Impact of Crude Oil Price Rise

Why in news?

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- As a large importer of crude oil, India benefited significantly from lower prices – due to consequent lower inflation & budget deficits.
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- As oil prices touched a 2 year high this week, some of these gains could be reversed.
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What has led to the price rise?

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- Drawdown in inventories, especially in the US.
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- Continued geopolitical risk in West Asia (particularly Saudi Arabia).
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- Better compliance with the voluntary production cut agreed by the 'Organization of the Petroleum Exporting Countries' (OPEC)
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- As the OPEC is expected to work for $70 a barrel, the price spike is expected to stay for a while.
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What are the challenges for India?

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- **The Fall years -** India witnessed significant positives when oil prices fell by over 50% between 2014 and 2015.

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- The windfall for the government was to the tune of 0.9% of the GDP in terms of lower subsidy outgo and higher tax collection.
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- This benefited firms, households and also boosted public investments.
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- **Currently –** As oil prices have increased, this could reverse the above and impede economic recovery in the near future.
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- It could have implications for growth, inflation, currency, current account deficit and fiscal deficit.
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- Every $10 increase in oil price has been noted to increase CPI inflation by 0.6-0.7% points and also worsen the 'Current Account Balance' by 0.4% of the GDP.
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What are the actions taken?

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- Since the government raised excise duty when prices were falling, it could come under pressure to reverse the hike now.
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- The Union government reduced excise duty by Rs 2 per litre on petrol and diesel last month.
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- This was followed by a reduction in VAT rates by states such as Gujarat and Maharashtra.
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- More such moves could strain government finances, lower revenues and would result in lower public investments.
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- Notably, reduction in excise duty on petrol and diesel by Re1 per litre lowers collection to the tune of 0.08% of the GDP.
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What are the macro-economic implications?

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- The uncertainty in the economy due to oil prices and other factors like GST

could worsen the overall outlook in the long run.
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- If oil prices reach $65 per barrel, inflation could go up by 30 basis points and the real GVA could be 15 basis points lower for the current fiscal.
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- Inflation fears could potentially prevent rate cuts and weaken market sentiments.
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- While bond yields have gone up already, persistent higher oil prices will also affect corporate India's profit margins.
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- This could delay the much awaited earnings revival and would also affect the equity market where stocks are richly valued.
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What is the way forward?

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- The situation is not alarming for India at the moment, but policymakers would need to be watchful.
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- While RBI will take a call on interest rates in December, the government needs to avoid the temptation of reducing taxes.
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- It would need higher revenue to push capital expenditure for fostering economic growth that is currently sluggish.
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- It will be extremely important to keep fiscal deficit in control in order to protect hard-won macroeconomic stability.
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Quick Fact

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OPEC (Organisation of Petroleum Exporting Countries)

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- It is an intergovernmental organization which was founded in 1960 and is headquartered in Vienna.

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- Its currently has 14 members - “Algeria, Angola, Ecuador, Equatorial Guinea, Gabon, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, UAE and Venezuela”.
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- OPEC countries account for an estimated 44% of global oil production and 73% of the world's proven oil reserves.
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- This gives OPEC a major influence on global oil prices and it acts as a cartel of sellers who wish attempt for maximum profits.
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Source: Livemint

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