

Market dynamics *and* price behaviour

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It has perhaps escaped notice of many that the national and international events preceding and during both 1974 and the current year have many similarities. During both these years the nation was struck by two consecutive monsoon floods that not only wrought widespread damage to aus and aman crops, but also greatly increased the misery of the people. Before the nation recovered from these shocks, it was hit in both these years by devastating cyclonic storms with large losses to life, property and agricultural crops. The aftermath of these natural calamities greatly stressed government budget and administration.

To compound problems, the international commodity prices, especially petroleum and cereals, increased by leaps and bounds during both these periods. The annual average crude oil price increased by nearly four times between 1973 and 1974. International rice price increased by 178 per cent, and wheat price increased by 78 per cent.

The price increases in recent times were less, but nonetheless quite severe. Between December 2005 and December 2007, international rice price rose by nearly 30 per cent whereas wheat price increased by about 125 per cent. Crude oil price increased by 67 per cent during 2007 (all price increases are in dollar terms). The currency also depreciated. These international events had strong flow-on effects on the domestic economy. The process of trade liberalisation that accelerated during the nineties has integrated the domestic economy firmly into the world economy. For a small open economy like Bangladesh, it is extremely difficult to cushion itself from international trends. Even during 1974, when Bangladesh economy was far less open than it is today, the flow-on effects of rising world prices could not be quarantined.

Business people today are well-informed and market savvy. International market trends get reflected in domestic conditions fairly quickly (just as they do in advanced economies).

Domestically, arbitrage activities of local business people do not allow the price of a commodity, say rice, to vary much (except for transaction costs) between say Dinajpur and Cox's Bazar. Similarly, international arbitrage forces domestic prices to follow



global market trends. Hence, these days domestic prices of tradable goods in any country do not differ much from the global trends. This is especially true of a small country that is only an insignificant part of the global market. The costs of deviations from the global trends could be very high. Rather than attempting to buck the international trends, which may prove very costly, it would be more useful to find alternative ways of minimising the adverse effects and adjusting to the new conditions.

World cereal prices were exceptionally low during 2000-01. For example, the dollar price of rice in 2001 was absolutely the lowest since 1972. Similar pictures also emerge for wheat, maize, and soybean and palm oil prices. Such low prices helped the economy to hold down the inflation rate which was at its lowest in 2001. Unfortunately, this comfortable situation did not last long; international cereal prices went on a roller coaster ride since 2002 and Bangladesh inevitably got caught up in it. The inflation rate has been steadily increasing since 2001-02.

The trends of global market price and domestic market price of rice, sugar and soybean oil are shown in the charts below. They all share one thing in common - both prices move together. In other words domestic price movements are very strongly influenced by international price movements. Observed deviations can be explained by tariff changes, expectations, errors and adjustment lags. It does not seem that the performance of these markets has changed much during the last several years, nor do the markets show any obvious signs of any significant inefficiency or distortion.

These findings cast some doubts about the validity of syndication, hoarding and middlemen hypotheses advanced at different times to explain intermittent price hikes. If any of these were responsible in a major way for the price hikes, there should have been a sustained divergence between domestic and international price trends when the alleged unfair business practices had occurred. But there are no such divergences between these prices evident from the charts. If these elements did have any role in price formation, that was already contained in the initial spread between international and domestic prices. Consequently they cannot explain the subsequent increases in domestic prices.

Only if the syndicates or the businesspeople had increased their margins, it could have been advanced as a possible explanation of the price hikes. However, the spreads between the international and domestic prices have remained fairly stable since 2004 for rice, while for sugar and soybean oil the spreads seem to have declined. Thus the notion of heightened profiteering through the alleged unfair means does not appear to be a significant force behind the recent price hikes of essential goods.

