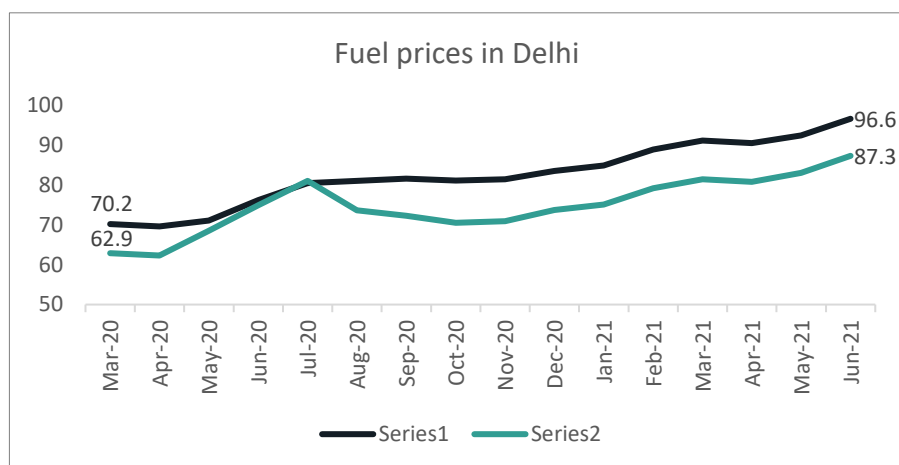


Runaway inflation in fuel: Is there an end?

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The rising prices of petrol and fuel has spooked the market which sees inflation climbing, that in turn has affected the bond market as the RBI has held on to the yield curve. How significant is the impact of fuel price hike?

If we look at Delhi, where the prices are more moderate relative to other cities, the increase has been sharp. Petrol is up from Rs 70.2/ litre in March 2020 to Rs 96.6/litre in June 2021 (It has crossed Rs 100 mark in July). For diesel, it was from Rs 62.9/litre in March to Rs 87.3/litre in June. The increase of between Rs 24-26.5/litre is quite sharp and represents increase of 37.6-38.7%.



Source: CMIE

The global price for Indian mix (Indian crude oil basket) has more than doubled from \$ 33 /barrel in March 2020 to \$ 72/barrel in June 2021. But this cannot be taken at face value as the prices of petrol and diesel did not come down when the crude oil price slumped to the \$ 33 mark. Table 1 below tracks the average monthly prices of Indian mix of crude along with the Delhi prices of petrol and diesel for first 5 months of 2020. As can be seen there has been intransigency in prices at the domestic end and this can be attributed to the high rate of taxes levied on these fuels which has been illustrated in Table 2. The tax rates are not uniform across states as states have the prerogative to decide the rates of local levies or value-added taxes. This is over the central taxes and hence automatically increases if excise is raised.

Table 1: Prices of Indian Crude Oil basket, Petrol and Diesel

	Indian mix \$/bbl	Petrol Rs/l	Diesel Rs/l
Jan-20	64.1	75	68.1
Feb-20	54.9	72.2	65.1
Mar-20	33.3	70.2	62.9
Apr-20	20.5	69.6	62.3
May-20	29.7	71.1	68.5

Source: CMIE

Table 2: The price build-up of petrol and diesel in Delhi as of 1st July 2021.

Per litre	Petrol	Diesel
Price to dealer	39.33	41.78
Excise	32.90	31.80
Dealer commission	3.82	2.60
VAT	22.82	13.05
Final price	98.87	89.23

Source: HPCL

As can be seen the share of taxes in price for petrol is between 50-56%.

Petrol and diesel along with other products like kerosene and LPG are major revenue earners for the government as the table below shows for FY21.

