

The inflation fallacy

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During a recent TV interview, the Minister of Finance told his audience that if the country produced essential goods in greater quantities, their prices would come down, and this would help tame the inflationary tendencies in the economy. Most intellectuals and civil society people seem to be of the same opinion. The opposition leaders have also espoused such a view for some time. The consensus of view on such a complex subject among people who otherwise disagree on virtually all important issues is remarkable and should be encouraged, except for a small problem: the argument is not valid as a general proposition.

There are at least three common fallacies embedded in the view above. The first arises from a confusion between relative prices and the general price level or what is commonly known as inflation. The high prices of essential goods that worry the ordinary people relate to an increase in the relative prices of those goods. This may or may not be associated with an increase in the general price level. If the relative prices do not change adversely for the consumers, they would have no reason to be aggrieved.

For example, if *all* prices were to double, we would have an exceedingly high inflation rate of 100 per cent. This would no doubt drive the IMF supervision team bananas, but it would hardly cause a stir among the people of the country. Since all prices, including prices of the services of factors or production (i.e. capital, labour, and land) doubled, all relative prices would remain unchanged, and hence nobody's purchasing power would be affected. There would be no reason to fret about the high prices. There is no necessary unidirectional correlation between relative prices and inflation. The source of the general confusion would appear to be the fact that increases in the relative prices of essential commodities have sometimes been associated with increasing inflation in the recent past.

The second fallacy is the presumed causal connection between an increase in domestic supply and reduction in market prices. Apparently this conclusion is firmly rooted in the most fundamental principle of economics: that market price is determined by the interaction of supply and demand, and that any increase in supply, *other things remaining the same*, will reduce the price.

Here the confusion arises in the interpretation of the relevant boundaries of the market, perhaps due to an inadequate appreciation of the implications of globalisation. Inexorable forces of international commerce have pushed virtually all countries of the world toward trade liberalisation such that individual countries are now firmly integrated into a single global economy. An implication of this process of greater integration is that prices of tradable goods in various countries are linked.

International trade establishes a single price for a tradable good; prices in individual countries can differ from this price only to the extent of transaction/shipment costs and taxes or subsidies. Since the latter do not vary on a day-to-day basis, domestic prices are essentially linked to international prices. This means that the domestic price of a good in any country can decrease only if the international price decreases or because taxes (or subsidies) are changed. The international price of a good is determined by the interaction of supply and demand in the global market, a change in domestic supply will change the international price only to the extent it can affect the global supply.

In other words, an increase in production in the country may lead to self-sufficiency or surplus, but it will not necessarily reduce the market price. Just as surplus production of rice in Chandpur or Kishoreganj does not cause a lowering of the market price in these districts relative to some other districts that are in deficit, so a surplus production of rice in Bangladesh will not reduce the domestic price of rice below the international price (unless the surplus rice is of such poor quality as to be non-tradable or the government prohibits exportation).

Bangladesh started producing shrimp in a big way since the eighties. But those who expected the price of shrimp to come down with an increase in supply were sorely disappointed. Indeed, the domestic price rose to match the international price. Despite the surplus production we cannot buy shrimp in the domestic market unless we are willing to match the international price. The market of the shrimp producers in Bagerhat or Cox's Bazar is no longer the domestic market, but the entire global market.

On the other hand, we produce no apples or steel. But we pay about the same prices as the Indians or Australians who are major producers. If we feel aggrieved when we pay Tk. 60-70 per kg of pulse, much of which we import from India, imagine how the Delhites feel when they have to purchase the same for Rs. 50! It seems safe to say that the prices of (tradable) essential goods are unlikely to deviate from the world prices unless the government decides to use fiscal measures to buck the trend.

The third fallacy arises from a confusion about the cause of an increase in a relative price and that of an increase in the general price level (inflation). An increase in the relative price of a good is always the outcome of an excess demand that can occur either because the demand for the good has increased or because the supply has decreased. Hence, a reduction in the relative price of a good requires an increase in supply.

In contrast, an increase in the general price level is independent of the real supply and demand situation in individual markets; it depends on aggregate demand, which is crucially dependent on money supply. In the words of the guru of monetary economics (Milton Friedman): inflation is always and everywhere a monetary phenomenon. That inflation does not have much to do with absolute shortages should be evident from the fact that inflation creeps up mostly when supplies are plentiful (business boom) and declines when the economy is in a slump. In most Saarc countries, including Bangladesh, inflation has picked up significantly during 2005-06, a period of relative prosperity in all these countries. Inflation can be controlled mainly by controlling the money supply. The monetary contraction put in place by Bangladesh Bank recently appears to have succeeded in slowing down the pace of inflation. An increase in output is desirable not because the prices will be reduced, indeed that might be a disincentive to produce more, but because income will increase. The increase in income represents an increase in the purchasing power of the producers, hence they can afford to buy more goods and services than previously, even at higher prices. Their economic welfare improves. The improvement of welfare does not require self-sufficiency in the production of essential goods, it depends on the deployment of the available resources in a manner that maximises the *total value* of production.

If domestic production of any good is less than the demand, surplus tradable goods can be exchanged at international prices in exchange for these goods. The pattern of production of the country in a globalised world should not be determined by the structure of domestic demand, but by international comparative advantage. An important implication is that self-sufficiency should not be by itself a goal of economic policy in today's world.

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