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SHOULD THE GOVERNMENT LOOSEN ITS PURSE STRINGS?

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With the Union Budget 10 days away, many economic observers are now focused on what support the Centre can offer the economy, which is still struggling to recover from the pandemic. Some analysts believe that the government must keep its spending in check to prevent price rise from getting out of control. Retail inflation is hovering close to 6%, while the wholesale inflation rate is in double digits. Other analysts, however, believe that the current rise in prices is a temporary phenomenon, and that the government must ignore the fiscal deficit and ramp up spending to support the ailing economy. In a conversation moderated by Prashanth Perumal J., N.R. Bhanumurthy and Himanshu discuss the way forward. Edited excerpts:

N.R. Bhanumurthy: First of all, when it comes to retail inflation, the latest reading says it is somewhere close to 5.6%. The Reserve Bank of India (RBI) has already predicted that it will remain below 6% by the end of March. However, many of us believe there are some upside risks when it comes to inflation and inflation expectations. This is for a couple of reasons. One, international oil prices have gone up to $87 per barrel this week. We also see that inflation pressure is building up across the world, especially in countries where there was a large fiscal stimulus. So, there could be the risk of transmission of international inflation to the domestic economy. But at the same time, one needs to really understand what drives this inflation. At least in the Indian context, supply-side constraints play a major role and this needs a different policy prescription. And I'm very sure that the RBI has many instruments to contain this inflation pressure. For the past three quarters, the RBI has been hitting bull's eye when it comes to inflation forecasts, so I think when it says that retail inflation will be less than 6%, it's likely to come true. With regard to Wholesale Price Index (WPI), I've been a little wary of this reading. You cannot have wholesale market prices and retail market prices diverging for a very long time. We generally expect the transmission between the wholesale market and the retail market to not be more than one or two months. But what we see now is a very prolonged divergence. We need to look at a little more in detail in terms of the coverage and commodities and all those things. We need to focus more on Consumer Price Index (CPI) and less on wholesale prices.

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Himanshu: We have to be very cautious in not just looking at inflation numbers in aggregate, but also what is driving inflation. I think that most of the inflation is basically driven by supply. Also, it not driven as much by domestic factors as it is by international factors. But domestic factors have added to the problem. The most obvious factor is that taxes on petroleum goods and services have increased. So, domestic factors have contributed to inflation, but the inflation is predominantly driven by the supply side. But I would also be a bit hesitant in saying that there is only little that can be done using fiscal policy.

Second, I think the gap between WPI and CPI is quite a big one and it has been so for a long time. Some of the inflation in wholesale prices will be passed on to consumer prices, so inflation is a cause of concern not just for fiscal policy or monetary policy, but also for the overall health of the economy because inflation is going to impinge on the basic economics of households.

N.R. Bhanumurthy: With regard to the fiscal policy, the current year is turning out to be a very good year in terms of tax revenues. If you look at the last Budget, the government was focused on the medium-term perspective, while leaving short-term issues to the central bank. I'm hoping that the same macro framework will continue in the coming Budget. But at the same time, measures that were brought in to help the poor in terms of providing safety nets continue. Right now, the government has fiscal room and will want to focus on the social sector as well as medium-term growth prospects. Ultimately, the biggest stimulus would be any measure that provides more employment opportunities. Economic recovery has to be on a more sustainable basis rather than in the form of short-term spikes in growth.

Editorial | Inflation conundrum

Himanshu: I think it should spend more. If there's any time that the government should be spending more, it is now. One has to go beyond this obsession with managing the fiscal framework. If fiscal prudence leads to growth slowing down, I don't think that is something sustainable. The reason I say this is because there are enough of the government's own economic indicators that show that there is excess capacity in the economy. Aggregate consumption, which is a big part of GDP, is slowing down and has been for quite some time now. I think at this point of time the focus should be on reviving the economy and that is best done using fiscal policies. The government will have to open its purse, not just in terms of improving the incomes of people in cases where it can directly do so, such as using social security schemes, but also by increasing the transfers to States. We are actually getting into a situation where the public debt to GDP ratio is going to increase because if growth is going to slow down, it would basically mean that government revenues will also slow down. So, I don't see how it is going to be good fiscal policy if growth is going to be affected by fiscal prudence. I would recommend that we not worry about the fiscal deficit at this point of time because once growth picks up, then a lot of the fiscal issues can be taken care of. But if the economic engines are not firing up, you are getting into a vicious cycle, and then I don't think any kind of fiscal management, either in the short or in the medium term, is going to be sustainable. So, I think we need the government to play the important role of reviving the economy.

