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South Asia's Inflation Challenges

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Executive Summary

Most South Asian economies are now faced with exorbitant price hikes in fuel and non-fuel commodities. The current hikes have exposed the vulnerability of the low and middle income groups and the government exchequers, particularly in Sri Lanka, Bangladesh and Pakistan. The point-to-point inflation in these three countries is now double-digit. India is relatively less vulnerable to the current inflationary shock. Nevertheless, of late, the Reserve Bank of India (RBI) acknowledged that price spiral in the economy is artificially "suppressed" as higher international oil prices have not been passed on to domestic consumers. The inflation scenario in Nepal is likely to follow the price level in India, largely because the former's domestic currency is pegged to that of the latter.

Apart from the current global commodity boom, inflation has surged in these South Asian countries due to low per capita agricultural production, the Central Bank's lax monetary policies or lagged effects of earlier monetary expansion, undervalued exchange rate polices (in economies other than India) and internal political instabilities.

Inflation in India, Pakistan, Bangladesh, and, to some extent, in Sri Lanka, could have been far worse than the current level had the exchequers not absorbed a substantial portion of the oil import bills as subsidies.

For the South Asian countries, the challenges of inflation are two-prongs. Firstly, galloping inflation could significantly destabilise key macro-economic variables. Secondly, price volatilities pose political dangers.

If the United States dollar continues to slide, oil prices remain high, strong demand for commodities persists and more and more oil-seeds and staples channel towards bio-fuel production, the South Asian economies may witness even higher than the current level of inflation in the coming months. Nevertheless, the flip side of this forecast is that the slow down in the United States and some other major economies may have a dampening effect on prices. Moreover, if China and other major emerging markets prioritise inflation check over growth, then the current sky-rocketed trend of commodity prices may slow down.

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Inflation control should receive priority over growth in South Asia. Both fiscal and monetary policy tools should be applied to contain price hikes. In India, currency appreciation continues to be used as a major instrument to contain imported inflation, though widening current account deficit is a concern for the policy makers. Following the latest Fed rate cut, the RBI may increase its key policy rates slightly. In an election year, the current United Progressive Alliance government may prefer inflation check as a priority even if such move would slow down India's economic growth.

Bangladesh can afford to keep its currency slightly stronger, thanks to its favourable current account position. The monetary policy should be more contractionary even if it affects the country's economic growth. Sri Lanka and Pakistan have to rely on the interest rates hike, as the current account deficits in these economies have been widening.

Fiscal policy tools, including a reduction in import and excise duties, could be applied to contain imported inflation, among others.

Introduction

After recovering from the two oil shocks in 1974 and 1979, the global economy enjoyed fairly stable price levels till early 2000 (see Figure 1). It is widely viewed that globalisation has had a positive impact on prices for over one and a half decade by increasing competition both on the demand and supply side. Central bankers, especially those pursued inflation targeting monetary policies, have widely been credited for keeping inflation low. However, many economies (net commodity importing countries, in particular) around the world are now faced with exorbitant price hike in fuel and non-fuel commodities (ss Figures 1 and 2). Since early 2007, oil and many agricultural commodities have been witnessing an abrupt price hike (see Table 1, and Figures 1 and 2). In the past year alone, prices of rice and wheat have hardened 52 and 112 percent respectively, and oil is now traded over US$100 a barrel.

In South Asia (excluding India), the current hikes have exposed the vulnerability of the low and middle income groups and the government exchequers. The price hike of primary commodities in most South Asian countries has further worsened due to low per capita agricultural production, the Central Bank's lax monetary policies (or lagged effects of earlier expansionary monetary policies), undervalued exchange rate polices (economies other than India and Nepal), and internal political instabilities.

South Asia's largest economy, India, is relatively less vulnerable to the current inflationary shock, thanks largely to its higher domestic production capacity of agricultural commodities and recent appreciation in its currency, *inter alia*. Nevertheless, oil price volatilities in the world market remain a worry for the economy. In its latest issue of *Macroeconomic and Monetary Developments*, the RBI acknowledged that "since pass-through of higher international oil prices to domestic prices remains incomplete, inflation has remained suppressed."

The other major economies in the region viz, Pakistan, Bangladesh, Sri Lanka who largely depend on international markets for fuel and, to lesser extent, for non-fuel commodities face much more daunting challenges than India to contain inflation. The inflation scenario in Nepal is likely to follow the price level in India, largely because the former's domestic currency is pegged to that of the latter.

According to the Economist Intelligence Unit (EIU), the CPI inflation in Sri Lanka recorded 17.5 percent in 2007, followed by Bangladesh (9.1 percent), Pakistan (7.6 percent), India (6.4 percent), and Nepal (5.3 percent) (see Figure 3).

For the South Asian countries, the challenges of inflation are two-prongs. Firstly, galloping inflation could significantly destabilise key macro-economic variables, including gross domestic (GDP) growth. Higher oil import bills that most economies in the region absorb through subsidies could further swell their fiscal deficits. Secondly, price volatilities pose political danger. South Asia hosts the largest number of poor people in the world and the correlation between per capita income and food weight in total CPI is generally higher for low-income group consumers. Rising food prices are effectively a regressive tax. If the past is any guide, price volatilities of South Asian staples, rice and wheat, could result in political instability in the region. The World Food Programme cautioned that the rising prices of food items, especially rice, may cause political instability, since poorer households spend up to 80 percent of their income on food.

Against this backdrop, this paper briefly analyses the ongoing inflation in South Asia. It also suggests some anti-inflationary measures for these economies.

