

*Round Table Discussion*  
*on*  
**The Role of IMF in Policy Making in Bangladesh**

*Prepared by*  
**M Iqbal Ahmed**

# Explore the IMF supported PRGF Programme

Objectives of the IMF supported PRGF Programme are

- ❑ To maintain macroeconomic stability through
  - lowering inflation
  - reducing Balance of Payment deficit
- ❑ To facilitate poverty reduction programme taken under PRSP

# Explore the IMF supported PRGF Programme

- Present study focus on two core areas namely fiscal and monetary policy where the IMF has maintained its supremacy under the current reform programme; and examines the impact of
  - prolonged contractionary monetary policy to contain inflation and its consequences;
  - fiscal austerity measures and its consequences;

# PRGF Loan and the IMF Conditions:

- ❑ Bangladesh has been promised to get a loan amounting to about US\$490 million in seven instalments under the PRGF programme
- ❑ But government needed to comply a certain set of conditions. These include
  - tightening demand management policy through monetary and fiscal reform including some austerity measures,
  - more liberal exchange regime by moving into floating exchange rate regime
  - more liberal trade regime by reducing tariff rate and removing trade barriers
  - Privatisation of NCBs
  - Privatisation/closure of SoEs

# Progress of Reforms

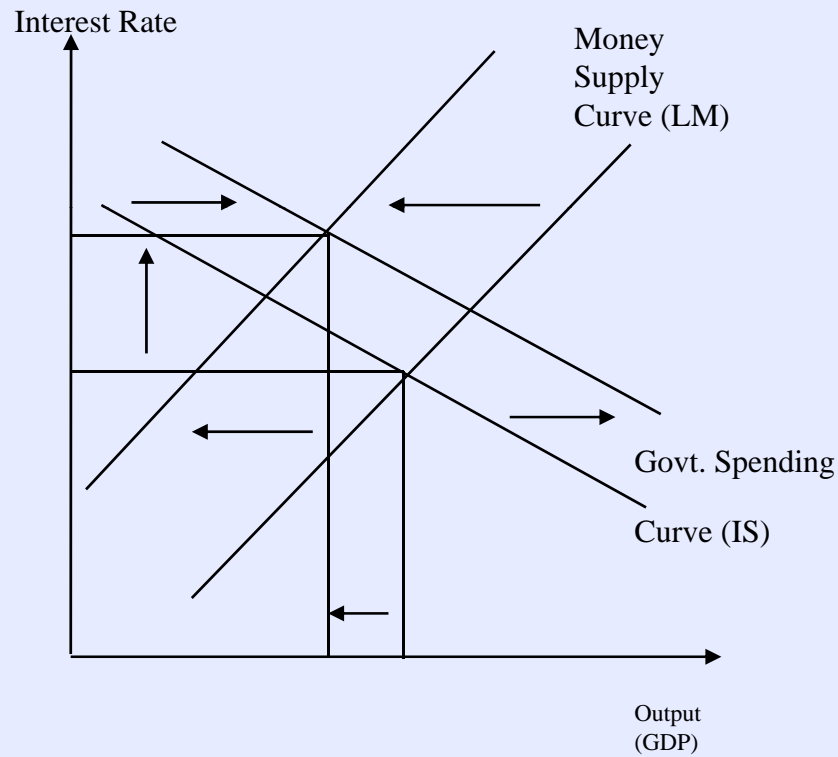
- Following the PRGF agreement Bangladesh introduced floating exchange rate in May 2003.
- Tariff rate reduced substantially with removing trade barriers
- Privatisation of the NCBs is underway
- SoEs have been either closed or being privatised
- Meanwhile, central bank has introduced a contractionary monetary policy to contain inflation
- Government has been keep on revising the administered prices of public utilities including the fuel price to ease the budget deficit

