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Will hikes in petrol and diesel prices impact inflation?

T.K. Jayaraman

The cash shortage of smaller denominations following the demonetisation of Rs 1000 and Rs 500 notes on 8 November triggered an unprecedented fall in household consumption. Consumption accounts for about 60 per cent of aggregate demand. Naturally, there were fears of disinflation. No one has bothered about inflation for a while, thanks to low commodity prices along, especially of petroleum crude.

Good times do not last forever; bad signs are on the horizon.

The latest information on inflation does not cover the post-demonetisation period. Data released shows decrease in inflation rate in November 3.63 per cent as against 4.2 per cent in October. The declining inflation rate has been attributed to improved domestic supplies of vegetables and fruits and of course, to the prevailing low petroleum crude price levels, which were close to US$45/barrel until recently, that is 10 December, 2016.

That was the day when all the 13- member Organization of the Petroleum Exporting Countries (OPEC), including the major producer Saudi Arabia, as well non-OPEC oil exporting countries including Russia, decided what a cartel would like to do: cut the oil output and work for increased prices. Decisions of cartels do not last long. Members change their minds. But any unanimous decision, however short-lived, can cause immense damage to oil dependent economies.

RBI's fears

There were fears lurking in the background when Reserve Bank of India (RBI) decided to stick to the bank rate of 6.25 per cent on 7 December. It was worried more about the long- and medium-term inflationary outlook. There has been a visible trend in the upward movement in the price of crude above US$55 per barrel, besides not so optimistic expectations on winter crop output.

That brings us to focus on two definitions of inflation. One is the core inflation and the other headline inflation. Core inflation does not cover goods and services, whose prices are highly volatile. They include food, which is seasonal and subject to weather conditions including excessive rains or droughts; and energy and fuel, which includes all petroleum products, much of which imported. Headline inflation covers all items in the basket of goods and services and is represented by annual change in the consumer price index; the prices of volatile items are excluded when the core price index is calculated. So when economists evaluate the impact of government policies and their implementation, they would like to go by the rise or fall in the purchasing power of money. They pay more attention to change in consumer price index. A rise in inflation rate reduces disposable incomes of the consumers.

The IMF study

There have been episodes of growth of gross domestic output (GDP) accompanied by inflation over a long period or growth in GDP with declining price level. An important study on *What is responsible for India's sharp disinflation* released in last August by IMF is relevant here. The authors of the IMF study, Sajjid Chinoy, Pankaj Kumar and Prachi Mishra, note between 2000 and 2006, India's headline inflation was low at 4 per cent. The consumer price index rose from 2006 at an average above more than 9 per cent during next seven years until 2013. The Indian rupee came under pressure, as external imbalances grew wider. After the annual inflation rose to 12.1 per cent in November 2013, inflation started falling: 4.3 per cent in December 2014, a fall by 800 basic points in 13 months, before increasing to 5 per cent in October 2015.

The IMF study notes 62 per cent of the decline in headline CPI inflation between 2013-14 and 2014-15 is attributable to the disinflation in food, and 38 per cent is attributable to non-food. Within non-food, 22 per cent of the decline is attributable to core and 16 per cent is attributable to fuel. No doubt food is a dominant factor. However, nearly 40 per cent of disinflation was on the non-food side. The IMF economists comfort us that the direct role of oil prices in India's inflation was relatively modest given the limited pass-through into domestic prices.

However, the popular perception of the direct connection between hike in fuel prices and inflation cannot be easily erased. With the rise in 14 December enter US Fed's benchmark interest rate by 25 basis points and the possibility of two or three rate increases in 2017, the picture is not pretty. The US dollar is rising.

The price of oil is always denominated in US dollars; we have a double whammy here. India's imports of crude and petroleum related byproducts would go up in value in rupees. Rise in fuel and energy prices push up transport costs and the spread effects will be felt across all productive sectors.

Price hikes and cuts in oil output

The price of petrol was increased by Rs 2.21 per litre and of diesel by Rs 1.79 a litre, effective from 17 December, 2016. In Delhi, a litre of petrol would cost Rs 68.31, while diesel Rs 56.36 per litre. The reasons are the surges in global petrol price: from $57.43 to $62.82 (Rs 3896.29 to Rs 4261.97) per barrel, and diesel rates shot up from $56.79 to $60.97 (Rs 3852.87 to Rs 4136.46) a barrel.

The revisions in prices are due to the announcement of cuts in output by members of OPEC and non-OPEC from the New Year Day. The combined cuts by OPEC and non-OPEC are expected to reduce supplies by 1.8 million barrels of oil per day by June 2017. If that materialises, oil price is expected to rise above US$ 70/barrel. The correlation coefficients between indices of petrol price and CPI and those of diesel price and CPI are very close to unity. In other words, holding other variables unchanged, there is a near-one to one relationship between CPI and price indices of petrol and diesel.

The US President-elect Trump is keen to dig and drill anywhere for oil. He also seems ready to set aside the outgoing President's ban on oil and gas drilling in most of Arctic and Atlantic oceans. If he acts early, the global oil situation will alter. The OPEC would be divided once again. Their proposed cuts would not take place. So, good times will continue?

Professor Jayaraman teaches at Fiji National University.