Macro Impact of Higher Crude Prices on India

September 13, 2023 l Economics

Concerns surrounding crude oil prices have resurfaced as Brent prices touched the psychological mark of USD 90 per barrel last week. Given India's oil import dependency averages around 85%, sustained upward pressure on international crude oil prices can carry significant macroeconomic implications. The income elasticity of domestic crude oil imports is higher than the price elasticity. Consequently, as the domestic economy grows, Indian crude oil imports tend to rise more rapidly than they respond to price fluctuations. On a global scale, India currently stands as the world's third-largest consumer of crude oil, and its import volumes are expected to remain elevated in the coming years, even in the face of global crude oil price volatility. In addition to domestic consumption, India maintains a substantial refining capacity, exceeding 250 million tonnes per annum, positioning the country as a net exporter of refined petroleum products.

The volatilities in global crude oil prices are largely attributed to geopolitical factors. Remarkably, despite a decelerating global economy and higher global interest rates, crude oil prices have surged to USD 90 per barrel, a level last observed in November 2022. The recent surge is primarily due to supply reduction announcements from key players such as Russia and Saudi Arabia. Markets had previously factored in an extension of Saudi Arabia's voluntary production cuts, which commenced in July to continue till October. However, Saudi Arabia has now set a production target of 9 million barrels per day (mbpd) for the remainder of the year, down from 11 mbpd in October 2022. Russia which also produce around 9.4 mbpd has extended its 300,000 barrels per day export reduction until the end of December to bolster the Ural prices. Thus, a prolonged reduction in crude oil production will put upward pressures on prices.

Evolving Global Dynamics of Energy Market and Indian Imports

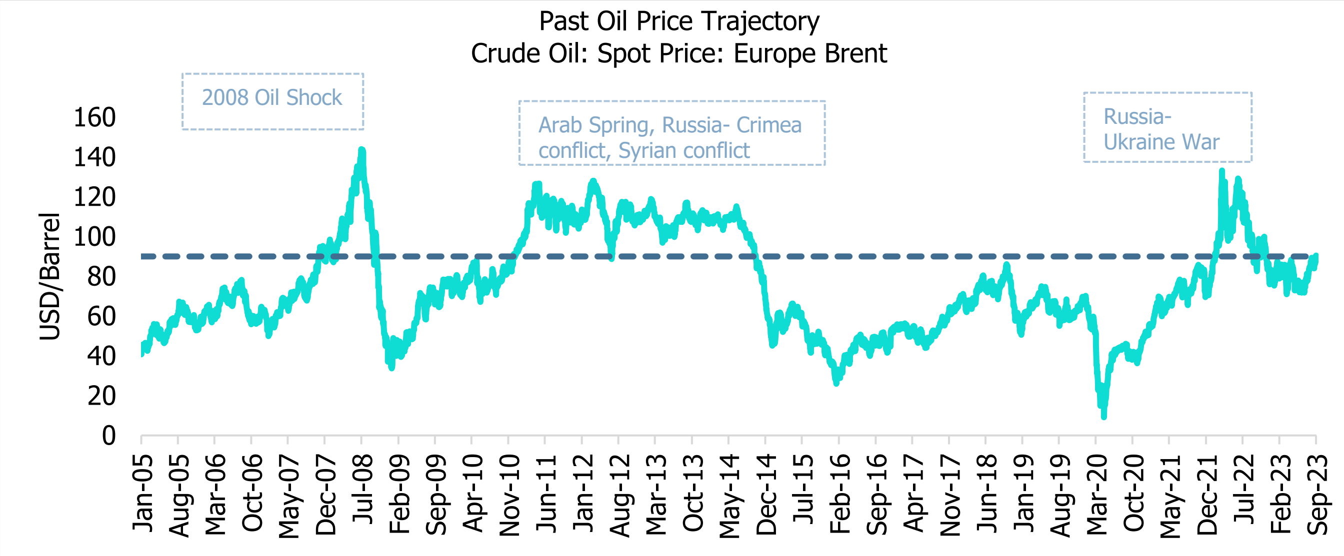
Over the course of the past year, India has experienced a notable increase in its imports of subsidized crude oil from Russia. However, recent data has illuminated a deceleration in the import of Russian crude oil due to a diminishing price differential when compared to other global crude oil benchmarks (refer Exhibit 2). For instance, the Brent-Ural price differential, which averaged approximately USD 28 per barrel in January 2023, has now halved to roughly USD 14 per barrel as of the first week of September (refer Exhibit 2). In the most recent week, the price of Russian Urals crude oil crossed USD 75 per barrel, surpassing the price cap of USD 60 per barrel enforced by Western nations. With rising Ural price, the share of Russian crude oil in India’s total import has reduced to 34% in August from 43% in April.

