Trade Off Between Budget And Inflation

Devid K. Basyal
Saturday, August 8, 2009
Source : *The Rising Nepal*

The government recently announced its budget for fiscal year 2009/10, a size that has been enlarged to Rs. 285.93 billion from about Rs. 236 billion the previous year - much against the suggestions and expectations of various economists.

Many arguments in the context of the present budget have been put forward on behalf of its size and proper implementation. There might be many arguments for and against its size, but one thing is for sure: a large budget means an expansionary fiscal policy. This results in more spending by the government, and ultimately an increase in the aggregate demand, which, in turn, leads to inflation. If the estimated budget is spent properly, it will increase the aggregate demand in the economy, which means more transaction of commodities.

Price hike

Generally, it is a common trend and customary of any government in the developing countries to present a deficit budget, which will pull the price of commodities up in the market. Hence, every rise in the dimension of the budget, generally, influences price hike.

It is rightly said that high inflation is a legal dacoit. It unknowingly makes the pocket of the ordinary people empty. Inflation is defined differently. On the basis of speed, it is creeping or walking or running or hyper (galloping). The rate of inflation of more than 10 per cent is associated with running inflation; however, inflation more than 5 per cent is the concern of any country. On this ground, inflation in Nepal, has persistently been increasing (13.1% in the first eight months of 2008/09 (Nepal Rastra Bank), which is nearly double that of the estimated 7.5% of the previous budget target) despite some efforts made by the government.

There are many reasons behind the high rate of inflation in the economy. If inflation occurs due to increase in the aggregate demand against its respective supply, it is called demand-pull inflation. Increase in money supply by the central bank and expansionary fiscal policy (increase in public expenditure, deficit financing, low tax rate and increase in the tax slab) by the government are the reasons of demand-pull inflation.

On the other hand, if prices of goods and services increase in the market due to increase in the cost of production, it is cost-push inflation. The reasons of cost-push inflation are increase in the wages of the labourers, increase in the price of raw materials, oil price and international reasons.

The present high rate of inflation is neither due to demand-pull nor cost-push inflation. It is due to supply constraints, which means the government mechanism is not functioning properly. Hence, Nepal Rastra Bank (NRB), the central bank of the country, failed to control inflation as expected even when

monetary measures were applied in the previous year. However, recognising the high inflationary pressure, NRB published its tight monetary policy on July 24 for fiscal year 2009/10 by reintroducing its Statutory Liquidity Ratio (SLR) after 17 years. But doubts are still there as to whether it will fuel growth and contain the price hike.

The main role of the central bank is undoubtedly to maintain price stability. In this connection, controlling inflation by implementing different monetary measures and other moral obligations is the main concern of NRB, but it was unsuccessful in the previous years. Past evidences show that efforts of the NRB alone will not be sufficient in controlling inflation.

The whole world is in a recession, and the IMF has predicted that the world economy is encountering its first ever severe economic downturn after the Great Depression of the 1930s and World War II. The IMF has again forecast that the world economy would turn negative by 1.3 per cent in 2009. Astonishingly, the rate of inflation in India turned negative after 32 years in June 2009.

On the whole, economic pundits tend to analyse the price hike in Nepal by connecting it with the situation in India, which has been proved incorrect given the Nepalese scenario. The current year's budget has announced maintaining the inflation rate within 7 per cent, which just seems to be inspired by the finance minister's forerunner and without any logical foundation.

The prices of such basic commodities like rice, flour, vegetables, pulses and fruits are increasing at hyper rates, and we can again predict that the poor monsoon rains will surely put our country in a mess. India's budget for FY 2009/10 has targetted economic growth at 9 per cent, and profound government expenditure (budget size is nearly IRs. 102 trillion, the biggest ever since its formulation) will raise the general price level in India. This, in turn, will have some effect on Nepal. The price of crude oil in the international market is also gradually rising, the main reason behind rising prices globally.

Strategy formulation

So after analysing all these facts, we can conclude that the target to keep the rate of inflation within 7 per cent is just a strategy formulation. No matter how brilliantly a strategy is formulated, if not implemented properly, it will simply be a futile exercise. Moreover, Nepal cannot absorb an expansionary fiscal policy at this transitional phase.