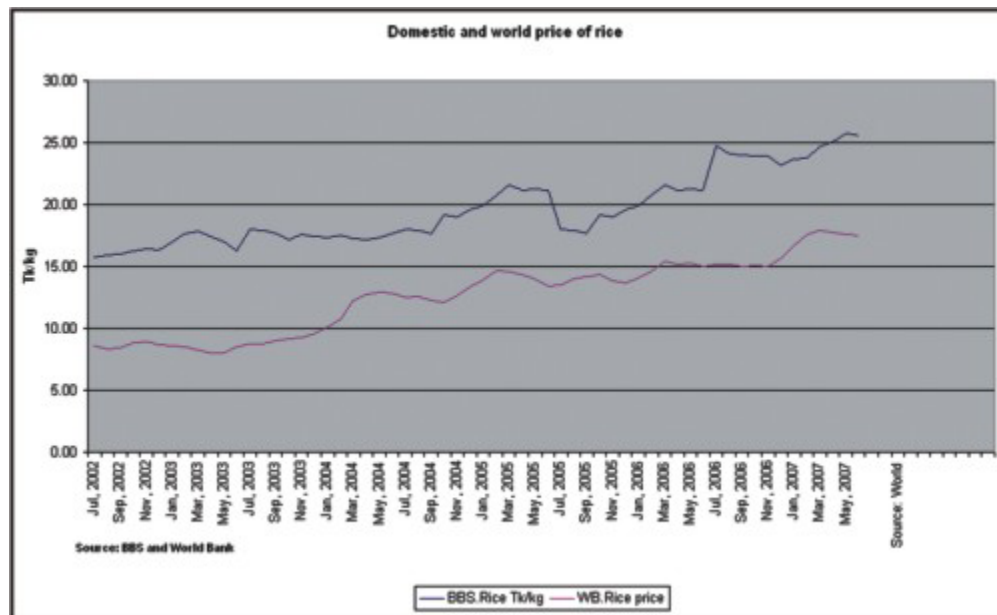
If the price hikes originated in domestic distortions such as mentioned above, it would be possible to bring the prices down by taking remedial measures against the unfair business practices. However, if the principal impetus originates overseas the task of controlling prices becomes difficult, and in some cases virtually impossible.

One of the easier methods of offsetting an international price hike is to reduce any trade taxes or restrictions on the commodity. At the moment, there are no taxes or restrictions on the import of rice and wheat, and hence, this method of reducing their prices is not feasible. Some products like edible oil and milk powder are still subject to substantial tariffs; hence the impact of international price hikes could be partly offset by reducing tariffs on these products. This was done some time ago for sugar.

While such a measure could ease the inflation situation to some extent, it also depletes the meagre revenue basket of the government and thereby reduces its ability to engage in development activities. Furthermore, if the international prices keep on rising, the tariff cushion will be exhausted sooner or later, and the problem will re-emerge.

The other way of holding the essential prices down would be to subsidise the commodities. But since a very large amount of money is spent on essential commodities such as rice, the subsidy required would also be large, and beyond the capacity of the government. For example, subsidising the rice price by only five taka per kilogram would require about 1500 crore taka per month.

Since, subsidising food grains en masse is not possible, the government could subsidise food grains sold to target groups such as the poor people. But this would require introducing a rationing system. Such a system did exist in past. (It exists now only for service personnel.) If the government wishes to introduce rationing, it should first examine why it was abandoned. The administrative and financial costs of running such a system are usually very high.

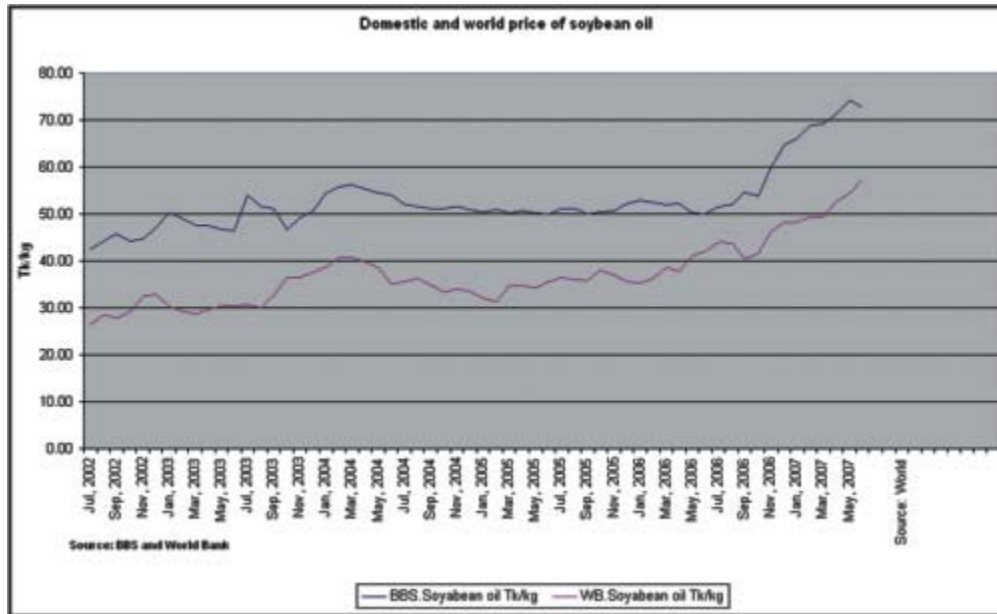


Another option would be to directly increase the purchasing power or the exchange entitlement of the poor. The government has already moved in this direction. Vulnerable group feeding, food for work, test relief and such other programs all raise the exchange entitlement of the poor and help them to tide over difficult times.

