Avoiding Stagflation: Urgent Action is the Need of the Hour

Brickwork Ratings, Mumbai, 18 December 2019: The recent spike in CPI inflation numbers and decelerating growth scenario bring back the memories of low average growth of 4.1% during 2000-01 to 2002-03 and the more recent 4.3% during the July-September quarter of 2013. In both these episodes, low growth was combined with high inflation and as the growth falters to 4.5% and consumer price index moves up to 5.54% in July-September of this year, there are concerns of the economy heading towards a stagflationary situation. Although the increase in CPI was mainly due to rise in the prices of food items (10.01%), particularly the price of onions (14.9%) there are fears of the problem spreading into the core areas, particularly after the increase in telecom prices. The expectation of lower output in agriculture due to unseasonal rains too could pose upward pressure. The RBI’s recent decision to hold the policy rate looks appropriate and as the inflation rate is close to the upper bound in the flexible target range, there may not be much space for further cuts if the trend continues. However, RBI may cut rates considering growth concerns, as the core inflation is still low at 3.5%, and if the inflation eases in the coming months.

The concern about faltering growth scenario is real and swift action is needed by the government. The reduction/rationalisation in the corporate tax rate is an important measure, but much more action is needed to augment private consumption and investment. There is not much fiscal space for spending at the Central level and the States too are constrained by lower tax devolution by the Centre due to low growth in Central revenues. More importantly, GST which was hoped to be a “money machine” has ceased to be so and although the Central government has decided to release Rs 35,000 crore to the States, the pressure will continue to build as the collection of compensation cess is much lower than the amount required for compensation. The Centre will have to honour the agreement, but substantial cut in capital expenditure at both Central and State levels are likely which will have adverse consequences on growth unless the government decides to abandon the fiscal correction path. The most important action needed now is to fast track the disinvestment and use the proceeds to augment capital spending. It is also desirable for the government to report the pending payments and off budget borrowings to show a realistic and transparent picture and then to provide a roadmap laying down the correction path. Perhaps, the Finance Minister will not have any other choice but to breach the target with a promise of returning to the correction path in the coming years. These are challenging times and hopefully, with so much political capital with it, the government will prove equal to the task.
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CONTACTS

Dr M Govinda Rao
Chief Economic Advisor
+91-080-40409940
govindarao.m@brickworkratings.com

Anita Shetty
Research Editor
+91 22 67456633
anitashetty@brickworkratings.com

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