The concerns have been prompted by OPEC nations surpassing their pledged reductions in crude oil supply. The top ten OPEC nations have exhibited a high compliance rate of 262%, implying they have actually cut production much more than what they had pledged (refer Table 1). Higher adherence to supply cuts have resulted in diminished global supply of crude oil.

Despite the anticipation of these supply pressures persisting, the global demand for crude oil is expected to remain subdued due to the muted growth prospects of the global economy. The recent downturn in China's property market has adversely affected economic momentum, and contrary to expectations, the anticipated post-pandemic surge in consumer spending did not materialize, even after the reopening of the Chinese economy.

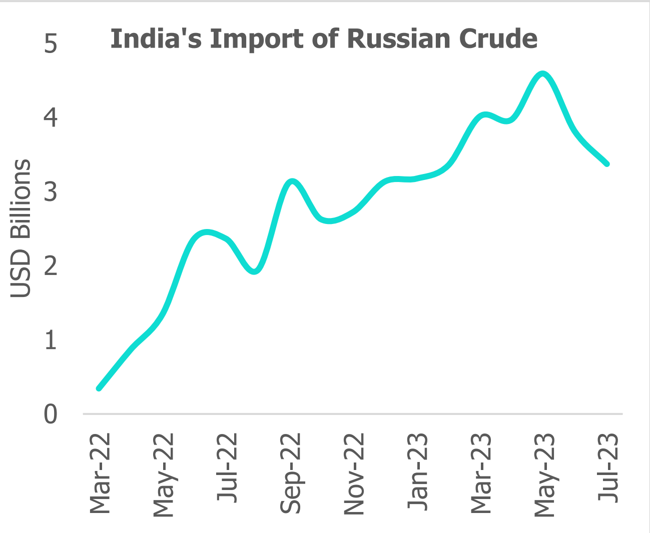
Over the past two decades, crude oil prices have failed to sustain above the USD 90 per barrel threshold for a long period unless major war or conflict-induced disruptions occur. Even in cases where there is a overshoot in international crude oil prices, historical trends suggest that corrections are likely to follow.

Exhibit 1: Historical Brent Crude Prices

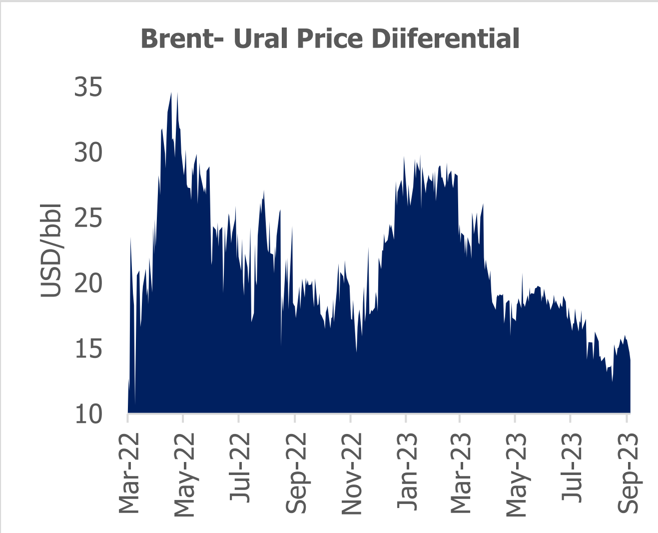


Source: CEIC

Exhibit 2: Narrowing Brent Ural differential has reduced import of the Russian Crude



