The Missing Honeymoon*

C.P. Chandrasekhar

When Prime Minister Narendra Modi declared that he has not been given a "honeymoon period" in power, his point seemed to be that the media and other observers have been unkind and expected him to deliver even before he settles down and to not take any decisions they dislike. But he has none to blame for his predicament but himself. His massively bankrolled and single-personality-centred election campaign was not only geared to generate expectations of the good times that a Modi-sarkar will bring, but to foster the belief that the BJP government would abjure certain policies that the UPA had adopted.

So those filled with the aspirations Modi himself created are unlikely to accept the view that the legacy the Congress has left him requires making "hard choices". The first such hard choice, in the form of pre-budget hikes in railway passenger fares and freight was received with much disappointment and some anger, with few willing to buy the argument that this was not only necessary but just the implementation of a decision taken by the earlier government. What the decision did signal was that the Modi government was planning not to go back on the UPA's effort to reduce the central fiscal deficit, and opting to finance any selective hike in expenditures it may choose to make in areas like infrastructure with increases in indirect taxes and user charges (such as railways fares).

This establishes that there is no magic potion that the BJP government can rely on to increase capital expenditures substantially if it wants to compete with the UPA on fiscal deficit reduction and hold back on direct tax increases to satisfy those who financed its successful election campaign. Interest payments are and would remain high, as they are the costs of past borrowing. And defence expenditures are likely to increase to match the BJP's appeal to a distorted nationalist sentiment. So the government would have to rely heavily on indirect tax revenues and administered price increases if it wants to raise capital expenditures and please the corporate sector while keeping the fiscal deficit under control.

It is here that two other factors that are not of Modi's making, and which seem to challenge him in his supposedly-absent honeymoon period, come into play. The first is a rise in international oil prices. If the recently witnessed rise in the prices of oil is sustained and strengthened, it could prove to be a double whammy for the government, worsening the current account deficit and aggravating already rampant inflation. News that the biggest oil refinery in Iraq has been attacked and taken over by militants has upset the sanguine view that the current domestic conflagration in Iraq will not affect global oil supplies and prices too much. It is true that though the rate of increase in oil prices in recent days has been high, price levels are still not too far from their near-term average. But it is disconcerting that over the three weeks ending June 23rd 2014, the spot price of Brent Sea crude rose from around \$100 a barrel to more than \$115 a barrel.

Even if just now the price increase is driven by speculation rather than a supply-demand imbalance, further price increases seem inevitable if production in and supplies from Iraq are adversely affected by the strife in the country. OPEC accounts for more than 80 per cent of world reserves, and within OPEC, Iraq is the country with the fourth largest reserves, after Venezuela, Saudi Arabia and Iran. Iraq is also the second largest oil producer in OPEC, accounting for much of the growth in aggregate production in all its twelve member countries.

In fact market expectation until recently was that Iraq's need for resources to accelerate reconstruction and development under a post-occupation government would take its crude oil production well beyond the current level of about 3.3 million barrels a day, facilitated by investments from international oil companies. If the current conflict had not intervened, the estimate was that Iraq's production would have risen to about 6 million barrels a day, or about 60 per cent of the 10 million barrels a day that the leading oil-producers, Russia and Saudi Arabia, are estimated to be producing. Now international firms are pulling out, even if temporarily. Thus, the benefits that accrued from the rise of shale oil and gas production in the US and the hand over of power in Iraq is not likely to bring prices down from their already high levels. In fact prices would rise.

For India, which has just corrected an unsustainable current account deficit and is combatting inflation, the threat this poses is obvious. The deficit on the current account of India's balance of payments, or the excess of foreign exchange expenditures over India's non-capital foreign exchange receipts, has shrunk substantially. Over the financial years ending March 2012 and 2013 the current account deficit rose sharply from 2.9 per cent of GDP (in 2010-11) to 4.5 and 5.1 per cent of GDP. As compared to that, the figure for 2013-14 reflects a sharp fall to 1.7 per cent of GDP, pointing to a significant strengthening of the balance of payments.