# Methodology

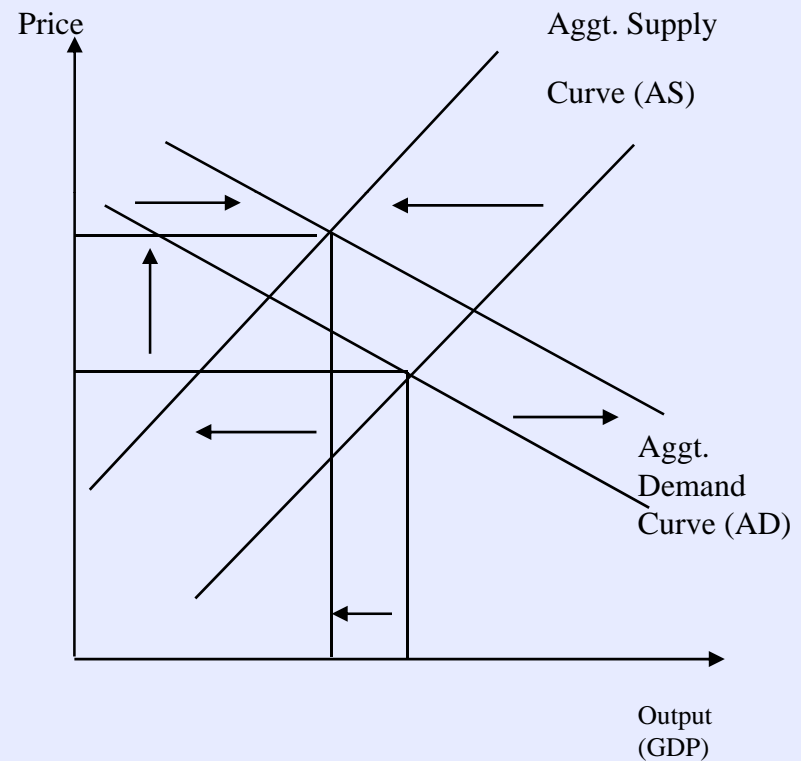
- ❑ To examine the impact of IMF stabilisation programme on economy we used simple macroeconomic model of IS-LM and AS-AD framework
- ❑ Our approach:
  - reviewed IMF policy, government policy and relevant literatures
  - used secondary data of key macroeconomic variables available from Bangladesh Bank, Bangladesh Bureau of Statistics, Economic Relation Division
  - Examined policy implications using macroeconomic assumptions

# Macroeconomic Assumptions:

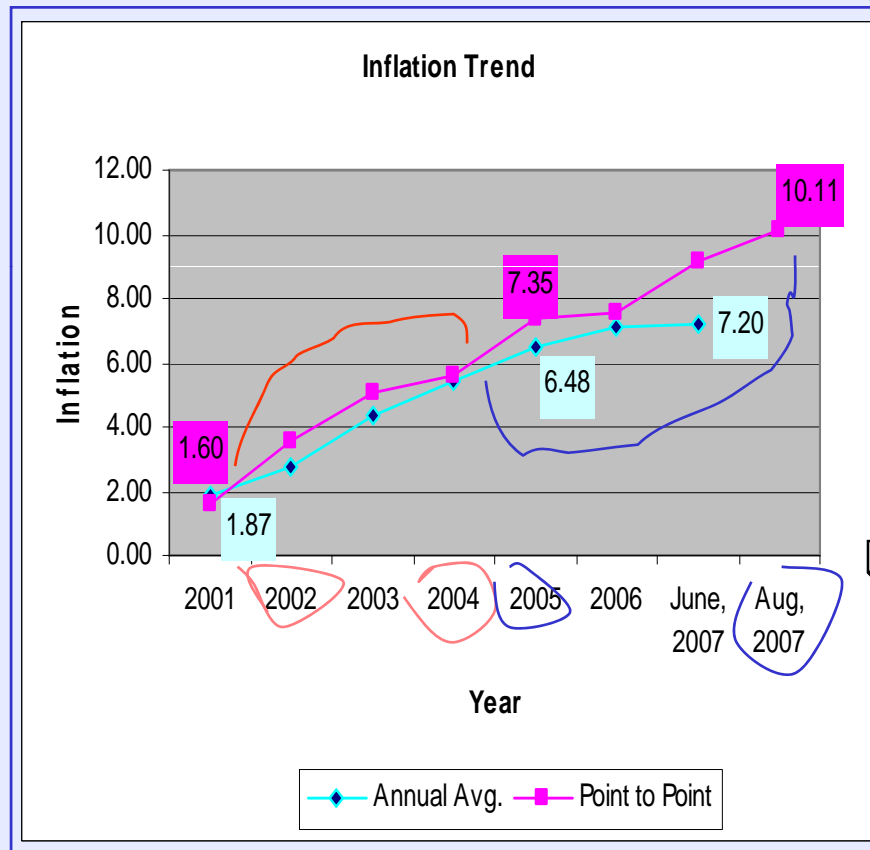
- IS-LM Framework



- AS-AD Framework



# Inflationary Trend in Bangladesh



- Price spiral between 2001 and early 2005 was mainly because of non-economic factors like extortion, syndication etc, and economic factors like increasing transportation cost, and fuel costs etc, which increased cost of production. Price spiral during the period can also be explained negligence of agriculture sector.
- From 2005 onward inflationary pressure, which was fuelled by international price-hike, was exaggerated due to some macroeconomic disturbances created from policy mismatch.