Source: CMIE, CareEdge

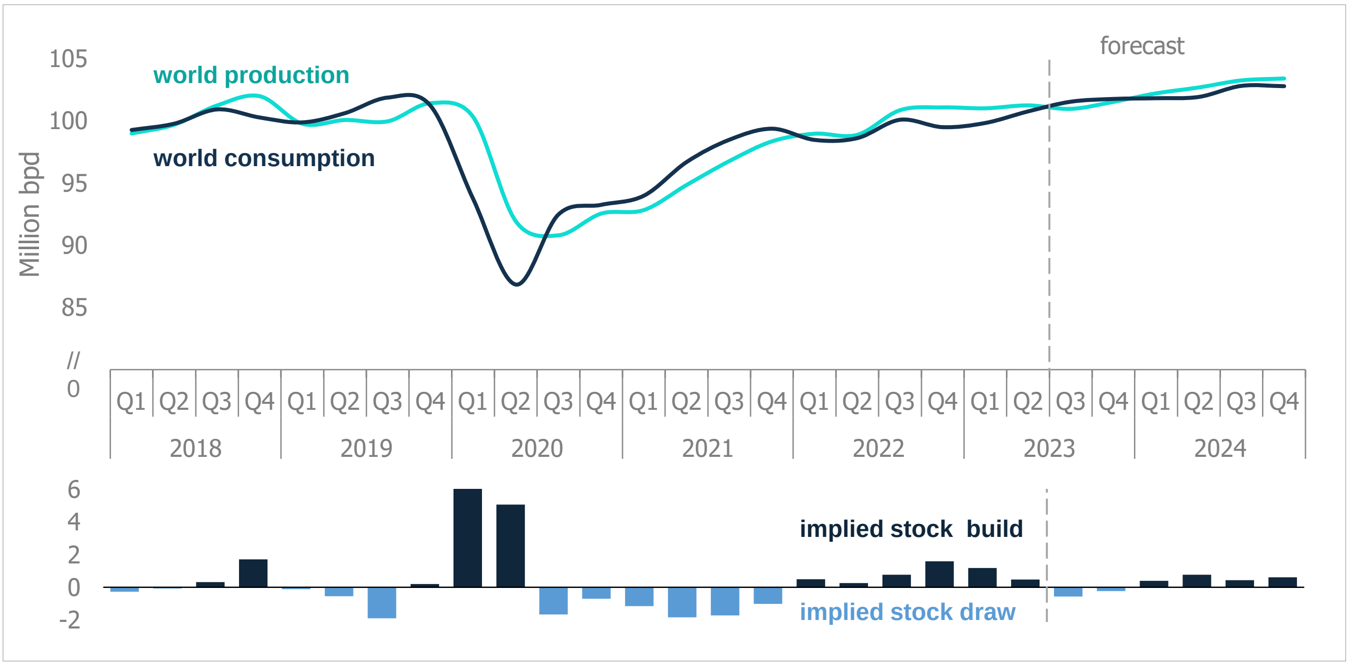


Source: Refinitiv, CareEdge

Table 1: Supply-side pressure continues due to higher compliance from OPEC nations					
	Actual Production (Million bpd) [A]	Baseline for cut (Million bpd) [B]	Pledged cut (bpd) [C]	Cut achieved (bpd) [D]	Compliance (%) [E]
Algeria	0.94	1.06	48000	115000	240
Angola	1.08	1.53	70000	445000	636
Congo	0.27	0.33	15000	55000	367
Equatorial Guinea	0.06	0.13	6000	67000	1,117
Gabon	0.19	0.19	9000	-4000	-44
Iraq	4.22	4.65	220000	431000	196
Kuwait	2.55	2.81	135000	261000	193
Nigeria	1.37	1.83	84000	456000	543
Saudi Arabia	9.01	11.00	526000	1994000	379
UAE	2.89	3.18	160000	289000	181
Total OPEC 10	**23.36**	**26.69**	**1273000**	**3329000**	**262**

A: Actual Production as of 31 August 2023.
B: Baseline from cut refers to the daily production for before the supply cut started.
C: Initial reduction in pledged production.
D: Actual reduction in production; D = [B] – [A]
E: Compliance is the ratio of achieved cut and pledged cut; E = [D] / [C]
bpd: Barrels per day

