OCCASIONAL PAPER

The Return of Inflation Implications for Bangladesh

M SHAHIDUL ISLAM

Centre for Governance Studies

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cgs Centre for Governance Studies

45/1 New Eskaton (2nd Floor), Dhaka 1000, Bangladesh
Phone: +880258310217, +880248317902, +8802222223109
Email: ed@cgs-bd.com
Website: www.cgs-bd.com

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The return of inflation: Implications for Bangladesh

M Shahidul Islam*

Introduction

After decades of price stability, notably in advanced economies, prices of food and non-food commodities are on the rise globally. The annual inflation rate in the United States (U.S.) soared to a four-decade high of 8.5% in March, widely missing the Federal Reserve's inflation target of 2%.[1] Not far below the U.S. rate, the overall price level in the eurozone registered a 7.5% increase in the same period.[2] The 10-year breakeven rate, derived from the difference between conventional and inflation-adjusted Treasury yields, is hovering around 3%,[3] surpassing the previous high reached in 2005.

In emerging markets and developing economies (EMDE) consumer prices are spiking fast. In almost all South Asian countries CPI (Consumer Price Index), which measures the total value of goods and services consumers buy over a specified period, inflation is rising steadily. In Bangladesh, year-on-year (YOY) consumer prices surpassed 6% in the first quarter of 2022, which is higher than the Bangladesh Bank's inflation target set at 5.3% for the year.[4] Although there are concerns that the official inflation figure of Bangladesh underestimates the actual consumer prices.[5] In Sri Lanka and India, CPI inflation shoot up 21% and 8%, respectively in March (Figure 1).

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* Dr. M Shahidul Islam is a Senior Research Fellow at the Centre for Governance Studies (CGS) and Distinguished Fellow at Yunnan Academy of Social Sciences (YASS), China. The author can be contacted at: shahid.imon@live.com. Expressed views are personal.

1 US Bureau of Labor Statistics. 2022. Consumer prices up 8.5 percent for year ended March 2022. Available at: https://www.bls.gov/opub/ted/2022/consumer-prices-up-8-5-percent-for-year-ended-march-2022.htm#:~:text=The%20Consumer%20Price%20Index%20increased,month%20advance%20since%20December%201981.

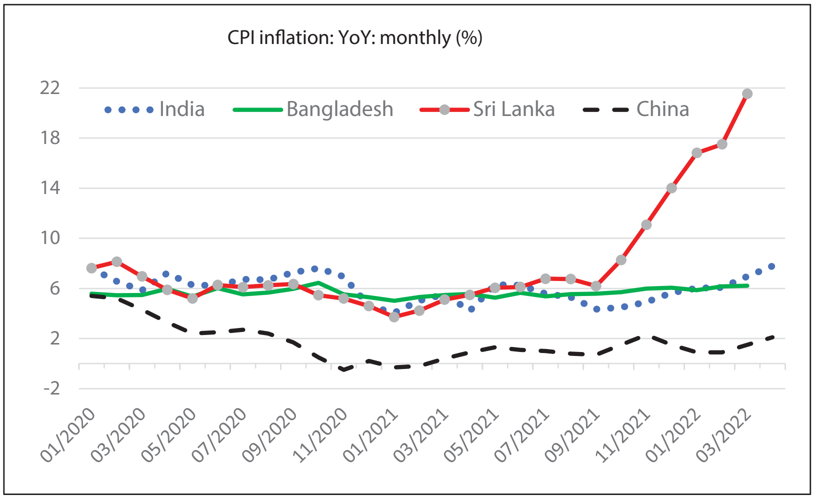
2 Eurostat. 2022. Euro area annual inflation up to 7.5%. Available at: https://ec.europa.eu/eurostat/documents/2995521/14497757/2-29042022-AP-EN.pdf/664dc8bd-4460-46f6-69ea-04c1763abd28#:~:text=Euro%20area%20annual%20inflation%20is,office%20of%20the%20European%20Union.