Inflation Scenarios in South Asia

Among all South Asian economies, Sri Lanka is the hardest hit by the current price spiral. The New Colombo CPI reached 21.6 percent in February 2008 while the annual average inflation moved up to 17 percent, according to the Central Bank of Sri Lanka (CBSL). Unlike the other economies of South Asia, Sri Lanka has revised its administered energy prices upward in several stages since 2000. The country imports almost 100 percent of its oil needs, and petroleum price hike in the international market is substantially being pass-through to its consumers albeit the Exchequer absorbs diesel and kerosene price rise to some extent.[1] As a result, oil price hike has had a direct impact on the economy's CPI inflation. Secondly, apart from oil, price hike in most soft commodities in the international markets, has had an impact on the country's inflation. Thirdly, the real wage increase in the recent past has put additional pressures on prices.[2] Fourthly, due to a setback in Sri Lanka's agriculture sector, the prices of domestically-produced agricultural commodities, that accounts for 78 percent of the total consumption basket in the CPI, have increased significantly. Fifthly, inflation has been exacerbated due to the distribution disruptions of agriculture produces following the adverse security developments in the Northern and Eastern provinces. Sixthly, imported inflation has soared as the Sri Lanka Rupee has weakened in recent years[3] (see Figure 7). Last but not least, between May and September last year, the CBSL issued currency worth of 49 billion Rupees (US$457 million). The extra cash injection in the economy, along with high government spending and rapid growth in credit, has also been exerting the price rise.

Consumers in Bangladesh have been observing the exorbitant price hike of primary commodities. The Bangladesh Bank, the central bank of Bangladesh, reported that inflation was 11.43 percent on a point-to-point basis in January 2008 whereas food-inflation hit 14.20 percent in the same period. The price hike of fuel and non-fuel commodities in the international markets is widely blamed for the current inflation in Bangladesh. Secondly, Bangladesh faced two major natural disasters (summer floods and cyclone *Sidr*) in 2007 which damaged standing crops, among others, and escalated food prices. Moreover, in recent years, growth in the agriculture sector has been sluggish. Thirdly, the recent ban on exports of some essentials such as rice, wheat, lentil and onion by neighbouring India has been a major supply shock for the economy. Fourthly, the current caretaker government's drives against corruption have exacerbated the supply-side problem. The actions against the so-called unscrupulous business people have greatly handicapped the country's business, including commodity trading. Consequently, there has been a supply side constraint in the food grain market. Fifthly, the depreciation in the country's currency unit, the Bangladesh Taka against its major trading partners, the expansion of broad money and credit have also played a part in raising prices. In its latest Monetary Policy Statement, the Bangladesh Bank acknowledged that the lagged effects of higher than programmed monetary expansion during fiscal year 2007 and excess liquidity played a part in raising prices.

[1] In January 2007, the prices of petrol increased to 127 Rupees (US$ 1.16) per liter from 117 Rupees and the prices of diesel and kerosene rose to 80 Rupees and 70 Rupees respectively. The gas price has also seen a similar trend.

[2] Public sector wages were increased from January 2007.

[3] The Sri Lankan Rupee depreciated by around 5 by September 2007, compared with 1.6 in the same period of 2006.

The inflation scenario in Bangladesh could have been much worse had the Exchequer not absorbed a substantial portion of the oil import bills as subsidies. The country imports 90 percent of its oil requirements from international markets but does not pass-through the full oil import bill directly to its consumers. The Bangladesh Petroleum Corporation (BPC), the state-owned energy entity, sells petroleum products at much lower prices in the domestic market than its actual import costs, and the difference (import price minus local market price) is being absorbed by the government of Bangladesh as subsidies. The BPC's losses are estimated at US$794 million or 1.1 percent of GDP in the fiscal year 2008, according to the Asian Development Bank (ADB). The Bangladesh government is under severe pressure from the World Bank and the International Monetary Fund to pass-though the oil prices instead of increasing its fiscal burden. The economy's fiscal deficit is projected to expand to five percent of its GDP in 2008 from 4.4 percent in 2007 (see Figure 4).

In Pakistan, the year-on-year consumer price inflation reached 11.3 percent in February 2008, largely owing to the extraordinary high food prices apart from higher energy prices. The food inflation reached 18.3 percent – the fifth consecutive month with a double-digit increase, according to the EIU. Pakistan is an oil producer but relies on imports for more than 80 percent of its consumption. The oil price hike in the international markets is absorbed partly by the government and partly by the consumers. As a result, the recent oil price hike pushed the CPI upward as well as added an extra burden on the government's fiscal health. The energy prices were revised upward in March 2008.[4] The government's domestic borrowing exceeded 350 billion Rupees (US$5.7 billion) out of which 150 billion Rupees (US$2.45 billion) went to the oil subsidies. Consequently, Pakistan's fiscal deficit is projected to increase to 5.3 percent in 2008 from 4.6 percent in 2007, according to EIU (see Figure 4). In its latest Monetary Policy Statement, the State Bank of Pakistan reported that inflation has been exacerbated due to high growth of money supply in current fiscal year. The broad money growth in the current fiscal year was 19.3 percent which exceeded its target level (5.8 percent). Further, like Sri Lanka and Bangladesh, the depreciating Pakistan Rupee has contributed to imported inflation (see Figure 8).

In India, the CPI inflation was in the range of 5.1 to 5.9 percent during November-December 2007. Inflation based on the wholesale price index soared to a 12-month high of 5.92 percent as on 8 March 2008 which is above the five percent limit set by the RBI for this fiscal year. India imports 70 percent of its oil requirements, and the petroleum import bill is largely absorbed by the Indian government and its public sector energy entities through oil bonds so that oil price hike in the international markets do not hurt the consumers and the central government's fiscal book.

In his 2007-08 Union Budget speech, the Indian Finance Minister, P. Chidambaram, too reckoned that there is pressure on domestic prices of food articles in India. He contended that, "Managing the supply side of food articles will be the most crucial task in the ensuing year and keeping inflation under check is one of the cornerstones of our policy".

