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US Sanctions on Iran and impact on Indian economy

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The price of crude oil has been increasing of late on account of demand-supply mismatches as well as news on inventories with the USA. However the decision taken by the USA to end Iran oil waiver is significant as it affects countries like India, Japan, Italy, Greece, and China among others. The price of oil has started moving upwards further which can get exacerbated over time. Meanwhile the impact on the Indian economy can be assessed against this background as it comes at the start of the year where the sanctions get invoked on 2nd May.

How important is oil in our trade?

The share of oil in imports has varied over the years depending on the price of international crude. With the price now rising, the share of oil in imports will also begin to increase. (Table 1)

Table 1: Share of oil imports in total imports (USD Bn)

	2014-15	2015-16	2016-17	2017-18	2018-19*
Imports	447.6	380.4	384.2	465.6	507.6
Oil imports	137.8	82.6	86.9	108.6	140.5
Share (%)	30.7	21.7	22.6	23.3	27.8
Brent (Avg) $	86.7	48.7	50.0	57.9	70.9

Source: CMIE; * for 11-months

How does Iran fit in our POL imports?

Table 2: Share of Iran in India's oil import

	Imports ($ bn)	Share of Iran	Imports mn t	Share
2014-15	137.8	5.3	222.0	5.2
2015-16	82.6	5.4	246.0	5.7
2016-17	86.9	10.4	268.0	10.2
2017-18	108.6	8.5	272.3	8.5
2018-19 (11 mths)	128.7	9.0	255.6	9.0

Source: CMIE

Iran is definitely an important source of oil for India as can be seen in Table 2 where the share in the last three years has been between 8.5-10%. A complete embargo on importing oil from Iran would mean that India has to shift to other markets for sourcing oil.

Where does India import oil from?

In 2018-19 (11 months), the total import of POL was $ 128.7 bn. The main suppliers were Saudi Arabia, Iraq, UAE and Iran which accounted for a little above 50% of the supplies. It can be seen that Iran is the fourth largest supplier of oil to India based on 2018-19 and hence an embargo would mean sourcing the same from other countries which may not provide the same benefits as were provided by Iran in the form of price and credit facility.

Table 3: Country-wise value of imports and share in total imports

Country	Value of Imports $ bn	Share
Saudi Arabia	22.4	17.4
Iraq	20.6	16.0
UAE	12.3	9.6
Iran	11.6	9.0
Nigeria	9.5	7.4
Qatar	8.6	6.7
Venezuela	6.6	5.1
Kuwait	5.8	4.5
USA	4.7	3.7

Source: CMIE

How will India be impacted?

1. **Impact on current account deficit**

   Higher crude oil prices will tend to pressurize the trade deficit and current account deficit. Table 1 indicates that as the price of crude oil goes up so do the value of imports as the quantity imported tends to be sticky in general. With the assumption of other things remaining unchanged, *a permanent increase in crude oil prices by 10% under ceteris paribus conditions could translate into the current account deficit increasing by 0.4-0.5% of GDP.*

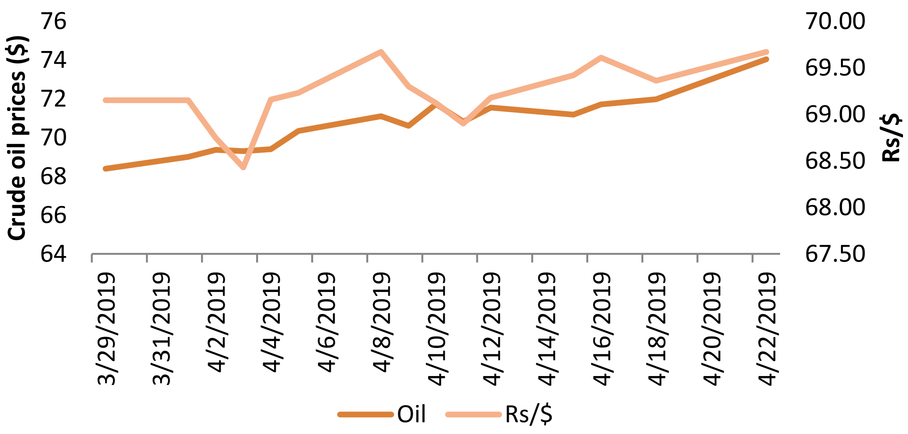
2. **Impact on Rupee**

   a. The currency will be the first point of contact as the trade deficit and current account deficit will widen. FII, FDI etc. would need to balance out this deficit or else the balance of payments would be under pressure. The sharp increase in import bill will hence tend to put pressure on the rupee.

