Impact of Falling Oil Prices on Indian Economy

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Energy plays an important role in the growth of any country. Moreover, when the source of energy is non-renewable, it becomes even more important. One of the most eminent sources of energy in the world, oil, is that one important resource that has played a significant role in world economy. With the 2014 world production of oil reaching a massive 93 million barrels a day (from 88 million in 2010), one can say as time is passing, the dependency on oil is increasing. However, as the recent supply of Oil did not completely meet the demand, the prices of oil have fluctuated drastically, a 70% drop since 2014, causing ripples across the world. This drop in oil price can have significant impact in the economy of India, a country that currently imports about 80% of its oil requirement. Hence it becomes imperative to understand what impact the drop could have on the country's economy.

THE FALLING OIL PRICES

The fall/rise of any commodity is driven by the supply and demand of that commodity. The point where the supply and demand curves meet is the price point. However, with a shift of any of the curves changes the price point. For example, if the demand curve shifts to the left or if the supply curve shifts to the right, the price of the commodity drops. Alternatively, if the supply curve shifts to the left or demand curve shifts to the right, the price of the commodity rises.

In the mid 2000s, the price of oil was rising because of a huge unmet demand – especially from China. During that time the oil price rose to reach the level of $100 per barrel at the end of 2011. Hence, in order to take benefit of the increase in oil prices, many energy companies found innovative ways to extract crude oil. For example, in countries such as United States, companies started using fraction technique to extract oil from shale formations. This extraction technique doubled the production capacity of the country from 2008 to 2011 reaching 7.8 million barrels per day production in 2013. Similarly, companies in Canada started heating oil sands with steam to gather more oil. In addition, Russia, which does not want to lose the European market to Saudi Arabia and also wants to keep up with the budget, also started to produce more oil than before. Moreover, with the nuclear sanctions in Iran (which restricted it to produce and trade oil) were removed and with the new sanctions, there was another country, that already had a huge stock of produced oil, joining the oil supply club. At this time, Saudi Arabia, (one of the dominating players in the Organization of the Petroleum Exporting Countries) in order to sustain its market share, convinced OPECof not to restrict the oil production but rather let the prices fall. It believed that with falling oil prices, many companies in US will go out of business as the shale gas production is relatively costly (which did not happen as companies found ways to cut costs). These factors caused a shift in the supply curve towards right.

However, there were demand factors as well that were changing. One of the biggest consumers of oil – United States, had no rise in the demand of oil. It was using renewable sources of energy such as Solar and Wind for day-to-day consumption. Moreover, with more efficient cars, the demand for oil became stagnant. In addition, the second biggest consumer of oil, China, also had its oil demand cut down while facing a slowdown. A similar situation was seen in Europe. Hence, this caused the demand curve to shift left.

All the above factors caused the daily production levels of oil to exceed more than 3 million barrels per day than the expected demand causing the oil prices to fall.

THE IMPACT ON INDIAN ECONOMY – MACROECONOMIC FACTORS

India is heavily dependent on its crude oil imports. It is estimated that with every $1 drop in oil price, India's import bill narrows down by Rs. 6500 crore and the Government subsidy burden comes down by Rs. 900 crore.[1]With a 70% crash in global oil prices, it adds a huge relief to India's imports. A report by Nomura group also estimates the Current Account Deficit to reduce to 0.5% of GDP from current 0.7%.[2]The CAD in the July-September quarter of current fiscal rose to $8.2 billion or 1.6 per cent of the GDP from 1.2 per cent or $6.1 billion in the April-June quarter.[3]A fall in oil prices by $10 per barrel helps reduce the current account deficit by $9.2 billion, according to a report by Livemint.[4]

With the fall of oil prices, the transportation costs for goods and services are sure to go down affecting the overall prices of the goods and services. Moreover, the disposable income of consumers will also increase causing a fall in inflation. Every $10 per barrel fall in crude oil price helps reduce retail inflation by 0.2% and wholesale price inflation by 0.5%, according to a Money control report [4].

