Money and inflation



Sadiq Ahmed
writes for Star Business

Bangladesh has been experiencing a long episode of near-double-digit inflation since FY2023. This inflation rate considerably exceeds the global inflation rate. Efforts to control inflation have yielded some limited results, but the inflation rate remains persistently high, hovering around 9 percent annually. Along with rising inflation, GDP growth has slumped. This has raised the question, is Bangladesh passing through a phase of stagflation?

Sustained high inflation, along with a sharp deceleration in GDP growth, has hurt employment and increased poverty. The World Bank estimates that the incidence of both poverty and extreme poverty has increased since 2022. This reversal of poverty progress is a serious social problem. The employment challenge is reflected in the reduction in employment in all three broad sectors of agriculture, industry and services.

This stagflationary phase cannot prevail for long without creating social discontent and must be addressed swiftly. The policy focus should concentrate on lowering the inflation rate sustainably, while supporting the recovery of GDP growth.

The first question is why the inflation rate is persistently high in Bangladesh even as global inflation has fallen. In a market economy, prices are determined by demand and supply. The aggregate price level for the economy as a whole, which is the weighted average of individual prices, is similarly influenced by forces of aggregate demand and supply. So, the inflation rate, defined as the rate of change of the aggregate price level, is determined by factors that affect the growth of aggregate demand and supply.

The oldest theory of inflation, known as the quantity theory of inflation, owes its origins to Polish mathematician Nicolaus Copernicus and states that the rate of growth of prices (inflation) is the difference between the rate of growth of money supply and the rate of growth of real GDP. While this simple theory has faced fierce criticism from Keynesian economists, it has grown in sophistication, led by monetarist economists like Milton Friedman. The Keynesian economists have argued that the demand for money can change and affect the velocity of circulation and thereby destroy the one-to-one correspondence between the growth of money supply and inflation. Yet, the substantial role of monetary impulse in affecting inflation has remained intact.

However, instead of targeting the growth of money supply as recommended by monetarists, modern central banks target the inflation rate directly by influencing the interest rate. When inflation is high, a typical central bank raises the interest rate to reduce demand through cutbacks in spending, which then lowers inflationary pressure.

In my book "Bangladesh Stabilizing the Macroeconomy" published in December 2023, I provided evidence that the main factors that initially fueled the acceleration in inflation in Bangladesh since August 2022 were the excess growth of domestic credit, mostly public sector credit, owing to the large stimulus packages of the Covid-19 period (FY20-FY21) funded mostly through budgetary deficits and money creation, the continued financing of fiscal and quasi-fiscal deficits (FY22-FY23) through money creation, and control over interest rates (July 2020-November 2023) that pushed up private sector credit growth and lowered the growth of bank deposits.

Monetary policy correction started in November 2023 when the interest rate was deregulated, and the financing of the budget deficit through money creation was stopped. These policies were strengthened in May 2024 and further tightened during August-October 2024. They have largely remained in place since then. The interest rate is now deregulated, and the official stance of monetary policy is to control inflation through interest-rate management.

Many observers are disappointed that despite considerable monetary tightening, inflation remains stubbornly high at near double digits. There is also some scepticism about whether monetary tightening has gone too far without favourable outcomes for inflation. This scepticism, however, is based on a partial view. A fuller analysis will show that the main reason the full benefit of demand tightening for lowering inflation has not emerged is because of a large supply downturn that has happened over the past several years.

in FY25 to 10.2 percent in FY26. Additionally, the velocity of circulation increased from 2.4 in FY23 to 3.0 in FY26, possibly reflecting higher inflationary expectations. This expansion in monetary and credit growth, along with rising velocity of circulation in the face of a falling growth of aggregate supply, has inevitably stoked inflation as predicted by the quantity theory of inflation.

The acceleration in money supply growth is partly the outcome of the creation of high-powered money through the Bangladesh Bank's purchase of foreign assets. Financing of a large budget deficit through bank borrowing by the Treasury has also contributed to the growth of money supply and domestic credit. Indeed, the Treasury deficit financing has tended to offset the reduction in total credit growth resulting from a reduction in private credit growth and thereby lowered the effectiveness of interest rate increases in reducing inflation. While private credit growth has fallen to a mere 5.3 percent, public sector credit growth surged to 26 percent. The conduct of fiscal policy is clearly not consistent with the targets of monetary policy. Moving forward, this must be corrected.

