

Fiscal policy needs to address triple whammy of inflation, low growth, threat of capital outflows

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By Alok Sheel

With the May CPI numbers raising fears of stagflation, and the US Fed announcing overnight that it will start taking baby steps towards tapering bond purchases, new issues arise as to how macroeconomic policy in India should respond.

Although its death rate measured as a proportion of the population during the first wave of the Covid pandemic was very relatively low compared to other major economies, India nevertheless had one of the sharpest declines in growth in FY 2020-21. The probable reason for this was that its economy was already struggling with a sharp economic downturn when the pandemic struck. Further, unlike other economies that imposed stringent lockdowns, fiscal support measured against output loss was modest.

Most of the stimulus announced during the first wave last year was in the form of liquidity support to businesses already overburdened with debt. Little was done to put money in the hands of those who lost their income and employment, as was done in the US, Japan and Europe that imposed stringent lockdowns. According to IMF's calculations India's fiscal stimulus, including revenue foregone, is just 3.3 per cent of GDP. Amongst G 20 countries, only Mexico, Saudi Arabia and Turkey have injected a lower fiscal stimulus.

The stimulus proposed in the 2021-22 budget works out to an additional 1.5% of GDP if this is assumed to be the difference between the pre-crisis expenditure growth of 12 per cent and the actual increase projected. The cumulative stimulus for the two years is therefore estimated to be 4.8 per cent of GDP, compared to the 8.8 per cent loss of potential output over these two years estimated by IMF based on its pre-pandemic January 2020 World Economic Outlook growth projections. There is therefore a strong case for an additional fiscal stimulus of up to 4% of GDP. The output loss is likely to be even higher as the above estimate was made prior to the devastating second wave, with earlier projections for 2021-22 being downgraded by several agencies.

The fiscal stimulus in the budget for 2021-22 is mostly in the form of enhanced outlays on infrastructure and capital investment, that takes time to kick in, rather than in income support whose impact on consumption and demand is immediate. Most of the additional fiscal stimulus could be in the form of income support for those thrown out of employment, those self employed in small businesses who have lost their means of income, and for families who have lost earning members. While some relief has been provided to the poor through the free provision of food grain, much more needs to be done in terms of share of GDP as pointed out above.

The nominal budget deficit is no doubt already high relative to mandated targets, and inflation is running high, so it can be argued that there is no fiscal space for an aggressive stimulus. Much of the enhanced deficit however is cyclical rather than structural, on account of the sharp decline in revenue associated with the collapse in growth. This component of the deficit will automatically shrink when growth revives. Policy makers are well advised to heed John Maynard Keynes advice that "The boom, not the slump, is the right time for austerity at the Treasury."

The decline in growth is unprecedented and calls for extraordinary measures. Unless strong measures are taken to revive growth the fiscal deficit would continue to worsen through revenue shocks in the absence of large welfare reducing expenditure cuts. Such extraordinary measures have been taken by several other countries, including largescale borrowing by the Government with central banks intervening to buy sovereign debt to keep interest rates low. This option should be seriously considered by government keeping the gravity of the situation in mind. This could weaken the rupee. But this could also have a beneficial impact on the lagging export sector as large capital inflows in recent years have tended to appreciate the rupee in real

terms.

That raises the issue as to how to tackle inflation. RBI's Monetary Policy Committee met recently and expectedly kept policy rates on hold. Monetary policy was already very accommodative, with the real repo rate in negative territory. With the Chair of the US Fed announcing that it would start taking baby steps towards tapering its bond purchases, and that US interest rates might rise sooner than expected earlier on the back of a strong US recovery, the threat of capital outflows again looms on the horizon after having receded for some time, making it difficult to lower rates. The central bank is in danger of being caught in the familiar trilemma, with external and domestic monetary policy compulsions pulling in opposite directions. Inflationary pressures add to RBI's woes. CPI in May 2021 crossed the RBI's upper range target of 6%, pointing to the possible emergence of stagflation, the combination of high inflation and low growth which is a central banking nightmare, as you need to raise rates to rein in inflation, and to lower them to stimulate growth.

With both stagflation and the trilemma rearing their ugly heads at the same time it is difficult to see what more the central bank can do. Supply side measures taken by the government, such as release of food stocks, lowering duties on fuel, and easing pressure on supply chains, rather than monetary policy, would need to be the policy instrument of choice in controlling inflation. This, combined with the continuing overhang of bad debt keeping the transmission channels of monetary policy weak, makes fiscal policy the only game left in town currently to address the triple whammy of inflation, low growth and the threat of capital outflows.

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