Growth in India's agriculture sector has been sluggish in recent years. However, the country is expecting a record harvest in 2008. The total food grains output in India in 2007-08 is expected to be 219.32 million tones. To avoid food price spiral in its domestic market, the authorities have banned exports of several commodities and fixed higher prices of exportable

[4] The price of gas rose 6.9 percent to 62.81 rupees (US$1.03) per liter. Diesel rose 7.2 percent to a little over 40 rupees (US$0.65) per liter.

agriculture produces. Further, Rupee appreciations since late 2006 have insulated the economy from imported inflation (see Figure 6).

The headline inflation in Nepal remains broadly in line with price developments in India. The appreciation of the Nepalese Rupee had contained the imported inflation. However, food and oil prices continue to push the prices up. In January 2008, the authorities have increased energy prices,[5] and, since October 2007, the prices have adjusted upward three times, as losses for Nepal Oil, the state-owned energy entity, have been soared due to global oil price increase. The Nepal Rastra Bank expects that inflation will remain about five percent in 2007-08, whereas the ADB projects that the figure will be 5.3 to 5.4 percent.

Based on the above analysis, we can summarise the current state of South Asia's inflation as follows:

1) Sri Lanka, Bangladesh and Pakistan are highly vulnerable to fuel and food price hike.

2) The CPI figure in Sri Lanka is much higher vis-à-vis its neighbours, as the country adjusted oil prices upward instead of putting additional pressure on its fiscal sector. The reason is that the fiscal deficit in Sri Lanka has already exceeded the danger level (6.7 percent of the country's GDP in 2007) as the government's expenditure outweighed its revenue income alarmingly. In Bangladesh and Pakistan, fiscal deficit has been swelled due to petroleum subsidies, among others.

3) The nominal effective exchange rate (NEER) and the real effective exchange rate (REER), except for the Indian Rupee, have been moving in opposite directions (see Figures 6 to 9). Generally, the NEER and the REER move quite closely together, with the exception being in high inflationary environments. In Figure 6, we see that, in 2007, the NEER and the REER of the Indian Rupee moved in the same direction largely owing to low to moderate inflation in India. Though the rapid depreciation in the Sri Lankan Rupee, the Bangladesh Taka and the Pakistani Rupee against the United States Dollar, in the recent past, has slowed down lately (the Bangladesh Taka even appreciated slightly), it has to be remembered that the United States Dollar has seen a sharp depreciation against major currencies which is known as the United States Dollar index of late. Consequently, India's exchange rate policies (so is Nepal's) have been of help in weathering imported inflation. In other countries, undervalued (competitive) exchange rate polices have exacerbated their domestic inflation. Economic theories too support that if the nominal exchange rate does not allow sufficient appreciation, real exchange rate adjustment only happens through increase in the price level over time, relative to trading partners. The Chinese economy also experienced a similar situation recently until its currency, the Yuan, was allowed to appreciate.

4) Monetary policies in most economies have been lax which is reflected by the fact that money supply has increased steadily in these economies in recent years. Even if the broad money and credit growth have declined in Bangladesh in the recent quarters (see Figure 5), there is a lagged effect of these variables on prices.

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[5] In January 2008, diesel prices were increased by nine percent to 61 rupees (96 US cents) and kerosene prices by 19.6 percent, also to 61 rupees. Liquid petroleum gas prices were also raised by 16 percent to 1,250 rupees per cylinder.

5) In Bangladesh and Pakistan, the supply-side of the commodity market has been disrupted by the internal political unrests and emergency rules, and in Sri Lanka, the market is disturbed by the ethnic conflicts.

Near Term Inflation Expectations

Although the global commodity prices worked predictably in line with the Prebisch and Singer (1950) hypothesis which states that the prices of commodities relative to that of manufactured goods will tend to decline over time, however, the recent trends show that the ongoing upturn in the global commodity markets has been large and rapid.

If the United States Dollar continues to slide, oil prices remain high, strong demand for commodities (particularly from emerging markets) persists, and more and more oil-seeds, and staples channels towards bio-fuel production, the South Asian economies may observe even higher than the current level of inflation in coming months.

Nevertheless, the flip side of this forecast is that the slow down in the United States and some other major economies may have a dampening effect on prices. Moreover, if China and other major emerging markets prioritise inflation checks over growth, then the sky-rocketed trend of commodity prices might slow down.

The EIU's inflation forecast for Sri Lanka, Bangladesh, India and Pakistan for 2008 shows that the prices in these economies are likely to follow the 2007 prices (see Figure 3). As discussed, India's inflation is still at a tolerable level. Moreover, the country is expecting a record harvest in 2008. To avoid food inflation, the authorities have banned exports of several commodities and fixed higher prices of exportable agriculture produces. Nevertheless, the potential risk of price hike in the economy may arise from three avenues. First, foreign portfolio investor's increasing appetite for the Indian market will continue to put pressure on the Indian Rupee. If not fully sterilised, the economy will have excess liquidity that can induce inflation. Following the sub-prime crisis, the Fed cut interest rates a few times and this has put pressure on the RBI to revise its key interest rates downward. However, the dilemma for the RBI is lowering interest rates will aloft inflation. Secondly, roughly 10 million public sector employees in India are likely to get a 40 percent pay rise this year. If wages go up, prices are also set to increase. Thirdly, the country is preparing for a parliamentary election early next year. Government expenditures and political parties' budget (both disclosed and undisclosed) tend to increase in election years. If all these issues left unchecked, inflation might surpass the RBI's expectations in coming months.

Fiscal and Monetary Measures to Contain Inflation

Both fiscal and monetary policies have a role to play in containing inflation. Fiscal policy tools, including a reduction in import and excise duties, could be applied to contain imported inflation. Indeed, such tools have applied in Bangladesh[6] and, lately, import duties on a number of essential commodities, in particular, edible oil, have been reduced in India. Sri Lanka had earlier reduced import duties but later re-imposed them with a view that the revenues generated from this avenue are too important to forgo, even albeit temporarily.

[6] The import duties on a number of essential commodities, including rice and wheat, have been withdrawn.