DETERMINANTS OF INFLATION

GROWTH RATE	FY2022	FY2023	FY2024	FY2025	FY2026
GDP	7.1	5.8	4.2	3.5	3.5
Manufacturing	11.4	8.9	3.2	5.8	3.3
Agriculture	3.1	3.4	3.3	2.4	2.8
Imports (Taka constant prices)	31.2	-9.8	-4.6	6.8	-1.2
Average lending rate	7.2	7.2	9.4	12.1	11.9
M2*	9.5	10.5	7.7	7.0	10.8
Growth of credit	13.7	10.6	10.0	8.3	10.2
BD inflation rate	6.3	9.4	8.9	9.5	8.8
World inflation rate	8.7	6.7	5.8	4.1	4.7

*Total amount of money circulating in an economy

GDP growth rate declined by 51 percent between FY22 and FY26. All sectoral components of GDP have experienced a reduction in growth; the sharpest cutback was registered by the manufacturing sector with a 71 percent decline in the growth rate between FY22 and FY26. At the same time, the volume of imports has been falling, with the deepest cuts in imports of consumer and capital goods. This magnitude of supply shock over a 5-year period is unprecedented in the recent history of Bangladesh and is a major factor for the persistence of high inflation.

A sustainable strategy for fighting inflation is to continue to restrain demand while seeking to restore the growth momentum for both GDP and imports. Indeed, the growth of GDP and imports is correlated, and GDP growth cannot be restored without allowing imports to grow. Similarly, to lower inflation, in addition to boosting domestic supply, it is important to lower trade barriers that restrict the import of consumer goods into Bangladesh at a time when there are supply constraints.

The policies for demand and supply management must be internally consistent. This consistency of policy-making has become a major challenge. Despite the stated monetary policy stance of monetary tightening to fight inflation, in recent months money and credit growth have exceeded prudent limits consistent with lowering inflation. After falling between FY23 and FY25, the growth of money supply accelerated in FY26 from 7 percent to 10.8 percent. Similarly, total credit grew from 8.3 percent

What is the role of money and credit policies for restoring the growth momentum? Looking at the supply side, it is hard to argue that GDP growth is constrained by a lack of liquidity. While the turmoil in the banking sector has created liquidity problems for the weak banks, the strong banks are flush with liquidity because they cannot find adequate traditionally defined creditworthy borrowers who are willing to borrow.

This slowdown in the demand for credit in the organised private sector is mostly a reflection of weak profitability of investment owing to several binding constraints, including high cost of doing business, a severe energy supply crunch, weak trade logistics, and shortage of skills. These constraints must be addressed swiftly to increase investment and GDP growth, but they cannot be removed by lowering the interest rate and increasing domestic liquidity.

Channelling greater credit growth to areas where there is indeed a credit constraint, such as the micro and small enterprises sector, would support a supply response by relaxing the credit constraint. But this credit expansion must be made consistent with the growth of total credit and money supply required for reducing inflation by lowering the bank financing of the budget deficit.

The writer is vice chairperson of the Policy Research Institute of Bangladesh (PRI). He can be reached at sadiqahmed1952@gmail.com

World faces fresh food price surge, FAO warns

REUTERS, *Frankfurt*

The world is on the verge of another bout of food inflation as wars in Iran and Ukraine along with El Nino create a perfect storm of higher costs and lower crop yields, the chief economist of the United Nations Food and Agriculture Organization said.

Food prices were a key driver of the 2022 global inflation surge but have been relatively benign so far this year, even tempering in some places the surge caused by high energy costs.

This calm is likely to be temporary, however, as higher crude oil prices, the loss of fertiliser from the Gulf region, the shortage of diesel in some parts of the world and extreme weather are feeding through to costs and will show up in consumer prices, even if with a delay.

COSTS SEEN ACCELERATING BY YEAR-END, NEXT YEAR

"I expect that commodity prices will start to increase more now ... and food prices will start increasing by the end of the year, and next year for sure they will increase more," Maximo Torero told Reuters in an interview.

"The transmission from the commodity to the final food price is around three to six months," he said. Although some commodity prices, such as wheat, maize and rice have increased in recent months, most still reflect relatively good harvests, rather than likely difficulties in the coming year.

"The Strait of Hormuz is a problem that affects all the inputs of agricultural commodities, agricultural systems," Torero said.



PHOTO: REUTERS

"Brent oil, because it's used for pumping, packaging, processing, and transportation. And natural gas because it's used for fertilisers."

Meanwhile the damage inflicted by Ukraine on Russia's oil and gas infrastructure curtails the export market for diesel and natural gas, both of them key inputs in food production.

Since commodity prices are global, this inflicts pain across the world, even if richer countries have more cash to buffer producers.

"You're hearing this in Europe, in the US, Brazil and in Asia," Torero said. "Tight margins are putting stress in planting decisions."

Indeed, even in the US, which is self-sufficient for most key inputs, without federal assistance farmers growing nine principal crops may lose $32 billion in 2027, the American Farm Bureau Federation, an industry lobby group, said.

On a per-acre basis, every crop analysed is projected to remain below breakeven in 2027, it said. Global wheat and corn planting was already cut in the first three months of the Iran war and some US producers have shifted to soybeans, because they require lower fertiliser inputs.

Indian central bank holds rates as it assesses Mideast shock

AFP, *Mumbai*

India's central bank kept interest rates unchanged on Wednesday as it waits to see whether volatile oil prices caused by the Iran war feed wider inflationary pressures.

