STUDY NOTES · BASIC CONCEPT

Why is RBI not increasing the interest rates despite inflation?

Indian Economy

26 Apr 2014

Central banks often face a complex dilemma when oil prices rise, and they may choose not to raise interest rates for several key reasons:

1. Firstly, rising oil prices are typically considered a supply-side shock to the economy. This means the price increase is due to factors affecting the production or availability of oil, rather than an overheating economy with excessive demand. Monetary policy tools, such as interest rate hikes, are primarily designed to curb demand-driven inflation. Raising interest rates in response to a supply shock is less effective at addressing the root cause of the oil price increase and could inadvertently dampen economic activity and increase unemployment.
2. Secondly, central banks must balance their mandate for price stability with their goals for economic growth and employment. Increasing interest rates when oil prices are already straining household budgets (as people spend more on fuel and electricity) could risk pushing economies into a slowdown or even a recession. Policymakers weigh the upside risks to inflation against the downside risks to growth and employment.
3. Thirdly, central banks often differentiate between temporary and persistent inflation. If the increase in oil prices is perceived as transitory, they may "look through" it, expecting inflation to return to target without intervention. However, they remain vigilant for "second-round effects," where initial oil price shocks lead to broader increases in inflation expectations, wages, and the prices of other goods and services. If these effects become entrenched, central banks are more likely to act. A crucial factor is the anchoring of inflation expectations.
4. If the public and markets continue to believe that inflation will remain at the central bank's target in the long term, then a temporary rise in oil prices may not necessitate an immediate rate hike. However, if these expectations begin to drift or become unanchored, central banks will feel more compelled to tighten monetary policy to maintain credibility and bring inflation back to target.
5. Finally, geopolitical uncertainty often contributes to rising oil prices, making central banks cautious. The unpredictable nature of conflicts and their impact on energy markets can lead central banks to adopt a "wait-and-see" approach, as they assess the evolving situation and its broader economic implications. While the general principle is to be cautious with supply-side shocks, recent developments (as of March-April 2026) show that some central banks, like the Federal Reserve, have been forced to delay anticipated

BECOME IAS
AI Powered UPSC Preparation by ELINKPOT

rate cuts due to rising oil prices.

6. The European Central Bank (ECB) and the Bank of England (BoE) are also signaling a potential shift towards rate hikes if significant second-round inflationary effects materialize. This indicates that while they may not immediately hike for every oil price increase, sustained high oil prices can still significantly influence their policy decisions, especially if they threaten to de-anchor inflation expectations.

BECOME IAS
AI-Powered UPSC Preparation by ZINKPOT