Economics

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Iraq Crisis: What does an increase of $ 10/barrel mean for us?

The unrest in Iraq threatens to aggravate oil supply shocks in a market already faced with disruptions owing to domestic turmoil in other petro countries viz. Libya and Nigeria. Concerns of potential lower oil supplies from key producer Iraq has pushed up global crude oil prices to 9 month highs in a short span of a week since the crisis erupted. As the unrest in Iraq rages, the risk of a spill over of the turmoil into neighbouring petro states has emerged, deepening fears of potential oil supply losses and concerns of long-term supplies from these regions.

Given India's vulnerability to a rise in global crude oil prices, considering that almost 75-80% of our consumption is met through imports, the sudden and rather steep rise in the same has the potential to dislodge the envisaged economic recovery of the country in the current fiscal.

It has the potential to:

- Widen the CAD and put pressure on exchange rate
- Hamper the fiscal consolidation intent of the government
- Increase inflation at a time when the news of a sub-normal monsoon has put pressure on food prices
- Delay any action on interest rates by the RBI

All these possibilities could come in the way of the revival of economic growth in the country which is expected given the early moves made by the government to reinvigorate the economy and put investment on a fast track.

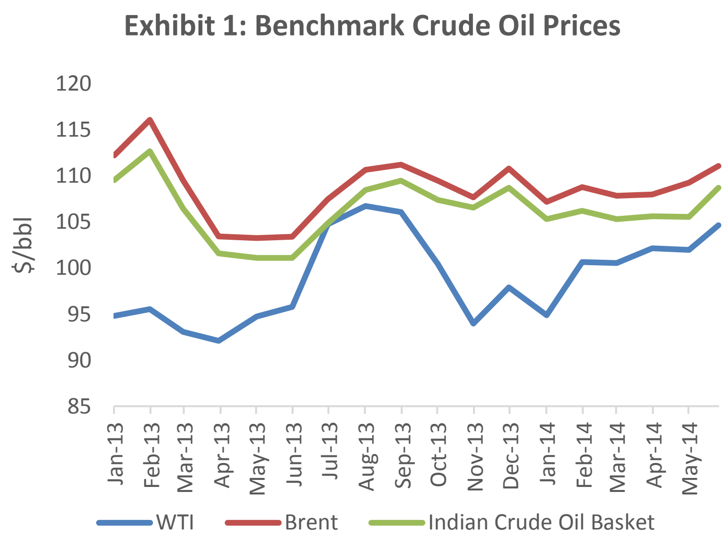
In the context of the escalating violence in key oil producer Iraq, the prevailing fundamentals of the oil markets and implications for oil import dependant India has been looked into here.

Price Movement

Since violence erupted in Iraq in the 2nd week of June'14, crude oil prices spiked to 9 month highs in a week's time. The benchmark WTI and Brent crude oil prices have risen by 4% (to $106/bbl) and 5% (to $ 114/bbl) respectively since the start of June'14. The Indian Crude Oil Basket (comprising the Oman Dubai sour crude and Brent crude in the ratio 69.9:30.1) too has seen a 4% increase (to $111/bbl) during the period. This increase in prices is solely driven by fears and speculation of supply disruption in Iraq.

Crude oil prices were seen to be ruling fairly stable in the run up to the Iraq violence. During Feb-May'14, WTI prices moved in the range $101-102/bbl, Brent crude oil in the range $108-109/bbl and the Indian Crude Oil basket was moving between $105-106/bbl. Price volatility during the period eased due to stable supply and demand fundamentals. The supply concerns from the continued violence in Ukraine and delayed return in Libyan output and exports were outweighed by the increase in US stocks to record levels. On the demand side, increased buying from the

Asia-Pacific region with refineries there coming out of maintenance balanced the lower crude demand in regions with economic weakness.



The exhibit alongside shows trends in the movement of crude oil prices since January 2013. The levels have appeared to go back to the Jan 2013 ones which were in the region of $ 115. Benchmark crude oil prices although still ruling at elevated levels have been steady in recent days, supported by reports of normal oil production in Iraq. However, prices are being pressured by the possibility of export disruptions with the spread of violence.

Iraq and the Oil Markets

Iraq accounts for nearly 4% percent of global crude oil production and is OPEC’s second largest producer after Saudi Arabia. Its daily average production in May’14 stood at 3.3 million barrels *(Source: OPEC).* Iraq’s oil production has increased in recent years with the country adding 1 million barrels/day output over the last 3 years. Crude oil exports from the country have registered a significant increase this year from 63 million barrels in Jan’14 to 80 million barrels in May’14 *(Source: Ministry of Oil, Iraq),* despite the sabotage of its Kirkuk pipeline (in the north) which led to a stoppage of pumping there since March’14 (exports from Kirkuk stood at 8.2 million barrels in Feb’14). Iraq’s southern regions accounts for the bulk (over 85%) of the country’s oil production which is shipped abroad from there. Exports from its southern ports in May’14 at 2.582 million barrels/day were the highest in over a decade.