# Policy Signals an Anticipated Inflationary Trend:

- Present inflationary trend is neither because of excessive demand nor it is an unanticipated one
- Instead it was an anticipated one because of the inertia and expectations formed by the people propped up by the policy signals of the authorities;
- This could happen if everyone expects the inflation to rise to a certain extent in the near future.

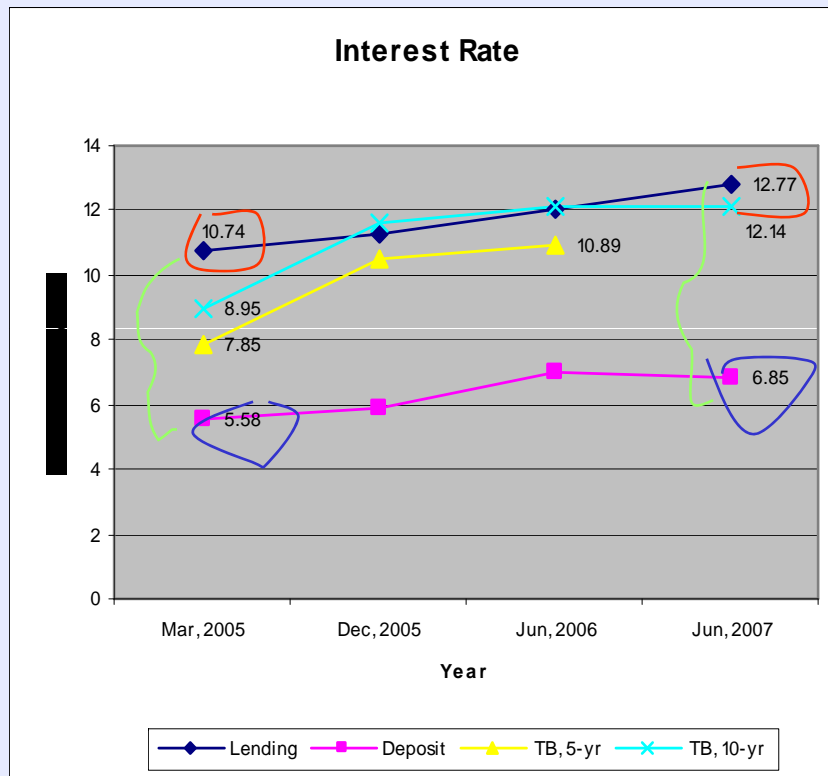
# Policy Signals an Anticipated Inflationary Trend:

- ❑ For example, followed by the pay hike of the government officials there was tendency among other working classes to bargain for an increase in nominal wages greater than expected inflation. The producers, on the other hand, continued to increase prices higher than the anticipated inflation. These together triggered the price spiral.
- ❑ Same thing happens when government decides to increase fuel price or other public utilities, which mostly affect the commoners.