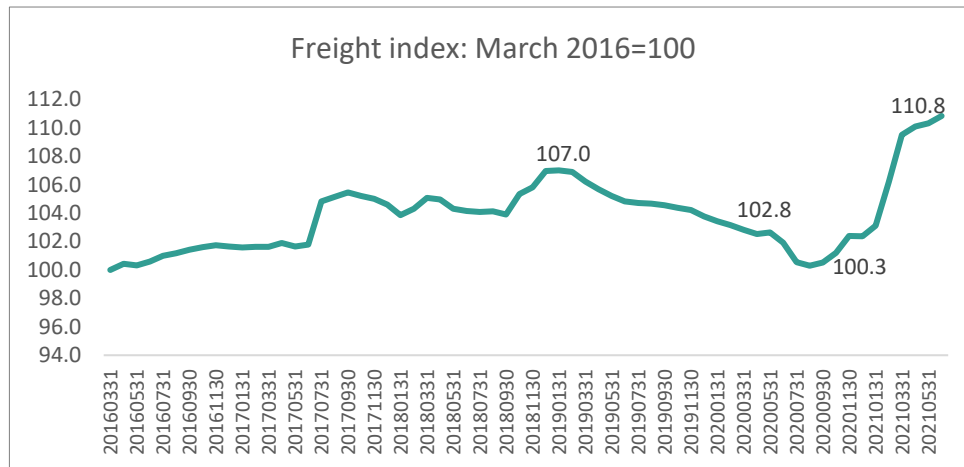
Table 3: Revenue earnings by government on fuel

Rs crore	
Central exchequer	418,637
Of which excise	371,726
State exchequer	217,721
Of which VAT	202,937
Total	621,574

Source: PPAC

Impact on inflation

In terms of the WPI (wholesale price index), petrol and diesel have weights of 1.6% and 3.1% respectively in the index. The WPI inflation (year-on-year growth) for both these fuels in June'21 reached 62.3% and 66.3% respectively. The weight in CPI for petrol is 2.18% while that for diesel is 0.15%. But this would be just the primary effect. The secondary effect is more pernicious as it percolates into prices of other goods too by way of transport, logistics and freight costs. The Chart below gives the movement of an imputed freight index with March 2016 as the base. It is an equally weighted average of monthly freight costs recorded for Delhi to 14 different locations for a 15-ton truck.



Source: CMIE, CARE Ratings

What does the chart show? Freight rates have been fairly stable over this period starting March 2016 and if the change is reckoned on a point-to-point basis it would be 10.8%. However, the problem of inflation in freight gets highlighted when one looks at the movement over the last one year or so. Compared with March 2020, the index has moved up by 7.8% while if compared with last June, it is up by 8.7%. Interestingly due to the recession in the country, freight rates had dropped between March 2020 and August 2020 by 2.4%.

Subsequently with crude oil prices moving up the freight index has gone up by 10.5%. This is a significant number as this cost gets embedded in the cost of all goods that are transported by road which includes foodgrains, horticulture, raw materials, oil, milk etc. Therefore, a part of the inflation that is being witnessed in commodities can be attributed to high transport costs as this gets transmitted to the retail prices. Even for agro products road transport costs increase once they leave the primary mandi to be sold in different regions.

What needs to be done?

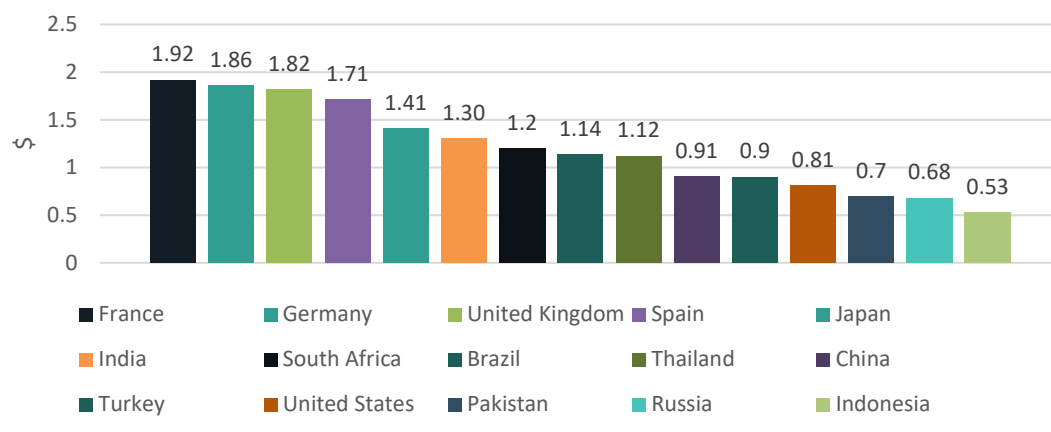
As the cost of crude oil is determined in international markets the onus is on the government, both the states and centre, to coordinate to lower their taxes. As long as they remain unchanged the component of price to dealer will keep changing as global price rises. In the past there was a subsidy which helped to buffer prices when crude was above \$ 100/bbl. Under the present decontrolled regime, the governments have to probably give in. VAT rates need to be reduced at a rate that ensures that state revenue is not compromised. Presently there are runaway gains as the revenue increases by more than proportion when the taxable price of petrol and diesel increase. The centre too must work towards lowering the excise rates.

