced the monetary policy. He mentioned that cautious monetary policy had been undertaken from the very beginning and through such a policy the volatility in the foreign exchange market had been reduced. Inflation also hovered around 7 per cent.

Domestic Monetary Accommodation

Dr Zahid Hossain noted that the explanation through accommodating monetary policy was oversimplified. While he found it true that, over the longer term, inflation in Bangladesh increased due to international price increases and domestic monetary accommodation of these price increases, it was also true that these price movements were compounded by short-term domestic supply shocks such as relatively poor crop harvests, the drives against corruption, adulteration, and hoarding, administered price increases, and now the floods. *Hossain* elaborated that supply shocks, could only cause level effects and could not lead to persistently rising prices when taken in isolation, but when they keep coming sequentially one after another over time, the price level keeps stepping up, thus looking like inflation.

The discussant disagreed with *Professor Osmani* on his claim that the non-tradable sector (which he equates with the non-food sector) would have collapsed in the absence of monetary accommodation. According to *Dr Hossain,* even if monetary policy was only protecting the non-tradable (non-food) sector, it had certainly gone overboard. Non-food inflation crossed 8 percent, compared with an average rate of 4 percent over FY1995-2005. The discussant called it to be much more of an "expansionary" rather than accommodating monetary policy.

On the same note *Dr Farashuddin* mentioned it might be true that the recent monetary policy pursued by the Bangladesh Bank had been accommodating or validating the upward trend in general price levels but such conclusion was made based on too much aggregation. The disaggregated analysis would show that growth in money supply was relatively faster in the public sector with a relatively lower demand for money supply in the private sector and the use of the additional money in the public sector, for more of consumption than investment, resulted in reduction of availability of goods and services. Thus, rising price was the outcome.

He added that increasing production by stimulating investment, with the objective mainly to create job would not be a credible solution in the short run. The discussant emphasised on the inappropriateness of the application of the monetary policy as the main instrument or a stand alone phenomenon in explaining the impacts of the recent inflation. He mentioned that if price was the ratio between the aggregate demand in monetary terms and the aggregate real output, then except in an advanced economy at or near full employment level, monetary policy would not be very effective in smoothening the price inflation. However, it could work as an auxiliary apparatus in supporting fiscal measures towards increasing investment and therefore growth in output through expansion of employment and reduction of unemployment of human resources and of unutilized capacity of the capital installations.

Dr Mujeri explained that in order to find out whether accommodating monetary policy deepened inflationary pressure, one needs to examine the extent to which the present situation depicted increased volatility of inflation. In this connection, government's policy in the light of its success/failure in preventing inflationary expectations from taking a firm hold needed to be assessed.

Syndication

Dr Zahid Hossain supported *Professor Osmani* for opposing the most popular theory of inflation in Bangladesh known as syndication. The discussant felt that not only this hypothesis was theoretically poor and lacked supportive empirical evidence; also the widespread belief in it had done some damage by distracting the focus of the government's policy responses. However, *Dr Nasreen Khundker*, Director, Research, CIRDAP and *Dr Selim Raihan*, Assistant Professor, Department of Economics, Dhaka University opposed this view and did not deny the possibility of the existence of some kind of syndicate and oligopolistic price setting mechanism.

Prosperity hypothesis

Dr Zahid Hossain claimed that the prosperity hypothesis was not implausible. He felt that Professor Osmani leaned a little too heavily on rising relative price of food as evidence against the prosperity hypothesis. In a small economy framework like Bangladesh, to what extent the increase in relative price of food was attributable to the changing composition of domestic demand was not immediately obvious. To him, the faster increase in food price relative to non-food items appear to have been mostly imported. Remittance was an important part of Bangladesh's recent prosperity. *Dr Hossain* explained that remittance could serve as an explanation of overall inflation because the foreign currency inflow from this source was not matched entirely by extra availability of goods. A significant part of it went into building foreign exchange reserves.

