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Impact of Fluctuating Oil Prices on Indian Economy

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Abstract

Economic impact due to high crude price is felt much more in emerging markets (EM) than developed markets, and within EM economies, there are likely to be clear-cut winners and losers. This is because of the risk of non-linear economic effects, or vicious spirals, to large net oil importers that have weak economic fundamental starting positions. The prospect of even larger twin current account and fiscal deficits could trigger sizeable net capital outflows and currency depreciation which, in turn, may add further upward pressure to inflation. Crude oil import dependency is one of the major economic issues for most of the countries. However, the oil exporting countries take this opportunity to perpetuate their economic power. Thus, the crude oil price fluctuation influences not only the oil importing and exporting countries but also the entire world economy in a significant way. India has recently started importing crude oil from the USA. This recent phenomenon has enhanced the significance of this study to a greater extent as the composition of Indian basket crude oil price will be affected. The current Indian basket crude oil price is a composition of Dubai and Oman sour crude oil price and Brent sweet crude oil price benchmark. Thus apparently, this composition is going to change in the near future. With this note, it is important to understand, how the global factors can influence this price benchmark.

Keywords: Emerging Markets, Indian Basket Crude Oil Price, Price Fluctuation, Indian Economy, Import, Current Account Deficit (CAD).

Introduction

Energy security is crucial for both sustaining high economic growth and controlling inflation. With rapid economic growth, energy demand in India has been rising rapidly, and India is now the fourth largest consumer of crude oil in the world. Unfortunately, India has to import most of its oil requirement, leading to severe pressure on the economy when the oil prices rise. Thus, estimations of crude oil demand and projections for the future should be useful to policy makers in making appropriate supply arrangements for the future.

There are many different sources of energy consumption, such as coal, crude oil, natural gas, hydroelectric, solar, wind, and nuclear energy. Out of India's total energy consumption, crude oil accounts for 24 per cent, natural gas 6 per cent, coal 40 per cent, combustible renewable and waste 27 per cent, hydroelectric power 2 per cent, and nuclear energy and wind energy about 1 per cent each; solar energy has an insignificant share. Thus, crude oil and coal account for about two-thirds of India's energy consumption. LOUCKS, Describes an economic system is a system of those institutions which a given nation or group of nations has chosen or accepted as the means through which their resources are utilized for the satisfaction of human requirements. Therefore, business can't be analyzed and understood properly without reference to the economics within which business activities are carried out.

As the world's third largest importer of oil, India is among the most vulnerable to rising energy costs. It imports more than 80% of its oil requirements. With Brent crude at a six-month high, it poses a clear risk to India's fiscal health. Inflationary pressures may also prompt the Reserve Bank of India (RBI) to rethink the pace of interest cuts.

In April 2019, Brent crude oil rose above $75 per barrel for the first time in 2019 in the wake of tighter sanctions on Iran. The US said it would end all exemptions for sanctions against Iran, demanding countries halt their oil imports from Tehran from May or face punitive action from Washington. India is an emerging economy with a Gross Domestic

Products (GDP) growth of 5-10% per annum. Moreover, the recent business reforms, initiated by Government may bring in changes in the Indian Economy. Business reforms further indicate the possibility of energy consumption. Crude oil is the second highest source of India's energy consumption with 23% of the share after Coal. The recent scenario of Indian crude oil segment is not appreciable. On one hand where crude oil consumption is increasing, on the other hand, the production is declining. It results in more import expenses. In this context, the major difference with the developed countries is its crude oil dependency. This is an alarming situation and India should start taking initiatives towards alternative energy sources.

Aim of Study

The paper aims to find out the factors influencing Indian basket crude oil price changes. Moreover, the paper attempts to investigate the impact of this price fluctuation on Indian economy. This study intends to explore the causes and consequences of international crude oil price changes on Indian Economy.

Methodology

The research is based on theoretical approach, and contemporary studies. The data has been collected from publication of Government of India like Economic Survey, Budgetary speeches, Journal of Energy Internationals etc. The data collected from these publications has been analyzed in view of contemporary events of world. These have been authentic source of data and have formed a crucial basis in development of this research paper.

Impact

With a weightage of 2.4 percent in the CPI calculation, crude prices have a moderate impact on overall CPI number. However, crude prices impact the cost of producing many goods as it is used as a raw material in many industries.

1. In 2017, India's trade deficit was $126 billion (4.8 percent of GDP), and crude contributed 35.1 percent to it. India exported $30.2 billion worth of refined petroleum products compared to imports of $74.7 billion.
2. India imported 220.4 MT (1.6 billion barrels) of crude oil in 2017-2018, up 3 percent YoY. In rupee terms, it amounted to Rs 5.6 trillion (3.3 percent of India's GDP), up 20.5 percent YoY.
3. If rupee depreciates by Rs 1 against the US dollar, import bill will increase by Rs 90 billion (For calculation, $1 = Rs 65 assumption is taken).
4. Current Account Deficit (CAD) is a measurement of a country's trade where the value of a country's imports exceeds that of exports. Crude oil being a major item among imports will have a higher impact on the CAD. Widening CAD further depreciates the rupee against global currencies.

