Fiscal Stimulus and Potential Inflationary Risks: An Empirical Assessment of Fiscal Deficit and Inflation Relationship in India

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Abstract

The fiscal response in India to deal with the contagion from the global crisis during 2008-10 was driven by the need to arrest a major slowdown in economic growth. However, there could be medium-term risks to the future inflation path, in the absence of timely fiscal consolidation. As highlighted in the paper, fiscal deficit could be seen to influence the inflation process through either growth of base money or higher aggregate demand. Empirical estimates over the sample period 1953-2009 suggest that one percentage point increase in the level of the fiscal deficit could cause about a quarter of a percentage point increase in the Wholesale Price Index (WPI). The paper emphasises that the importance of fiscal space in the India specific context needs to be seen in terms of not only the usual output stabilisation role of fiscal policy but also the need for use of fiscal measures to contain inflationary pressures that often arise from temporary but large supply shocks.

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• Keywords: Fiscal Deficit, ARDL, Price Level
I. Introduction

Fiscal stimulus emerged as the key universal instrument of hope in almost every country around the world, when the financial crisis in the advanced economies snowballed into a synchronised global recession. Borrowing as much at as low a cost as possible to stimulate the sinking economies necessitated unprecedented coordination between the fiscal and monetary authorities. It is the fiscal stance that had to be accommodated without any resistance by the monetary authorities so as to minimise the adverse effects of the crisis on output and employment, while also saving the financial system from a complete breakdown. Given the deflation concerns in most countries -rather than the fear of inflation - monetary authorities had no reasons to resist. The universal resort to fiscal stimulus, however, has now led to significant increase in deficit and debt levels of countries, which may operate as a permanent drag for some time, affecting the overall macroeconomic outlook, including inflation. OECD projections indicate that OECD level fiscal deficit may reach 60 year high of about 8% of GDP in 2010, and public debt may exceed 100% of GDP in 2011, which will be 30 percentage points higher than the comparable pre-crisis levels in 2007.

In India, the fiscal response to the global crisis was swift and significant, even though India clearly avoided a financial crisis at home and also continued to be one of the fastest growing economies in the world in a phase of deep global recession. Despite the absence of any need to bailout the financial system, it is the necessity to partly offset the impact of deceleration in private consumption and investment demand on economic growth, which warranted adoption of an expansionary fiscal stance. One important consequence of this, though, was the significant deviation from the fiscal consolidation path, and the resultant increase in the fiscal deficit levels over two consecutive years (2008-10).

The immediate impact of the higher levels of fiscal deficit on inflation may be almost negligible, since: (a) the expansionary fiscal stance was only a partial offset for the deceleration in private consumption and investment demand, as the output-gap largely remained negative, indicating no risk to inflation in the near-term, and (b) despite large increase in the borrowing programme of the Government to finance the deficit, there was no corresponding large expansion in money growth, since demand for credit from the private sector remained depressed. Thus, neither aggregate demand nor monetary expansion associated with larger fiscal deficits posed any immediate concern on the inflation front. The usual rigidity of deficit to