Repeated shocks, the Ukraine war and spectre of stagflation

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Policy simulations indicate that the government must temporarily absorb higher oil costs and pass them on only gradually

Since 2016, the Indian economy has been repeatedly battered by severe shocks. First, there was de-monetization in November 2016. Many micro, small and medium enterprises (MSMEs), employment-intensive but cash-dependent, perished. Then there was the botched roll-out of the goods and services tax (GST) in 2017 when the GSTN IT-platform, tax officials and taxpayers were not yet ready. MSMEs were again the worst affected. Economic growth declined from 8.3% in 2016-17 to 4.1% in 2019-20. The covid pandemic and a stringent nationwide lockdown then struck in early 2020. The economy contracted by an unprecedented 24% in the first quarter of 2020-21 and by 6.6% for the whole year.

The pandemic raged for two full years, taking lives and destroying livelihoods. Despite this, the economy grew by a very high 9.2% in 2021-22, mainly due to the strong base effect of the 2020-21 contraction. Nominal gross domestic product (GDP) at ₹198 trillion almost caught up with the pre-pandemic level of ₹201 trillion in 2019-20. The economy finally seemed to be recovering. The Reserve Bank of India (RBI) forecast GDP growth of 7.8% in 2022-23. Our growth forecast was more modest at 5.1% (‘A Nowcast for 2021-22 GDP and a Forecast for 2022-23 based on a Factor Augmented Time Varying Coefficient Regression Model’, Bhattacharya R. and S. Mundle, NIPFP Working Paper No. 361). However, in the wake of the Russian invasion of Ukraine, even this modest growth forecast now seems beyond reach. The Ukraine war, now in its fourth week, has set in motion tectonic shifts in global geopolitics. But that’s for another discussion. In this column, I limit myself to the immediate impact of the war on the Indian economy and the required policy response to moderate if not altogether avert stagflation.

The first impact channel is trade. The spike in global prices of oil, fertiliser, wheat and other commodities, triggered by the sanctions against Russia, will sharply increase India's import bill. The disruption of wheat supplies from Russia and Ukraine has an upside for India. Our huge excess stocks of wheat will help to meet this shortage and raise exports. Despite this, India's growing trade deficit will now balloon, adversely impacting both growth and foreign exchange reserves.

An outflow of foreign portfolio investments (FPI) is the second impact channel. FPI was already flowing out of India and other emerging market economies as investors factored in an impending increase in US interest rates. This outflow has accelerated since the war's outbreak. The consequent depreciation of the rupee will help switch expenditure from imports to exports and contain an increase in the trade deficit. But it may further accelerate the FPI outflow.

The third and most important impact channel is imported inflation due to the soaring price of oil. Crude oil prices, which had been rising since late 2020 with a gradual economic recovery, spiked to a peak of $139 a barrel (Brent crude) on 7 March 2022 following the invasion of Ukraine. Since oil is a key input, rising crude prices have a pervasive impact on inflation. Way back in 1987, Jha and I had estimated a petroleum price elasticity of inflation of 0.14., i.e., a 7% increase in the price of petroleum products would raise WPI inflation by 1% ('Inflationary implications of resource mobilization through administered price increases', Jha S. Shikha & S. Mundle, Economic & Political Weekly, 15 August 1987). Subsequently, RBI estimated in 2011 that this elasticity had risen to 0.2, presumably because of the rising transport intensity of our economic structure ('Price Situation in India', Reserve Bank of India Bulletin, 2 May 2011). Today, a decade later, this inflation elasticity would be even higher.

The impact of rising oil prices on growth and inflation will depend crucially on the government's policy response. A few years ago, my co-authors and I measured the impact of a 50% increase in oil prices on growth and inflation under alternative policies of passing on the price increase to consumers ('Subsidy elimination with and without an oil price shock: The macroeconomics of oil price policy reform', Mundle S., N.R. Bhanumurthy and S. Bose, in *The Political Economy of Energy and Growth* edited by N. Jung, Oxford University Press, 2014). We found that if the entire price increase was passed on immediately, the impact would be disastrous stagflation; GDP would contract by 2.2 % while inflation would spike to 16%. If the price increase was passed on gradually, with oil subsidies being eliminated over a five-year period, growth would decline more moderately to 3.7% while inflation would rise to a more manageable 8.5%. The fiscal deficit would be initially higher in the gradual adjustment case, but it would converge to about 8% (Centre+ states) in both cases over the medium term. The debt-GDP ratio would also not be materially different under the two pass-through policies over the adjustment period.

The precise numbers of those policy simulations would vary if the model is re- calibrated to the current year, but the main policy insight would hold. To contain stagflation, it is imperative that the government temporarily absorbs higher oil subsidies and passes on the oil-price increase to consumers gradually. There would be no compromise in fiscal consolidation over the medium term in following this policy option.

These are the author's personal views.