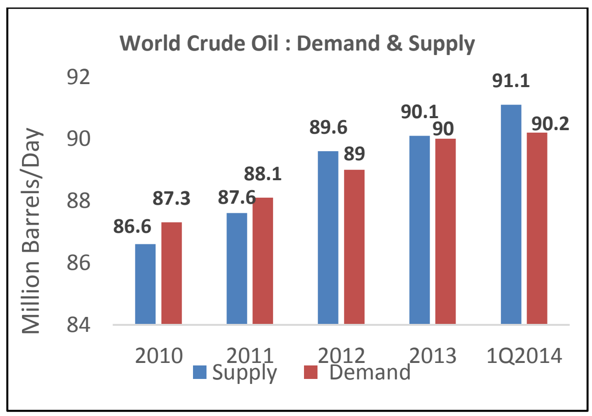
Iraq’s oil production is undisrupted by far as the ongoing violence has been restricted to the northern and western parts. The country’s oil exports too have so far been unaffected. On the contrary production and exports from the country’s southern regions are slated to increase in coming months with new infrastructure in place and large projects in the process of completion. Iraq is targeting crude oil output of 4 million barrels/day by the end of 2014, 21% more than its May’14 output.

Fundamentals: Demand and Supply

In terms of supply, global crude oil supplies have been on the rise, having grown 1.2% in the first quarter of 2014. It increased by 0.2 million barrels/day to 90.99 million barrels/day in May’14. OPEC’s output, at 30 million barrels/day (as of May’14), accounts for around 33% of global production. OPEC has indicated that it would be maintaining stable supply levels despite political disturbances in its member nations that could impact their domestic output, suggesting that members nation’s with spare capacity would fill in the shortfall. In recent years when production from OPEC member nation’s such as Libya and Nigeria dropped owing to domestic crises, increase in output from other member nations with spare capacity viz. Saudi Arabia, has helped maintain overall OPEC supply levels. Moreover, non-OPEC supplies have been on the rise, from 52.86 million barrels/day in 2012 to 54.20 million barrels/day in 2013 *(Source: OPEC)* and the forecast for 2014 has been put at an average 55.6 million barrels/day in 2014. The increase in non-OPEC supply is largely being credited to the rise in US crude oil production, which added over 1 million barrels/day output in 2013, taking its total output to 11 million barrels/day. The total non-OPEC oil supply including the natural gas liquids (NGL) is forecast, by OPEC, to grow from 59.9 million barrels/day in 2013 to an average 61.5 million barrels/day in the Apr-Dec’14 period. Assuming stable output from OPEC (of 30 million barrels/day), global oil supply for the 9 month period would average 91.5 million barrels/day.

	Global Crude Oil Supply				
	2010	**2011**	**2012**	**2013**	**1Q2014**
Non-OPEC Supply	**52.4**	**52.4**	**52.9**	**54.2**	**55.6**
OPEC Supply	**29.2**	**29.8**	**31.1**	**30.2**	**29.8**
Natural Gas Liquids + non conventional oil	**5**	**5.4**	**5.6**	**5.7**	**5.7**
Total Supply	**86.6**	**87.6**	**89.6**	**90.1**	**91.1**

**Source : OPEC*



**Source: OPEC*

With the global economy expected to see improved economic growth in the current year, world oil demand too is estimated to increase. OPEC forecast’s oil demand to increase by 1.3 million barrels/day (in Q12014) to 91.46 million barrels/day during Apr-Dec’14.

Also, global oil inventories/commercial stocks and reserves are on the rise, both in the developed (US, Europe) and developing countries (viz. China). Many countries are seen building up their Strategic Petroleum Reserves (SPR). In Q12014, developed countries had 1,586 million barrels in their SPR, providing 35 days of forward consumption cover (Source: OPEC). Their commercial stock for the period was 2,570 million barrels, providing a forward cover of 57 days. Any tightness in the oil markets would see countries tapping into their reserves.

Thus, based on prevailing conditions and projections, the rise in global oil supplies is seen to be adequate to meet the growth in demand for the remainder of the year, indicating a balance in the global oil market.

Implications for India

The physical dimension

India's is the world's 4th largest crude oil importers, importing nearly 75-80% of its energy requirements and is thus highly sensitive to actual/perceived disruption in supply of the same. Crude oil is one of the most essential commodities for India and greatly influences the domestic economy. The country's envisaged growth in coming times would largely be an energy driven one, both in the rural and urban areas. Consequently, its oil import dependence would increase further.