# I. Why Inflation is Skyrocketing?

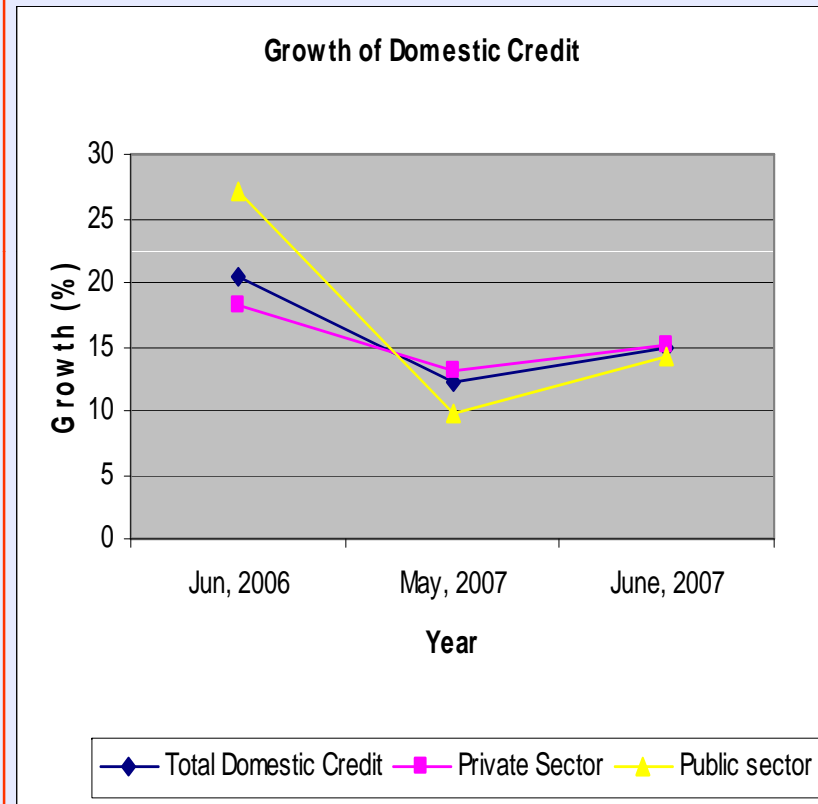
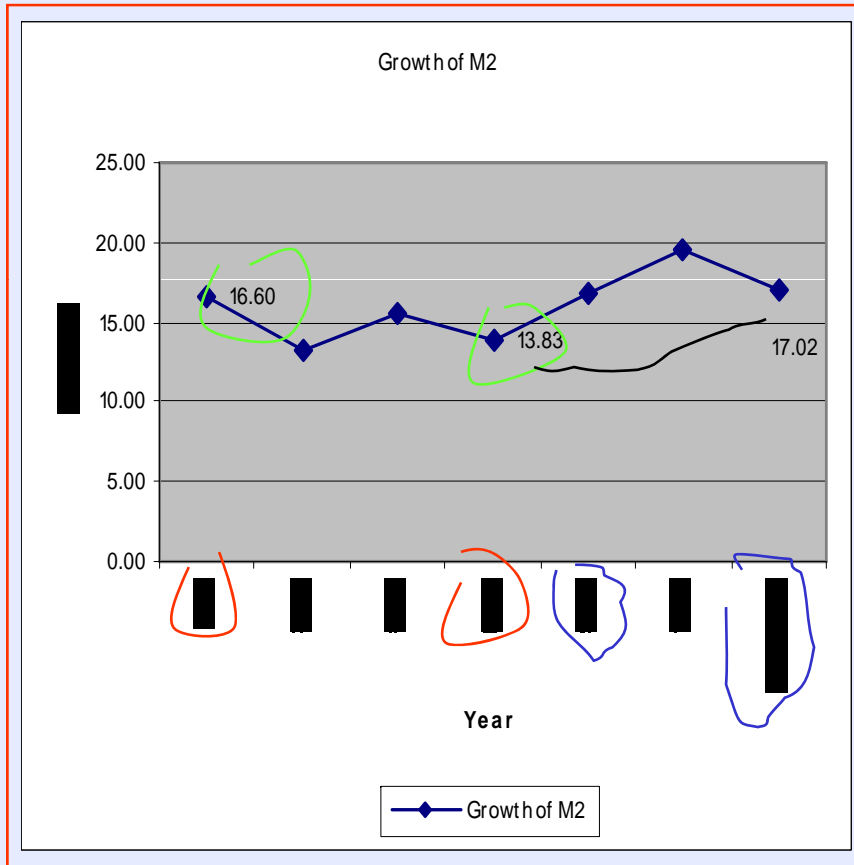
1. Policy Mismatch: Central bank has been persuading **contractionary monetary policy**, while over the past few years **budgetary measures were expansionary**.

# Consequences of Prolonged Tightening Monetary Policy: Interest Rate



- ❑ Tightening monetary policy initiated in early 2005 following an instruction of IMF; IMF reasoned that the economy was overheated, which triggered inflation;
- ❑ BB raised SLR, CRR & Bank Rate
- ❑ This followed by an unhealthy competition within the banking as well as non-banking financial institutions to rise the interest rate;

# Consequences of Prolonged Tightening Monetary Policy: Growth of Money (M2) & Domestic Credit



# Why Inflation is Skyrocketing?

## 2. Currency Depreciation is an Inflation Booster

- ❑ Depreciation tends to increase the domestic price of imported goods which led to an increase in price of final output and then wages.
- ❑ The higher inflation requires further depreciation to maintain export competitiveness.
- ❑ Consequently, this has three broad implications:
  - First, the depreciation further stimulates inflationary pressure.

