

# CHAPTER 7

## DISSECTING INDIA'S STAGFLATION EPISODE

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*"Hopefully in the short run, we are all fed"*

— This Author, 2007.

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### 7.1 INDIA'S HIGH GROWTH PHASE

India's boom and slowdown has been broadly dealt with as part of the emerging economies in the previous Chapter. Here we document and analyse in more detail both its growth performance and the responses of economists and policy makers to this growth. Since the 1991 liberalization, India's economy has been growing fast, building on its competitive strength of software exports. During the 2001 recession in the USA, India's growth – which had become closely aligned with that of the USA – slowed down in response. However, from 2003 onwards, defying all expectations, India grew even more rapidly, by over 9% for over *three years* in a row.<sup>1</sup>

The early years of this high growth were accompanied by low inflation both in the Wholesale Price Index (WPI), the government's preferred measure for analysis and policy making, as well as the CPI. Let us look at GDP and inflation data for the ten years ending 2007/08. The comparison of the second five year period with that of the first five year period is quite striking. Growth had risen by over 2 percentage points while the WPI, the policy makers' measure, had fallen slightly (see Table 7.A).

**Table 7.A** GDP Growth, Consumer Prices and Wholesale Prices Inflation

Period	Average Values		
	GDP Growth	CPI Inflation	WPI Inflation
1998-99 to 2002-03	5.6	6.3	5.9
2003-04 to 2007-08	8.8	5.0	5.5
Change	3.2	-1.3	-0.4

Source: HOSIE 2012, RBI

<sup>1</sup> This Chapter's main content are based on seminars titled "Understanding India's Stagflation: A Labour Supply Approach" by this author in December 2012 and July 2013, mostly covering the period up to March 2013.

Most economists who were following the Indian economy were euphoric that India's sustainable or potential GDP growth rate had risen hugely.<sup>2</sup> A rise in growth without higher inflation over five years is generally adequately long to capture long run effects. In fact the rise in growth was accompanied by a small drop in inflation during this period. It somewhat justified the consensus conclusion, arrived at in real time, that India's potential GDP growth was much higher than earlier estimates. The general mood of infectious optimism and business sentiment was very similar to that in USA in the late 1960s, where due to longest expansion on record, the business cycle was pronounced dead.

### 7.1.1 The Widespread Nine Percent Euphoria

Policy makers, high level economists and various CEOs were very optimistic about India's potential GDP growth. The following quotes listed chronologically are a testimony to this optimism. For the reader to appreciate the context in which these were made, the full quotes are provided here, along with the cited source.

- (1) In the coming decade or two, India –riding the wave of growth fundamentals such as demographic transition, human capital accumulation, improved incentive structures, diffusion of new technologies.. and an improved security environment – will be growing at growth rates which can be above 10% per annum, i.e., double digit growth rates." Vijay Kelkar, "India on the Growth Turnpike", 2004 Narayanan Oration, Australian National University, Canberra.
- (2) "Does high growth entail overheating? My categorical answer is no". (Ashok Lahiri, Chief Economic Advisor, 9<sup>th</sup> February 2007, Business Standard).
- (3) "So look out for GDP growth above 9.4% to even begin thinking about an overheating India" (Surjit Bhalla, When Will They Ever Learn?, 23<sup>rd</sup> June, 2007, Business Standard).
- (4) The Finance Minister, P Chidambaram, who was replying to questions after delivering the Annual Lakshman Kadirgamar Lecture here on Sunday, said "Aggregate efficiency of both capital and labour and the 35% investment in proportion to the GDP ratio quite easily translates to about 9% growth". (12<sup>th</sup> November, 2007, live mint)
- (5) The Prime Minister Manmohan Singh said the country's economy is even now capable of growing by 8-9%, the same rate as it did before the global financial meltdown set in. "Since our savings rate is as high as 35%...if all work together, we can achieve a growth rate of 8 to 9%, even if the world economy does not improve", he said to joint sitting of Parliament. (9<sup>th</sup> June, 2009, PTI/Reuters)

<sup>2</sup> Here, we analyze the growth inflation outcomes. However, a discussion of the factors underlying this high growth during 2003-2011 (with a break in 2008), in particular, monetary policy are outside the purview of this discussion.

- (6) "There is no reason why we cannot achieve a 9% growth rate..With effective use of PPP, we can achieve the desired level of growth" – Pranab Mukherjee, as Finance Minister, 21<sup>st</sup> August, 2011, Hindustan Times.
- (7) "..And if that (uncertainties in policy-making) can be tackled by the government, it is going to restart the process of 8–9 percent growth" – World Bank's Chief Economist for South Asia Region Kalpana Kochhar, 18<sup>th</sup> January, 2012.
- (8) "We believe India has the potential to grow at rates between 8 or 9% for the next twenty years and to do so in an inclusive manner" - Montek Singh Ahluwalia, Vice Chairman, Planning Commission (19<sup>th</sup> May, 2012, Indian Express)
- (9) "If some of the reforms are implemented at an early date and some of the negative perceptions about the Indian economy and about India are overcome quickly, then India can easily get to a 9 percent growth path again" - Adi Godrej (6<sup>th</sup> July, 2012, NDTV)
- (10) "India could go beyond 9% if some of the reforms we recommend in the recent Bhagwati and Panagariya book are adopted" in "Arvind Panagariya on Fixing India's Economy". (26<sup>th</sup> July, 2013 interview by Sriram Balasubramanian in The Wall Street Journal)

One can easily put together more such quotes and other leading figures, but the number has been deliberately capped at ten. Also in the quotes from both the (former) Prime Minister and Finance Minister, note the underlying framework of the Harrod Domar Model is arriving at the 9% value for potential GDP growth, with ICOR of 4, as in Section 1.3.1.

Further, various econometric estimates by RBI researchers, made in 2009, of India's potential GDP growth were all above 9% (Section 1.9).<sup>3</sup>

With regard to the first two quotes, made as early as 2007, that growth was not accompanied by overheating, there were dissenting opinions. Although CPI was also unusually low, it rose above 6% in 2005 and 2006 and in intra year 2007-08 was much higher, partly due to global factors. This is clearly not a base effect. For readers not familiar with this term, the well-known base effect refers to random shocks to the price level that get reversed in the next period (year). As a result, inflation jumps when the price level jumps and then falls in the subsequent year. Accordingly, a three year average is needed to smooth-out these shocks, as used in Moorthy and Kolhar (2007) partly written as a rejoinder to some of the optimistic views cited above. This measure of inflation indicated some overheating.

Basic and relevant macroeconomics of the EAPC (Expectations Augmented Phillips Curve) discussed in Chapters 2 and 3 implied that the low inflation during high growth phase was a temporary phenomenon. The alternative explanation provided here for the subdued inflation during the high growth period is that it can and does take several years before overheating shows up in a shifting Phillips curve. Further, specific features of India's economy, including controlled prices for petroleum products, transport prices, etc., contributing to *delayed* responses in the EAPC process. The overheating will (and did) eventually catch up, and by early 2012 India was undergoing mild stagflation, i.e., falling growth and rising inflation.

<sup>3</sup> To prevent this list becoming too long, and for other reasons, statements by some RBI officials about sustainable 8-9% growth have been left out.