Exhibit 3: World liquid fuels production and consumption balance



Source: US EIA, Short-Term Energy Outlook, September 2023

The substantial reduction in production by leading OPEC nations is anticipated to result in an imbalance between supply and demand, primarily during the Q3 and Q4 CY 2023. Nevertheless, sluggish consumption growth is expected to counteract this supply-demand gap starting from 2024. According to the global demand and supply projections by the US Energy Information Administration (EIA), despite the ongoing production cuts, global liquid fuel production is predicted to surpass liquid fuel consumption by the first quarter 2024. Consequently, this will result in a build-up of inventories and likely exert downward pressure on crude oil prices.

Given the circumstances, Brent crude prices will likely maintain an average range between USD 87 and USD 92 per barrel for the remainder of the financial year unless unforeseen tail risks materialise.

Impact on Indian Economy

India, being heavily reliant on energy imports, is particularly vulnerable to fluctuations in international crude oil prices, which can significantly impact macroeconomic stability.

Impact on Inflation: If the higher global crude price is transmitted to the retail market, it can increase domestic inflationary pressures. However, given that there is already pressure on CPI inflation, due to higher food inflation, there would be pressure on oil marketing companies (OMCs) not to hike retail petrol/ diesel prices. In fact, recently the government reduced LPG cylinder prices by INR 200-400, depending on the beneficiaries of the Ujjwala scheme. As we approach the pre-election period, we anticipate that OMCs will absorb a significant portion of the elevated global crude prices. The government may also consider partially sharing this burden with OMCs by reducing certain duties and taxes on retail fuel prices. **Given the expectation that retail fuel prices are unlikely to be affected, there would be no impact on domestic inflation.**

Impact on CAD: We had projected a current account deficit (CAD) of 1.6% of GDP for FY24, based on the assumption that the India crude oil basket would average USD 85 per barrel for the fiscal year. The Indian crude oil basket has averaged ~ USD 80.1 per barrel in the first five months of FY24. But the price of the Indian crude basket touched USD 90.7 per barrel in the first week of September. If Brent crude prices remain elevated at this level for the remainder of the fiscal year, we anticipate that the full-year average price for Indian crude oil basket could be ~ USD 86-87 per barrel.

Assuming India imports ~ 5 million bpd of oil, the full-year current account deficit will likely increase by approximately 20 basis points (bps). Consequently, CAD may increase to 1.8% of GDP if Indian crude basket averages ~USD 90 per barrel for the remainder of the year.

Impact of Fiscal Balance: Since OMCs are expected to bear most of the rise in global crude prices, we expect the risk of fiscal slippage to be limited. However, if global prices stay higher for longer, the government may decide to partially absorb the increased costs associated with higher global oil prices by sharing the burden with OMCs. Central excise duty still constitutes ~20.6% of the overall retail price and the Centre can reduce it in case global oil prices shoot up further. To cover up for the loss of revenue from reduced excise duty on domestic retail prices of petrol/diesel, the Centre may raise windfall taxes further and hike Special Additional Excise Duty (SAED) on the export of refined petroleum. The government has already hiked the windfall tax on petroleum crude to Rs 7100 rupees per tonne from Rs 4250 per tonne in mid-August but reduced it again to Rs. 6700 on 1st September. **Consequently, we don't see much impact of the higher crude oil prices on government finances.**

Table 2: Composition of Retail Price of IOCL (As of 1st Sep 2023)

Base Price including freight charges	Rs. 57.3
Average Dealer Commission	Rs.3.8
VAT	Rs.15.7
Excise duty	Rs. 19.9
Retail Price of IOCL in Delhi	**Rs. 96.7**

The recent rise in global crude oil prices is majorly due to steep and prolonged supply cuts by major crude oil producers and we need to monitor further developments carefully. Since OMCs are expected to absorb much of the recent volatility in crude oil prices, it is unlikely that there will be impact on inflation. In the present context, the downside risk of fiscal slippage appears remote. However, rising crude oil import bills may result in widening of the current account deficit. Having said that, RBI and the government have enough firepower to tackle the external headwinds.

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