Should the Government Loosen its Purse Strings?

What is the issue?

With the Union Budget few 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.

What is the current trend in price inflation?

> *Inflation is the rate at which the value of a currency is falling and consequently, the general level of prices for goods and services is rising.*
>
> *The most commonly used inflation indexes are the Consumer Price Index (CPI) and the Wholesale Price Index (WPI).*

- **Retail inflation-** The retail inflation is somewhere close to 5.6%.
- The RBI has predicted that it will remain below 6% by the end of March.
- **Causes**- Supply side constraints play a major role in driving this inflation.
- Domestic factors such as increased taxes on petroleum goods and services have also contributed to inflation.
- **Risks**- International oil prices have gone up to 87 dollar per barrel this week.
- There is a risk of transmission of international inflation to the domestic economy.
- **WPI and CPI**- The wholesale inflation rate is in double digits and there is a possibility that some of the inflation in wholesale prices will be passed on to consumer prices.
- It is a cause of concern not just for fiscal policy or monetary policy, but also for the overall health of the economy as inflation affects the basic economics of households.

> *The CPI is a measure of weighted average of prices of a basket of goods and services which are of primary consumer needs such as transportation, food, and medical care.*
>
> *The WPI is measures and tracks the changes in the price of goods in the stages before the retail level mostly including items at the producer or wholesale level.*

What is the role of fiscal policy in a high-inflation environment?

- The current year is turning out to be very good in terms of tax revenues.
- The macro framework of government focussing on the medium-term perspective, while leaving short-term issues to the central bank will continue in the coming Budget.
- The government has fiscal room and should focus on the social sector as well as medium-term growth prospects to provide more employment opportunities.
- Aggregate consumption, which is a big part of GDP, is slowing down for quite some time and

the focus should be on reviving the economy using fiscal policies.
- The government will have to open its purse, not just in terms of improving the incomes of people using social security schemes, but also by increasing the transfers to States.
- Fiscal deficit is not to be worries at this point of time because once growth picks up, then a lot of the fiscal issues can be taken care of.

What about stagflation?

Stagflation is characterized by slow economic growth and relatively high unemployment which at the same time is accompanied by rising prices (inflation)

- **No stagflation**- WPI is a very segmented indicator that doesn't include services and other things and hence to gauge inflation, CPI is taken into account.
- The CPI inflation is well within the RBI's targeted range of 2% to 6%.
- When it comes to the unsteady Index of Industrial Production (IIP) numbers, it should be noted that the IIP covers a very small component of the industry.
- There is a very substantial rise in exports, so the recovery seems to be sharp.
- So, some experts argue that we are nowhere close to stagflation.
- **Might lead to stagflation**- If the economy bounce back once the pandemic is over, it may actually aggravate the inflation situation.
- There is a threat of high inflation and low growth persisting for at least some time.
- A lot depends on how the government responds to the situation, in terms of reviving demand in the economy and managing inflation.

Can Budget address the inflation driven by the supply side?

- Fiscal policy can directly address inflation driven by supply-side factors by reviving the growth.
- The government has to protect the demand, the economy, the middle class, and particularly the poor and the vulnerable from the impact of high inflation.
- When it comes to rising fertilizer prices, the government can increase its contribution and reduce the prices that the farmers are paying.
- The industry, such as automobile sector can pass on its high input cost to the consumers and the government can cushion the impact of high inflation on consumers by lowering direct and indirect taxes.
- The government should be looking at the long-term picture rather than the short-term picture of generating revenues by taxing more.
- It should allow people to have a larger disposable income so that consumption in the economy increases.

References

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