Price movements in a global economy

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There seems to be a great deal of confusion regarding the reasons and consequences of price hikes. Just about everyone in the country seems to believe that a price hike is a bad thing; it hurts people and the economy. The truth is, however, not this simple. Some price increases are innocuous and some are actually good for the economy. If all prices, including prices of labour and capital, were to increase similarly, the resultant price hike will not have any impact on anybody. Economists in general regard a mild increase in the prices of locally produced commodities as helpful for economic growth and welfare. The kind of price hike that really hurts the ordinary people is the one that reduces their purchasing power. When the prices of essential commodities, that constitute a large part of the consumption basket of the ordinary people, go up without a compensating increase in their incomes, their ability to purchase the same amount of goods and services as before is impaired. A large increase in these prices can have a devastating impact on people with limited fixed incomes. They are particularly vulnerable to the vagaries of the market.

Many people seem to believe that these price hikes are mostly artificial, or at the least the government could use its regulatory powers to hold prices in check. While this may be true in some special circumstances, in most cases there is not much the government can do to contain prices in a market economy, nor is it advisable that they should necessarily try to do so. Only when prices increase because of some criminal activities or unfair business practices, the government should intervene. The former are a law and order problem and should be dealt as such. The latter are not necessarily an offence unless these are explicitly outlawed. It is doubtful if there is any law in Bangladesh that explicitly prohibits all that could be considered unfair business practices. Bangladesh is one of those countries that have neither a Consumer Law nor a Competition Law. Even if there were such a law, it would require a great amount of investigative and intellectual capacity on part of the government to identify an unfair business practice and to take a legal action. Extra legal measures are most likely to be counterproductive (prices may increase even more or shortages may be created) in addition to being morally questionable.

If a commodity is mostly imported, such as edible or fuel oil, domestic prices in a small open economy such as Bangladesh will be determined by import costs. Two things that are important in determining import costs are import prices and the exchange rate. If these move upward, domestic price are likely to rise in response. There is precious little the government can do to reduce the import prices, and its ability to influence the exchange rate is also very limited in a flexible exchange rate regime especially with the puny amount of reserves that Bangladesh holds. The only way it could reduce the adverse impact of upward movements in import prices or the exchange rate would be to subsidise the domestic sale of the commodity. This is precisely what the government has done in the case of fuel oil. The cost of such a measure is by now obvious.

In certain cases, it might be possible for the government to reduce the impact of rising import prices and exchange rate by reducing import taxes. This is possible only if there is a substantial import tax on the commodity whose import price has increased. A significant cut in the tax may fully or at least partly offset the increase in the import prices or the exchange rate. The government took such an action in the recent past to reduce the market price of sugar. This is not much different from providing subsidies. In both cases the budget deficit worsens. Subsidising fuel oil (and to a lesser extent sugar) has created a large hole in the government budget during the last year or so.

It is frequently claimed that if domestic production is increased, domestic prices will come down. This simplistic argument is made especially in respect of agricultural products. As a general proposition the statement is *false* in a modern economy although it was quite correct for a closed economy such as the early Soviet Union or Mao's China. Those who make the argument are apparently still caught in the straitjacket of the economic paradigms of a bygone era. In the modern globalised world domestic prices of most goods are not determined in the domestic market, but influenced by the global market. An increase in agricultural cereal output by a few million tons will not materially affect the global supply of the commodity and hence will not significantly affect the price. People of Thailand and India, the largest exporters of rice, pay about the same price for rice as the people of Bangladesh (save for transaction costs and local taxes), a country that imports substantial quantity of rice. Bangladesh now produces much more shrimps than it consumes (or what it produced in the past), but this has not reduced the domestic prices of shrimps since these prices are tied to the EU and US market prices. It is instructive to note that import of food grains reached the highest level in the history of Bangladesh during the last Awami League regime (1998-99), and yet the prices were low. A glance at the international prices at the time (and the exchange rate) should reveal why the prices were low despite severe shortages of domestic supply of food grains. Similarly international prices also explain to a large extent the current high prices of rice despite moderate level of imports. During the last three years the international prices of rice adjusted for the exchange rate have nearly doubled and this is reflected in the domestic price. Globalisation has ensured that there is no systematic relationship in a small open economy between domestic shortages (or surpluses) and domestic prices except when there are government interventions of the sort mentioned earlier. This should be borne in mind while contemplating any price control measures.

Although the scope for compensating interventions by the government is limited when prices rise due to international competition, it is possible to check rising domestic prices if these are caused by unfair business practices. However, three conditions must hold if domestic price hikes due to unfair business practices are to be prevented: (1) there must be a political will to do so, (2) appropriate laws (such as consumer protection law and competition law) must be put in force, and (3) the government machinery must have the capacity to identify unfair business practices and take punitive measures according to the laws. None of these conditions holds for Bangladesh. Hence, whenever essential prices go up we hear the government making some noise about going after the people responsible, but nothing is ever done. Successive governments had neither the political will nor the means or capacity to take the culprits to task. The present government has also boldly declared, like its predecessors, its firm resolve to control prices within a short period. The future will reveal if it does any better.