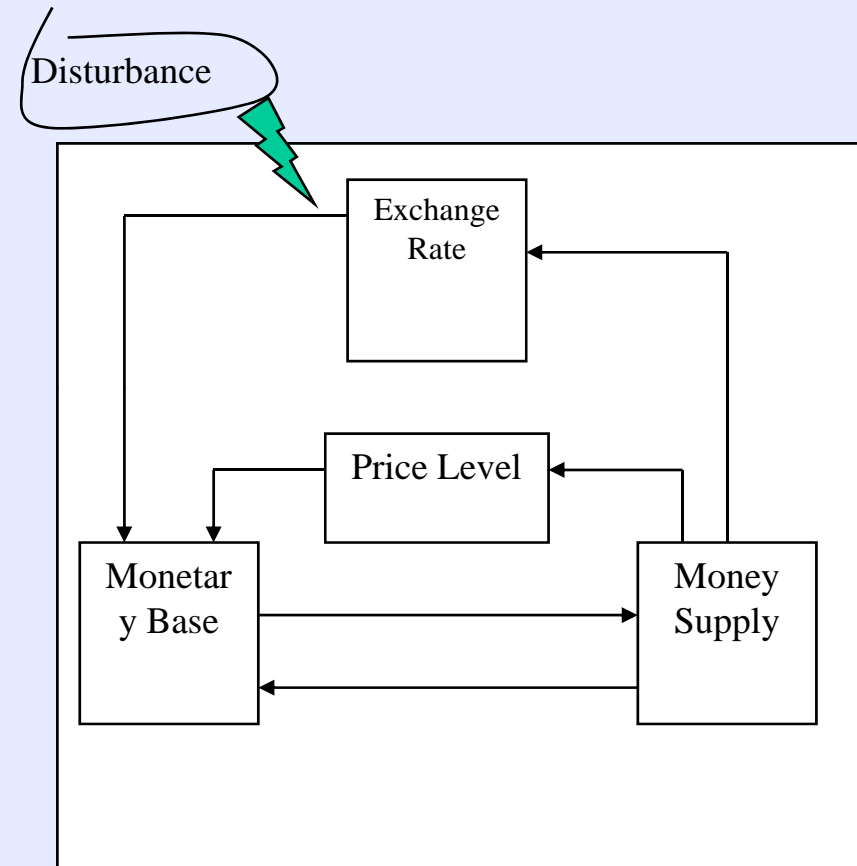
# Why Inflation is Skyrocketing?

Second, the depreciation means that country's terms of trade eventually deteriorate, implying that cost of import is higher than the cost of export, which in turn causes a negative impact on trade balance. Thus further lead currency to depreciate;

Third, since price is sticky in the short run, it gradually adjusts in line with the rate of currency depreciation. This means that export lose competitiveness after a certain period of time, stimulating currency to depreciate further to maintain the export competitiveness, thus, puts further pressure on inflation.

# Why Inflation is Skyrocketing?

- According to the vicious circle of hypothesis, under a floating exchange rate system, an initial disturbance (either domestic or foreign) can create an exchange rate-inflation spiral. That is the disturbance can set into motion a cumulative process of inflation and exchange rate depreciation, through which exchange rate effect is rapidly translated into domestic prices and costs and back to the exchange rate.



Source: Onis and Ozmuca, 1990: 137

# Why Inflation is Skyrocketing?

## 3.Lack of Financial Instruments:

❑ Given the floating exchange rate regime why the inflation targeting scheme has not been effective as an anti inflationary tool is because

- The measure has not been complemented by the open market operation because of lack of financial instruments.

- Without a well functioning market, a floating regime could indeed become a source of volatility and other distortions, creating speculative bubbles. Therefore, because of absence market instruments the central bank often resorts to interventionist steps, like managing the exchange rate, which may not be synchronized to other policy objectives,

# Why Inflation is Skyrocketing?

## 4. Trade liberalisation and Increasing Trade Deficit:

- ❑ Over the last decade the (weighted) average tariff reduced to 6.98% in February 2007 from 23.6% in June 1993; un-weighted avg. tariff reduced from about 49% to about 13%.
- ❑ Number of restricted items which were 193 in the import policy of 1991-93 was reduced to 63 in the import policy of 2003-06.
- ❑ This has intensified the dependency of import
- ❑ As a result trade deficit increased by 85% to US\$3458 million in 2007 from US\$1865 million in 2000
- ❑ High trade deficit also leads currency to depreciate thus has an impact on inflation

# Why Inflation is Skyrocketing?

## 5. Increasing Dependency on Import:

- ❑ India and China are the main sources of import Bangladesh, accounting for, on an average, around 28-30% of the total import in the last four to five years.
- ❑ In the last few years, Indian Rupee and Chinese Yuan has appreciated by 15-17% and 4-6%, respectively, against dollar while between 2003 and June, 2007 taka depreciated by about 19%, meaning that cost of import from these countries increased substantially.

# Why Inflation is Skyrocketing?

## 6. Expanding Budget Deficit:

- ❑ Fiscal authority was not accommodative to complement the monetary authority; instead it continued pursuing an expansionary budgetary measures.
- ❑ As a result budget deficit which was 4.19% in 2004 rose to 4.5% in 2007.
- ❑ Budget deficit is a problem for an inflationary economy. Bangladesh's inflation experience may be explained in a large part by the needs of public finance.

