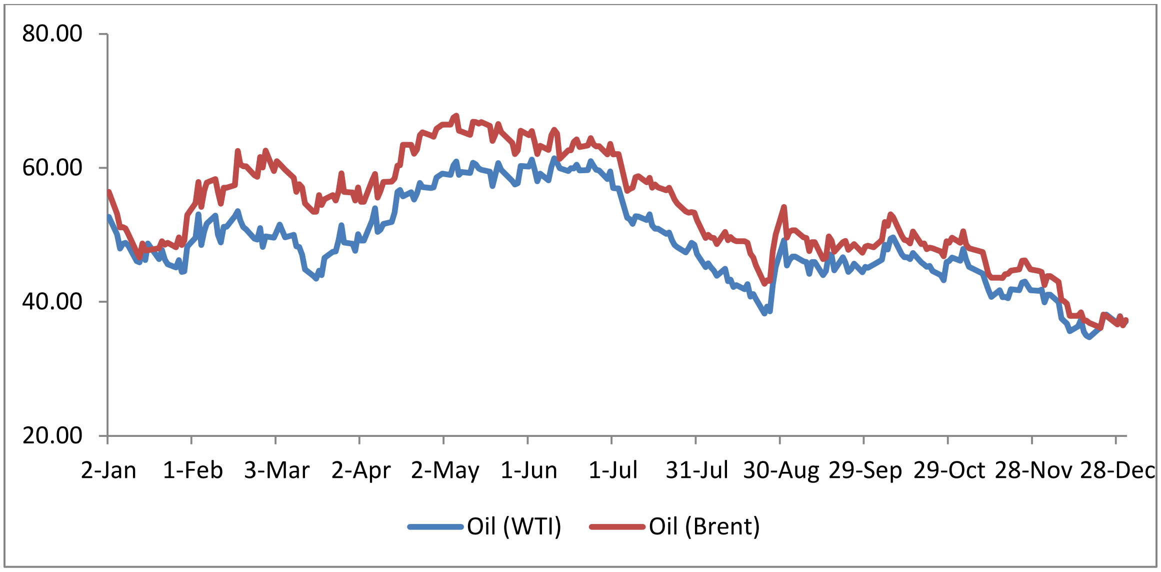
Crude Oil Scenario & Indian Economy

The price of crude oil has moved towards the $ 30 /bbl mark and there is speculation that the price may go down further. This has been accentuated by the tremors in the Chinese market as well as the strong dollar. The former reflects low demand conditions to prevail in future, and the latter the price adjustment to the strength of the dollar which is the standard used for benchmarking the price. It may be recollected that in the past when the dollar weakened, the price of oil had increased to adjust for the same. A perspective of the oil market and its implications for the Indian economy is examined here.

Chart 1: Oil Price Movement in 2015 (January – December)



Source: Oil – Net

Global view

The cause of this decline in oil price has been a combination of a supply glut and weak demand conditions that have prevailed since mid-2014. The former began when the US shale supply increased substantially. And surprisingly, the OPEC was unwilling to rollback its output as member nations wanted to maintain their own fiscal balances. It has been estimated that OPEC is even today adding to global excess supply by over 1 million barrels per day. Hence, if the world economy does not pick up there could be further downward pressure on prices.

US-EIA's (Energy information Administration) estimates for global oil inventories is that it increased by 1.9 million b/d in 2015, which would be the second consecutive year of inventories increasing. Inventories are expected to increase by a further 0.7 million b/d in 2016, before the global oil market becomes relatively balanced in 2017. The EIA further expects that the first draw on global oil inventories would be in the third quarter of 2017, marking the end of 14 consecutive quarters of inventory builds. Till then prices may be expected to remain stable in the downward direction.

The futures market also indicates that the Short positions held by oil producers have declined and that there could be more cuts to production a result of low prices.

What kind of numbers are we looking at?

Analysts at Barclays, Macquarie, Bank of America Merrill Lynch, Standard Chartered and Societe Generale have lowered their 2016 oil price forecasts. Some forecasts look at Brent averaging $ 42.50 and WTI $ 40.50 in 2016.

According to EIA forecasts, Brent crude oil prices would average $40 per barrel in 2016 and $50/b in 2017. WTI is expected to be $2/b lower than Brent in 2016 and $3/b lower than Brent in 2017. EIA says that there will be uncertainty in the crude oil price outlook through these two years. The forecast for the average WTI price in April 2016 is $37/b, while going by trends in the derivative market the price could range between $25/b to $56/b (at the 95% confidence interval) for April 2016 delivery.

Supply Perspectives

Since 2012, the United States has been responsible for the global increase in production of petroleum and other liquids. However, in 2016 and 2017, OPEC is expected to account for most of production growth. EIA expects non-OPEC production to decline by 0.6 million b/d in 2016, which would be the first decline in non-OPEC production since 2008. About two-thirds of this forecasted decline in 2016 would come from the United States.