Dr Farashuddin expressed that *Professor Osmani's* explanation of the recent inflationary trends in terms of remittance was somewhat confusing. Though theoretically the positive income accrued from the remittances against the negative impact of the overall inflation was sound, however serious imperfections could have been caused by the aggregate nature of the remittances considered. According to the discussant it was difficult to accept that the poor and the fixed income earners bearing the maximum burden of the rising price particularly the food items could be the main beneficiaries of the remittance inflow. This needed further analysis, he observed.

The Exchange Rate Extension

Dr Zahid Hossain disagreed with Professor Osmani regarding his suggestion that exchange rate management was to blame for the increase in inflation. He felt that despite Bangladesh Bank's rapid accumulation of reserves and lack of sufficient mechanisms to mop up the excess liquidity generated, the central bank could influence demand for money by influencing nominal interest rates.

Dr Hossain also pointed out that nominal taka-dollar rates had in fact appreciated from an average Tk 69.7 in July 2006 to Tk 68.5 in August 2007. This coupled with the fact that inflation rate in Bangladesh during the same period exceeded the relevant international inflation which implied that real exchange rate appreciated in Bangladesh even more. Exchange rate depreciation therefore, could not be relevant as an explanation of the rise in inflation, particularly recent inflation. *Dr Hossain* described that what Bangladesh Bank's reserve accumulation did was, it prevented even greater appreciation of taka, which if allowed to happen, would have at least diluted the international price increases. Perhaps Bangladesh Bank was worried about risking damage to exports and remittances.

Dr Farashuddin referred to the contradiction of depreciating taka in the face of increasing reserves with vigorous remittance growth and impressive growth in exports. He pointed out that excessive private demand for dollar cannot be responsible for depreciation and Bangladesh Bank's policy to accumulate reserve by buying dollar from the market allowing taka to depreciate, needs further scrutiny. He found that the current free float policies were not "free enough" to reflect the realities in the foreign exchange market while *Dr Mujeri* argued that it was important to analyse whether the correct policy assignment could manage the nominal exchange rate to secure external competitiveness while anchoring inflation by domestic policies.

Speaking on the relationship between exchange rate and inflation, *Dr Salehuddin* pointed out that though a number of findings showed an association between exchange rate and inflation, there are also many other studies that revealed no such relationship. Moreover, the studies that found positive relationship had insignificant coefficients. In that connection, according to the speaker, if exchange rate was used as a tool for controlling inflation, some problems might have arisen. Unless there was full knowledge on the prevailing misalignments of the market, using exchange rate and reserve policy mechanisms would be highly risky. Thus, the central bank had to be cautious and so had been Bangladesh Bank. The governor explained that if reserve was manipulated without knowing how depreciation was affecting, there was a possibility that cost would outweigh benefits.

The Governor emphasised that it was too simplistic to suggest that the central bank could adjust Taka against Indian Rupee. Imports in Bangladesh were made from a number of countries, not only India. Thus recommendation to select a basket of currencies and adjust the exchange rate was easier said than done. Calling this to be an unrealistic solution, he said that this would raise the question on how and which currencies would be in the basket.

Disagreeing with the Governor's notion, *Mr Hossain Ali*, Economic Consultant, Dhaka Chamber of Commerce and Industries (DCCI) said that according to trends in import, exchange rate and inflation, it could be inferred that a relationship existed not only between import of food items and inflation rate but also between the level of foreign exchange reserve and inflation.

Foreign Exchange Reserve

Dr Farashuddin reminded that the Bangladesh Bank was highly criticised for a low reserve during FY2000-01. The reserve went down due to an additional amount of import of food grain in the previous fiscal compared to normal food import. This helped to push down inflation below 2 per cent. He suggested that part of the reserve be spent in replenishing the availability of the tradables, particularly food grains and embanking a massive OMS drive of food and edible oil at a subsidised rate. *Professor Wahiduddin Mahmud* in his discussion explained that the equilibrium exchange rate policy and reserves were interlinked with each other. According to him, Bangladesh Bank's reserve policy should not be compared to that of one in India. Reserves were kept for emergency and thus it needed to be decided whether the prevailing situation could be considered to be an emergency or not. Choice had to be made whether the reserve should be used now or be kept when Bangladesh's export is affected which was likely to happen during the present year. *Mr Syeduzzaman* added that a single energy shock could halve the existing foreign exchange reserve.

