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Fiscal vs monetary steps

A sound fiscal policy is key to combatting inflation

Food inflation. Targeted subsidies work better ▪ Sushil Kumar Verma

The Monetary Policy Committee (MPC) held the repo rate constant at 6.5 per cent for the fifth consecutive meeting in this Financial year.

This move was largely expected as inflation had softened but the risk from food inflation particularly in the coming months still exists.

The Reserve Bank of India also appeared buoyant as it revised the GDP growth forecast to 7 per cent from 6.5 per cent for this FY.

RBI's monetary instruments directly impact interest rates which makes borrowing costly for consumers thereby impacting demand and also encouraging savings which work in favour of postponement of current consumption.

However, these factors are not that effective when it comes to the purchase of essentials — food (46 per cent weight in CPI) and fuel (8 per cent weight in CPI).

Hence, these are not included when one talks of core inflation. US Fed Governor Jerome Powell once said that monetary policy tools (interest rates) are famously blunt tools, they are not capable of surgical precision. This leaves us to ponder is targeting interest rates the right approach to tackling inflation?

If interest rates are not the right instruments, then how can the economy deal with inflation specifically non-core inflation? The rational way of tackling food and fuel inflation is through targeted subsidies which is a component of fiscal policy. This brings to fore the silent role of fiscal policy in controlling inflation and helping the RBI achieve its mandate. Fiscal deficit leads to cost-push inflation.

Higher fiscal deficit necessitates rising interest rates which make their presence felt through increased production costs which spiral into cost push inflation. This is an area where monetary instruments are also weaker as compared to combating demand-pull inflation. However, fiscal policy also supports growth through expenditure on capital goods which is considered good quality expenditure with a multiplier effect.

How untamed fiscal spending in the wake of the pandemic in the US, UK and the Euro Zone led to a 4-decade high double-digit inflation is known to all. In complete contrast, India's inflation though on the higher side, never spiralled out of control. India's fiscal deficit did shoot up to 9.2 per cent of GDP for FY 2020-21 which was understandable during the pandemic.

However, the deficit has continued to fall and it is projected to be close to 5.9 per cent of GDP for FY 2023-24. This achievement has been made possible on two counts. First, the increase in capital expenditure and front-loading of capital projects are leading to quicker returns on investment. Second, there has been steady growth in tax revenues (both direct and indirect).

On the back of strong consumption, the IMF has revised India's growth projection to 6.3 per cent from 6.1 per cent for FY 2023-24 which is significant for any major economy.

No magic target

It is not to say that monetary policy is ineffective at mitigating inflation. Just like there is no optimum magic figure for fiscal spending, there is no magic number for interest rate.

However, there is no denying that the impact of monetary tools is paramount in 'anchoring' inflation expectations. More often than not the RBI's repo rate announcements are a signalling mechanism which does have an impact on moderating inflation as time progresses.

However, fiscal policy is the one, specifically through price controls and targeted subsidies has a more immediate impact on inflation. However, one cannot keep on

relying on mere price controls/subsidies in the long run and this is where monetary tools gain prominence.

For a healthy economy to keep functioning well, sound fiscal policy is of utmost importance along with monetary policy to combat inflation. It would be most apt to describe monetary and fiscal tools as two sides of the same coin.

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