N.R. Bhanumurthy: I think they are being alarmist for a simple reason. We, at least in India, have a consensus that the right inflation number which is relevant for the household is the retail inflation number. The WPI is a very segmented indicator that doesn't include services and other things. So, let's be clear that if we are to look at one number to gauge inflation, it is CPI inflation. And the CPI inflation is well within the RBI's targeted range of 2% to 6%. When it comes to the faltering Index of Industrial Production (IIP) numbers, it should be noted that the IIP covers a very small component of the industry. The IIP is a very crude leading indicator. So, I don't think we need to make a judgment based on IIP numbers. My own assessment is that we are nowhere near stagflation. In fact, for the next financial year, my own prediction for GDP growth is somewhere close to 6.5%-7%. And if we look at exports, there is a very substantial rise in exports, so the recovery seems to be very, very sharp. If we can continue with the kind of fiscal framework that was adopted in the last Budget, I think we should be looking at close to 7% GDP growth for the next year. And as we already discussed, the inflation pressure is definitely there. It may be somewhere close to 6%. So, I would not really support the argument that we are anywhere close to stagflation.

WPI inflation eases to 13.56% in December; food items, veggies see price rise

Himanshu: Stagflation may be too strong a word, but I think there are certainly pressure points. Inflation and low growth persisting for a long time is something that I don't think we can rule out completely. Where I disagree with Bhanu is with his optimism as far as growth prospects are concerned. At least when it comes to the economic numbers that I can see, it's not something that is going to be very easy to deal with. A lot of the inflation right now is still coming from the supply side. But if the economy does bounce back once the pandemic is over, it's not going to lead to the softening of inflation; it may actually aggravate the inflation situation.

Second, as far as the growth numbers are concerned, again, I'm not so optimistic. I'm not going to make a prediction on the growth numbers for next year because in this crisis situation, most of these numbers are affected by the base chosen to calculate these numbers. I think it will be some time before we come back to a normal situation. Unless we are back in a normal situation, I think all these numbers don't have much meaning; they are just bouncing up and down. In the broadest sense, the threat of high inflation and low growth persisting for at least some time is real. A lot depends on how the government responds to the situation, both in terms of reviving demand in the economy, but also in terms of managing inflation. These are issues for which we still have no conclusive answers.

N.R. Bhanumurthy: I'm not really sure whether fiscal policy can directly address inflation driven by supply-side factors, except maybe by reviving growth. But to go back to an earlier point, if we look at the advance estimates of GDP, they suggest that the investment rate is somewhere close to 36%, which is very close to the investment rate during the high growth period that we saw in the last decade. This is one of the major indicators for me when I say we are going to see 7% GDP growth.

Retail inflation rises to 5.59 % in December

Himanshu: There's not much that the government can do. But what it certainly can do is protect demand, the economy, the middle class, and particularly the poor and the vulnerable from the impact of high inflation. That, I think, is the role of the government. Taxation of petroleum products, for instance, is something that is part of fiscal policy. So, that is something that the government can influence. When it comes to fertilizer prices, which are rising very fast, the government can increase its contribution and thus reduce the prices that the farmers are paying. Remember, the cost of inflation is not just a direct cost, it can also be passed on indirectly to other prices and this can have a very debilitating impact on the economy. The industry, such as the automobile sector, can start passing on its high input cost to the retail sector, that is to consumers. That's where I think the government can actually step in and cushion the impact that high inflation has on industry as well as on consumers by lowering direct and indirect taxes. That's something that will have an impact on what happens overall to the demand side and to the revival of the economy. So, I don't think that the government's hands are completely tied; it certainly has a role to play. The government should be looking at the long-term picture rather than the short-term picture of generating revenues by taxing more. It should rather allow people to have a larger disposable income so that consumption in the economy increases. And one way to do it, other than through income transfers, is to reduce taxes on goods and services that are witnessing high inflation.

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