# Why Inflation is Skyrocketing?

## 7. Growing Public Indebtedness:

- ❑ Expanding budget deficit means that the deficit to be financed by borrowing from domestic and external sources;
- ❑ Currency depreciation and increased interest rate cause to increase the cost of borrowing, implying growing public indebtedness;
- ❑ This means that budget deficit tends to be higher in the subsequent period; since the source of government revenue is limited, it further depends on public borrowing; leading to inflationary pressure;

# Why Inflation is Skyrocketing?

## 8. Using Pricing Policy is Unsustainable to Mitigate Budget deficit:

- ❑ In recent years there is a tendency that government has been trying to finance some of the public sector units' deficit by increasing the tariff of public utilities;
- ❑ Government in several attempts has revised the pricing policy of the PSUs to make up loss of the PSUs as dictated by the donors. For example, government has increased the price of fuel, electricity and gas prices substantially.

# Why Inflation is Skyrocketing?

- ❑ Government is further mulling to increase the utility prices including that of water in order to reduce the deficit;
- ❑ However, the policy of increasing prices of public utilities would not solve the overdue loss incurred by the public utilities, therefore, to reduce the deficit burden, which is the resultant effect of the prevalent mismanagement and corruption in the past;
- ❑ Instead it would add inflationary pressure in the economy, reducing consumer welfare;

# Why Inflation is Skyrocketing?

## 9. Increasing Workers' Remittances Creates Expansionary Demand:

- ❑ In addition, strong expansionary influenced the economy as a result of improvement of the current balance due to rising expatriate workers' remittances, putting pressure on money market.
- ❑ Despite the fact that central bank has adopted an inflation targeting scheme through tightening demand management, strong growth of remittances has created an expansionary demand, which is basically inelastic in nature, by the household level.
- ❑ Again due to lack of availability of financial instruments, the authorities could not able to mop up the excess demand, ending up with inflation targeting scheme ineffective.

## II. Fiscal Austerity Measures

- ❑ Another common prescription of the IMF is to pursue fiscal austerity measures in order to contain budget deficit.
- ❑ In Bangladesh, with one of the lowest tax-GDP ratio in the world, it is difficult to rise revenue earnings as required.
- ❑ At the same time it is difficult to cut revenue expenditure for political reasons. As a result, the only option that remains for the government is to spend less on capital expenditure or to downsize the ADP spending, especially those targeting the poor.

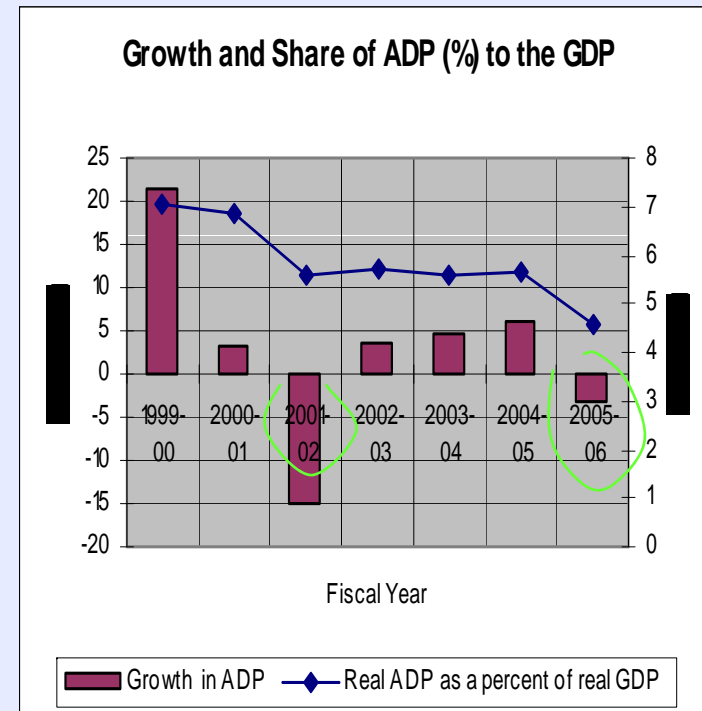
# Fiscal Austerity Measures

- ❑ This happens because proportional cuts on such spending are easier to implement quickly both in technical terms and in terms of raw politics.
- ❑ Since poor people usually do not form organized groups, and so lack a political voice, spending cuts on social protection and other development programmes that benefit the poor often tend to be larger in relative terms.