Monetary- and exchange-rate policies in these inflation-hit economies should be applied prudently. Most emerging market economies are now fighting inflation either by appreciating their currencies or hiking policy rates or applying both, depending on their macro economic conditions. In India, currency appreciation is continue to be used as a major instrument to contain imported inflation, though widening current account deficit is a concern for the policy makers (see Figure 10). Nevertheless, as most of India's competitor economies, including China, are now appreciating their currencies to contain inflation, the competitiveness concern for the economy is becoming a less pressing issue. Following the latest Fed rate cut, the RBI may increase its key policy rates slightly. In an election year, the current United Progressive Alliance government may prefer inflation check as a priority even if such move (containing credit and money supply growth) slows down India's economic growth.

Bangladesh can afford to keep its currency slightly stronger, thanks to its favourable current account position, albeit the current account surplus in the economy is projected to decline in 2008 (see Figure 10). The Bangladesh Bank has already tightened the broad money supply and credit growth though there is a lagged effect of its previous expansionary monetary policies. The monetary policy should be more contractionary even if they cost the country's economic growth. Sri Lanka and Pakistan have to rely on the interest rates hike, as the current account deficits in these economies have been widening (see Figure 10).

Apart from fiscal and monetary measures, it is important for the South Asian states to address domestic supply-side bottlenecks. There is a need to tackle the supply-side constraints in the commodity markets, particularly in Bangladesh, so that international market prices can converge with the domestic prices.

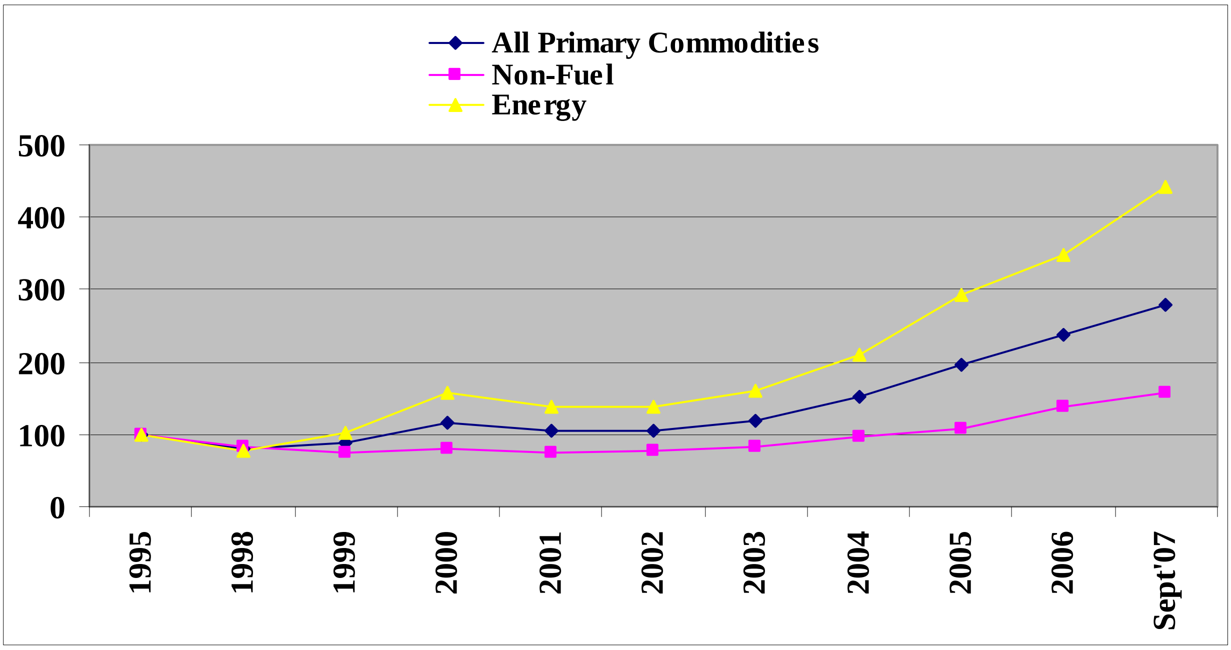
The South Asian economies, other than India, may also need to rely on external aid if their agriculture sectors fail to provide a good harvest in coming months.

There is a need for fuel cost economisation in most South Asian economies. However, automatic adjustment of oil prices in the midst of ongoing sky-rocketing inflation might bring countervailing results, especially in Bangladesh and Pakistan. At the same time, there is a high fiscal risk of petroleum subsidies in these economies. Gradual price adjustment for the high-end energy products might be a viable option. In the absence of a vibrant financial sector, bond markets in particular, India's strategy to cushion off the consumers and the fiscal sector from the ongoing oil price hike may not be a feasible solution for other countries in South Asia.

Figure 1: **Commodity Research Bureau Spot Index (1967=100): January 1947 to February 2008**

Source: Commodity Research Bureau (http://www.crbtrader.com/)

