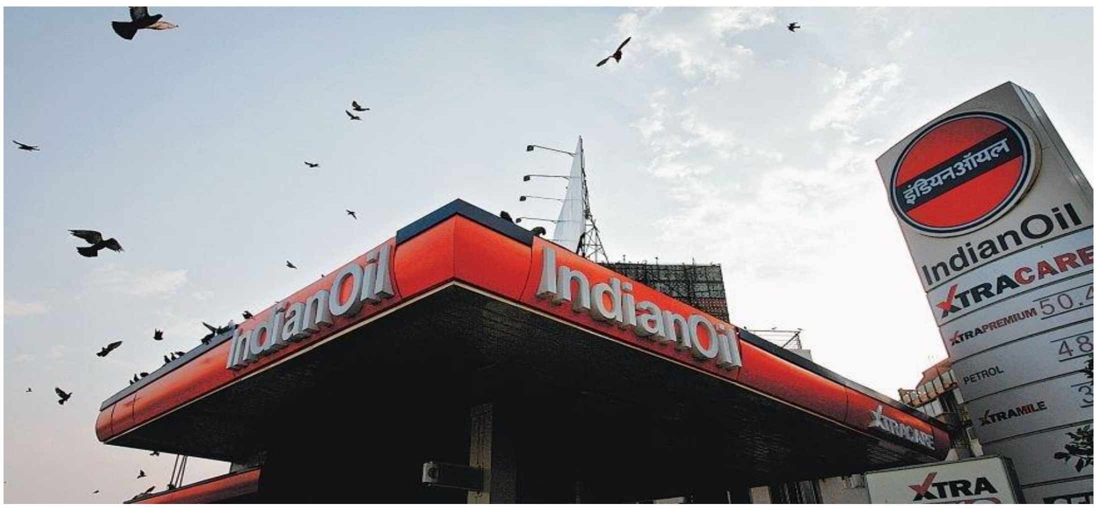
BW BUSINESSWORLD

Oil On A High; Govt Goes Dry

Crude oil is the most traded commodity in the world – more than all metals market combined! All countries are integrated in this market



Dealing with high oil prices is a complex affair as it involves geo-politics & exchange rates variations also, which further impacts almost all aspects of economy. Diesel price, in Gurgaon, breached Rs 70 barrier. I could see the discomfort in Bablu's expression – our cab driver. He had negotiated his deal about providing cab service to the institute, considering diesel price would remain below Rs 67. He wanted to understand why the price is rising and why isn't government doing anything about it? I wonder how do I explain this to him? The reasoning is more complex than the widely quoted reasons like.

- Donals Trump's decision to re-impose sanction on Iran
- Opec's decision of recent past to cut oil production
- Venezuala's deteriorating oil industry
- Geopolitical instability caused by Iraq, Libya, Syria and Yemen
- Global GDP growth rate going towards 3.9 percent.

Crude oil is the most traded commodity in the world – more than all metals market combined! All countries are integrated in this market. Asia, home to fastest growing group of countries, is dominant and will pay more than $1 trillion oil bill per year if oil prices stay around $80 per barrel. With this kind of spread and magnitude, the oil price gets impacted by myriad factors. Intricate enmeshing of these factors further adds to complexity. For instance, the Trump administration's decision to re-impose sanctions against Iran which exports 2.6 mbpd of crude oil. The scarcity caused by sanctions will lead to increase in price. Though the sanctions will kick-in in November, traders and refiners increase buying in expectation of future scarcity. Saudi Arabia, arch rival of Iran in OPEC, sees it as an opportunity and has targeted to increase its production. Russia too has planned to increase its production. With increased supplies the oil price should decline. Now Iran doesn't wish to lose its market share to anyone. So Iran has threatened that attempts by OPEC countries to usurp its market share will see disruption of oil trade through 'Straight of Hormuz,' which connects Persian Gulf with Indian Ocean and Arabian Sea. 85 per cent of the Persian Gulf's oil supplies pass through Straight of Hormuz to reach East Asia which is the major consumer of oil. Disruption here implies oil price rise. During 1980s Iran-Iraq war, both tried sinking each other's tankers. Some maritime experts believe that the supplies will not get disrupted as the ships are far better than the ships of 1980s. Most of them are double hull and can't be sunk unless very sophisticated attack happens. So supply of oil may continue but cargo insurance premium will rise significantly and eventually price of oil may rise. This is how a single actions can create ripples in this market.