Iraq met nearly 13% of India's crude oil requirements/imports last year and is its largest source of crude oil imports after Saudi Arabia. In the current year, India's planned oil imports from Iraq are to increase to 20% (19.4 mn metric tonnes) of its total requirement. Indian oil marketing companies (OMCs) such as IOCL and HPCL are the main importers of this oil. Of the 18.7 mn metric tonnes contracted to be imported by the 2 OMCs from Iraq, 50% has already been imported as reported by the Ministry of Petroleum. Attempts are also being made to increase buying from other oil suppliers such as Saudi Arabia and other Middle Eastern petro states.

In terms of stocks/reserves, India currently lacks a strategic oil reserves that can be tapped into in times of supply crisis. Construction of 3 strategic reserve facilities with a combined capacity of 5 million tonnes has been underway and there are plans to construct 4 additional such reserves with a capacity of 12.5 million tonnes. However, India oil marketing companies reportedly carry inventories for around 30 days

India's vulnerability

CAD

Already struggling with record low growth, high inflation, a weak currency, low manufacturing growth and possibility of sub-normal monsoon, the threat of oil supply shock and the resultant increase in prices add to the risks faced by the country which could hamper India's envisaged improvement in economic growth in FY15. If crude oil prices rise unhindered, it could lead to a reversal in the reduction in the current account deficits achieved in FY14, exacerbating the weakness in the domestic currency. ***CARE's estimate of CAD for the year is 2.5% of GDP assuming stable crude oil prices and a recovery in industrial production. A higher persistent price would upset this calculation.***

Exchange rate

The rupee has shown signs of strengthening in the recent past on account of a fairly steady trade deficit and higher capital inflows. The rupee had moved below the Rs 60/$ level and there was some consternation on the impact on exports. However, with some measures being taken to liberalize gold imports, the deficit was expected to widen. With crude oil prices increasing, it would pressurize the import bill and hence the traded deficit further. ***In the absence of a substantial compensation from capital inflows the rupee would tend to move in the Rs 60-61 band depending on the developments in the oil market*** as well as action being taken by the government and RBI. The latter becomes important as expectations start building of depreciation, which in turn causes importers to buy and exporters to hold back their dollars thus reinforcing the depreciation.

Fiscal strains

The fiscal strain too could increase and the fiscal consolidation intent of the government by way of subsidy reduction could fail to materialize. Petroleum subsidy is one of the major subsidies of the government and at Rs. 96,880 crs accounted for 38% of the government subsidy in FY13 and at Rs. 85,480 crs for 33% in FY14 (as per the estimates of the interim budget for FY15). There has been an attempt to reduce the petroleum subsidy by way of reduction/doing away with administered prices for petroleum products i.e. diesel and petrol. Petroleum subsidies were 12% lower in FY14 and were expected to be lowered further in the final budget for FY15. ***An increase in crude oil prices could result in the contrary. Higher crude oil prices would reduce flexibility for the government in managing subsidies considering the stiff trade-off with inflation.***

Given the sub-normal monsoons this year the government would have to provide compensation to the farm sector along with contributing towards food subsidy too would place a heavy burden on government finances, inhibiting allocation of funds towards the much needed investments which in turn would impact economic growth.

Inflation

The rise in crude oil prices could further aggravate the inflation situation which has already been on the uptrend even before the impact of weak monsoons sets in. It is estimated that a persistent increase of 10% in crude oil prices (which is roughly $ 10 per barrel) will increase WPI inflation by roughly 0.7% directly assuming that LPG and kerosene continue to be protected as is today and diesel is market driven as per the current calibrated approach. The indirect effect through pass through transport charges would be roughly half of the direct impact***, thus leading to an overall increase of 100 bps in inflation.***

The under recoveries/losses of oil marketing companies could widen with the rise in crude oil prices. In FY14, the under recoveries stood at Rs.1,39,869 crs, 13% lower than that in the previous fiscal on account of the gradual de-regulation in diesel prices.

Monetary policy

The RBI has indicated that it would be looking closely at inflation when taking a call on interest rates. With inflation being stable for some time, it was hoped that the RBI could consider cutting rates at some point of time. The possibility of an adverse monsoon did push back such expectations. ***Now with oil prices rising and the possibility of higher fuel inflation adding to inflationary expectations, any sustained increase in prices would hold back any decision to lower interest rates. In fact, in case the crisis escalates and inflation increases sharply, a rate hike may not be ruled out.***

Concluding remarks

An immediate resolution of the crisis seems unlikely. It could be a long, drawn-out conflict with possibility of spill-over to other countries. Although the upside to oil prices seems limited given the prevailing fundamentals, the uncertainty surrounding the crisis could prevent a reversal in prices from recent highs. The ramifications of the crisis on the long term prospects of Iraq's oil industry will have to be closely watched. India could seek diversification for its crude oil imports and build up on its reserves to tackle risk associated with geo-political instability.

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