# Fiscal Austerity Measures

## 1. Annual Development Expenditure:

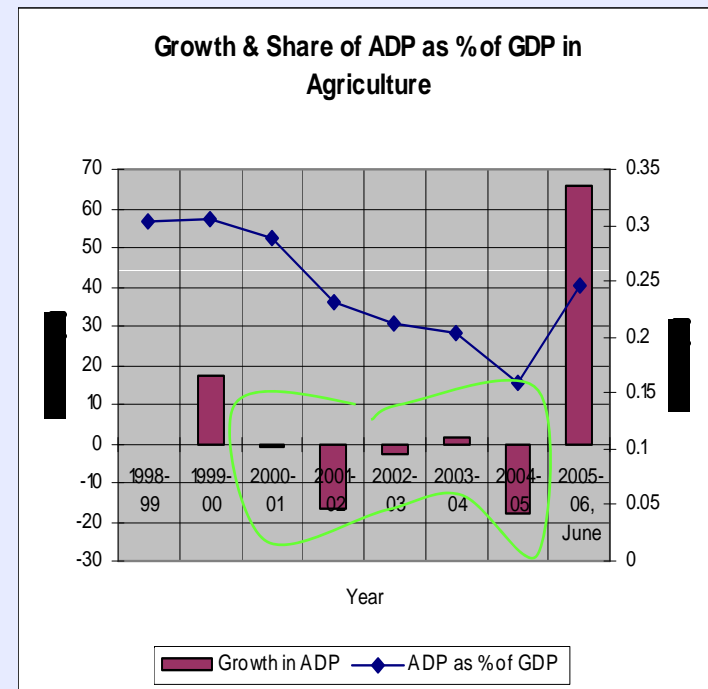
- ❑ While the objective of the government remains same reducing poverty through output and employment generation, the public investment scenario remains poor in the country.
- ❑ Public Investment (after inflation adjustment) in proportion to GDP has declined significantly to below 5% in FY 06 from 6.53 in FY 2000



# Fiscal Austerity Measures

## 2. Public Spending on Agriculture

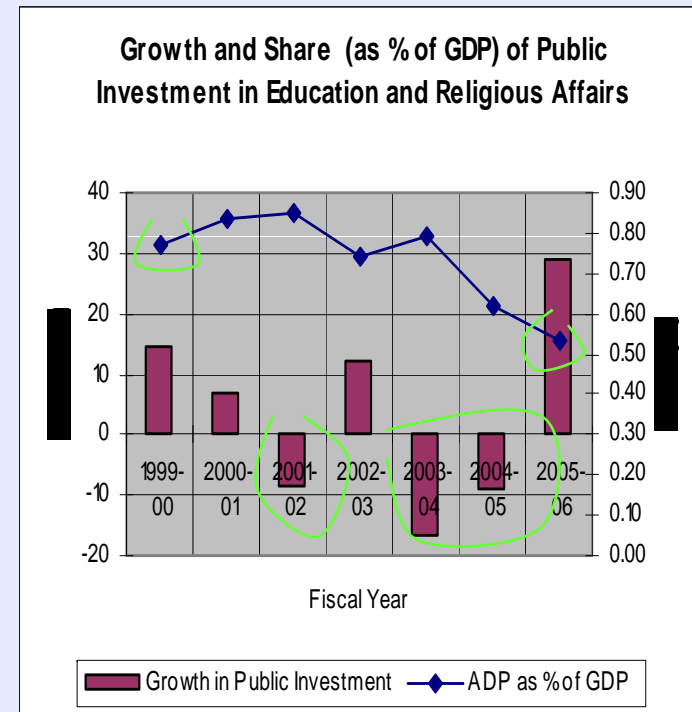
- ❑ Between 2001 to 2005 public investment in agriculture did not grow, in fact marked a negative growth as shown in the figure.
- ❑ Government spending on agriculture in proportion to GDP has slide down to 0.16% in fiscal 2005 before raising it to 0.25% in 2006 from 0.31% in 2000 (the growth and share are measured in real terms with base 1995-96=100).
- ❑ The poor investment in agriculture is reflected from the poor performance of agriculture during the period. The agriculture sector (excluding fisheries, which grew at 6.92% in fiscal 2000, plunged to a negative growth rate of 0.62% in fiscal 2002. The growth in the subsequent year was not very enthusiastic.