The EIA has argued that changes in non-OPEC production are driven by changes in U.S tight oil production, which is characterized by high decline rates and relatively short investment horizons' that make it among the most price-sensitive production globally. It is expected that U.S. liquid fuels production would come down by 0.4 million b/d in 2016 and remain relatively flat in 2017 as low oil prices contribute to drilling rig counts falling below levels required to sustain current production rates.

OPEC crude oil production is forecast to increase by 0.5 million b/d in 2016, with Iran accounting for most of this. Iran is expected to increase its production once international sanctions targeting its oil sector are suspended which is expected by EIA in Q1-2016 as it complies with the key obligations required under the Joint Comprehensive Plan of Action, which has been implemented faster than previously anticipated.

How about demand

EIA expects global consumption of petroleum and other liquid fuels to grow by 1.4 million b/d in both 2016 and 2017. Further, its forecast of real gross domestic product (GDP) for the world, weighed by oil consumption is expected to rise by 2.7% in 2016 and by 3.2% in 2017 from 2.4% in 2015. Therefore, the overall expectations are of demand to remain fairly stable and move only gently upwards.

Impact on the Indian Economy

The Indian economy is affected in a number of ways given that imports dominate the consumption patterns. Besides affecting the trade account and current account deficit, the price of oil also impacts inflation quite sharply as well as the government's fiscal balances through both tax collections and subsidy on fuel.

1. ***Inflation***

Impact of a decline in oil prices on inflation would be dependent on the depreciation of the currency as well as the change in the oil prices. Average rupee depreciation for Apr – Dec FY16 has been 6.6% while the WTI oil price averaged $ 48.91 per barrel and Brent stood at $ 53.11 per barrel. The table below provides three scenarios of depreciation for the current year. The table provides prices in rupee terms (dollar price * the exchange rate).

Table 1: Rupee value of Brent @ 40 $/barrel in FY17 (calendar 2016)

Depreciation	6%	8%	10%
Exchange rate	68.61	69.97	71.27
Rupee value	2,744	2,799	2,851

**Rupee value at current price stood at Rs 3,441 per barrel*

The weight of fuel products in WPI and CPI stand at 9.36% and 6.35% respectively and hence inflation will be impacted by these price changes. However, even at a level of 10% depreciation, the total price of oil in rupee terms would still be lower in 2016 and 2017 from the current level. Therefore, the overall cost of oil will remain lower and in line with movement in global crude price.

The impact on WPI would depend on the extent to which the government allows the price to move towards the market level as there could be a tendency to make adjustments given that there are products like LPG and kerosene that are being subsidized. The impact on CPI would be an indirect one as it needs to be seen as to how elements like energy and transport cost get affected. Normally they never come down even when the cost of oil declines. On the whole the impact would be positive on inflation even after taking into account a declining rupee.

Import bill

India is one of the largest importers of oil in the world. It imports nearly 80% of its total oil needs. This accounts for about one third of its total imports. Thus a change in oil prices has an impact on the current account balances. India's estimated oil imports for 2015 and 2016 stand at 188 MMT and 190 MMT respectively. Using the conversion rate of 7.33 (1MT is equal to 7.33 barrels) and the estimated oil price as mentioned in the table above, the import oil for the country is expected to come down by approximately 20% assuming only marginal increase or unchanged in consumption. Thus, the current account would be positively impacted with lower oil prices.

Exports

Refinery products account for around 20% of India's exports and have ranged between $ 55-65 bn in the last few years. Low oil prices have affected their exports in value terms, and one reason for exports growing by a negative rate this year has been low crude oil prices. Therefore, growth in exports would also be affected by low crude prices.

Subsidy bill

The government fixes the price of fuel at a subsidized rate. It then compensates companies for any loss from selling fuel products at lower rates. A fall in the oil prices helps the government to reduce the subsidy on the respective products and thus helps in narrowing the fiscal deficit. Petroleum subsidy was targeted at Rs 30,000 cr for FY16, down by 50% from FY15 level. Lower crude oil prices will provide room for further reduction in the subsidy and the government can concentrate on rationalization of the same for LPG and kerosene.

Tax collection

Typically, a decline in oil prices should result in a decline in the tax collections on the petroleum products in the form of excise duty and customs. Petro products account for around 45-50% of the Centre's excise and 7-9% of customs collections. However, the total collection would be depending on other factors such as quantity imported, exchange rate, extent to which lower prices are transmitted to the consumers etc. In FY16 collections have not been impacted by negative growth in imports or low industrial growth. Hence, while several factors would determine the overall effective impact, there could be some pressure on revenue.

Contact:

Madan Sabnavis
Chief Economist
madan.sabnavis@careratings.com
91-022-67543489

Anuja Shah
Economist
anuja.jaripatke@careratings.com
91-022-67543568