As the world's third largest importer of oil, India is among the most vulnerable to rising energy costs. It imports more than 80% of its oil requirements. With Brent crude at a six-month high, it poses a clear risk to India's fiscal health. Inflationary pressures have prompted the Reserve Bank of India (RBI) to rethink the pace of interest cuts. So far this year, crude has jumped nearly 33%, while Sensex is up over 8%. In April so far, Brent has climbed 5.25%.

UK-based Oxford Economics expects Brent rising to $100 per barrel by the end of 2019. "When this happens, global GDP (gross domestic product) growth may decline by 0.6% in 2020 with global inflation rising by 0.7 percentage point," it said. It also added that the hardest hit economies in 2020, are large oil-importing emerging markets such as the Philippines, China, India and Argentina.

While there is a possibility that the impending supply crunch would be alleviated by higher production elsewhere, a single supply shock could easily send oil prices to shoot up to $100 per barrel. Brent crude had touched $100.6 per barrel on 9 September 2014 and is currently down 29% from that level.

Thus the risk from a supply-side driven rise in oil prices is negative for Asia markets and especially for India, the Philippines and Thailand; as the economies that could suffer the most due to rise in oil prices are Cambodia, Romania, Turkey, Sri Lanka, Ukraine, India, and Pakistan.

The economic impact due to high crude price is felt much more in emerging markets (EM) than developed markets, and within EM economies, there are likely to be clear-cut winners and losers. This is because of the risk of non-linear economic effects, or vicious spirals, to large net oil importers that have weak economic fundamental starting positions. The prospect of even larger twin current account and fiscal deficits could trigger sizeable net capital outflows and currency depreciation which, in turn, may add further upward pressure to inflation.

What Impacts Crude Oil Prices

The Organisation of the Petroleum Exporting Countries (OPEC) has around 81.9 percent of proven crude oil reserves. Within the OPEC, Venezuela (24.9 percent), Saudi Arabia (21.9 percent), Iraq, and Iran (24.9 percent) have the highest reserves.

According to the US Energy Information Agency's report, the US likely has surpassed Russia and Saudi Arabia to become the world's largest crude oil producer. Shale oil production in the US has increased in recent years, resulting in a decline in oil prices.

However, shale oil production is expensive compared to traditional oil production. Hence, in mid-2018, the US crude oil production came down due to lower oil prices. With prices rising higher in FY 2016, they have increased their investment and production.

Any production cut by the OPEC would drive the prices higher, but the individual countries do not want to surrender their market share. Geopolitical tensions among OPEC countries have led to a decline in oil prices. It is becoming more difficult to curtail the supply, which is important for the prices to stay higher.

Higher crude price will have a negative impact on the fiscal and current account deficits of the economy. Increase in these deficits will lead to higher inflation and also impact monetary policy, consumption, and investment behaviour in the economy. A 10 percent increase in oil price will increase the trade deficit by $7 billion, that is, trade deficit will widen by 560bps.

Upstream Versus Downstream Companies

In the oil and gas industry, companies are further divided into upstream or downstream, depending on their role in the supply chain.

Upstream companies are those who identify, extract, or produce raw materials that are used by downstream companies to refine them into diesel, gasoline, natural gas, pesticides, and other petroleum products.

ONGC and Oil India are Upstream Companies

Downstream companies also indulge in the marketing of these products to consumers. HPCL, BPCL, and IOCL are downstream companies in India.

Decreased Fuel Subsidy by The Government

As the oil prices rise, ONGC and Oil India may have to absorb fuel subsidy. As the fiscal deficit widens, the government would want to share the subsidy with these companies. In 2015, as the prices were lower, these companies did not contribute to fuel subsidy. Whereas oil marketing companies, were asked to share less than 1 percent of total subsidies since 2012. As long as the crude prices stay below $60/barrel, the impact of fuel subsidy on these companies would be minimal.

In its latest budget, the government decreased fuel subsidy by 5 percent to Rs 20,800 crore. It comes as a negative statement to companies like ONGC and Oil India. These companies P&L would be affected adversely because of this move.

Impact on Indian financial markets

Energy stocks have 12.5 percent weightage in the Nifty50 and 15.2 percent in the Sensex. Hence, the Nifty and the Sensex are sensitive to oil price movements. Higher crude prices adversely affect tyre manufacturers, footwear, lubricants, paints, and airline companies.

Stocks of interest:

RIL

The company receives 74.8 percent of its revenues from petrochemicals business. It posted good December quarterly results. It is constructively trading above its 50- and 200-DMA.

