Managing the Crude Price Pressure

Why in news?

Surging oil prices constitute visible terms of trade shock and will necessitate skilled macro management.

What are the channels through which the Russia-Ukraine conflict will impact economy?

- The negative terms of trade shock from higher commodity prices, particularly oil
- A direct trade channel to the affected region
- An indirect trade channel from weaker global growth
- The tightening of financial conditions and capital flows as global risk appetite wanes

To know more about war impacts beyond oil, click here

What is the trend in crude prices?

- Crude prices have surged well past a 110 dollar per barrel and as the conflict gets more entrenched, crude could remain elevated for much longer.
- This would constitute a large, negative terms of trade shock to India to the tune of 1.2% of GDP.
- The size of the commodity shock rises once higher prices for coal and gas imports are included.

What will be the implications on Indian economy?

- The situation is similiar to an adverse supply shock to the economy that simultaneously impacts growth, inflation and the current account deficit (CAD).
- **Growth**- The growth impact will manifest through
  - constraints on fiscal space
  - household purchasing power being impinged
  - firm margins coming under pressure
- The quantum of the growth impact will depend on how the shock is distributed across the fiscal, households and firms.
- The excise duty cuts will absorb the shock from oil and this year's budget, therefore, forecasted lower excise duties collections and has less spending space.
- **External balances**- Oil at 100 dollars will leave a tangible imprint on India's external balances.
- **CAD**- The October-December CAD is tracking 3% of GDP and the CAD is likely to stay close to those elevated levels in the coming quarters if crude is in triple digits.
- The RBI has a war chest of foreign currency reserves, so there is no imminent threat to macroeconomic stability but the current account and balance of payments needs close

monitoring.
- **Inflation**- Higher commodity prices can pressure inflation.
- **Depreciation of rupee**- The widening of the CAD and associated BoP pressures will create some depreciation pressures on the rupee.
- A persistent negative term of trade shock will argue for a weaker equilibrium real effective exchange rate.

How should policy respond in the wake of terms of trade shock?

- **Allowing real depreciation of currency**- Policymakers should let the rupee reach the new equilibrium in a gradual and non-disruptive manner
- This is because it will facilitate the necessary expenditure switching to reduce imports, boost exports and help narrow an elevated CAD.
- A real depreciation of the currency that acts as a shock absorber for the economy is the optimal response to a negative terms of trade shock.
- While a real deprecation can be expansionary, it can also be inflationary generating an aggregate demand boost in the wake of an adverse supply shock.
- All this will contribute to inflationary pressures, and will warrant a commensurate monetary policy response.
- **Excise duty cut**- Cutting excise duties would buffer the impact on households and protect consumption, but potentially result in a larger hit to demand by shrinking fiscal space to spend.
- If the government doesn't cut duties, this will mean higher retail prices that can harden inflationary expectations, increasing the challenges for monetary policy.
- **Disinvestment-** As soon as markets begin to stabilise, authorities must plough ahead with planned asset sales/disinvestment to create more fiscal headroom.
- The new equilibrium will inevitably need some combination of a weaker rupee, higher rates, and judicious fiscal management.
- **Reducing import dependence**- Policymakers must seriously consider systematically hedging crude price imports in global markets to protect the economy from periods of outsized volatility, apart from the medium-term objective of reducing our dependence on imported crude.

Reference

1. https://indianexpress.com/article/opinion/columns/managing-the-crude-oil-price-pressure-7799847/