Figure 2: **Indices of Primary Commodity Prices: 1995-2007**



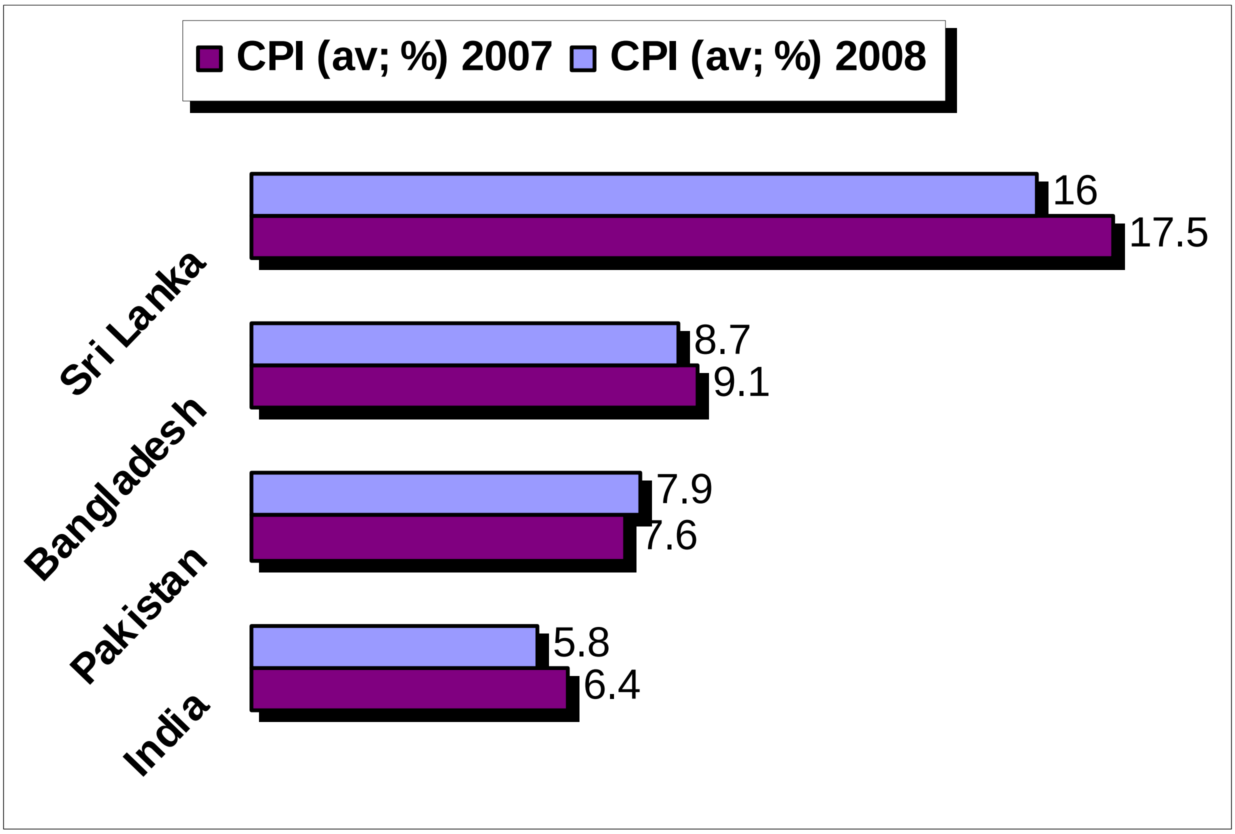
Note: 1995=100, Non-fuel commodities comprise of cereals, vegetable oil and protein meals, meat, sugar, bananas, oranges, Beverages, industrial inputs, agriculture raw materials, and metals.
Source: Based on *International Monetary Fund*'s *Primary Commodity Price* data

Table 1: Actual Market Prices for Selected Fuel and Non-Fuel Commodities: 2004-February' 2008

Commodities	Units	2004	2005	2006	2007 Q2	2007 Q4	February 2008
Wheat	$/MT	157	152	192	206	342	425
Rice	$/MT	246	288	304	323	357	481
Soybean Oil	$/MT	590	496	551	751	965	1308
Palm Oil	$/MT	435	368	417	711	862	1109
Copper	$/MT	2863	3676	6731	7649	7203	7941
Aluminum	$/MT	1719	1901	2573	2768	2445	2785
Dubai Brent	$/bbl	33.5	49.2	61.4	64.7	83.2	90.0

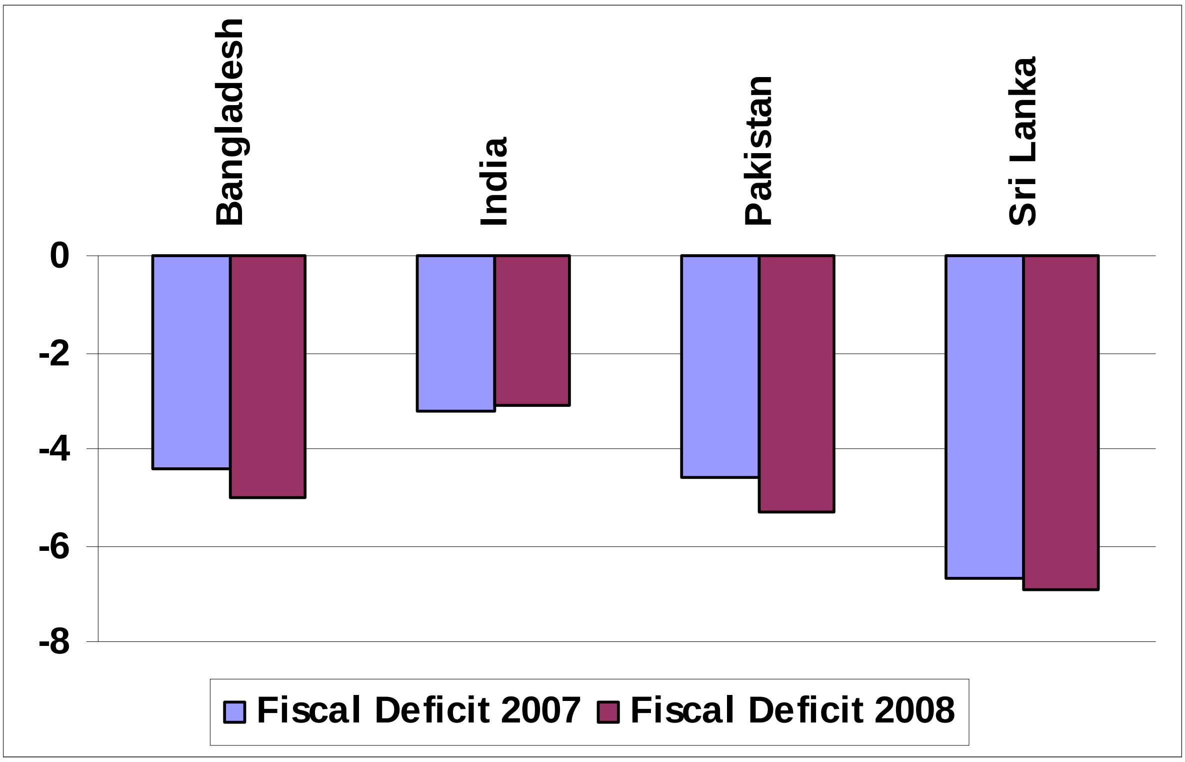
Source: *International Monetary Fund's* Primary Commodity Price data