3 FRED. 2022. 10-year breakeven inflation rate. Fred Economic Data, St Luis Fed. Available at: https://fred.stlouisfed.org/series/T10YIE

4 Financial Express. 2021. Inflation target set at 5.3pc for FY22. Financial Express, 03 June 2021.

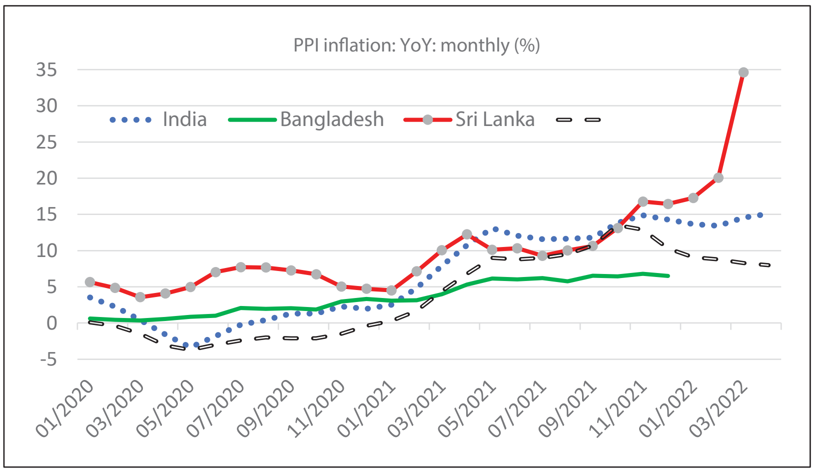
5 Daily Star. 2022. BBS inflation figures don't reflect the reality: Sanem. 03 March. Available at: https://www.tbsnews.net/economy/bbs-inflation-figures-dont-reflect-reality-sanem-379219

Figure 1: Consumer prices in selected countries: January 2020-March 2022



Source: CEIC World Trend Plus database

Figure 2: Producer price index in selected countries: January 2020-March 2022



The Producer Price Index (PPI) measures price changes before goods reach consumers, it is seen as an earlier predictor of inflation than the CPI. The YOY growth of monthly PPI, which was close to zero for Bangladesh, low in Sri Lanka, and negative for both China and India at the beginning of the Covid-19 pandemic, increased sharply in recent months reaching 7%, 22%, 8%, and 15%, respectively (Figure 2). This relatively higher input inflation will initially be passed through to retailers and eventually to consumers.

That said, the rising consumer and producer prices have several implications for Bangladesh and other South Asian economies, affecting the region's macroeconomic and political stability.

Inflation, in particular, is a *de facto* regressive tax that hurts the poorest most and worsens income distribution. The rest of the paper is organized as follows. Section 2 briefly discusses theoretical issues pertaining to inflation. Section 3 outlines the current drivers of inflation. Section 4 focuses on the inflation outlook for 2022 and beyond. Amid the specter of stagflation, Section 5 briefly highlights the ongoing debate on whether the global economy is headed for recession. The final section provides policy suggestions.

Inflation: Theoretical perspectives

One of the oldest theories in economics the *quantity theory* of money postulates that "the general price level of goods and services is proportional to the money supply in an economy."[6] If money supply grows higher than the relative size of the economy, then prices rise eroding purchasing power of consumers. In other words, expansionary monetary policy causes higher inflation.

Aggregate demand fueled by fiscal stimulus and lower interest rates, among other factors, and supply shocks such as energy shortage can cause inflation- the former and latter known as "demand-pull" and "cost-push" inflation, respectively. The macroeconomic theory of the 1960s on the trade-off between inflation and unemployment, known as the Phillips curve, ended in the stagflation of the 1970s.[7]

Lately, following the advent of rational expectation theory which was popularized by economists Robert Lucas[8] and T. Sargent in the 1970s[9] as part of the new classical revolution, numerous studies find that households' and firms' expectations of future inflation are a key determinant of actual inflation. The mechanism in which it works is that "expectations determine households' savings and consumption through the relationship between perceived real interest rates and consumption."[10] Former Federal Reserve (Fed) Chairman Ben Bernanke find that "inflation expectations also drive agents' wage bargaining, durable investment including housing, and portfolio choices."[11] The New Keynesian Phillips curve which explains the determination of realized inflation attributes an important role to inflation expectations.[12]

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6 Britannica. Quantity theory of money. Available at: https://www.britannica.com/topic/quantity-theory-of-money

7 Amid the stagflation of 1970s Paul Volcker, the then chairman of the Federal Reserve, proclaimed before the Senate Committee on Banking, Housing, and Urban Affairs in 1981: "I don't think that we have the choice in current circumstances — the old tradeoff analysis — of buying full employment with a little more inflation. We found out that doesn't work." Also see Dorn, A. James. 2020. The Phillips curve: A poor guide for monetary policy. CATO

Journal, Winter 2020. Available at:
https://www.cato.org/cato-journal/winter-2020/phillips-curve-poor-guide-monetary-policy

8 Lucas, R.E. and Sargent, T.J. eds., 1981. Rational expectations and econometric practice (Vol. 2). U of Minnesota Press.

