Synchronize policies to counter weak growth and high inflation

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The challenging combination has again underlined the urgency of close fiscal-monetary policy coordination.

Following the Tinbergen rule, the monetary and fiscal policy instruments should be separately assigned to address the two conflicting policy goals of containing inflation and reviving growth.

There is a wide consensus that India's gross domestic product (GDP) will grow at 7%-7.5% during 2022-23. Growth forecasts of the Reserve Bank of India (RBI), International Monetary Fund (IMF), World Bank and other agencies are mostly in this range. Our own forecast is 7.3% (S. Mundle, R. Bhattacharya & D. Nayak, NIPFP Policy Brief). However, no one—least of all policymakers—should believe that the Indian economy is now on a strong recovery path. The expected high growth in 2022-23 is mainly attributable to the strong base effect of the slowdown in the first quarter of 2021-22 following the deadly spread of the Delta variant of covid. Stripping out this base effect-driven high growth of 13.5% in Q1 2022-23, growth during Q2, Q3 and Q4 of 2022-23 will average less than 5%, according to our forecast and that of others. Thus, growth remains weak and way below the 6.3 % trend rate maintained prior to the pandemic's outbreak.

Meanwhile, the headline inflation rate has remained above RBI's upper tolerance limit of 6% since January and now has again exceeded 7%. Though mainly driven by high food and energy price inflation, high headline inflation also reflects elevated inflation across a wide range of non-food, non-fuel core inflation components. This challenging combination of low growth and high inflation has again underlined the urgency of close fiscal-monetary policy coordination.

Finance Minister Nirmala Sitharaman reportedly remarked that RBI cannot contain inflation on its own. She may well be right. RBI's policy instruments are not particularly effective in addressing supply constraints. This is especially important now, with significant supply disruptions both at home and abroad, first because of the covid pandemic and now the Ukraine war. The Agreement on Monetary Policy Framework requires RBI to achieve a target inflation rate of 4%, with 2% tolerance

above or below that target. If the target is breached for three successive quarters, as has happened now, RBI is required to submit a report to the government explaining why it has failed to achieve the target, what remedial measures it proposes and the time that may be required to bring inflation down within the tolerance band.

RBI can certainly provide explanations for the persistent high inflation, but remedial measures to bring inflation down are quite another matter. Given supply constraints, RBI can impose exceptionally harsh contractionary policies that can severely curtail demand, even for necessities like food. The inflation rate may come down, but at the cost of great misery especially among poor households. It would make so much more sense for the central and state governments to intervene using a whole range of instruments to help ease the supply constraints. Hence, the Finance Minister's remark that RBI needs help in containing inflation is timely.

Government interventions can range from easing domestic infrastructure bottlenecks, including power shortages, to production-linked incentives to temporary restrictions on exports of supply- constrained essential commodities, and special-case imports of such commodities (e.g. oil at low prices from Russia). Some of this is already being done. But let me set aside these sector or commodity-specific interventions and focus instead on macroeconomic policies.

Close coordination between RBI and the government is a core feature of macroeconomic management. This was particularly evident after the massive pandemic shock. The Centre struggled to maintain budgeted expenditure levels even as economic activity collapsed and hence tax revenues as well. Consequently, the fiscal deficit ballooned. Whether or not the government should have done more has been much debated. But the point is that RBI did a great job in providing a massive increase in liquidity, using unconventional measures, to finance the huge increase in government borrowing and thereby containing the economic contraction. Fortunately, the price situation remained benign throughout this period.

Stimulating an economic recovery remained RBI's priority until May this year, when rising inflation induced it to shift back to its principal mandate of containing inflation. It has raised the policy rate three times and taken other strong measures to drain excess liquidity from the system. Apart from domestic inflation, RBIs policy stance also takes into account other factors, in particular global supply disruptions, high inflation and rising policy rates in the US and other advanced countries. It is

likely to raise the repo rate again by another 25 to 50 basis points in the forthcoming monetary policy review.

Given the backdrop of low growth along with high inflation, and with RBI now focused on containing inflation, what should be the policy stance of the government? Apart from the interventions mentioned earlier, which will help ease supply-side bottlenecks, the central government's fiscal stance should continue to focus on stimulating aggregate demand and reviving growth. In other words, following the Tinbergen rule, the monetary and fiscal policy instruments should be separately assigned to address the two conflicting policy goals of containing inflation and reviving growth.

Using our forecast of 13.7% nominal growth in 2022-23 (7.3% growth and 6.4% inflation) and estimated buoyancies, we project the fiscal deficit will rise to 7% instead of declining to 6.3% as envisaged in the budget. In the interest of reviving growth, the central government should accept this fiscal slippage in the short term, but with a medium-term goal of gradually reducing the public debt-to-GDP ratio and the interest burden of servicing public debt to enable higher social spending and capital expenditure.

These are the author's personal views.

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