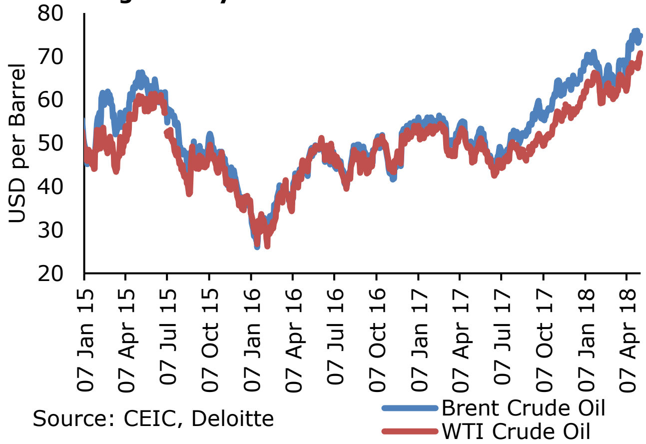
Will the build-up in crude oil prices put India's growth under stress?

India has long benefitted from lower crude oil prices, especially as energy demand has seen considerable rise with rapid economic growth. The southward movement in crude oil prices started during the latter part of 2015 on account of rapid expansion in unconventional sources, shift in OPEC policy, and changing market sentiments. Certainly, India benefitted the most as inflation and twin deficits – fiscal deficit and current account deficit – were brought under control. While the year 2015 saw production levels rise and oil prices fall, 2016 was marked by some correction as outputs fell while oil demand rose robustly. As per BP statistical review of world energy report[1], China and India together accounted for close to half of the increase in global demand for energy consumption in 2016, a trend which has likely continued in the ongoing period.

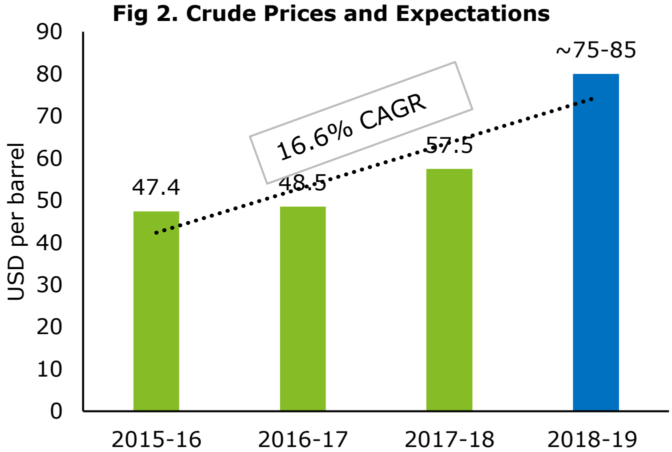
However, after marking a period of easing, oil prices started their up move beginning Nov'2017 and have now reached a USD 80 per barrel mark. We expect crude prices to see further hikes, as stifled supply and rising demand will likely push it in the USD 75-85 per barrel[2] range in the near term. A key reason for rise in crude oil prices in the recent past can be attributed to rising geopolitical risks, as well as on account of OPEC members and others holding their commitment for production cuts.

Fig 1. Daily Crude Oil Price Movement



Source: CEIC, Deloitte

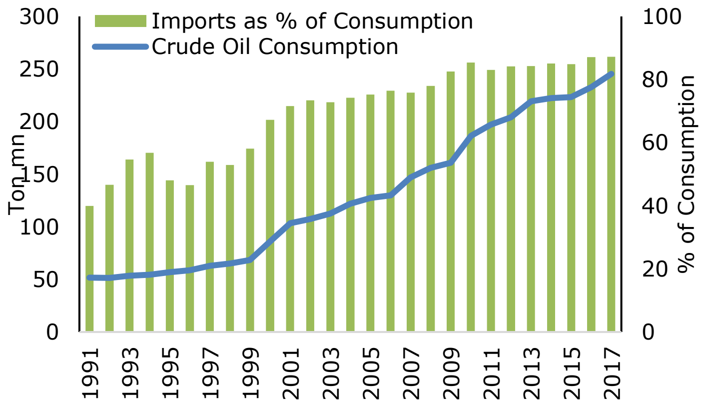
Fig 2. Crude Prices and Expectations



Source: CEIC, Deloitte

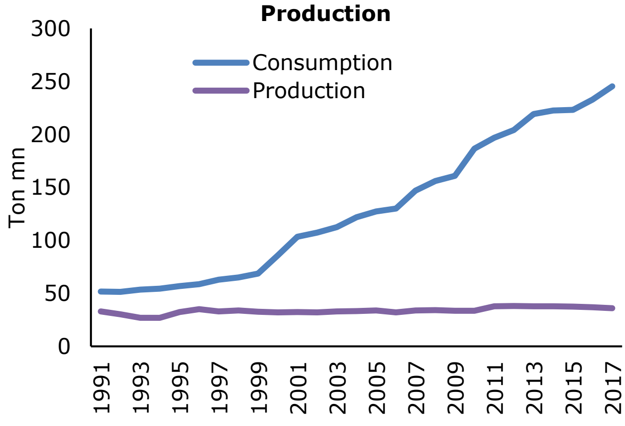
Currently, imports of crude oil accounts for more than 87% of the total energy demand (Fig 3) while the remaining is met via in house production capabilities. With limitations to production capacity and a corresponding rise in energy demand, it is safe to assume that imports of crude oil are likely to inflate in the period ahead. To provide clarity, oil & gas account for close to 35 % share in India's energy consumption[3] and should oil prices continue to remain at high levels, the Indian economy is looking at a scenario of higher inflation along with higher deficits, which may likely divert resources from consumption as well as productive investment. Even a partial pass-through of global increase in prices would imply that the oil marketing companies will have to absorb the underlying losses, ultimately putting pressure on public finances.