9 Sargent, Thomas J. 1986. Rational Expectations and Inflation. New York: Harper and Row.

10 D'Acunto, F., Malmendier, U. and Weber, M., 2022. What do the data tell us about inflation expectations? (No. w29825). National Bureau of Economic Research.

Recent drivers of inflation

Several factors drive the current global inflation. These are discussed in brief.

Massive fiscal stimulus amid the pandemic: Governments notably in advanced countries allocated USD10 trillion for economic stimulus in just two months after World Health Organization declared the Covid-19 a pandemic in March 2020. According to McKinsey, the size of the stimulus is three times more than the response to the 2008-09 financial crisis.[13] In Bangladesh, the stimulus package of TAKA 1.24 trillion might have contributed to inflationary pressure.

Some economists, notably former U.S. Treasury Secretary and Harvard Professor Larry Summers cautioned as early as 2020 that "macroeconomic stimulus on a scale closer to World War II levels than normal recession will set off inflation pressures of a kind we have not seen in a generation."[14] He reasoned that "persuasion of fiscal and monetary policy on a transcendent scale to increase demand, at a time when Covid-19 was likely to curtail the supply of labor and goods, risked generating a huge overflow of demand." He has been proven to be right.

Disruption in the global supply chain: The initial large-scale lockdown measures and the prolonged pandemic owing to the Delta and Omicron variants have had damaging effects on supply chains and the labor market. The supply of numerous commodities and goods has been unresponsive to higher demand reflected in, among other factors, bottlenecks, rising shipping costs, delivery delays, and shortages of key production inputs such as computer chips.

There was a dramatic rise in container freight rates between January 2019 and March 2022, reaching a record price of nearly $10400 in September 2021 from as low as $1446 in April 2020, a 600% increase (Figure 3).

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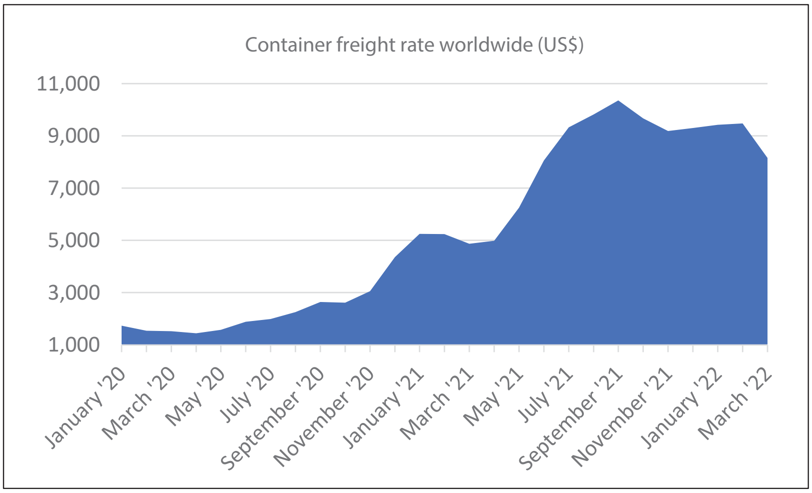
[11] Bernanke, B (2007), "Inflation expectations and inflation forecasting", Technical report, Board of Governors of the Federal Reserve System (US).

[12] Goodfriend, Marvin, and Robert G. King (1997), The New Neoclassical synthesis and the role of monetary policy, in B. S. Bernanke and J. J. Rotemberg, eds., NBER Macroeconomics Annual 1997, Cambridge, MA, MIT Press, 231-283

[13] McKinsey. 2020. The $10 trillion rescue: How governments can deliver impact. Available at: https://www.mckinsey.com/industries/public-and-social-sector/our-insights/the-10-trillion-dollar-rescue-how-governments-can-deliver-impact

[14] Summers, H. Lawrence. 2022. On inflation, we can learn from the mistakes of the past - or repeat them. Washington Post, February 3. Available at: https://www.washingtonpost.com/opinions/2022/02/03/inflation-warning-history-lawrence-summers/

Figure 3: Trends of container freight rate worldwide: January 2020-March 2022



Source: World Container Index, MacroMicro, Drewry.

China's zero covid policy: China's status as the factory of the world and its critical role in the global supply chain markedly affected the prices of manufacturing goods owing to the country's zero-Covid policy. The recent lockdown in Shanghai is likely to exacerbate global supply-chain problems and inflation concerns as the city accounts for around a fifth of China's port volume.[15]

Relatively higher spending on goods than services: Before the pandemic, consumer spending on goods had been declining relative to services for several decades. However, given the travel ban and other restrictions put in place during the pandemic coupled with the rise in online platforms, the demand for goods outpaced services.