# Fiscal Austerity Measures

## 3. Public Investment on Education

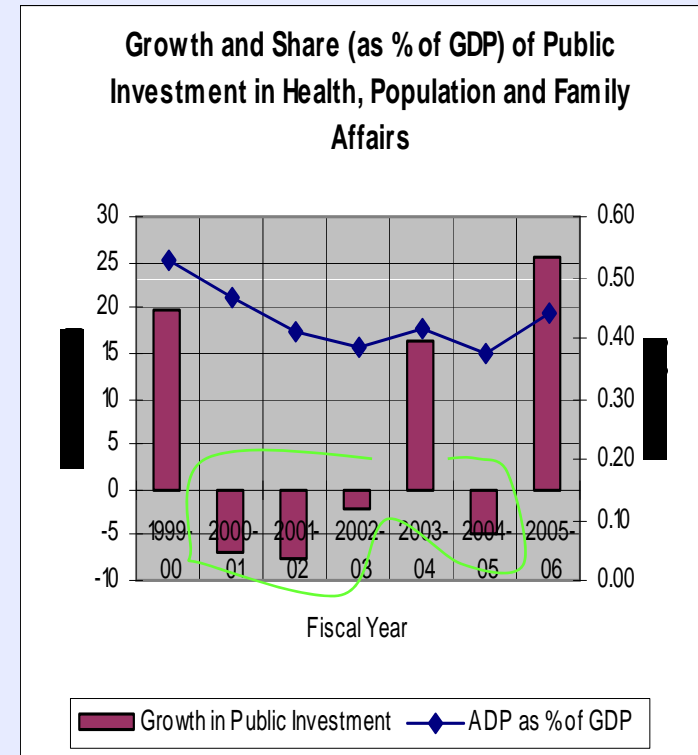
- ❑ As the GDP grew over 5% to 6% during the last few years, the proportionate public investment on Education has not been increased in real terms,
- ❑ In fact, in some instances (it was – 8.7% in fiscal 2002, and –16.55% and –8.56%, respectively, in 2004 and 2005).
- ❑ As a result its share as percentage of GDP (after inflation adjustment), has declined from 0.85% in fiscal 2001 to 0.64% in fiscal 2006 before falling it to 53% in fiscal 2005.



# Fiscal Austerity Measures

## 4. Public Investment on Health

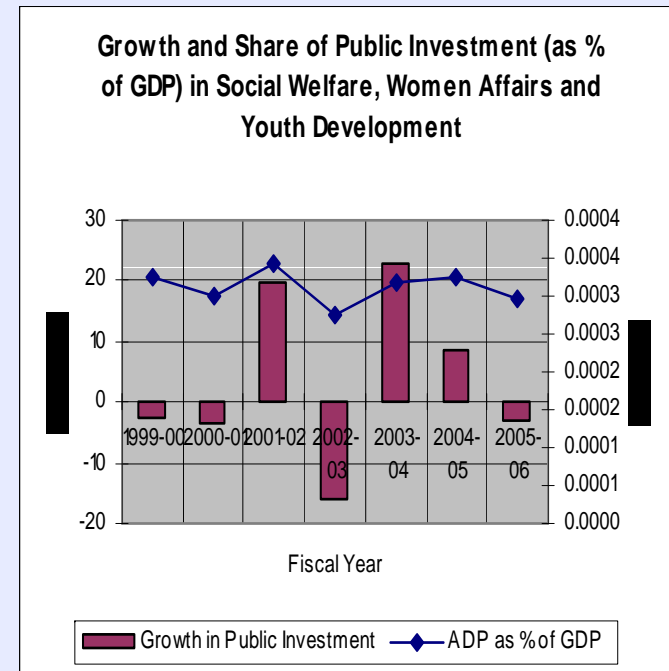
- ❑ Public investment on Health and Population and Family Welfare sector has also marked negative growth (in real terms)
- ❑ During most of the period between fiscal 2000 and fiscal 2006 (-6.93% in 2001, -7.66% in 2002, -2.09% in 2003, 16.18% in 2004, -4.97% in 2005 and 25.39% in 2006). Its share in proportion to GDP (after inflation adjustment) declined from 0.53% in fiscal 2000 to 0.37% in fiscal 2005, before raising it to 0.44%.
- ❑ The negligence of the public investment reflects the poor quality of the public health system across the country, both in urban and rural areas. The campaign for family planning seems to come under pause due to government's negligence on health and population sector.



# Fiscal Austerity Measures

## 5. Public Investment on Social Welfare, Women Affairs and Youth Development

- ❑ Growth of public investment Social Welfare, Women Affairs and Youth Development remain dismal.
- ❑ The government spending in real terms was negative which is -16.6% in 2002, -18.68 in 2004 and -8.02 in 2005. The investment in proportion to GDP remains at negligible level, slid to 0.042% in 2006 from 0.073% in fiscal 2000.



# Consequences of the Fiscal Austerity Measures:

- ❑ Such austerity programme have adverse effects on poverty reduction scenario and caused dislocation within the economy, especially for the poorest and most vulnerable sectors of society that are most dependent on the state for valuable services like health care and education.
- ❑ The impact of the austerity may not be discernable in the short run.
- ❑ However, the recent success on various social issues that the country has achieved might disappear in the long run if the social spending continues to decline

# Conclusion

- ❑ When the country needed a investment friendly environment to generate employment and output to eradicate poverty, a tight demand management with contradicting policies has been destabilising the economy with low investment, low capital formation, low output and low employment thus leading to a stagflation.
- ❑ At the same time cut in public spending making the poor marginalised further.

**Now the question is.....**

Do we need IMF?

Thank You