

Impact of Falling Oil Prices



Oil price has slumped by around two thirds, bringing much needed relief for the otherwise tormented consumers

Had it not been for the ‘Global Financial Crisis’, the year 2008 would have been remembered as the year of escalating oil prices.

Early last year, the price of crude oil hit \$100 a barrel for the first time - a record that was soon surpassed, as oil eventually peaked at \$147 six months later in July.

A year later, the price has slumped by around two thirds, bringing much needed relief for the otherwise tormented consumers. Basically falling demand due to the slowdown is the main cause for falling prices. A reasonably stable dollar too has a role to play in the softening of prices.

Whatever be the cause, this has led to a fall in inflation. In the absence of inflationary forces countries can use the available monetary tools more effectively to re-inflate their economies.

But why did oil prices soar?

For nearly two decades, following the oil boom of the 1970s, oil traded in a relatively narrow band, but rising demand from emerging markets, geopolitical unrest in the Middle East and concerns over a lack of supply drove up prices.

While China's consumption of around 7m barrels of oil per day is still dwarfed by the more than 20m barrels consumed daily by the US, the emerging giant is often cited as a critical factor in the rising oil price, as it accounts for around 40% of the increase in demand.

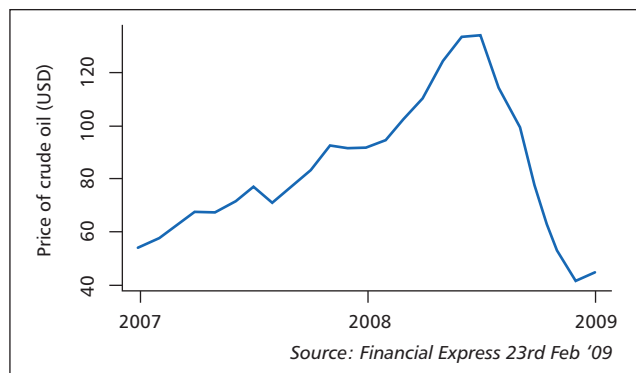
It is important to note, however, that an increase in demand from China also coincided with a long period of low crude prices, which resulted in a lack of investment in the industry.

A 2008 study found that while world oil production had risen by 40% over the past 20 years, refinery capacity had risen by just 15%, as oil companies refrained from investing in further capacity, as the price of oil was deemed too low to make the projects profitable.

Benefits accruing on account of decline in crude prices

The total crude oil import in India grew from 74.09 million tons at a total cost of \$12.9 Billion in 2000-2001 to 120.01 million tons at the cost of \$ 61.72 billion in 2007-2008. Since India imports more than three quarters of the total oil consumed domestically, the price inelastic crude occupies centre stage in India's economic growth.

Price of crude oil



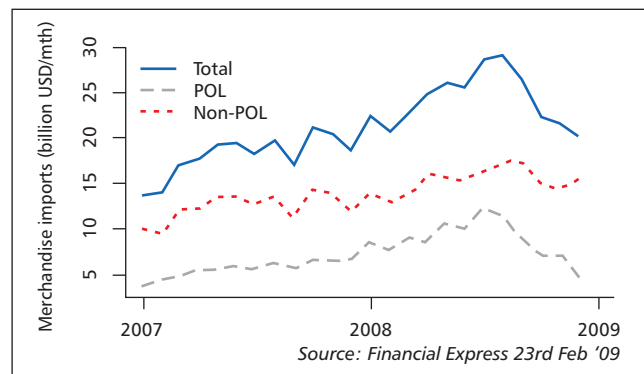
The above figure shows the price of crude oil which had dropped dramatically from a peak of \$147 a barrel in July 2008 to \$45 a barrel in January 2009. India imports roughly 2 million barrels a day of crude oil. The decline in the price of crude oil to \$47 per barrel provides a benefit of \$7.7 billion a month or roughly \$92 billion a year.

Against this backdrop of falling oil prices, it is important to understand the benefits for the economy.