War in Ukraine and elevated energy and commodity prices: According to World Bank, energy prices were more than four times higher in March 2022 than their April 2020 lows—the largest 23-month increase since the oil shock of 1973.[16] Fertilizer prices rose by 220% during the same period.[17] Similarly, prices of food of which Russia and Ukraine are large producers supplying over a quarter of global wheat exports rose by 84%.[18] As a result, there has been a big jump in fuel and non-fuel commodity price indices in the past five quarters (Figure 4).

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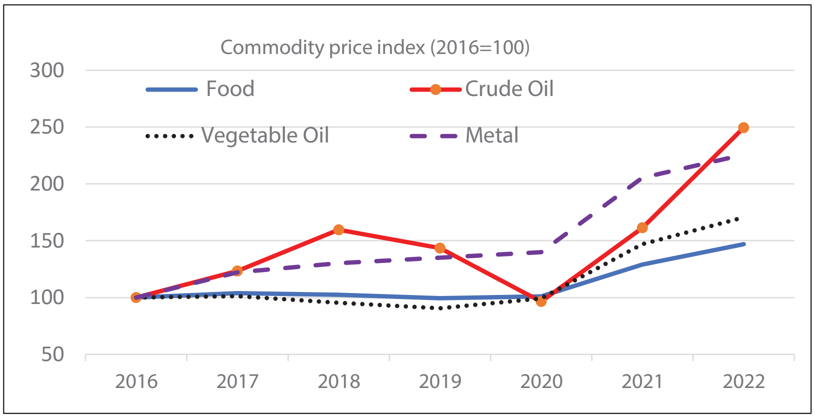
[15] Financial Times. 2022. Shanghai lockdown exposes global supply chain strains. 14 May.

[16] World Bank. 2022. Commodity markets outlook. Available at: https://openknowledge.worldbank.org/bitstream/handle/10986/37223/CMO-April-2022.pdf

[17] Ibid.

[18] Ibid.

Figure 4: Food and non-food commodity price index: 2016-2022



Source: CEIC World Trend Plus database.

The inflation outlook for 2022 and beyond

Now the big question is whether the current bout of inflation is transitory or elevated prices are here to stay. Amid the lockdown, Besides, China's zero-Covid policy, the war in Ukraine and associated geopolitical risks, the export ban of commodities by several countries, and the strong US dollar are driving near and mid-term inflation expectations.

Bull run of fuel and non-fuel commodity: A World Bank estimate shows that energy prices could rise more than 50% in 2022 before easing in 2023 and 2024.[19] A senior executive of Singapore-based energy trading outfit Trafigura is of the view that "it would be nigh on impossible for the industry to supply enough oil in time to stop further inflation. There are plenty of scenarios where oil, come summer, is $150 per barrel."[20] Investment Bank JPMorgan predicts oil could reach $125 a barrel this year and $150 in 2023.[21] Non-energy prices, including agriculture and metals, are projected to increase by almost 20% in 2022. Export ban on several commodities by numerous countries including India will only exacerbate price hikes.

Ascent of US dollar and imported inflation: Amid Fed's monetary tightening by raising interest rates to fight inflation, capital is flocking to the U.S. in search of higher yields. The US Dollar Index, which tracks the dollar against six other important currencies reached the highest level since 2002. Figure 5 captures the trends of the USD Index in recent months.

There is a growing demand for safe-haven assets like the U.S. Treasury (10-year Treasury yields 3.1% return) which is more attractive compared to the bond issued by other central banks, including the Bundesbank of Germany (1.1%) and Bank of Japan (0.25%).[22]

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[19] Ibid.

[20] Financial Times. 2022. The new energy shock: Putin, Ukraine and the global economy. 28 February.

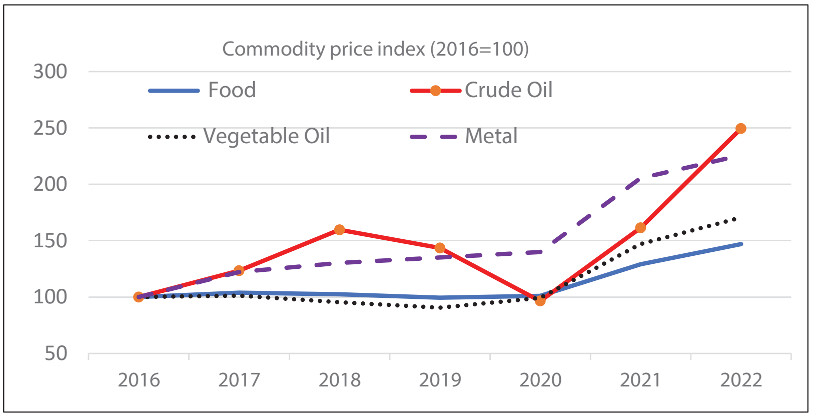
[21] Reuters. 2022. As inflation breaks records, $100 oil is also looming. Available at: https://www.reuters.com/markets/europe/inflation-breaks-records-100-oil-is-also-looming-2022-01-19/

