The Gathering Storm Clouds*

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The last time the Indian economy had faced a serious macro-economic disruption, as distinct from the more or less steady poverty-enhancement that accompanies its growth performance, was in 2013, when the rupee had depreciated sharply. The fact that since then no similar disruption has appeared on the horizon, despite the country's running a continuous current account deficit, has been because of two specific factors: the reduced international crude oil prices which have kept India's import bill and hence current account deficit restricted; and the easy inflow of finance, owing to reduced U.S. interest rates, which have made shifting funds to countries like India, offering comparatively higher rates, an attractive proposition for globalized finance.

It does not require much ingenuity to see that this situation could not have lasted forever. The U.S. had to increase its rates sooner or later to placate rentier interests. A rise in U.S. interest rates was already happening, and when it gathered momentum, India would have faced a balance of payments crisis anyway. But even before this source of disruption could become effective, another source of disruption has cropped up: there has been a sharp increase in international oil prices which is threatening the Indian economy. The working people of the country who suffer both from the "normal" functioning of the economy, and even more from a disruption of this "normal" functioning, are facing a sharp attack on their living standards, of which the acceleration in inflation that is already occurring is only the first symptom.

The sharp rise in oil prices, with Brent crude rising to $80 a barrel, the highest level since 2014, has of course a speculative element underlying it, which arises from expectations of U.S. sanctions against Iran in the wake of Trump's scrapping of the Iran Nuclear Agreement, and also the political turmoil in Venezuela, with the Right, backed by the U.S., creating economic disruptions. But quite apart from speculative factors, there is a more basic cause of the oil price increase and that relates to the fact that the OPEC has finally managed to put its act together.

For a long time there were divisions within the OPEC, with Saudi Arabia opposing any output cut to reverse the fall that had occurred in oil prices, on the grounds that this would allow U.S. producers, including of shale oil, to capture a larger share of the world oil market. If world oil prices remained low, then several U.S. producers would not find it profitable to produce oil at all and hence would cease operations. Others within OPEC wanted the cartel to cut output and raise prices; but they could not overcome Saudi opposition. But Saudi Arabia itself, which is critically dependent upon oil revenues, began to feel the pinch of low oil prices and had to deflate the economy, cutting back on a number of subsidies and other transfers, which threatened to erode the political support commanded by the monarchy.

In December 2016 therefore Saudi Arabia changed its position, and a decision to cut back output was reached, which was agreed to even by Russia, another major producer. Many were sceptical at the time whether this agreement would actually be acted upon; but it seems to have been, which is the main reason behind the current rise in oil prices. Saudi Arabia this time is not only adhering to the cut-back, but is even reported to favour a rise in Brent crude price to $100 a barrel. At such prices no doubt, U.S. production will expand; and this would exert a downward pressure on oil prices. Where the prices would ultimately settle remains to be seen, but there can be little doubt that during 2018, and even much of 2019, oil prices are not going to experience any decline. This in turn would raise the prices of a whole range of other raw materials and thereby exert an upward pressure on final goods prices in the world economy.

This pressure is already evident in the case of India where the absurd rule of the government that any rise in the imported price of oil should be passed on immediately has led to a significant upward revision of petrol and diesel prices in the week following mid-May. But quite apart from its inflationary consequences, the oil price increase portends serious balance of payments difficulties. The rise of Brent crude to $80 a barrel is estimated to cost the economy an additional $50 billion in import bill. In fact during the financial year 2018-19, the current account deficit as a proportion of GDP is expected to increase to 2.5 percent.

This itself would not have caused any immediate disruption if financial inflows of an appropriate magnitude were coming into the country. But there are indications that finance is beginning to turn its back upon the Indian economy, which is manifest in a decline in the value of the rupee to even 68 per US dollar, despite the fact that the Reserve Bank has been running down its foreign exchange reserves to shore up the rupee. Earlier, the inflow of finance was large enough not only to cover the current account deficit, but even to add to the country's foreign exchange reserves at the going exchange rate (which the RBI tried to maintain in order to prevent a loss of external competitiveness for Indian goods through an exchange rate appreciation). The forex reserves as a result had crossed $400 billion a few months ago; but now there has been some decline because the financial inflows are not large enough to cover the current account deficit.

The net financial inflows are likely to dwindle further and even become negative (i.e. turn into outflows) because of the very depreciation of the rupee which creates expectations of a further depreciation for two reasons: first, the persistence of the balance of payments difficulties the country is facing; and second, because of the acceleration of inflation that is occurring. (Exchange rates are typically expected to decline when inflation in the country is occurring at a faster rate than abroad; and this would happen in India's case if the rule of "immediate pass-through" of oil import costs into final prices persists).

This will lead to further actual depreciation of the rupee, a case of expectations realizing themselves; and such actual depreciation in turn will cause further expectations of a depreciation and further actual depreciation through a vicious spiral. But since the depreciation of the rupee will increase the rupee import cost of oil even if the world oil price stabilizes at $80 per barrel, under the government's policy of immediate "passing on" of higher oil import costs to the buyers, there will be a persistence of inflation. Such persistence of inflation will then be an additional reason for creating expectations of depreciation of the rupee, and hence causing actual depreciation.

Whenever expectations come into play, vulnerable economies tend to get caught in such vicious spirals. And the Indian economy, which was all along been a vulnerable one despite its apparently high growth, since it has been critically dependent upon the inflow of speculative finance to sustain its balance of payments, is now faced with the prospects of such a spiral.

There is another element in the picture that is also working in the same direction, and that has to do with interest rates. If other things remained the same then an increase in India's interest rate could have been one way of breaking this spiral. But other things are not going to remain the same. Since the rise in oil prices will stimulate inflation everywhere, including in the U.S., the interest rates in the latter will be raised to reduce aggregate demand and raise unemployment. This is to prevent the working class there from obtaining money wage increases to compensate for inflation, so that inflation thereby gets "controlled" (at the expense of workers). Such an increase in interest rates in the U.S., and elsewhere, will of course aggravate the world capitalist crisis. Additionally however it will prevent the net inflow of adequate amounts of finance into India for covering our current account deficit.

True, India can raise its interest rates still further to maintain a differential vis-à-vis U.S. interest rates, such that it again makes India an attractive destination for financial inflows. But there are limits to which the interest rates can be raised in a capitalist economy without undermining its very viability. (They cannot for instance exceed the profit rate). A rise in U.S. interest rates therefore will be typically accompanied by a reduction of the interest-rate-differential between the U.S. and India (this is going to be even more true when we look at the "real" interest rate differential, i.e. the nominal interest rate differential minus the inflation rate differential). The prospects of net financial inflows being large enough to cover India's growing current account deficit are likely to be even bleaker for this reason; and the prospects of India's getting into the vicious spiral mentioned above even greater.

All this underscores the seriousness of the problems that threaten the Indian economy if it continues with a policy of unfettered operation of markets. But preventing such unfettered operation amounts to a withdrawal from neo-liberalism and hence requires overcoming the resistance of globalized finance and the domestic big bourgeoisie.

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