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THE OIL EFFECT

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Inflation & Monetary Policy

On October 5, when the Reserve Bank of India (RBI) did not raise its benchmark short-term lending ("repo") rate, even while changing the monetary policy stance from "neutral" to "calibrated tightening", the markets weren't impressed. They had expected a minimum 0.25 percentage point increase in the repo rate, with one out of the central bank's six monetary policy committee (MPC) members actually voting in favour of this. In its latest meeting on Wednesday, the MPC has unanimously decided to keep the repo rate unchanged at 6.5 per cent. It has also stuck to the stance of "calibrated tightening", though one member voted for going back to the previous "neutral" position.

What has changed so much in two months to make the same markets, which had earlier believed that the RBI wasn't responding enough to inflation risks and defending the rupee against capital outflows, to now not rule out the possibility of rate cuts down the line?

The simple answer is oil. Two months ago, Brent crude was trading at around $85 per barrel. That price has since eased to below $62 levels. The rupee, whose internal as well as external value is significantly linked to oil, has also strengthened to 70.5-to-the-dollar after slipping to a record low of 74.39 on October 9. Inflation risks have receded further with food prices entering deflation territory. Although not a good sign — the MPC's statement has pointed to private consumption falling "possibly on account of moderation in rural demand" — the fact is that negative/low food inflation, along with oil's recent weakening and the rupee recovering, has suddenly changed the outlook for interest rates. The RBI, which had projected annual consumer price inflation at 3.9-4.5 per cent for October-March 2018-19 in its October monetary policy statement, has now revised this range downwards to 2.7-3.2 per cent. That, in turn, means no pressure to hike interest rates. It should provide considerable relief, in a scenario of economic growth slowing to 6.9 per cent year-on-year during July-September (from 8 per cent for the preceding quarter) and a liquidity squeeze particularly impacting non-banking financial companies that lend mostly to small borrowers.

There is one elephant in the room that can, however, make even a pause on interest rates, let alone cuts, difficult. With the general election just four months away, the risks of fiscal slippages would obviously weigh on the minds of the RBI/MPC. Ideally, this should be the time for both the Centre and state governments to restore the excise duty and value-added tax rates on diesel and petrol to their pre-October levels, now that global oil prices have softened. But that may be too much to expect; the only realistic hope lies in not compromising further with fiscal discipline.

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