With respect to refining, the company reported Gross Refining Margin (GRM) of $8.8/bbl in Q3 FY 2019, outperforming Singapore complex margins by $4.5/bbl. The company's exports of refined products increased 19 percent y/y to $6.9 billion aided by volume growth of 5 percent to 10.8 MMT.

HPCL, IOCL, and BPCL are trading 53.1 percent, 40.1 percent, and 37.4 percent off-highs, respectively, and below their key levels of 50- and 200-DMA.

OPEC output hike may not be enough

Data showed combined crude output from Iran and Venezuela, another sanctions-hit country, dropped by 5,00,000 bpd (barrels of oil per day) in March quarter.

Commodity analysts attributed the current oil price rally to US sanctions on the two oil producers along with potential supply shocks from Libya and Algeria and a pledge by OPEC and its allies to cut output by 1.2 million barrels per day (mbpd).

Rise in crude prices also impact raw material supply chain of many manufacturing companies as India imports a major portion of its crude requirements. Impact on demand and higher input costs puts pressure on the operating margins and it has to be seen if this extent of price rise will be absorbed or passed on to consumers. Indirectly, there will be additional burden of freight cost for some companies. However, the negative impacts will materialize only if oil continues to sustain at elevated levels.

India's Target for Growth

The current spike in oil prices has revived concerns of 2018, many international agencies have downgraded India's growth target. The oil prices which had been kept at an increased level by increasing the excise duty many folds are to be leveraged to keep prices in check. The new government will have to tackle this oil price while ensuring that pressure on inflation is low. In fact, the Monetary Policy Committee of RBI has also cautioned about it.

It is felt, that low oil prices between 2014 and in the first half of 2018 helped contain fiscal deficit and inflation. But, the growth would have been at a higher pace, had it not been for demonetisation and GST. This had also led to questions being raised on the strength of the Indian economy.

Observer at Research Foundation, has a word of caution for the new government that comes in. What the fiscal deficit numbers hide are the inordinate gains from high oil taxes and dividend stripping and share transfer/buyback bonanza extracted from the oil companies meaning to impoverished PSUs but a richer government. As Government has been filling the coffers by increased Basic Excise and additional excise duty, has to pass on to the PSUs who have been procuring the crude at higher rate. Fundamentally, low oil prices were not passed on to the larger economy or they would have boosted GDP growth. The collapse of Jet Airways and Air India is also a consequence of high aviation fuel taxes, also noteworthy that Pakistan closing airspace is adding to the costs of domestic airlines.

High demand for oil and rising dependency on crude imports also means a drain on the country's foreign reserves, which will get exacerbated by a weaker rupee against the dollar, but, crude is still a buyer's market and major Asian economies such as China and India have a strong bargaining power with their term suppliers in West Asia, especially as competitive US supplies are starting to flood into these markets. It is up to the PSUs to secure good deals in their terms crude import contracts.

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materialize only if oil continues to sustain at elevated levels.

As the dependence on imports is likely to continue and so is the vulnerability to shocks, it is pertinent to look at measures that help in reducing the vulnerability and building resilience to oil shocks.

In the short term, building defenses against supply and price shocks by construction of Strategic Petroleum Reserves (SPRs) provides the most immediate defence against any shocks in supply or even demand. Further, SPRs also have the potential to act as a strategic signal against any intended blockage of supplies.

In order to reduce the impact of oil price shocks on the domestic economy, it is critical to review the country's policy on fuel subsidies and to manage the energy access agenda in a financially sustainable manner. As mentioned in the preceding sections, petroleum product subsidies form a major proportion of the country's total fiscal outgo. In addition to this, the contribution from oil companies (especially those in the upstream sector) also affects the ability of these companies to invest in increasing their domestic production capacity and expansion of infrastructure to effectively reduce reliance on imports. Efforts to diversify sources of crude oil imports and substitution towards alternatives need to be made. As stated previously, countries from the Middle East constitute the largest sources of crude oil supply for India. Efforts need to be made to diversify the crude oil import portfolio of the country and to enhance diplomatic relations with oil producing countries. Cross investments wherein companies from oil producing countries are allowed to make investments in energy infrastructure in India can also be considered (TERI, 2009b). In this context, countries from Latin America and Africa provide vital options. In the past few years, imports of crude oil from Venezuela, Nigeria, have increased. Increasing imports from these countries and furthering bilateral ties with their respective governments will form a key component of India's oil security policy in the coming years. In addition to these emerging players, imports of unconventional oil (tar sand, natural gas liquids etc.) from North America (Canada and USA) also provide an opportunity to diversify the country's supply base. Not only do these options provide additional sources of oil, the relative geo-political certainty of supplies in the region adds to the long term security of oil supply for India.

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