BENEFITS TO CORPORATE INDIA

Apart from the relief in the above factors, the fall in crude oil prices will also have a positive effect on India Inc. These are majorly the industries that use Oil as part of raw material.

Paint Industry

A big chunk of raw materials such as titanium dioxide (accounting for 20% of raw material costs), solvents etc. for companies in the paint industry come are actually crude derivatives. A 10% drop in crude oil prices increase margins by 200-300 basis points. This will help companies such as Asian paints and Berger to have better profits in the coming year (the extent will depend on product mix). Antu Eapen Thomas, research analyst, Geojit BNP Paribas, said, "We have seen a rise in gross margin by 313 basis points YoY to 46.3 per cent and profit grew by 25 per cent YoY to 854 crore in H1FY16." Companies providing industrial paints such as Nerolac will benefit even more so due to the cumulative effect of automotive industry seeing better results.

Upstream Oil companies

Paradoxically, the companies that generate revenue from oil will benefit when the price of oil goes down. Currently, the upstream companies such as ONGC support a lot of under-recoveries of OMCs which cause their net realisation to suffer. With oil prices going down, the under-recoveries improve and hence, the share of upstream companies also goes down.

They provide lesser subsidy to OMCs. Crisis Research had estimated that lower under-recoveries will add about Rs. 10,500-12,000 crore to the profit of upstream companies in 2014-15 and another Rs. 7,000-7,500 crore in 2015-16 and a big chunk will go to ONGC.

Automotive Industry

With gasoline being a major part of the entire car ownership, the consumers can breathe easy with oil prices going down. This may have significant impact on automotive industry as consumers who would have stretched the life of the current vehicle due to high prices may be willing to go for an extra purchase early. Moreover, consumers will be more willing to use their personal vehicles rather than public transport. This will cause high usage of vehicles thereby driving the service sales for many car manufacturers. This will have a cumulative effect on other industries such as Industrial paints, Tyre etc.

FMCG Industry

Although they are not the direct beneficiaries of oil prices going down, they do benefit because of the oil derivatives they use in their packaging. Petroleum derivatives are used in packaging such as tubes, bottles, soaps, shampoos etc. One of the biggest beneficiaries has been Colgate Palmolive India.

Tyre Industry

Crude oil derivatives such as carbon black, synthetic rubber also come as part of raw material for the tyre industry. Analysts suggest that a 10 per cent hike in prices of these products could push up operating margins to the tune of 100-200 basis points. Hence, as crude oil prices go down, the costs of many of these products go down. The industry is also to benefit from the boos the oil prices will give to the automotive industry.

Aviation Industry

Among the major beneficiaries of falling fuel prices will be the aviation sector. About 45% of Jet Airway's total operating costs come from fuel. This is a little higher for its competitors such as Spice Jet which has 48% of its costs pegged to fuel. Analysts say even a one per cent correction in jet fuel prices could mean a 4.5-4.7 per cent gain for airline companies at the operating profit levels before rentals.[3]

Textiles Industry

Companies operating in the manmade fibre space are sure to benefit from the drop in prices. Products such as synthetic yarn use crude oil derivatives like terephthalic acid and mono ethylene glycol and these derivatives constitute about 60% of total sales value. These companies will save big on their raw material costs thereby increasing margins.

Fertilizer Manufacturers

With falling oil prices, the price of one of the key raw material ingredients of the fertilizer industry, benzene, has also started to decline. From the June 2014 peak of $1,420 a tonne, the price of benzene (Korea) has fallen by over 20 per cent. This brings good relief to state owned fertilizer maker GSFC which has seen profit margins shrinking by almost 3 percentage points in 2013-14.

CONCLUSION

Hence the falling of oil prices can turn out to be a big boon for India's economy. The macroeconomic conditions are sure to improve with corporate India benefitting as well. However, it is unsure as to how long will this fall continue and how much can India actually capitalise against high expectations.

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