Figure 3: CPI Inflation in Selected South Asian Economies: 2007 and 2008*



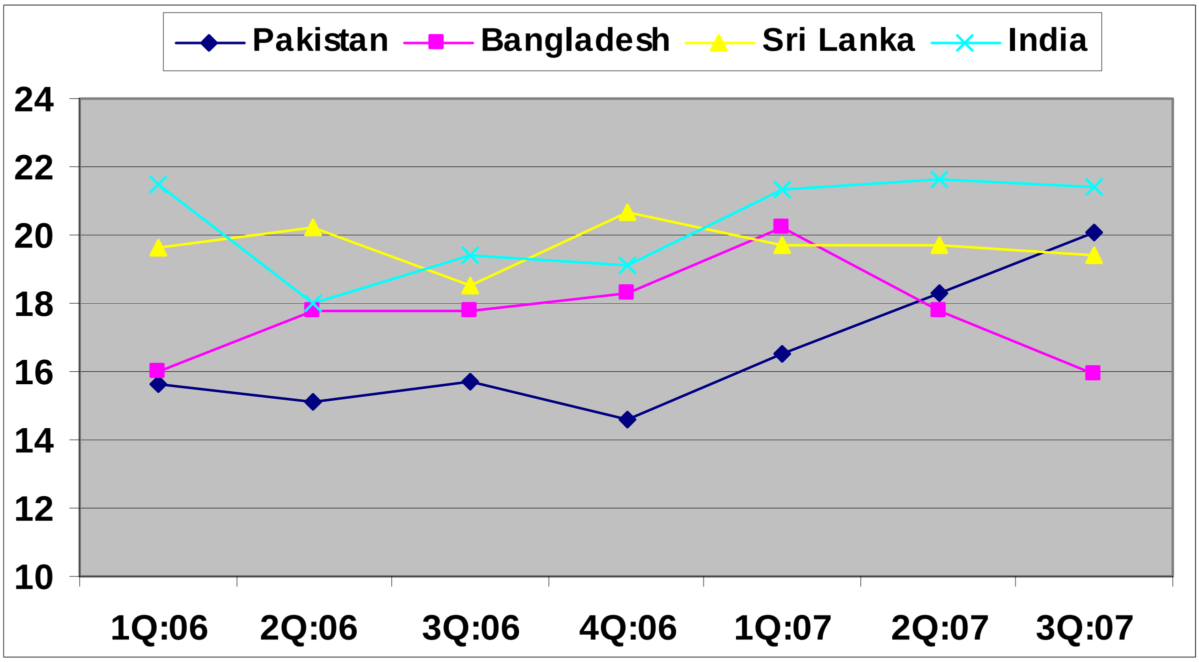
Note: * indicate forecast value
Source: Based *on Economist Intelligence Unit*

Figure 4: **Fiscal Deficit in Selected South Asian Countries (% of GDP): 2007 and 2008**



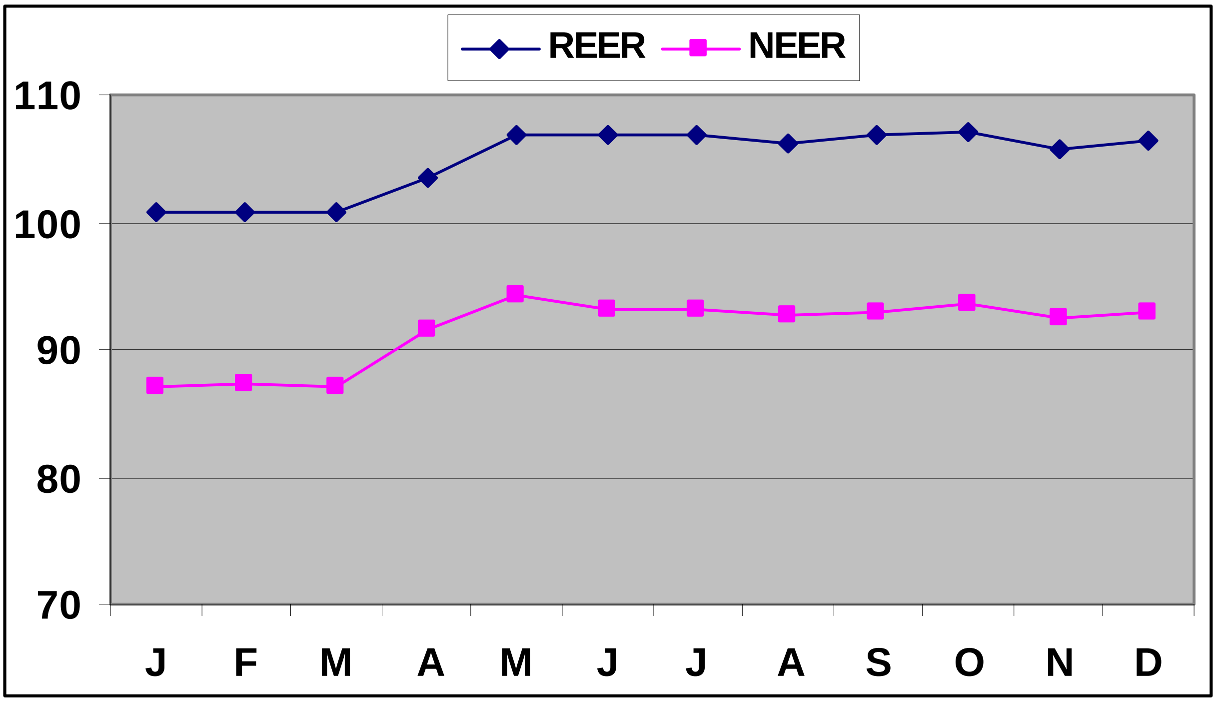
Note: * indicate forecast value
Source: Based *on Economist Intelligence Unit*