The phenomenal increase in excise collections last year was due to higher duties as consumption was lower. For example, in FY21 consumption of petrol was around 3,900 crore litres of petrol and 8,600 crore litres of diesel. The combined consumption is around 12,500 crore litres and hence a Rs 1 reduction in taxes will mean just Rs 12,500 crore of outflow. This can be a big compromise!

How is petrol priced in other countries?

This is an interesting question that is often asked. What is the price of petrol in other countries? Such a comparison is not really appropriate due to the variations in currencies against the dollar. As the rupee is weak against the dollar with the exchange rate being in the region of Rs 74-75/\$ it would tend to lower the value. Yet, the comparison is insightful and is presented in the graph below.

Petrol prices \$/litre in June 2021



Source: Trading Economics

As can be seen in the graph producers of oil have an edge when it comes to pricing though the low price in Pakistan is an aberration. Saudi Arabia has a price of 0.62/litre while it is lowest in Bahrain at \$ 0.37 (not in graph). As the global price is in the same range for all countries depending on the quality that is being used, the tax element provides the differentiation. India is high at \$ 1.30/litre, though still lower than France, Germany, UK and Spain.

As currency value does tend to tilt the picture for countries, another way of looking at the price of petrol is to compare the same with the price of a staple like milk. Milk is a unique commodity which is consumed everywhere. In India it has the feature of witnessing a constant increase in price every year, and unlike other perishables where prices can move down when there is excess supply, it is not the case with milk. The formation of the cooperative approach to marketing has ensured that there is really no downside to price for the farmers even while output can vary. Therefore, the ratio of petrol to milk price will throw more light on the extent to which the fuel is fairly priced.

Table 4: Ratio of Petrol price to milk (prices are \$/litre for both)

Country	Ratio	Country	Ratio
	>1.0		<1.0
India	1.91	Pakistan	0.95
Spain	1.84	United States	0.94
Germany	1.79	Australia	0.86
France	1.64	Japan	0.79
Brazil	1.44	Russia	0.76
United Kingdom	1.43	Bolivia	0.68
Denmark	1.40	Thailand	0.68
Turkey	1.36	South Korea	0.67
Sweden	1.35	Philippines	0.64
Austria	1.20	Canada	0.57
South Africa	1.12	Indonesia	0.42
China	1.02		

Source: Trading economics and www.numbeo.com

The table above shows that the ratio is highest for India at 1.91 followed by Spain, Germany and France. US, Pakistan, Japan, Russia and the southeast Asian nations have a ratio of less than 1. Quite clearly the price of petrol in India is mispriced due to factors discussed earlier especially in the area of taxation.

The way forward

With global crude oil prices likely to only increase with a stalemate on supplies by OPEC + countries the possibility of fuel prices galloping cannot be ruled out. At some stage the government has to intervene because it is not just a case of saying that petrol and diesel are used by the higher income groups. It enters transport costs which get embedded in the final prices of all commodities. The fact that fuel is not in the GST gives freedom to the government to increase taxes without any constraint. But allowing prices to increase has distorted inflation which in turn has kept the bond market edge. The RBI's resolve to manage the yield curve has caused a disconnection between monetary policy action and interest rate action.

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