In response to the comments and queries made by the participants, *Professor Osmani* agreed that if he were the Governor of Bangladesh Bank, he would certainly have followed an accommodative policy. However, he also mentioned that he would reverse the exchange rate policy by selling some of the reserve to adjust the depreciation and bring it to the equilibrium level. He said that Bangladesh Bank could accumulate more reserve, but for the time being a better choice would be to reduce reserve which would help reducing harassment of consumers who were already suffering due to rising world food price.

Professor Osmani, referring to the study conducted by the Bangladesh Bank and said that the study did not mention if inflation was caused due to a supply or demand side pressure. Money supply, rather than leading the price, follows it. Thus, demand side factor needed to be determined independently.

Temporary and Permanent Shocks

Dr Farashuddin explained that recent data on ADP allocations, food production and food import revealed that the aggregate demand for money increased while the availability of tradables had reduced resulting into soaring inflation. He mentioned that ADP expenditure in actual terms was 5% for agriculture and 8.2% for water resources during FY1996-97. Compared to the 13.2% expenditure in these two sectors during this period, the expenditure was 8.03% in FY2002-03, 8.08% in 2003-04, 6.06% in FY2004-05, 8.42% in FY 2005-06 and 6.88% in 2006-07. It was thus no surprise that food grain production in the country stagnated at 26.69, 27.44, 26.13, 27.27 and 27.31 million tonnes respectively during those years. With reduction in food imports and increase in money income of an increasing population, inflation, in general, had to be propelled by relative reduction in the availability of food. That according to *Dr Farashuddin* was the major explanation of the inflationary trend in recent times.

Dr Mujeri raised the point that it was important to distinguish between temporary and permanent shocks. Temporary shocks were more likely to be self-reversing and could be handled by maintaining investment and running down previously accumulated food and foreign exchange reserves to stablilize food prices and smoothen food consumption. He also emphasised on income support measures to address adverse consequences of inflation.

Dr Mujeri discussed that in a supply side induced inflation it was difficult to find an obvious role for demand management policies; a fiscal-monetary contraction would reduce the pressure on food prices very little due to relatively low income elasticity of demand, while reduction in demand for non-food products would cause a recession in the non-food economy.

The discussant argued that the current inflationary pressure in Bangladesh had been the result of mechanisms that translate an increase in the relative price of food into an overall inflationary spiral. *Dr Mujeri* highlighted that under the prevailing circumstances demand management was probably a realistic choice. Along with moderating inflation, such action could act as an attempt to earn credibility and signal government determination to maintain low trend rate of inflation. One important concern at this point, according to the discussant, would be to consider the timing, magnitude and content of the policy package and how would these affect the expenditure on capital formation. He also noted that if supply-side policies were working, there would be a reduction in undesired money balances and moderate price increases so that too much reliance on demand management would be counter productive.

Dr Nasreen Khundker reminded that it was to be agreed that there had been disruptions in the supply chain. She also reiterated the existence of oligopolistic pricing in certain cases. Besides that, stricter border control measures, floods, removal of hawkers, closing down of mills according to her did have an impact on the price level as well.

Other Factors Influencing Inflation

Dr Farashuddin described that increase in transport cost, disruption in the retail chaining particularly of the domestically produced food, vegetable, fruits etc, excessive margin kept by the middle men, absence of a Consumer’s Rights Protection Law and the government being either unable or unwilling to undertake massive OMS for breaking the psyche of the hoarders as was done after 1998’s floods where some of the other factors accentuating the recent inflationary trends.