[22] Wall Street Journal. 2022. 10-year treasury yield hits 3% for first time since 2018. 02 May.

Amidst a strong dollar, currencies in developing countries have weakened significantly. Most South Asian currencies, including the Bangladesh Taka, have lost significant value in recent weeks which could further fuel imported inflation, increase debt servicing costs, and rise in financial instability.

The volatility in the exchange rate market could place Bangladesh's hard-earned macroeconomic stability at stake. Nevertheless, compared to most South Asian economies, Bangladesh's natural gas which comprised 69% of the country's primary energy mix, takes some pressure off the dwindling foreign exchange reserves.

Figure 5: U.S. Dollar index: May 2021- May 2022



Source: CEIC World Trend Plus database.

Inflation expectations: Whether the current bout of inflation is transitory or is here to stay for a few years is to large extent determined by households' inflation expectations. The current high inflation regime episode is largely manifested in the goods sector and a technical study interprets goods inflation as being predominantly transitory.[23] However, as pandemic restrictions eased, the demand for services will rise keeping pressure on prices. In most South Asian economies, services account for over half of their GDP. Studies suggest that oil shocks are historically known to fuel inflation expectations and dis-anchor the expectations of both consumers and price setters.[26] Figure 6 also indicates that there is a link between oil price and inflation expectations in the U.S., although a periodic variation in correlation is observed.

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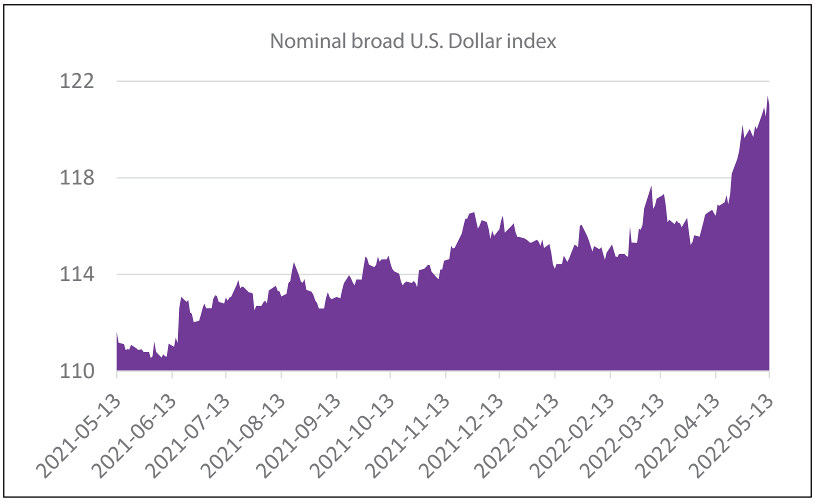
[23] A study shows that since the early-1990s, goods inflation has played a minimal role in fueling trend inflation, which is a contrast with the "great inflation" of the 1970s when goods inflation was a larger contributor to variation in overall inflation. See, Eo, Yunjong, Uzeda, Luis and Wong, Benjamin. 2022. Goods inflation is likely transitory, but upside risks to longer-term inflation remain. Voxeu, Available at: https://voxeu.org/

[24] Coibion, O, Y Gorodnichenko, and S Kumar (2018), "How do firms form their expectations? new survey evidence", American Economic Review 108(9): 2671-2713.