Fig 3. Crude Oil Consumption and Imports



Source: CEIC, Deloitte

Fig 4. Crude Oil Consumption and Production



Source: CEIC, Deloitte

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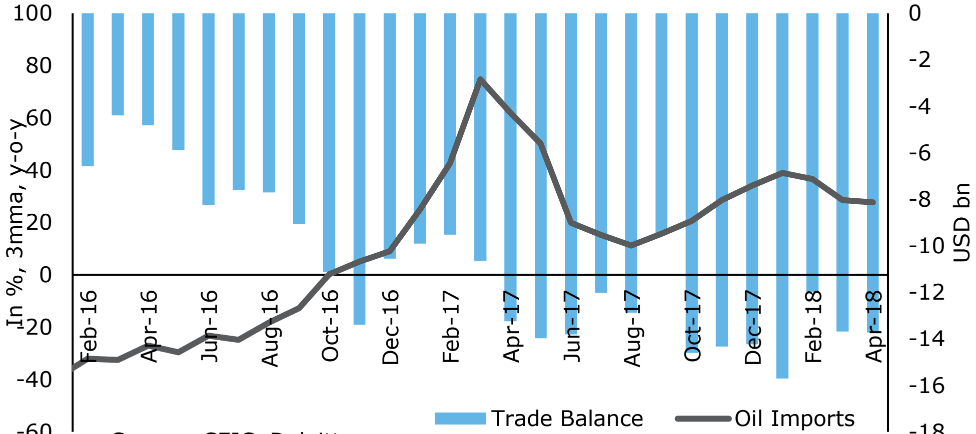
[1] https://www.bp.com/content/dam/bp/en/corporate/pdf/energy-economics/statistical-review-2017/bp-statistical-review-of-world-energy-2017-full-report.pdf
[2] CEIC and Deloitte Analysis
[3] https://www.investindia.gov.in/sector/oil-gas

To put things in perspective, crude prices (Brent) have inched up by more than 12% since the beginning of the year. What has followed on expected lines is a corresponding rise in petrol and diesel prices in the recent months. What may become a serious concern is the possible bulge in the imports bill, given oil imports form one of the largest chunk of shipments. The oil import bill is already more than INR 7 trillion in the fiscal year 2017-18[4] and it is expected to account for more than 4% of GDP. Hence, pressure on current account deficit is expected to rise while a parallel increase will possibly be felt in narrowing foreign exchange reserves, and widening of the trade deficit. It is important to note that, foreign exchange reserves remains an important accounting figure in terms of providing secure imports cover net, managing currency stability, and handling liquidity concerns. Over the recent months, foreign reserves recorded some deceleration, largely on account of weakening investor sentiments and improving dollar strength, and now with additional oil price concerns, further dip in foreign exchange reserves can also be expected. With the twin deficits likely to increase, current weakening of the rupee may also continue with a spiralling effect on imports and inputs become dollar expensive, impacting the already pressurized inflation prints.

Fig 5. Oil and Trade Balance (3mma, y-o-y, %)



Source: CEIC, Deloitte

With these developments, a greater challenge will be faced by the Reserve Bank of India (RBI) if financial market volatility increases, given rupee is already under a possible downward spiral as US economy gains strength. This could mean a sooner than expected rise in interest-rate given than a rise in crude prices with an accompanying weaker rupee will accelerate inflation. Ultimately, the impact will depend on how fast the positive growth in demand and investment can outweigh the growth in input and transport costs. It is in this sense that there is some urgency to get policies in place to increase short-term energy efficiency and allow for a long-term movement to alternate sources. If other parameters driving growth can be harnessed and short team efficiency measures can be put in place, such as reducing single vehicle commute, shifting to electric vehicles, solar power electric usage among others, dependence on energy imports can be eased, at least to some degree.

The long term solution is to shift to alternate sources of energy, including hydroelectric, wind, geothermal and solar power. India has made some progress in fostering an environment to boost alternative sources of energy, especially additions have been made in installed capacities of wind and solar power, and Electric Vehicles (EVs) have seen increasing market growth. But much more needs to be done. In a counter-intuitive way, the latest crude oil price rise can also be seen as a possible opportunity for pushing faster and effective implementation of policies that encourage renewable energy deployment.

Information for the editor for reference purposes only

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[4] CEIC and Deloitte Analysis