Supporting this view, *Dr Mujeri* explained that *Professor Osmani* rejected the interplay of several hypotheses as no evidence existed at the macro-level on their underlying propositions. However, the contributions of such factor could not be ignored at the disaggregated level. The discussant mentioned that only disaggregated analysis across markets of major commodities could help draw robust conclusions regarding market behaviour and that the underlying factors governing price behaviour in the domestic rice market would be very different from those in the edible oil market. The speaker added that it was also important to recognise the increasing role of destablising private speculation, especially in the food market in affecting the price behaviour.

Challenges for Bangladesh

The Bangladesh Bank Governor highlighted some challenges for Bangladesh to fight inflation. He mentioned that controlling inflation would depend on controlling expectation of inflation. In doing so the nature of price fluctuation had to be monitored. In order to reverse the prevailing situation which is nearing a stagflation, the government would have to think about a counter cyclical method. Concentration should be given on providing higher level of income, employment and businesses. The overall macroeconomic framework could be made flexible and pragmatic. Since most central bankers around the world disagree with the choices of exchange rate manipulation, this cannot be a possible solution.

Highlighting some of these issues, *Dr Atiur Rahman*, Chairman, Unnayan Shamannya also emphasised on addressing inflationary expectation. He mentioned that lack of food stock adds on to such expectation. He suggested pumping in more OMS and reaching the hard core poor. *Professor Wahiduddin Mahmud* explained that in the past, Bangladesh used to import food grains on seasonal basis. But at present, import became a regular round the year practise, thus price level in Bangladesh is affected by the fluctuation in global price level. According to him having sufficient food stock would be the solution for Bangladesh.

In doing so, he suggested to remove import duty when world price rises and raise duty when world price falls. *Professor Mahmud* mentioned the need for building up a buffer stock to be used when there is shortage in the short run. For doing so through the government, there needs to be an agency to work as a market player but it should not be like Trading Corporation of Bangladesh (TCB). However, he warned that unless maintained properly, such agencies can create even more distortion in the market. He added that when it comes to the issue of food grain distribution by the government, certain policy issues need to be addressed. One such issue would be whether open markets should be established in the urban areas or food should reach those who have been the worst affected.

Concluding Remarks by Professor Rehman Sobhan, Chairman, CPD

In his concluding remarks, *Professor Sobhan* mentioned that in most instances it was the ordinary people who suffered the major blow of inflation while there was another section of people for whom even a 50 per cent rise in price level would not matter. According to him, the nature of monetary policy was that it was a broad based tool that failed to address the problem felt by ordinary people. Such broad based tools, in his view, is an imprecise form of intervention because many established literatures underlined inflation as the greatest problem from the structuralist perspective and the different outcomes within South Asia itself reaffirmed the structural nature of inflation.

Professor Sobhan mentioned that it was the different structures of the respective economies that were responsible for variable outcomes of inflation. But the problem was that the governors of banks or any bank whose main tools were monetary tools were very inadequate to address the problem of inflation because they were addressing only one aspect of it. The major component of processes of inflation was derived from the supply side responses in the economy. Major challenges would therefore be, how to increase both the short run and long run interventions on the supply side responses in the economy. According to *Professor Sobhan,* the reasons why India pursued a tight monetary policy upto a point and yet had got much more robust credit policy was because this supply side responses within the economy tended to be much more direct and positive. In his view, these countries have a strong and diversified economies with high rates of investment and growth and therefore responses tend to be very rapid.

Professor Sobhan made a remark that, probably the reserves of Bangladesh ranged about 10 billion dollars and only half of this happened to be under the control of the Bangladesh Bank. But there were significant reserves in private hands and the relevant issue was the capacity of the Bangladesh Bank to bring some of these under its control. Even if the central bank was unsuccessful in the task, it did not mean that the resources were not accessible to those in need because there was a very proficient and well functioning curb market which stimulated both the supply and demand of reserve outside the control of Bangladesh Bank. One of the reasons why the central bank might have had the exchange rate stability to some extent was because of the functioning area of monetary policy which was not within its control.