A study shows that in both advanced economies and EMDEs, long-term (five-year-ahead) inflation expectations fell during the past three decades.[25] However, in recent times, among EMDEs, there has been a marked increase in inflation expectations, notably in Central Asia, Latin America, and South Asia, largely perpetuated by the effects of higher food and energy prices and currency depreciation.[26]

Figure 6: Link between oil prices and inflation expectation



Source: Federal Reserve Bank of St. Louis

The Bangladesh Capital Market Sentiment Survey 2022 by Lanka Bangla Securities shows that inflation would be the biggest risk to the Bangladesh economy, with 83% of respondents seeing elevated inflation.[27] Bangladesh Bank's recent inflation expectation survey shows around 77% of the respondents expect one-year-ahead average inflation to be above 6% in 2022.[28]

Both in Europe and the U.S. inflation expectations have increased. The April 2022 Survey of Consumer Expectations in the U.S. shows that inflation expectations are 6.3% at the one-year horizon and 3.9% at the three-year horizon.[29]

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[25] Ha, Jongrim, Kose, M. Ayhan, Hideaki, Matsuoka, Panizza, Ugo and Vorisek, Dana. 2022. Anchoring inflation expectations in emerging and developing economies. Voxeu. Available at: https://voxeu.org/

[26] ibid

[27] The Business Standard. 2021. Investors cautiously optimistic about 2022 market: LankaBangla Survey. 02 March.

[28] Financial Express. 2022. Inflation in Bangladesh expected to exceed 6% by June. 02 March.

[29] Federal Reserve Bank of New York. 2022. Inflation expectations mixed; credit access expectations deteriorate. 09 May. Available at: https://www.newyorkfed.org/newsevents/news/research/2022/20220509

The fear of inflation overshooting is gaining ground among top economists. Nobel laureate Paul Krugman discards his earlier stance that inflation would be transitory subscribing that "rising prices will get worse before they get better. There's still a lot of inflation in the pipeline."[30]

Risk of wage-price spiral: Both in advanced countries and EMDEs, households' and firms' near-term expectations of inflation have increased, while long-term expectations are at best mixed. An executive of the Bank for International Settlements observed that "while the message is more mixed regarding longer-term inflation expectations, it is not a source of much comfort. When inflation starts affecting the cost of living, it is more likely to take center stage in price- and wage-setting decisions, triggering a dangerous wage-price spiral."[31] A wage-price spiral- a consequential relationship between prices and wages- to large extent depends on the complex interplay of consumer psychology, the bargaining power of workers, the productivity of businesses, and the credibility of central banks.[32] Although there is an optimism that the wage-price spiral of the 1970s is unlikely to be repeated as "wage inflation and other inflationary pressures will subside, once supply bottlenecks and labor market shortages ease."[33]

Fear of stagflation: soft or hard landing?

There is little consensus among central bankers and economists as to how the ongoing inflation will eventually come down. There is a fear of stagflation, a cruel mix of high prices and low growth. IMF slashes global growth to 3.3% for 2022, down from 4.1%, while foresees elevated inflation of 6.2%, a 2.25 percentage points higher.[34]

Amidst overhitting of the U.S. economy with a tight labor market (below 4% unemployment) and 8% inflation, Alex Domash and Larry Summers of Harvard University foresee a very substantial likelihood of recession over the next 12 to 24 months. They cite that since 1955, there has never been a quarter with average inflation above 4% and unemployment below 5% that was not followed by a recession within the next two years. Another Harvard Professor Jason Furman added that "there are very few examples in history that so-called soft landings (through interest rate hike) rarely helped to bring down inflation, and in cases where the inflation rate came down a lot, they're almost all hard landings (recessions)." [35] As far as Europe

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[30] Krugman, Paul. 2022. How high inflation will come down. Network Times. 24 March.

[31] Carstens, Agustín. 2022. The return of inflation. Speech delivered at International Center for Monetary and Banking Studies, Geneva, 5 April 2022. Available at: https://www.bis.org/speeches/sp220405.pdf

[32] Hilsenrath, Jon. 2022. Echoes of the wage-price spiral of the 1970s. Wall Street Journal. 11 Feb. Available at: https://www.wsj.com/articles/echoes-of-the-wage-price-spiral-of-the-1970s-11644575402

[33] Ibid.

[34] IMF. 2022. World economic outlook. International Monetary Fund. April 2022. Available at: https://www.imf.org/en/Publications/WEO/Issues/2022/04/19/world-economic-outlook-april-2022

[35] Wieczner, Jen . 2022. Jason Furman saw inflation coming. does he now see recession coming too? Intelligencer. 09 May. Available at: https://nymag.com/intelligencer/2022/05/jason-furman-predicted-inflation-does-he-see-recession-too.html

is concerned, the possibility of recession largely hinges on energy supply- experts warn that a ban (or major disruption) on Russian gas would trigger one of the deepest recessions of recent decades in the eurozone.