The Reserve Bank of India (RBI) said the benchmark repurchase rate, the level at which it lends to commercial banks, would remain at 5.25 percent after a unanimous vote by a six-member panel.

Emerging and frontier market central banks from Indonesia to Sri Lanka have raised rates to curb price rises and boost their currencies since the outbreak of the Middle East crisis in February.

Limited and staggered fuel price hikes by the Indian government have so far shielded citizens from the worst of the war's economic impact but there are signs that this may not hold.

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Retail inflation rose to 4.4 percent in June -- breaching the central bank's medium target of four percent for the first time in 17 months -- though it remains within RBI's 2-6 percent tolerance band.

Bank governor Sanjay Malhotra said economic growth was supported by "resilient domestic demand" and inflation was not "broad-based" yet.

"The MPC (Monetary Policy Committee) noted that even though headline inflation is projected to increase, it is primarily on account of supply side pressures caused by food and fuel. It is not getting broad-based," Malhotra said in a televised address from the financial capital Mumbai.

"There is a need for greater clarity to emerge, especially regarding inflation, its path and composition before taking any policy action."

Analysts said Malhotra's speech had a dovish tinge.

"What stood out just as much as the tone itself was what was missing from it," Sneha Pandey of Quantum AMC said. With the war still unresolved and already influencing both oil markets and yields, there were ample reasons for the central bank to express greater concern, she said.

"It didn't... and that comfort is a genuine positive for equities." Adding to the central bank's calculations is pressure on the Indian rupee, which slid to a record low before its June policy meeting.

WB warns developing countries to embrace AI or be left behind

AFP, *Washington*

The World Bank on Tuesday called on developing countries to embrace artificial intelligence technology tools to deliver better governance outcomes, warning that they risked being left behind if they failed to do so.

"AI has thrown developing economies a lifeline, and they should seize it," Indermit Gill, chief economist of the World Bank Group, said as the organization launched its annual World Development Report.

"They do not need large models or big data centers to reap its benefits," he added, advocating for the adaptation of lower-cost AI tools to local conditions to deliver results in the health, education, justice and agricultural sectors.

Advanced AI models -- largely developed in the United States and China -- offer the ability to quickly analyze data and automate many tasks that otherwise take skilled humans longer to do.

These AI models, however, require huge data centers and large amounts of complex computing power, using massive amounts of electricity and water -- with implications for climate change.

"Developing economies today are in the midst of their weakest average growth performance in three decades," said a World Bank statement accompanying the report. "AI could significantly boost that performance before the end of the 2020s while delivering tangible benefits to people."

The report calls for countries to use AI to "help extend otherwise costly medical, legal, educational, and agricultural services to underserved billions -- doing in a decade what might otherwise take a century."

Lower-income countries have struggled through the 2020s, hit by a series of successive shocks that saw the World Bank earlier this year dub it a "lost decade" for their economic growth.

The Bank has lowered its 2026 global growth forecast to its lowest level since the pandemic, with the economic fallout of the Iran war battering countries around the world.

The shock has hit low-income and developing countries hardest, with Asia the worst-affected region.

The Bank's new report advocates for developing countries to start working with localized AI tools and solutions now, and to invest in electricity generation and distribution; expand access to computing power; and improve the availability of local data.

"The window to get this right is narrow," said Gaurav Nayyar, director of the report.

"AI presents a once-in-a-lifetime opportunity to solve problems that have resisted solutions for generations," he added.

For the 6.8 billion people -- 83 percent of humanity -- who live in low-income and developing countries, AI tools will need to be adapted to meet their needs.

The report shares examples of AI applications in governance, such as to increase diabetes screening volumes in Bangladesh, or in reducing costs for Indian farmers through advanced weather forecasts.

The solutions, the report stresses, will need to meet people where they are.

"For example, AI solutions will need to be delivered through voice calls on basic mobile phones for those who cannot read or afford smartphones," it says.

"Simply importing an AI model does not mean it will work well locally."

The report calls for policymakers to also build public trust as they expand AI use.

"Improved public services and better learning outcomes in schools will reinforce trust -- but if AI embeds bias in government decisions or erodes data privacy, that trust will be difficult to recover," said the statement.

The report delivers a stark warning, too: "AI could widen gaps between countries, increase inequality within them, concentrate market power, weaken trust in public institutions, and create new risks for safety, rights, and social cohesion."

And while risks to employment in developing countries are low at the moment, it warns that in the long run AI tools could cut off economic mobility by eliminating many of the middle-class jobs that enable it.

The report was written with the aid of several of the world's most advanced AI tools, including offerings from OpenAI, DeepSeek, Google and Anthropic, according to a disclosure.



People visit the Alibaba booth during the World Artificial Intelligence Conference in Shanghai on July 18. PHOTO: AFP