- India now pays significantly less for imports. The chart below shows India's merchandise imports, expressed in billion dollars per month. The three series' shown below i.e. total imports, imports of Petroleum, Oil and Lubricants (POL) and Non-Petroleum, Oil and Lubricants (NPOL) illustrate a dramatic decline in imports of crude oil and products, from a peak of \$12.4 billion in July 2008

to the latest value of \$4.7 billion in December 2008. There was a saving of \$7.7 billion on this count alone. The reduction in crude oil prices has given India a substantial respite, one that roughly counter-balances the decline in equity flows and weakening INR against the US dollar.

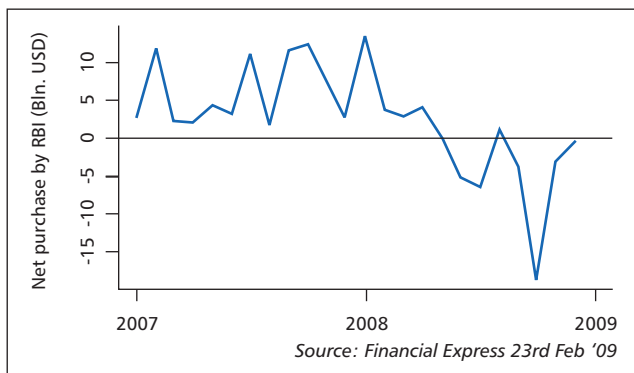
Merchandise Imports



- As seen above, the Kerosene and Diesel prices are highly subsidized in India. The subsidy bill of the government, shown in the off-balance sheet items (to understand the concept of off-balance sheet items please refer to the Prof *Simply Simple* lesson on page 10) could go down as would the subsidy on fertilizers. Subsidies as such are a bane for an economy and a reduced subsidy bill would augur well for economic prosperity.
- The benefits to India of this changed international environment could extend beyond crude oil. India is largely a commodity importer or a commodity re-processor. Decline in crude oil prices has reduced ethanol consumption world wide leading to softening of cane sugar and cereals prices. Numerous commodity prices have dropped, including energy, metals etc. Also, Indian imports of capital goods, machinery, telecom equipment, computer equipment have all benefited from the global softness in prices.
- Due to the global turmoil, India has not only witnessed a decline in capital in-flows but has also seen huge capital outflows. These outflows may have had a significant effect on the currency market. The RBI had to defend the rupee artificially for only one month: in October, the RBI

sold \$19 billion. But after that, the rupee has held up fairly well without any simulated props. In November, the RBI sold \$3.1 billion and in December, the RBI sold only \$0.3 billion. Thus while inflows have been hit, outflows are at their peak, i.e. exports are affected and the only savior for the rupee has been the decline in oil prices.

Net currency purchase by RBI



- Lower oil prices also boost profit margins and hence investment. If companies pass it on in terms of lower prices, then real personal incomes could rise along with consumer spending, assuming everything else remains unchanged. Increased consumption will stimulate the economy leading to higher growth of GDP. It is estimated by HSBC Global Research that a 10% decline in the price of crude would typically add GDP growth by 4 basis

points. The biggest benefit to India is also indirect — lower prices increase disposable incomes in the west which in turn spur consumption, leading to better export opportunities for emerging economies like India.

- India is now presented with a historic opportunity for building roads, railways, ports, airports, urban mass transport, pipelines, and telecom infrastructure, given the unprecedented lower prices of capital goods. Given that India is a natural long-term importer of capital goods, the recent events have acted in India's favour. Low commodity prices such as metals also augur well for the infrastructure segment. Due to slowdown in real estate sector the pressure on cement prices has reduced and this can help boost the efforts for building infrastructure. International engineering companies, who are starved for work, will now come forth with better bids to build infrastructure facilities in India. This opportunity of building infrastructure should be grabbed with both hands by policymakers.

What to expect in 2009

In the short term, oil prices could remain heavily dependent on how deep the global recession proves to be, and with little sign of the credit crunch dissipating, oil prices seem likely to remain at current subdued levels for much of 2009.

Recent figures from China suggest the economy is slowing down, which could drag prices even lower, whilst analysts are also revising down their estimates of global oil demand for the year.

To sum up, low oil prices could now provide an immediate relief for consumers, who will benefit through higher disposable income which in turn can become a key factor in reviving a slowing economy.



Lower oil prices boost profit margins and hence investment

■ Surendra Kudav & Luv Chaturvedi