      The rupee will be under pressure on account of both sentiment which will drive the currency in the short run and dollar outflows which will be the natural outcome of higher oil prices. The coefficient of correlation between absolute value of exchange rate and Brent between 1st April'19 and 22 April'19 was high at 0.62.

      Sustained increase in the price in the range of $70-75/barrel or higher *can move the rupee down by 3-4% on an annual basis given that the dolla*r has already started strengthening in the world market.

Chart 1: Movement in Rs/$ and crude oil prices



Source: Bloomberg and RBI

b. Pressure on the rupee will definitely keep the central bank alert as there may be the need to intervene if there is excess volatility. The RBI presently has $ 415 bn (as of April 12, 2019) of reserves which is a strong buffer for intervention. In FY19 (Apr'18 to Feb'19), the RBI has net sales of around $ 24.7 bn which can be persevered with in case it is required.

3. **Impact on inflation**

a. The impact on inflation is also significant as it will be driving monetary policy decisions in future. Inflation has been low of late and increasing only gradually due to food and fuel prices moving up. The impact would depend on two factors:
   i. The extent to which crude oil price goes up.
   ii. The extent to which the government allows the pass through of crude oil price to the consumer. Until the elections are completed, it is unlikely that there will be a full pass through as it will affect voting patterns.

The increase in crude oil prices could also have a bearing on the Indian consumers who could have to spend a higher amount on petrol and diesel. Currently, the Indian consumers are paying well above Rs. 70/- per litre on petrol.

The table below gives the weight of select oil products in the two indices

Table 4: Weights of selected oil products in the CPI and WPI basket

WPI		CPI	
Product	**Weight**	**Product**	**Weight**
Mineral oils	**7.95**	Fuel and lighting	
Petrol	1.60	Kerosene	0.55
HSD	3.10	LPG	1.28
Aviation fuel	0.32	Transport and Comm	
LPG	0.64	Petrol	2.19
Kerosene	0.19	Diesel	0.15
Minerals		Lubricants	0.05
Crude and natural gas	**2.41**	Bus/taxi/auto/air/school bus	2.25

Source: CSO, Office of Economic Advisor

- The impact on inflation will vary depending on the index being viewed. In case of the WPI, the overall impact will be more significant as the weight in the index is above 10% and hence depending on how much of the increase in price is passed on the *impact of 10% increase in crude oil prices can lead to 1% in the WPI in the extreme case*. If only petrol, diesel and aviation fuel are considered, the weight would be around 5% which can mean an increase of 0.5%.

- In case of the CPI the impact directly would be through transport and communication where the weight is 2.39% *which can mean an increase of around 0.24%* assuming that the kerosene and LPG prices are fixed and are not changed. The impact on transport that is linked with crude oil, the pass through will be indirect and normally not in the same proportion as some of these services are controlled by state agencies.

4. Impact on MPC decision:

The first bi-monthly monetary policy statement highlights in its inflation forecast that the outlook for crude oil prices is hazy with both risks on the upside and downside. With the imposition of US sanctions and consequently rise in crude oil prices could lead to the RBI indicating that crude oil prices need close monitoring and may be one of the important considerations which *could lead the MPC to postpone a rate cut* in the June bi-monthly committee meeting.

RBI has to be watchful because rise in crude oil prices due to sanctions would coexist with the trade tensions (US-China).

5. Fiscal impact

The impact on the government budget will be in two ways. The first is on revenue side and the other on expenditure. The table below gives the revenue implications for the government (both centre and states) as there is substantial revenue which is driven by the oil economics. In FY18, a sum of Rs 5.53 lkh crore was earned by the government, of which Rs 2.85 lkh crore was direct revenue as tax from oil products. In case of states it was Rs 2.08 lkh crore. A separate income came in the form of tax payment by OMCs, dividend and profits of Rs 0.59 lkh.

Higher oil prices will definitely *mean more revenue for the states as tax is ad valorem*. For the centre it may not matter as the rates are fixed. Normally the OMCs would earn higher profits if there is a pass through which can be beneficial for the government too unless the subsidy element on kerosene and diesel comes in the way. Therefore a lot will depend on how the government passes on the higher cost to the consumer.

