The inflation–fiscal deficit linkage

Having adopted flexible inflation targeting, macroeconomic consistency can be achieved through the adoption of flexible fiscal targets

N R BHANUMURTHY

An interesting discussion is currently taking place in India on both the fiscal and the monetary policy front. With the adoption of the new monetary policy framework and with a committee revisiting the Fiscal Responsibility and Budget Management (or FRBM) Act road map, one would expect a huge shift in the way both policies are going to be adopted and implemented. However, what is seen is that most of the discussions on these policies are largely independent of each other, and this is the motivation for this short piece.

With the new monetary policy framework that is now in place following the recommendations of the Urjit Patel Committee, India has adopted flexible inflation targeting. Under this the central bank is mandated to achieve an inflation target of four per cent, +/- two per cent. Interestingly, targeted inflation numbers are not very different from the median of threshold inflation estimates provided by various studies presented in the appendix of the report of the Chakravarty Committee in the mid-1980s and reiterated by almost all Governors in the past (especially by Dr Rangarajan).

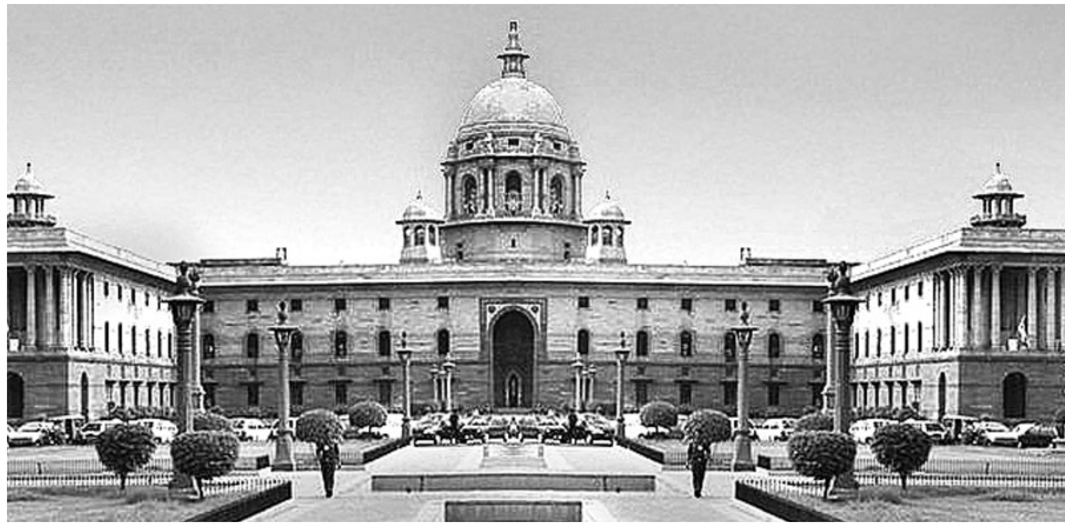
While it is not clear which theoretical framework the Patel Committee has adopted and whether this framework could provide such a range of inflation, one question is whether inflation targeting is still valid — more so when many countries that adopted inflation targeting have failed in their mandate and are taking a second look at the framework itself. Now that we have adopted it, another question is whether such inflation targets can be independent of fiscal policies.

Based on our experience working on estimating macro-consistent fiscal targets (the FRBM road map) for both the 13th and 14th Finance Commissions, as well as in carrying out some policy simulations relevant for the 12th Five Year Plan, it is evident that fiscal indicators and inflation are inter-related. Such a relationship can also be seen in the trends in recent data. However, the magnitude of those relationships is generally found to be time-varying.

