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Perspective

Are we heading for stagflation?

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The monetary policy committee (MPC) of Reserve Bank of India (RBI) will face the dilemma when it meets early next month in the midst of declining economic growth rate, coexisting with rising consumer price index (CPI). To cut the interest rate or not, that will be the question. The retail inflation is now at a 16 month high of 4.62%, which is well above the RBI's target rate of 4%.

Indian economy is in doldrums. After growing at more than 8%, up Q2 of FY 2017, the next quarter which is a watershed as it witnessed demonetization was the beginning of the downward trend. The resultant cash shortage halted economic activities and growth rates declined to 7.5% in Q3 and 7% in Q4 of FY 2017. Introduction of the nationwide uniform GST brought its own woes. The growth rate sank to 6% in Q1 of FY2018. Worldwide uncertainties consequent to the beginning of trade war between US and China with tariffs on imports from each other in the late 2018 engulfed the world. Indian economy grew at a slower pace: 7% in Q2, 6.6% in Q3 and 5.8% in Q4 of FY 2019. In the latest quarter, Q1 of FY 2020, it was at 5.0%

Mounting bad loans of the banking sector in public sector banks (PSBs), frauds and scams with culprits absconding and escaping punishment due to poor handling by investigating agencies have also reduced consumer and producer confidence. We had also failure of some leading non-banking financial institutions, resulting in reduced credit flows for financing economic activities, domestic investment and consumption

Fall in household incomes in rural and urban India and financial stress have reduced consumption for necessities such as tooth paste and biscuits and demand for durable goods and passenger cars and two wheelers. Decrease in domestic demand appears to be main cause behind falling growth.

State Bank of India says growth would decrease further in Q2 (July-Sept) of FY 2020. The forecast is based on the poor show by industrial production, which would be less than 2.7% in Q1 of FY20. The official figures are expected on November 29.

For reviving the sagging economy, expansionary fiscal policy measures have been initiated. In September, the government cut corporate tax rate to 22% from 30%. For the new manufacturing companies, tax rate was reduced to 15%. As part of expenditure policies, the government decided to recapitalize PSBs and merge 10 PSBs into an eventual four. Further, it was decided to support automobile sector and prepare plans for future infrastructure spending.

Fiscal policy tools are always blunt. They take time to yield tangible results. So, RBI decided to make the borrowing cost cheaper for boosting investment in durables including housing and encourage consumption of semi-durables including automobiles and appliances. Over the past 11 months, RBI is on an interest cutting spree, reducing the policy rate by 135 basis points from 6.50% to 5.15% in October. With the economic outlook growing more pessimistic, further rate cut next month looked certain until last week.

There are new concerns for RBI. The disturbing news is that CPI in October recorded an increase, 4.62% exceeding the RBI's target rate of 4%. That is also the highest during the last 12 months, rising from September inflation rate of 3.99%. The culprits are the volatile, food related items: vegetables and fruits, while the imported petroleum crude price has been low. If it has also risen, it will be another story of misery. Facing the high retail inflation, any decision to cut the interest rate on December 5 would be inappropriate. RBI would be accused of not following its mandate.

The only comforting point in favour of an interest rate cut is the core inflation rate (which is measured leaving aside the volatile food and beverages and petroleum crude) which is not only low but negative: minus 0.84. The CPI index has risen in October mainly because of food prices rising by 7.89% as compared to 5.11% in September. On the other hand, the wholesale price index (WPI), comprising final manufactured goods, has risen only by 0.16%. Thus, the final and processed agricultural and food products included in WPI is responsible for WPI inflation. That brings us to the good old debate whether the 2013 decision to switch to CPI from WPI as the target right for RBI is the correct approach for measuring inflation and taking monetary policy decisions. So, with highest inflation at 4.62%, along with stagnation, the dilemma facing MPC members is clear.

The latest Reuters report says China faces a similar situation, with strongest inflation in eight years. With surging imported pork prices due to switching on to safer sources away from countries affected by African Swine Fever, China's consumer inflation has gone up. That exceeded the target rate of 3% in October in eight years. Its economic growth is now at its slowest pace in nearly three decades due to global slowdown and trade war with USA.

It is hotly debated whether China should raise the interest rate to fight inflation or cut interest rate to boost economic growth.

Are we now heading for another episode of global stagflation as well?

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