Incidentally there are many such developments happening. One of the other reasons for price rise is the US second quarter GDP growth rate. It grew more than 4 per cent, resulting in increased energy demand hence increased crude oil price. This becomes a double whammy for the Indian consumer as he pays higher crude oil price as well as more rupees (INR) per US dollar (USD). Strong growth in US strengthens the USD as more investments come into US cutting off flows to emerging markets. Large amount US dollars flowed out of our economy to go back to US. INR, thus, weakens. Yesterday, the exchange rate was Rs 70.32 per USD. Crude oil price reported yesterday was $74.69. So, cost of 4.4 million barrels, that we import per day, amounts to Rs 2100.88 crores. By yesterday afternoon, while I was writing this piece, the Rupee had already depreciated to 70.52 per USD. The cost of import thus increases to Rs 2106.86 crore. Rs 6 crore addition in expenses in just half a day with just 20 paise depreciation. With exchange rate being Rs 63.80 on Jan 1, 2018. This amounts to paying around Rs 200 crore per day more in comparison to what we paid at the beginning of the year. Unfortunately, the Rupee-USD exchange rate depends on other countries' currencies too. For instance, Yuan has depreciated against USD due to US-China trade war; Turkish Lira has plunged into crisis due to its mounting foreign currency denominated debt; South African Rand has been falling due to conflicts over land rights. Such developments alter relative strengths of currencies and change the trade and investment flows around the globe and hence other currencies including INR may also weaken.

Now, who should bear the burden of increased crude oil price in rupee terms? Consumer or the government? Common man's expectation is that government should bear this burden. But where will the government pay from? The governments in India have always been in deficit. So how do they get the additional money to pay for the increased price? By increasing taxes. For a country where just 1 per cent of people pay tax, is it fair to burden the honest tax payer for consumption done by the entire country? No, I don't think so. Other alternative is that consumers pay the market price. This will make the oil demand more price elastic. Consumers will be more conservative in consuming if they have to pay higher price. Hence, overall import bill may remain in check. This leads to added benefit of arresting the rupee depreciation. The current government has followed this strategy and enabled market pricing for oil products. In order to cushion the blow on vulnerable households, it continues to provide them subsidy on LPG through cash transfer to consumers' bank account. Some people argue that government could have reduced the taxes on petrol and diesel. It is very important to note that the economy has been largely burdened with stressed assets – banking, power, roads, real estate and telecom etc. With industry not willing to invest, the government had to invest a lot to generate growth. At the same time fiscal deficit needed to be controlled to improve the country's ratings by the agencies like Moody and Fitch. In such a case, tax revenues from oil sector have indeed been a savior for our economy.

Interestingly, despite the increased crude oil price, the CPI based inflation came down to 4.2 per cent YoY growth in July 2018, though it had been rising in the past three months. This is largely because 'Food and Beverages' that has around 55 per cent weight in the CPI fell to 1.4 per cent, owing to bumper crop yield. 'Fuel and Lighting' that has around 8 per cent weight grew by 8 per cent during this period. Clothing, Footwear and Housing also fell marginally. Hence, overall the retail inflation fell. The increases in repo rates announced in the past two monetary policies have further contributed to arresting retail inflation. The government has been able to rein in inflation also because of prudent fiscal management. The fiscal deficit has been kept in check; the current account deficit has also been kept in check for last four years though now it seems to be moving towards 2.8 per cent of the GDP; demonetization has led to a significant increase in number of tax payers and electronic transactions; GST has been implemented and simplified to yield buoyant tax revenues; IIP has grown by 7 per cent in June 2018, which shows a promise of revival in manufacturing; and RBI, IMF, Moody's all project India's GDP to grow at 7.3 -7.4 per cent and remain the fastest growing large economy. Hence, I would like to allay any fears of high crude oil price as I expect the incomes to grow much more enabling us to buy even more. Bablu… sun raha hai na tu!!!

The article can be read online here.