Oil price volatility: Policy options

Oil industry forecasters and economists have been trying to predict future oil prices for over 70 years. The major analytical conclusion (see *www.forbes.com/008/o9/04/oil-price-/forcast-opeac-cx_jt_pv0904tailorvandoin* for a summary) is that the best predictor of future oil prices is the present oil price. Technically, this means oil prices move akin to a random walk without drift.

In India, analysts in the private sector and media commentators appear ignorant of this. Like central planners, they read supply-demand forecasts to make predictions about future prices and use this as a basis to advocate government intervention. This leads to accusatory hysteria about government doing nothing to temper the effect of rising oil prices on purchasing power.

PUBLIC INTEREST

RATHIN ROY

Given the random walk, changing oil prices impact *short-term* macroeconomic stabilisation. The only medium-term factor that needs to be kept in mind is that oil prices will fall as technology reduces demand for fossil fuels. A random walk, therefore, means that government policy must be to select a benchmark price for oil, and then devise policies that stabilise short term oil prices (or a derivative set of prices for petroleum products) around this price, consistent with macroeconomic stabilisation objectives.

The major macroeconomic policy implication of oil price fluctuations is on the balance of payments (BoP). In India, this is complicated by the fact that India imports crude oil and exports refined petroleum products. The difference between the two, net oil imports, halved between the first quarters of 2014 and 2015. That trend has reversed since the second quarter of 2017. In value terms, exports have stagnated while imports have increased by 39 per cent. Exports are now 36 per cent of imports compared to 32 per cent in Q2, 2017, in turn, down from 42 per cent in Q1, 2015. This is a structural trend and must be dealt with as such by petroleum experts, as it affects the impact of changes in oil prices, not price formation.

For BoP management, it is desirable that consumption growth is tempered when oil prices fall, but is constant, or falls, when prices rise. This would mean that, having set a benchmark oil price consistent with BoP management, government should tax oil (and its derivative products) when market prices are lower, (and do as little as possible when market prices are higher), than the benchmark price.

This government has so far (without explicitly saying so) done exactly this, for which it is to be commended. However, it has to be mindful of the impact of rising oil prices on the voiceless poor and vulnerable. But the political noise comes not from them, but from commentators whose clientele are an elite addicted to oil, that constantly needs to top up its fuel tanks to meet western lifestyle aspirations. For both these reasons, government may need to consider policies to limit the impact of rising oil prices on purchasing power.

There are four policy options. First, to hedge against future price rises. This is unfortunately costly, both in terms of capacity to hold and to store petroleum products, and because the cost of financial hedging instruments is high — precisely because oil prices are a random walk! Second, to tax when prices are low, save a part of the proceeds, and use these to balance the fiscal books and reduce taxes when prices rise. This is difficult to do in India where the central government has expensive development obligations, but is also in a long term fiscally constrained situation. Third, tax petroleum products, especially luxuries, so that consumption falls, and aggregate purchasing power is maintained by changing consumption patterns. This takes time and requires cooperation of the elites, which is not forthcoming. As long as automobile and FMCG sales growth is considered a leading indicator of economic health, this is off the table. Fourth, subsidise oil prices/reduce taxation of petroleum products until prices fall.

The first three options all have a positive impact in ameliorating the impact of rising oil prices on the BoP. The fourth has a negative impact as it leaves demand for petroleum products unchanged even as prices rise. Even the expectation that such an intervention will happen (reasonable considering India's past record on petroleum subsidy), means that the value of oil imports continues to rise as prices rise. Clearly, this is undesirable.

Based on the above reasoning, my professional view is that the pressure on government to intervene to moderate domestic oil prices is unwarranted and not in the public interest. But I understand that government may be politically compelled to contemplate the undesirable fourth option. If this is inevitable, then I recommend that government announces a time- and price-bound policy intervention. Thus, government could commit to maintain oil prices at or below a specified level, until a specified future date. This would be an explicitly limited intervention, and would promote economy of consumption and temper expectations, as consumers and markets use the transition space to adjust to a higher oil price future. This would minimise fiscal costs, moderate the skittish reactions of our immature bond markets, and silence the garrulity of commentators pandering to middle-class sentiments in the name of the common man. The government could introduce simultaneous measures to protect the poor and vulnerable through income support using the Direct Benefit Transfer (DBT) modality (which can be done even if price subsidies / tax cuts are not executed).

The writer is Director, National Institute of Public Finance and Policy.
Views are personal