The head of IMF does not expect a recession for the world's major economies but also does not rule it out. Although its chief economist feels current growth forecasts (3.2% global GDP growth) offer a buffer against a potential global recession.[36] In South Asia, India and Bangladesh are projected to outperform the average GDP growth of emerging and developing Asia in 2022 and 2023, however, both the countries are likely to experience higher inflation, as IMF's latest economic outlook indicates.

It is still a little early to predict whether the global economy will plunge into recession, however, the conservative view is that "bringing inflation under control without a recession and large increase in unemployment will be challenging."[37]

The way forward

High inflation matters- it is often associated with lower growth, price distortion, financial crises, and political unrest. In its latest world economic outlook IMF cautioned, "as advanced economies lift policy rates, risks to financial stability and EMDEs' capital flows, currencies, and fiscal positions– especially with debt levels having increased significantly in the past two years– may emerge."[38]

Policymakers in Bangladesh now face extraordinary challenges to tame inflation. The scope of policy response is constrained by two key reasons. First: the drivers of ongoing inflation- the pandemic, the war, supply chain disruption, sanctions, geopolitical factors, etc.- are to large extent beyond the control of the country. Second: There are adverse developments in key macro variables, notably large "twin deficits" in the past few months: the consolidated fiscal balance (% of GDP) registered a large deficit of 5.2% in December 2021.[39] The external sector of the country also faces significant challenges owing to big gaps in export earnings and import payments and the slowdown in inward remittances. Bangladesh's current account deficit is projected to be 3.1% of its GDP in 2022.[40]

That being said, to limit the adverse impacts of inflation, there are still some scopes for policy maneuver through monetary and fiscal policies aimed at limiting the impact of current

[36] Business Standard. World economy has 'buffer' against recession. May 24. Available at: https://www.business-standard.com/article/international/wef-summit-world-economy-has-buffer-against-recession-says-gopinath-122052400050_1.html

[37] Financial Times. 2022. Is the global economy heading for recession?, 20 March. Available at: https://www.ft.com/content/35b31fb0-f8ad-4557-9d95-267e0ed958eb

[38] Op. cit. IMF 2022.

[39] CEIC World Trend Plus database.

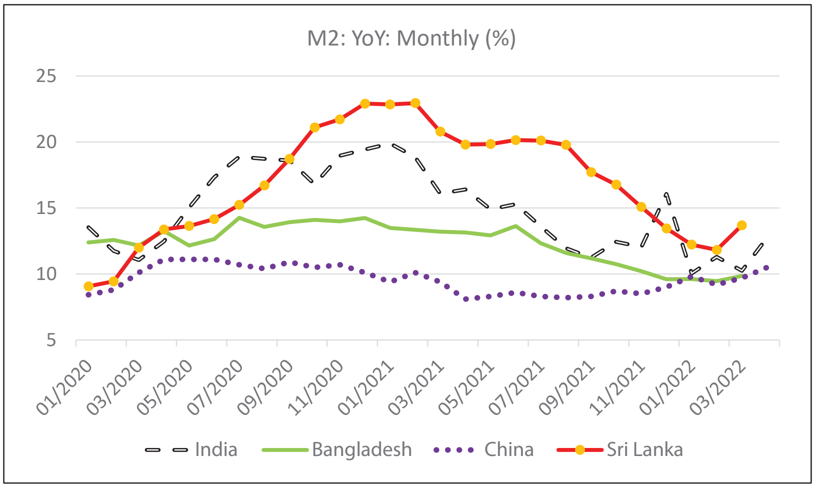
[40] Ibid.

inflation as well as anchoring medium- and longer-term expectations at moderate levels. The latter determines the effectiveness of fiscal and monetary policy and shapes realized inflation.

Monetary policy response: Nobel laureate Milton Friedman famously observed that "inflation is always and everywhere a monetary phenomenon." As such, monetary policy transmission through interest rate and exchange rate could play a crucial role in limiting inflation shock. In this regard, the central bank's credibility holds the key. Studies suggest that inflation expectations are shaped by among others, the degree of credibility of the central bank.[41]

One of the constraints in this regard is that the interest rate is largely administered rather than market-determined in Bangladesh. As a result, there are marked anomalies between policy rate, deposit rate, and lending rate. Currently, depositors are punished for savings with a negative real interest rate. Clearly, with this interest rate policy, it is challenging to manage aggregate demand in line with BB's inflation target. Tightening monetary conditions including credit growth in less productive sectors is advisable. Nevertheless, broad money (M2) growth in recent months has declined to below 10% (Figure 7) and the Bangladesh Bank has raised its policy rate to 5%.