Professor Sobhan explained that the central bank was dealing with a situation in which our exchange rate had severely depreciated in relation to our principal dealing partner India. In his view, this was however, not at all significant comparing the responses in 1998 and today. In 1998 there was not such a wild depreciation of taka vis a vis Indian Rupee, moreover India was sitting at a point on 20 million tonnes of food stocks which was in the official reserve of India and they were quasi subsidising it into the world market. Under that situation when Bangladesh opened the borders in the wake of the flood, all the traders big and small rushed across the borders to India and imported close to four millions tonnes of food at relatively cheaper prices. He continued that this privilege no longer existed because food prices in India had gone up. The present supply situation is tighter and Indian government is also thinking that they were being too generous to send half a million tonnes of food grains to Bangladesh.

Professor Sobhan went on discussing that Thai Bath was highly appreciated against dollar and Taka more than it did against Indian Rupee. Bangladesh could not have actually appreciated Taka against Dollar because of competition in the RMG Industries all over the world and particularly with China who would become a much more significant competitor in the course of the next year. He elaborated that China was one of the few countries whose currency had not significantly appreciated against Bangladeshi Taka because the Chinese were pursuing exchange rate policy in the sovereign interest of the Chinese people. Bangladesh thus needed to keep an eye on related competitors in the readymade garments market. *Professor* remarked that monitory policy was too serious a matter which needed to be addressed by a variety of the riders in the private and public sector and there should be a mechanism of designing and developing the monetary policy through a more broad based process of consultation.

He also noted that Bangladesh did have reserves, but it went into the hands of the people who had rapidly utilised this and translated it into widening the supply side capacity of the economy either through intervention and capacity utilisation in the manufacturing and goods producing sector or rapidly used it for import. *Professor Sobhan* recalled and praised previous policymakers for their good sense of using reserve for deficit financing and not being obsessed with maintaining the reserve level. The deficit financing at that period significantly enhanced the supply side of the economy in response to the post flood situation and it paid off in terms of level of the prices keeping inflation rate at 2.5%. So when the government is facing macroeconomic imbalances and looking for a way to finance deficit they forgot about the rate of inflation which might be a more relevant indicator to look at.

Professor Sobhan described that in the Bangladesh context agricultural output could be significantly enhanced if interventions were made in the critical areas and the right intermediate inputs were provided and credit was injected into the economy particularly in the post flood period. He referred to the 1998 flood recalling the brilliant response by the team which was there during inflation at that time. According to him that was the most significant flood in the history of Bangladesh, but there was no significant deceleration in agricultural output in that particular year because the supply side response to access the farmers was calibrated in the most affected areas. *Professor Sobhan* emphasised on involving the private sector of Bangladesh for addressing such issues. To him, these issues should not be left alone in the hands of the central bank governor.

He thanked all the participants for such a rich discussion.

