The Indian outlook for Inflation and Growth: 2022-23 and beyond

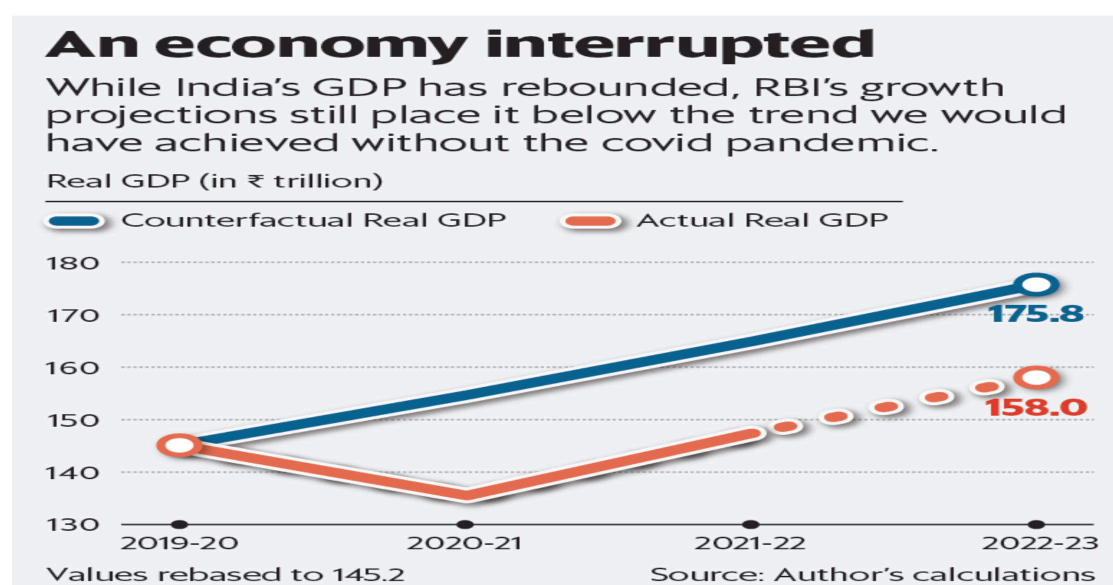
Sudipto Mundle, *Livemint*, 17 Jun 2022, 06:40 AM IST

- Price stability looks like a tough ask while GDP expansion can be boosted by an investment upturn and new trade prospects

Heightened political tensions during the past two weeks have overshadowed some important developments on the economic front.

The most important of these is inflation. Through much of 2020-21 and 2021-22, the headline Consumer Price Index (CPI) inflation rate remained well above the 4% target of the Reserve Bank of India (RBI) and often even above the 6% upper limit of the tolerance band. Core inflation (excluding food and fuel) remained above or close to 6%. Non-food inflation was even higher, sometimes crossing 7%. The GDP deflator was in double digits for 2021-22. The Wholesale Price Index (WPI) inflation rate was also in double digits throughout 2021-22 and has exceeded 15% in April and May 2022.

Despite these multiple indicators, and its single formal mandate of ensuring low inflation at 4% (+/- 2%), RBI maintained that high inflation was transitory and continued focusing on promoting growth, maintaining a low policy rate and high liquidity. It is understandable that under exceptional circumstances, like the steep decline in economic activity due to the covid pandemic, RBI had to temporarily depart from its mandate to contain economic contraction, and it did that remarkably effectively through 2020-21. But it still needed to get back to its inflation mandate sooner rather than later, leaving it to the government to focus on growth.



Many economists emphasized this on multiple occasions, including this columnist (see Mint, 17 December 2021). However, RBI continued to prioritize growth until CPI inflation exceeded 7% in April and again in May. It then suddenly changed its stance and announced an off-cycle repo rate increase of 40 basis points in May, followed by another 50 basis points increase on 8 June. The rate for the Standing Deposit Facility, which has effectively replaced the reverse repo rate, has also been raised, while the cash reserve ratio has been raised 50 basis points to 4.5% to suck out excess liquidity. This reversal of the central bank's policy stance and its swift measures to rein in inflation are welcome, but RBI has forecast that inflation will still persist above its tolerance band at 6.7% for the fiscal year 2022-23.

What are the chances of India doing better than that on the inflation front? It is not clear how soon the Ukraine war situation will improve and ease global supply constraints. But monetary policy is being tightened quite sharply in the US and other advanced countries. Hence, on balance, the external pressures driving Indian inflation are likely to weaken in the months ahead. On the domestic front, assuming a normal monsoon, no new supply side disruptions or duty increases on fuel are expected to exacerbate inflationary pressures. For its part, RBI is likely to raise the policy rate again and take further measures to squeeze liquidity. Hence, inflation may indeed decline to less than 6%, though the 4% target seems beyond reach.

What about growth? Following the unprecedented 6.6% contraction in 2020-21, triggered by the pandemic, growth bounced back to 8.9% in 2021-22. Gross domestic product (GDP) at ₹148 trillion exceeded its previous peak of ₹145 trillion in 2019-20. But how is GDP likely to grow going forward? Based on high frequency data then available, our forecasting model was indicating in November that GDP would only grow by 5.2% in 2022-23. As the data was updated, our growth forecast was progressively revised upwards to 7.5%, while other early forecasts of over 8% growth were revised downwards. Views have now converged that GDP will grow at about 7%-7.5% in 2022-23. RBI has maintained its growth forecast at 7.2%.
Real GDP of ₹158 trillion in 2022-23 would still be far short of the ₹176 trillion that trend growth would have generated without a pandemic (see chart). However, a growth rate of over 7% is way above the pre-pandemic growth of 3.7% in 2019-20 and also higher than the trend growth of 6.6% achieved during the 5 years preceding the pandemic. Would such high growth be sustainable? We are probably at the cusp of a new private investment cycle. Corporates used their surpluses during the past two years to reduce debt rather than invest in creating new capacity. Hence, the

corporate sector is now less leveraged, while rising capacity utilization is signalling that it is time to invest in new capacity. The investment rate has accordingly started rising and is higher today at 33% than it was in 2019-20.

This new investment cycle could be powered by the Production Linked Investment scheme, which has proven very popular and may be expanded. Another important development that could significantly boost investment over the medium term is the US led Indo-Pacific Economic Framework (IPEF) just launched in May, with India as one of its 13 founding members. An open regional formation that other countries may join, the IPEF is not a conventional free-trade agreement. But trade is one of its four main pillars along with supply chain resilience, clean energy and decarbonization infrastructure and tax and anti-corruption. Details are yet to be worked out, but it is potentially a fresh opportunity for Indian producers to embed themselves in regional and global supply chains, an opportunity that was missed by staying out of the Regional Comprehensive Economic Partnership. If IPEF takes off and India can negotiate early and successfully, using domain experts and not just bureaucrats, to secure its national interests, this could be a game changer for India, enabling high growth led by exports and investment.

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