Figure 5: **Broad Money Growth in Selected South Asian Economies (in %): 2006-2007**



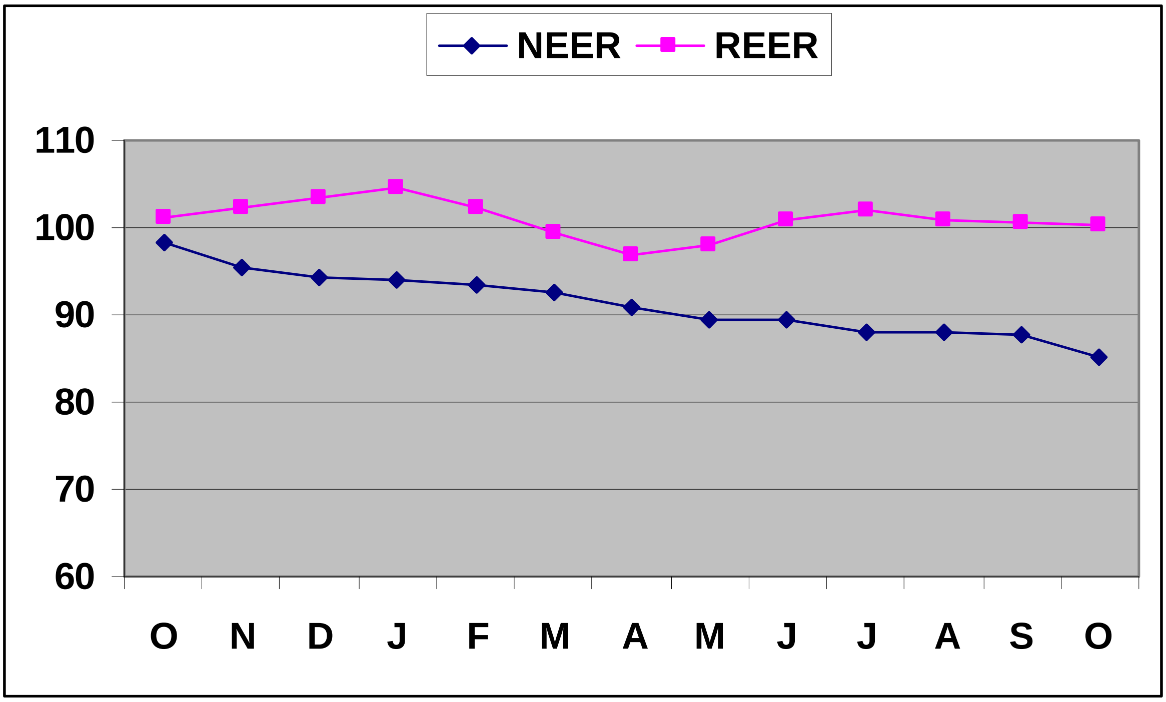
Source: Based *on Economist Intelligence Unit*

Figure 6: **NEER and REER Movements of Indian Rupee: January 2007- December 2007**



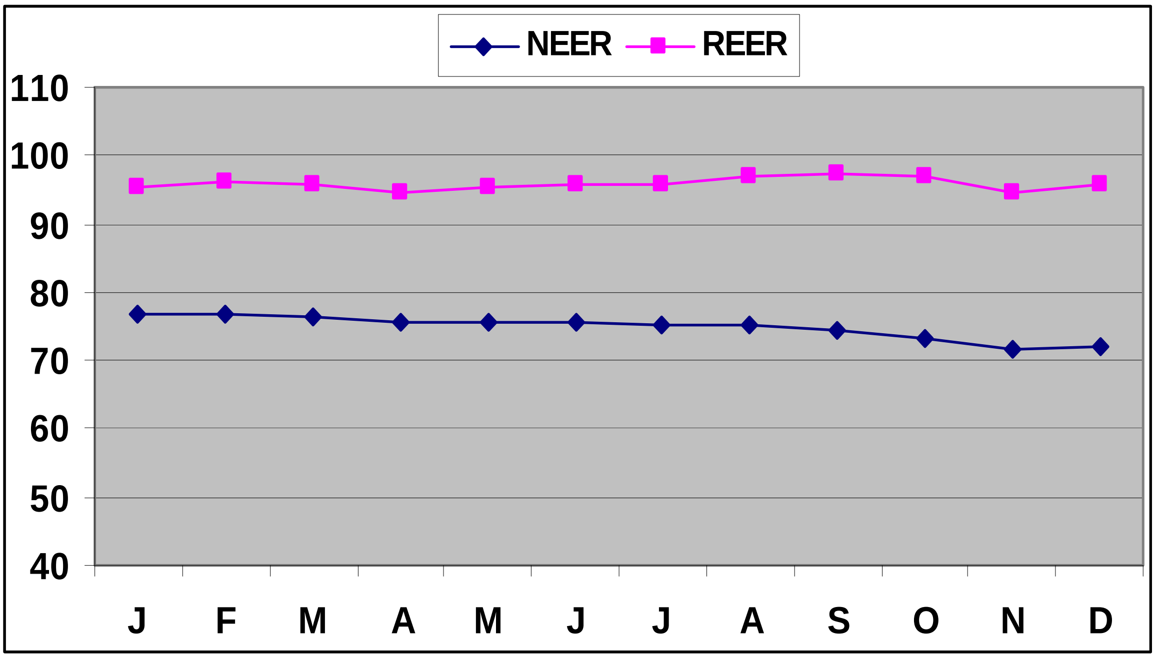
Source: Based on *Reserve Bank of India*

