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Rising inflation, crude oil are a new worry for financial markets: Analysts

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New Delhi Last Updated at December 11, 2020 12:43 IST

Steadily rising inflation and the recent spurt in crude oil prices are a new worry for India's fiscal health and financial markets, say analysts. Although at current levels, international oil prices are unlikely to pose a major challenge to India's macro stability, the country would have to manage the inflation / fiscal deficit trade-off as oil prices climb, they believe.

Over the past one month (since November 13), Brent crude oil prices have surged nearly 18 per cent to $50.34 a barrel now. According Barclays' estimates, a $10/barrel-increase in the price of crude oil, which implies Rs 5.8/litre increase at the pump, would add around 34 basis point (bp) to headline inflation over three to six months, assuming no change to petroleum taxes.

A Rs 5.8/litre-cut in petrol and diesel taxes to offset rising crude oil prices, Barclays believes, would result in a loss of revenue of Rs 872 billion (around 0.39 per cent of gross domestic product), assuming normal fuel consumption.

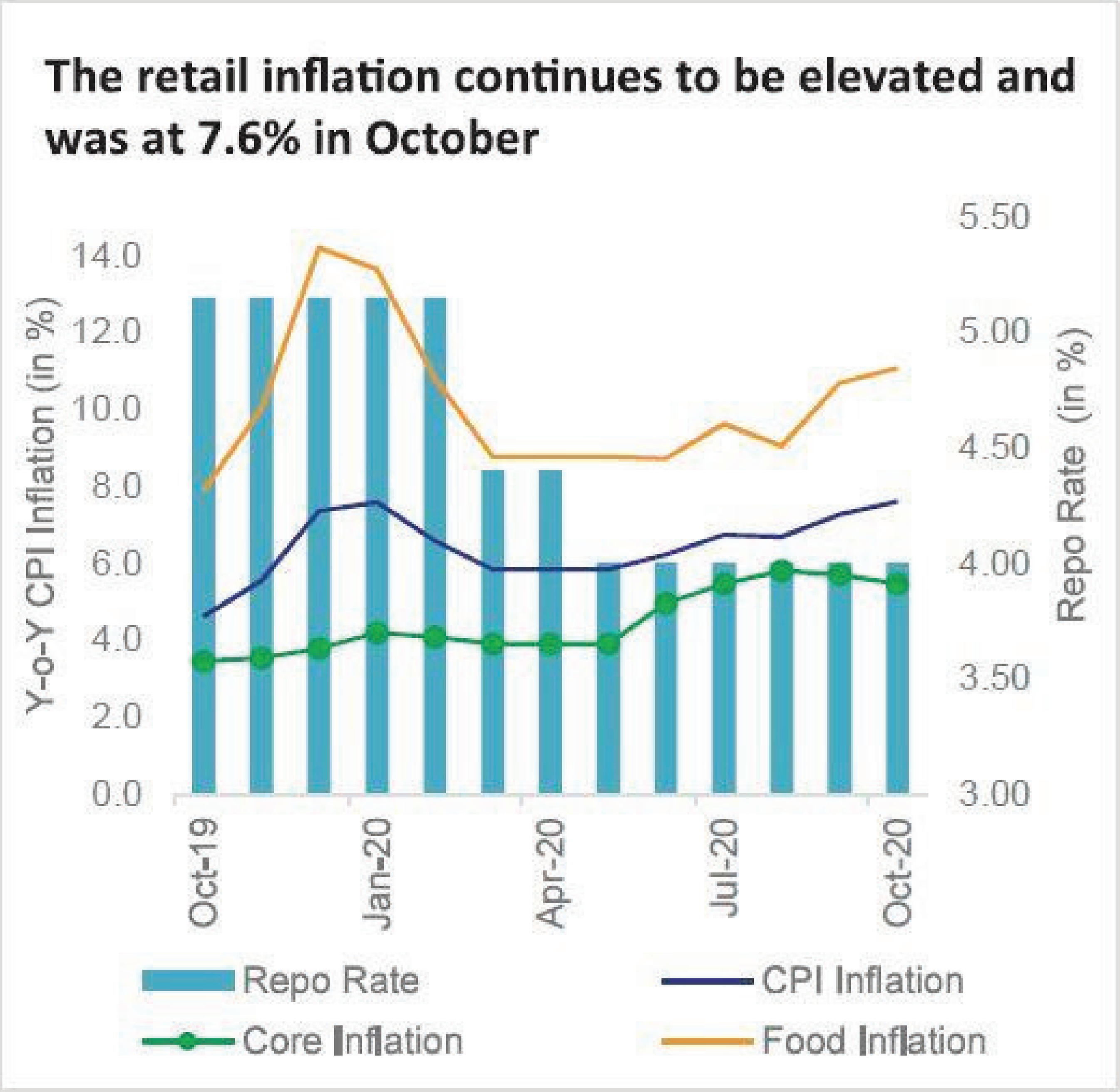
"According to our analysis, this would raise inflation by around 56bp, given the current level of inflation and size of the fiscal deficit, but stretched over a longer period of one year. India's reliance on fuel taxes is posing questions for the government as higher crude prices feed inflation. Cutting excise duty would only delay inflation thanks to the wider fiscal deficit. That may buy some time for the recovery, however," wrote Rahul Bajoria, chief India economist at Barclays.

Meanwhile, since 2014, petroleum taxes' share total tax revenues has risen and, thanks to Covid-19, likely will reach 25 per cent in financial year 2020-21 (FY21), according to estimates.

The government, reports say, is considering giving some leeway to the Reserve Bank of India (RBI) as regards inflation, allowing it to focus more on economic growth in the backdrop of Covid-19 pandemic. As a result, the consumer-price inflation (CPI) band may be relaxed from the current 2 – 6 per cent range.

On its part, the RBI expects inflation at 6.8 per cent in the current quarter and 5.8 per cent in the next (January - March 2021). Though the RBI has projected inflation rate at 5.8 per cent in the March quarter and in the range of 4.6 per cent to 5.2 per cent in the first half of financial year 2021-22 (H1FY22), there are considerable uncertainties and upward risks to these estimates, analysts say.

"The major risk is excess liquidity in the system, and the RBI has not taken any measure to drain this. Although the present inflation is primarily driven by supply-side factors, it is important to be vigilant about demand-side factors, too, before it is too late," cautions Dr. M. Govinda Rao, chief economic adviser at Brickwork Ratings.



Source: MOSPI, RBI, BWR Research

In its latest policy statement, the RBI had acknowledged that cost-push pressures continued to impinge on core inflation, which remained sticky and could firm up as economic activity normalizes and demand picks up. This comes in the wake of the central bank raising its inflation forecasts, partly reflecting rising crude oil prices, which it expects to remain volatile in the near-term.

Calendar year 2021 (CY21) could be a challenging year for the government, feels G Chokkalingam, founder and chief investment officer at Equinomics Research. "Not only crude oil, but prices of most metals and vegetables (food) are rising. 2021 could see both demand and supply-side pressures. All this will weigh on the already fragile economy. The stock markets, as of now, are ignorant of this and are driven more by the gush of liquidity. Sooner or later, they will realise the stark reality," he says.