Table 5: Details of central and state government revenue via tax on oil (Rs. crs)

Rs crore	2016-17	2017-18	9M, 2018-19 (P)
Cess on Crude Oil	13,082	14,514	13,352
Customs Duty	8,798	11,171	11,351
Excise Duty	242,691	229,716	148,531
IGST		16,385	21,796
CGST		6,401	7,832
Tax To central government	**273,225**	**285,255**	**208,701**
Corporate/ Income Tax	31,870	33,021	24,377
Dividend income to Central Govt.	17,501	14,575	7,039
Dividend distribution tax	6,196	5,981	3,266
Profit Petroleum on exploration of Oil/ Gas	5,742	5,839	5,254
Dividend/income to central government	**61,309**	**59,416**	**39,936**
Royalty on Crude Oil / Natural Gas	11,943	9,370	10,305
Sales Tax/ VAT on POL Products	166,414	186,394	149,992
SGST/UTGST		6,721	7,941
State collections	**189,587**	**208,893**	**172,899**
Total	**524,304**	**553,826**	**421,581**

Source: PPAC

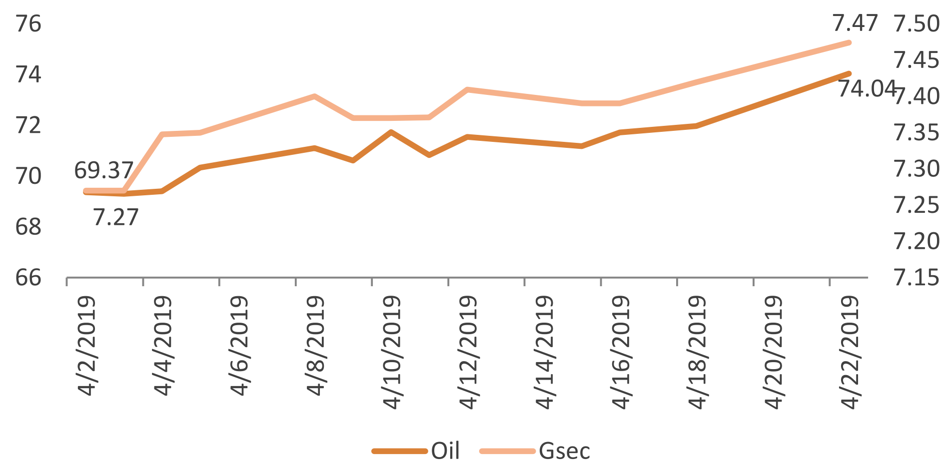
The other impact would be in terms of expenditure. Presently the subsidy is provided on LPG (Rs 32,989 cr for FY20) and kerosene (Rs 4,489 crore). Depending on how the prices move there could be pressure here which can be countered by increasing the outlay or rolling over in case the need arises.

6. G-Sec Yields

The rise in crude oil prices also leads to firming up of G-Sec yields as investors see a rise in crude oil prices leading to inflationary concerns. On, 22nd April, 2019, a rise in crude oil prices by almost 3% to $74/barrel was associated with firming up of GSec yields by 5 bps to 7.47%. Going forward, the rise in crude oil prices would not only build inflationary pressures but would also push GSec yields higher if sustained.

The following chart 2 shows that close relationship between the movement in crude oil prices and 10 year benchmark GSec yields during 2 April'19 to 22 April'19. GSec yields have firmed up by almost 20 bps in the previous 20 days under study.

Chart 2: Movement in crude oil prices (USD/barrel) and 10 year GSec yields (%)



Source: Bloomberg and FBIL

Concluding Remarks

India's dependence on Iran to the extent of almost 10% of total oil imports means that the immediate challenge is to find alternative suppliers which will provide crude oil at the same competitive terms. India will have to increase its dependence on oil imports from OPEC nations like Saudi Arabia and United Arab Emirates (UAE). In addition, India may also have to look at US shale gas to stabilize its high oil demand.

Crude oil is one of the critical commodities for India and changes in oil dynamics have repercussions on the external sector (including currency), fiscal math, inflation and financial markets. With the sanctions kicking off from 2nd May, 2019, it would be interesting to see how the various macroeconomic indicators of the Indian economy change course owing to increase in crude oil prices.