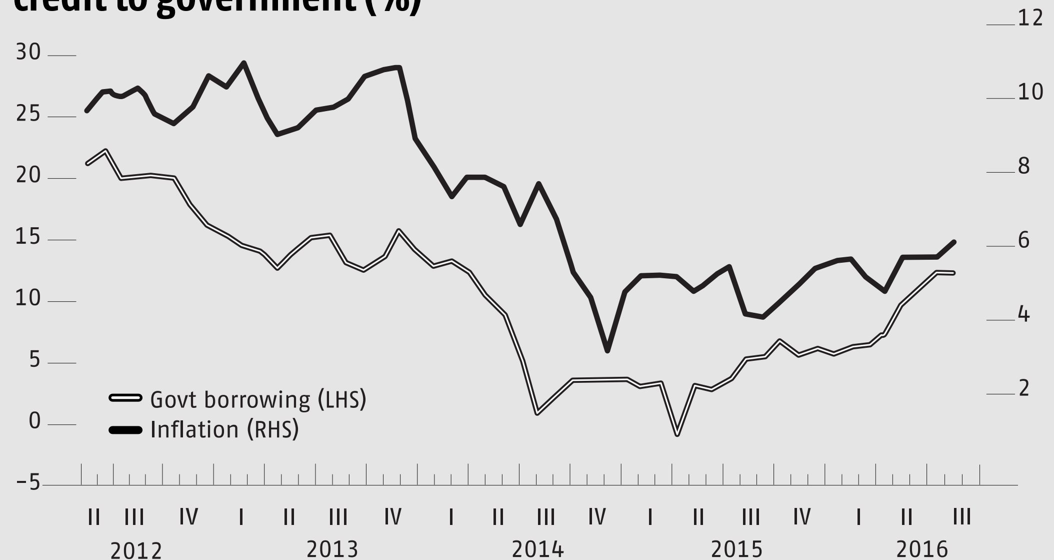
In the accompanying graph, following a decomposition methodology, we have presented the monthly permanent (structural) components of CPI (combined)-based inflation and the growth of bank credit to government (general), which is part of the sources of money supply growth and a proxy for the general government fiscal deficit. Compared with many other analysts, who use only central government borrowing (or fiscal deficit), general government borrowing is considered here, since state government borrowings also have almost equal, if not greater, effect on money supply and, hence, inflation.

It may be noted that the structural component of both inflation and government borrowing have similar movements, with the positive correlation as high as 0.86; and the causality has been found to be one way — from government borrowing to inflation. We also looked at transitory government borrowing (which is the difference between the actual and the permanent component) and transitory inflation. While the contemporaneous correlation is low, there exists bi-directional causation — although weak — between government borrowing and inflation, with a lag of four months. From this one can conclude that the fiscal deficit (both anticipated and unanticipated) and inflation are inter-related.

On the FRBM road map, in our view, it is a misunderstood subject in India. Most analysts think that it has only to do with the fiscal deficit target, while ignoring the revenue deficit target. While fiscal consolidation is macro-consistent and results in shifting the balance of demand from consumption (revenue deficits) to investment (capital expenditure), the problem lies in the estimates — more so when the estimates do not consider the anticipated fiscal expansion, leave alone unanticipated shocks.



North Block in New Delhi, the seat of the Finance Ministry, where preparations for the Budget are on



Take for instance the 14th Finance Commission's FRBM targets. While there could be a genuine reason for not pre-empting the 7th Pay Commission on its recommendations, so obvious and anticipated a fiscal expansion resulting from the pay hike was not considered while suggesting the fiscal consolidation road map for the 14th Finance Commission period.

At least there could have been some discussion on the downside risks due to the pay hike (or any other unanticipated fiscal shocks) that could have allowed the government to re-draw the fiscal road map. Hence, while government struck to the FRBM road map and proposed a fiscal deficit of 3.5 per cent of GDP for the current year, on the face of it, implementing the pay hike and at the same time achieving such a tight target may be difficult. Or, the pay hike may crowd out public investments, which could hamper growth prospects. The other option could be to revisit the fiscal targets, even though one budget opportunity will be lost. That is what government has done.

One of the terms of reference of the FRBM Committee is "to examine the need and feasibility of having a 'fiscal deficit range' as the target in place of the existing fixed numbers (percentage of GDP) as fiscal deficit target". As discussed, as FRBM targets do not consider the unanticipated and sometimes even the anticipated fiscal expansion, in our view, having rolling or "range" targets could be a feasible option.

But, most importantly, as we showed, there is a strong linkage between fiscal deficits and inflation, and a need for maintaining consistency between fiscal and monetary policies. Now that we have adopted flexible inflation targeting with an inflation range, macro consistency can be achieved by adopting flexible fiscal targets with a range. Here, as the purpose is expansionary fiscal consolidation, setting a "revenue deficit range" while retaining the capital expenditure target may be a wise strategy, as it could absorb fiscal shocks and at the same time enhance growth.

The writer is professor at the National Institute of Public Finance and Policy, New Delhi.
nrbmurthy@gmail.com