List of Participants

Dr Salehuddin Ahmed	Governor, Bangladesh Bank
Mr Kazi Sabbir Ahmed	Lecturer, Department of Economics, North South University (NSU)
Mr Mansur Ahmed	Research Associate, SANEM
Mr Mahbub Alam	Chairman, BAKSAL
Mr Md Hossain Ali	Economic Consultant, Dhaka Chamber of Commerce and Industries (DCCI)
Dr M Asaduzzaman	Research Director, Bangladesh Institute of Development Studies (BIDS)
Dr Manzoor Elahi Chowdhury	Associate Professor, Independent University of Bangladesh (IUB)
Mr Abul Hasan Chowdhury	Former State Minister and Managing Director, KMS Consultants
Mr Narayan Chandra Das	Senior Research Associate, Research and Evaluation Division (RED), BRAC
Dr Mohammed Farashuddin	Former Governor, Bangladesh Bank and Former President, Board of Directors, East West University (EWU)
Dr Mohammad Osman Gani	Assistant Professor, School of Business, IUB
Mr Gazi Mainul Hassan	Lecturer, Department of Economics, NSU
Mr Zobdul Hoque	Former Deputy Director General, Bangladesh Bureau of Statistics (BBS)
Dr Anwarul Hoque	Professor and Chairperson Department of Economics and Social Science (ESS) BRAC University
Dr Zahid Hussain	Senior Economist, The World Bank
Mr Hasanul Haq Inu	President, Jatiyo Samajtantrik Dal (JSD)
Mr Piash Karim	Associate Professor, ESS, BRAC University
Mr Mashfiqur Rahman Khan	Lecturer, Dept of Economics, Dhaka University (DU)
Mr Anis A Khan	Managing Director , Industrial Development Leasing Company (IDLC)
Ms Shaila Khan	Senior Program Officer (Policy Support and Advocacy), UNDP
Dr Nasreen Khundker	Research Director, CIRDAP
Dr Chowdhury Shameem Mahmoud	Assistant Professor, Department of Economics, NSU
Professor Wahiduddin Mahmud	Dept of Economics, DU and Former Advisor to the Caretaker Government
Mr Mir Nahid Mahmud	Research Associate, South Asian Network on Economic Modeling (SANEM)
Mr Alamgir Morshed	Head of Global Markets, Standard Chartered Bank
Dr Mustafa Mujeri	Professorial Fellow, BIDS
Dr K A S Murshid	Research Director, BIDS
Dr S R Osmani	Professor, University of Ulster, United Kingdom (UK) and Visiting Professor, Department of Development Studies BRAC University
Ms Lutfun N Khan Osmani	Visiting Faculty, BRAC University Lecturer, School of Management & Economics Queen's University of Belfast, UK
Ms Shaila Parveen	Lecturer, ESS, BRAC University
Mr G M Quader	Former Member of the Parliament
Dr Atiur Rahman	Chairman, Unnayan Shamanny
Dr Selim Raihan	Assistant Professor, Dept of Economics, DU and, Chairman, SANEM
Mr Abdul Awal Sarker	Deputy General Manager (DGM), Research, Bangladesh Bank
Professor Rehman Sobhan	Chairman, Centre for Policy Dialogue (CPD)
Mr M Syeduzzaman	Member, CPD Board of Trustees, Chairman, Bank Asia and Chairman, British Oxygen Company

List of Journalist

Mr A M M Jahangir Alam	Staff Reporter, Radio Today
Mr Zulfikar Ali	Special Correspondent , NTV
Mr Rokonuzzaman Anjan	Staff Reporter, The Sangbad
Mr Salahuddin Bablu	Senior Reporter, The Daily Inquilab
Mr Rejaul Karim Byron	Staff Reporter, The Daily Star
Mr Sanjoy Chaki	Staff Correspondent, Channel i
Mr Pulack Ghatack	Senior Reporter, The New Nation
Mr Nazmul Haque	Economic Reporter, The Daily Jugantor
Mr Mohammad Hasan	Staff Reporter, The Daily Star
Mr Hamidul Huq	Staff Reporter, RTV
Mr Shiekh Didarul Islam	Staff Reporter, The Bangladesh Today
Mr Saidul Islam	Staff Reporter, The Daily Amar Desh
Mr Jibon Islam	Economic Reporter, The Bhorer Kagoj
Mr Rakibul Islam Mukul	Reporter, Boishakhi Media Limited
Mr Mamun Neysar	Senior Reporter, The Daily Manab Jamin
Mr Syed Shamsuzzaman Nipu	Senior Economic Reporter, The Daily Naya Diganta
Mr Golam Parvez	Reporter, ATN Bangla
Mr Sajjadur Rahman	Senior Staff Reporter, BD News 24
Mr Sadequr Rahman	Staff Reporter, The Daily Sangram
Mr Kazi Rokon Uddin	Staff Reporter, The Executive Times
Mr Hasan Imam Rubel	Staff Reporter, The Prothom Alo
Mr Meer Saiful Islam Tushar	Senior Staff Reporter, United News of Bangladesh (UNB)