

# West Asia macro shock is no repeat of Covid

The Indian economy has been pumelled by a series of domestic and global shocks since the start of the current decade, impacting its gross domestic product (GDP) growth trajectory. The West Asia crisis is the latest addition to this list of shocks, disrupting the stability experienced during the economy's Goldilocks phase in the previous financial year.

At present, the West Asia crisis has largely manifested itself as a supply shock, impacting energy output, its availability and prices, leading to a spike in input costs, given India's excruciatingly high import dependence. However, high-frequency indicators suggest that domestic demand is holding up so far across a variety of sectors.

The Covid-19 pandemic, in contrast, had caused simultaneous demand and supply shocks for a prolonged duration, leading to an anomalous slump in GDP in FY21. The lockdown-led constraints on mobility affected consumption, particularly of the services segments, while also shrinking output via business closures. For the period during which plants were closed or supply chains were disrupted, the manufacturing sector faced a challenge. However, inventories were drawn down and replenished later by running plants at higher capacity, limiting the loss in output.

Interestingly, when consumption of some services is skipped, as was the case for out-of-home services during the pandemic, it may not be made up later, resulting in a permanent loss of output to the producer. Examples include labour-intensive services, such as physiotherapy, sports training and personal care, to name a few, which may also be predominantly in the less formal space.

The length of the adverse supply shock owing to the ongoing conflict in West Asia would be crucial in determining the macroeconomic outcomes for

India. So far, while energy prices have spiked, supply chains have been disrupted only for a section of manufacturing and services, particularly those dependent on natural gas.

A prolonged supply shock can, however, transmit to lower incomes, and dampen confidence and sentiment. This could thereby generate a demand shock, as higher inflation impacts discretionary incomes and demand of households, and elevated input costs impact corporate profitability, weighing on expansion plans. In the Indian context, this implies stagflationary outcomes and is reflected in the downward revisions in growth projections along with an upward revision in inflation projections.

Assuming crude oil prices average at \$85/barrel in FY27, against \$70-75/barrel previously, ICRA has pared its GDP growth forecast to 6.5 per cent for the financial year from 7.1 per cent earlier. Besides, we have raised our consumer price index (CPI)-based inflation projection for FY27 to 4.5 per cent, from 4 per cent before the onset of the conflict.

While these numbers don't seem too bad, given the global context for growth and India's past experience with inflation, they are subject to sizeable risks. An average crude price of \$85/barrel factors in a quick resolution of the conflict, leading to a correction in prices for the remainder of the year. An extended conflict that entails crude prices remaining around \$105/barrel would pull down growth to sub-6 per cent, while pushing up the CPI inflation closer to the 5 per cent mark.

The Government of India's initial response to shield end-consumers from the sharp rise in global energy prices by cutting excise duty on fuel prices was prescient, given that higher fuel prices transmit across the consumption basket. Some constituents of

the CPI may see prices being reset at infrequent intervals, for instance, various types of fees. A subsequent cooling in oil prices may not, therefore, get reflected in a moderation in such prices, imparting stickiness to CPI inflation.

However, keeping pump prices unchanged may not be sustainable in the event of a long-drawn conflict and prolonged high energy prices. An eventual rise in fuel prices would readjust the balance between the fiscal and inflation outcomes. The risks of fiscal slippage along with tight global financial conditions have already led to a spike in G-sec yields, mimicking the impact of a rate hike, even though policy rates were kept unchanged and are likely to remain so in the next 2-3 policy meetings.

Lowering fiscal risks by increasing passthrough to end-consumers would worsen inflationary outcomes, necessitating higher yields. Thus, higher yields (compared to pre-conflict levels) appear to be here to stay. This contrasts with the pandemic period, when interest rates had fallen to ultra-low levels (despite a material worsening in the fiscal position), as the central bank focused on ameliorating weak demand.

Finally, the most significant difference in the macroeconomic impacts of the West Asia conflict and pandemic would be visible on the balance of payments front. The rare scenario of excess domestic savings over domestic investments had led to a current account surplus in FY21, after 16 years.

In contrast, the current account deficit is expected to spike to a four-year high of 1.7 per cent of GDP in FY27, in the baseline scenario, reflecting a widening savings-investment gap. Amid expectations of subdued capital inflows, liquidity could turn into a deficit from the current ample surplus, as opposed to the sizeable liquidity surpluses that persisted during the pandemic.

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