Underlying the decline in the current account deficit is a sharp fall in the trade deficit. After having risen from $118.6 billion in 2010-11 to $183.4 billion in 2011-12 and $190.3 billion in 2012-13, the excess of India's merchandise imports over its exports fell to $138.6 billion in 2013-14. That decline, in turn, was the result of a small $12 billion rise in exports and a substantial $36 billion fall in imports. Thus, since there is unlikely to be any major export boom in the near future given the still depressed global environment, the persistence of a low current account deficit is predicated on imports not rebounding from their depressed levels in 2013-14.

This depends on what happens with respect to two sets of commodities that are largely responsible for India's balance of payments turnaround: petroleum products and gold. It must be noted that the contribution of oil to changes in the trade deficit has been significant in the past. The average price of oil in the OPEC reference basket rose from a low of $61.1 per barrel in 2009 to $77.5 in 2010, $107.5 in in 2011 and $109.5 in 2012. That increased India's oil import bill from $87.1 billion in 2009-10 to $155 billion in 2011-12. But prices fell subsequently, to $105.87 per barrel in 2013 and $104.81 in 2014. As a result India's oil import bill stayed at $164 billion and $167.6 billion in 2012-13 and 2013-14 despite increased imports. India may now be losing the benefit of this respite.

Another consequence of an increase in the international price of oil is domestic inflation. The price of the Indian crude oil import basket has risen to more than $111 a barrel from $106.72 in early June 2014. This is putting pressure on the government to allow for increases in the domestic price of oil. If the government chooses to compensate the oil marketing companies for their notional under-recoveries rather than raise prices, the fiscal deficit would rise, which the government is not willing to accept. Thus, an oil hike influenced spur to inflation seems a real possibility.

It is in this background that the import of the second “external factor” challenging the government needs to be assessed. A month into the 3-4 month long southwest monsoon season, there is reason to fear that this year’s monsoon would be substantially deficient, adversely affecting agricultural production in general and food grain production in particular. That too would aggravate inflation and constrain the government. A combination of routine variations in weather conditions and the El Nino effect had led the Indian Meteorological Department (IMD) to predict a subnormal Southwest monsoon this year. While the outcome of the El Nino effect is uncertain, in four of eight El Nino years since 1991 the deficiency in the Southwest monsoon exceeded 10 per cent, with the deficiency being more than 20 per cent in 2009. So there is reason for concern.

In fact, the IMD’s prediction seems to be coming true thus far with rainfall between June 1 (when the monsoon normally crosses India’s south western coast) and June 24 estimated to be just 40 per cent of the long period average for that time of the year. The deficiency varies across the country with rainfall being in excess over one, normal over 11, deficient in 11 and scanty over 14 of India’s 36 meteorological sub-divisions. Even by late June, the monsoon had still not reached parts of Madhya Pradesh, west Uttar Pradesh, Maharashtra and Gujarat.

Since, around half of India's farmland still lacks access to irrigation a deficient monsoon can adversely affect production. Kharif sowing has been lagging with the total area under the kharif crop placed at 131.52 lakh hectares this year as against 200.96 lakh hectares last year. Acreage under paddy is still at 21.91 lakh hectares as compared with 35.77 lakh hectares last year, or short by 36 per cent as of now, and that under pulses at 4.30 lakh hectares as compared with 13.62 lakh hectares, or down by 65 per cent thus far. Thus, unless there is a significant change in monsoon incidence, shortfalls in production are likely to be substantial. This may not be a supply-side disaster, as the government has a significant volume of stocks in its warehouses. But the evidence is already out that expectations that the monsoon would be deficient have set off a speculative price surge that threatens to take food price inflation to unsustainable levels.

Inflation and a current account deficit imply that government spending may be further constrained because of a fear of aggravating these adverse trends. It is quite likely that there would be no large expenditure boost in the coming budget. Even if the Modi government chooses not to be concerned about the fiscal deficit levels in the first year of its tenure and budgets to finance infrastructure spending with capital receipts from, say, accelerated privatisation, it may be forced to hold back in practice because of signals on the price front.

That leaves the government only one strategy to overcome the current ‘stagflation’, which is that of coaxing the private sector to invest heavily. Talk of ensuring quick environmental and land acquisition clearances for, and incentivising banks to lend to, large, infrastructure projects is indicative of the government’s intention to adopt this strategy. This is possibly the main area where the new government’s decisiveness would be visible during the so-called honeymoon period. That would please the corporate sector and big private capital, which would be the ones to enjoy a honeymoon. The rest of India is likely to be left out and not pleased at all.

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