Figure 7: Broad money growth in selected countries: January 2020- March 2022

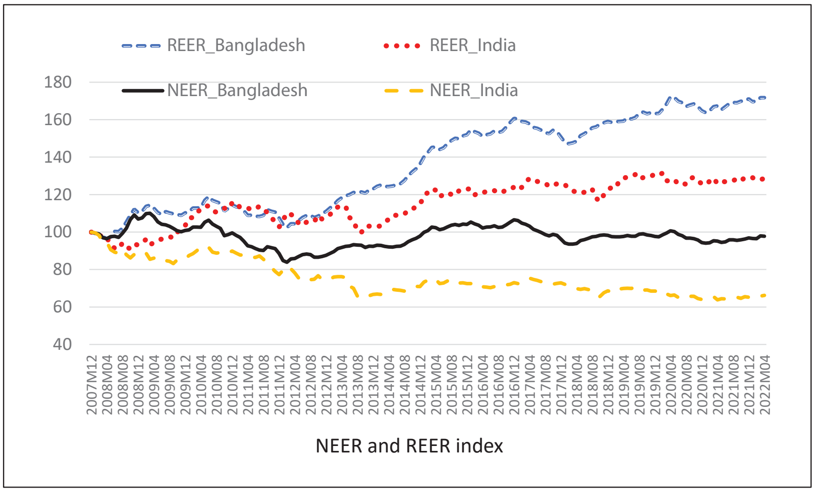


[41] "A central bank is credible if people believe it will do what it says." Also see, Blinder, A.S., 2000. Central-bank credibility: Why do we care? how do we build it?. American economic review, 90(5), pp.1421-1431, Issler, J.V. and Soares, A.F., 2019. Central Bank credibility and inflation expectations: a microfounded forecasting approach.

Given the nature of the exchange rate regime that Bangladesh Bank pursues the central bank has to intervene in the foreign exchange market when the impact of inflation is persistent. Amid the steady depreciation of most currencies of EMDEs vis-à-vis the US dollar, maintaining an appropriate level exchange rate of Bangladesh Taka is imperative limiting the impact of imported inflation as well as sustaining export competitiveness. In recent weeks, there has been marked misalignment between the official and kerb (unofficial) market Taka-Dollar exchange rate, leading to volatilities in exchange rate markets.

Since the pandemic, Bangladesh's real effective exchange rate (REER) appreciated by about 7% while the nominal effective exchange rate (NEER) index remained the same, indicating inflation in Bangladesh is higher than its trading partners, indicating exports have been more expensive and imports cheaper (Figure 8).

Figure 8: Nominal effective and real effective exchange rate of Bangladesh and India: December 2007-April 2022



Source: Bruegel Datasets

In addition, a study shows that "there is a risk of policy missteps if the pass-through, the effect of exchange rate changes on domestic inflation, is not properly evaluated, notably in EMDEs, where large currency movements are more frequent".[42] As such, a correct assessment of the exchange rate pass-through ratio (ERPTR) to inflation, the percentage increase in consumer prices associated with a 1% depreciation of the effective exchange rate, is advisable.

[42] Ha, Jongrim, Stocker, M. Marc and Yilmazkuday, Hakan. 2020. Inflation and exchange rate pass-through, Journal of International Money and Finance, Volume 105, DOI: https://doi.org/10.1016/j.jimonfin.2020.102187.

Fiscal measures: The priority of fiscal authorities should be protecting those struggling with the double whammy of the commodity price hikes and the pandemic-induced economic crisis through targeted food subsidies and safety net measures. The provisions of food-support programs designed and implemented to mitigate the pandemic's adverse impacts should be revisited amid the rising prices of essentials.[43]

The upward adjustment of energy prices should be delayed to suppress inflation and inflation expectations, although this could further increase the country's fiscal deficit. The austerity measures that have been introduced should be maintained until inflation is eased to Bangladesh Bank's targeted level. The forthcoming national budget is also critical to reduce tariff rates for essentials and elevate luxury items to control imports.

The signal (supported by actions) that both monetary and fiscal authorities need to give to the market is that they are determined to ease inflationary pressure as much as they can, even if that cost some growth limiting current inflation and anchoring medium-term inflation expectations.

[43] Islam and Khayum.2022. Protecting the poor from food inflation. Financial Express. April 17. Available at: https://thefinancialexpress.com.bd/views/protecting-the-poor-from-food-inflation-1650210416.

Centre for
Governance Studies

45/1 New Eskaton (2nd Floor), Dhaka 1000, Bangladesh
Phone: +880258310217, +880248317902, +8802222223109
Email: ed@cgs-bd.com
Website: www.cgs-bd.com