The all-important difference between 1974 and the current year is that the former ended in a tragedy in which tens of thousands of poor people perished, but the latter escaped with increased misery of the ordinary people. Two reasons among others for the relatively 'better' outcome during the current year are: (a) the per capita purchasing power of the nation has risen markedly and (b) the markets are a great deal more open and less encumbered by government interventions. The former gave people the means to withstand difficulties while the latter made the essential goods available promptly to any pockets of scarcity.

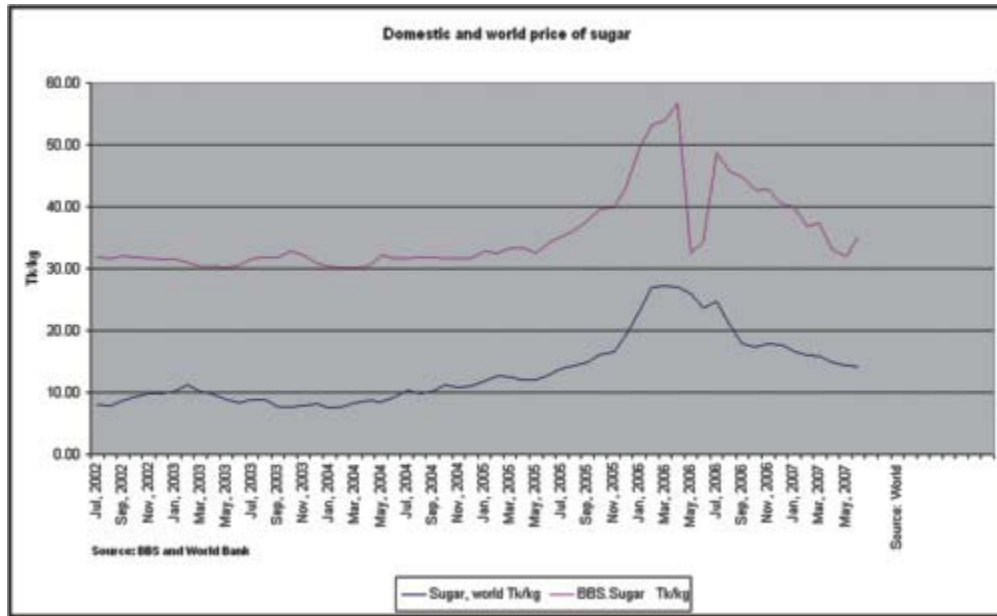
These factors that helped the economy to withstand the adverse domestic and international shocks should not be impaired because of some mistaken notion of controlling the market or the urge to solve longstanding problems immediately. Nothing should be done that reduces the growth rate of the economy or disrupts the market mechanism. No policy has ever worked as well as high economic growth in

reducing poverty and empowering the ordinary people anywhere in the world. This is the only certain route to a permanent solution to the problem of poverty although the journey is not always smooth or time-bound.



Government interventions in the market can be justified only if there is market failure in some sense. Such interventions can only reduce welfare if the markets are well functioning. Hence, before the government contemplates any market intervention, such as procurement and distribution through government agencies, it should first satisfy itself that a market failure has occurred or that the government agencies can deliver more efficiently than the private traders. The charts below do not suggest any significant market failure or distortions in the case of any of these commodities. In this event the government interventions could have worsened an already difficult situation and delayed the recovery.

The problems that the nation is facing now did not emerge suddenly and cannot be solved immediately. Economic policies of the yester years were not conducive to moving the economy in a direction that could ensure that these problems resolve quickly. The crux of the problem is that a large part of the population live under the poverty line; they do not have sufficient purchasing power either to live a decent life or to adjust quickly to sharp price fluctuations.



A lasting solution then is to raise the purchasing power of the ordinary people, which will give them the ability to withstand any unforeseen difficulties. This can be achieved only by accelerating economic growth. Hence, every effort should be made to raise economic growth which alone can give a reasonable guarantee of a sustainable solution to the primordial problem of poverty. Most importantly, no policies or measures should be taken that disrupt the market or constrict the supply chain.

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