Figure 7: **NEER and REER Movements of Sri Lanka Rupee: October 2006- October 2007**



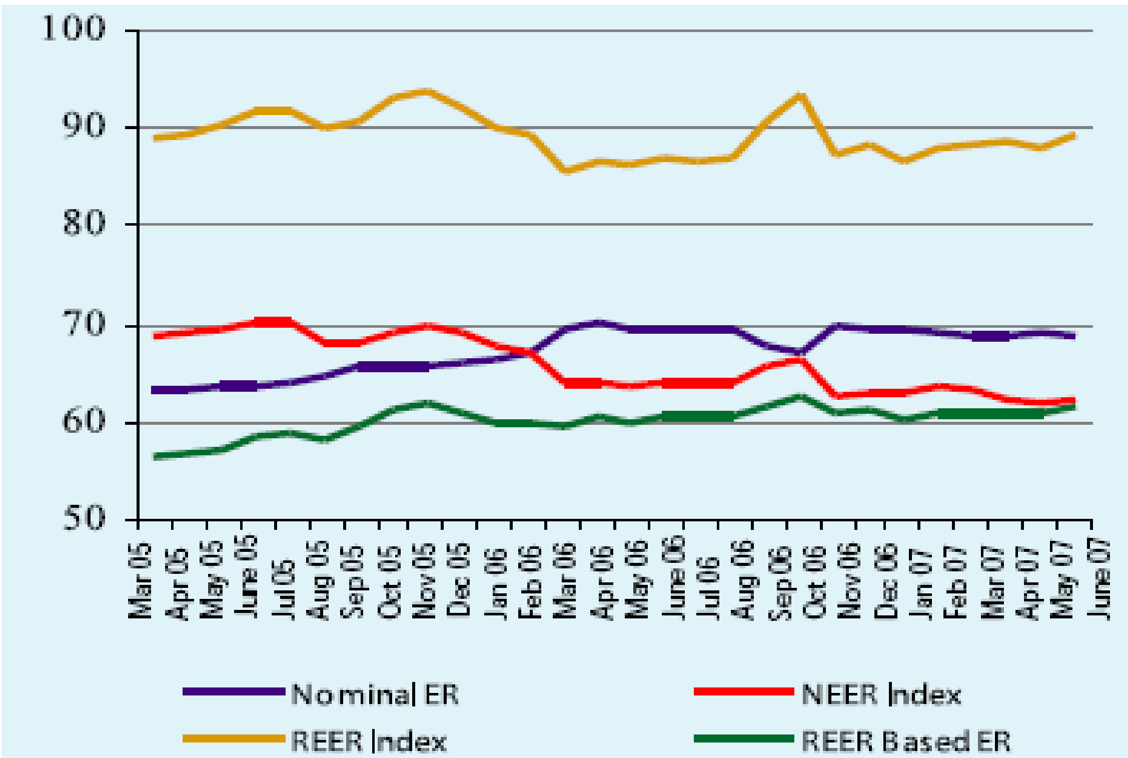
Source: Based on *Central Bank of Sri Lanka*

Figure 8: NEER and REER Movements of Pakistan Rupee: January 2007-December 2007



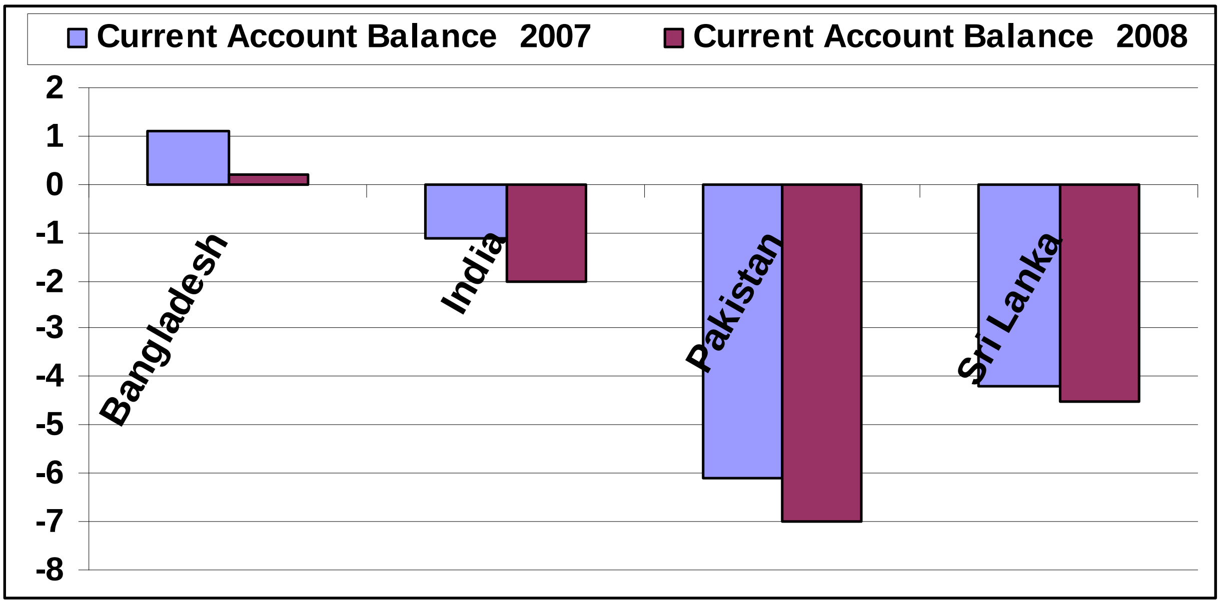
Source: Based on *State Bank of Pakistan*

Figure 9: NEER and REER Movements of Bangladesh Taka: March 2005-June 2007



Source: *Bangladesh Bank*

Figure 10: Current Account Balance in Selected South Asian Countries (% of GDP): 2007 and 2008*



Note: * indicate forecast value
Source: Based on *Economist Intelligence Unit*