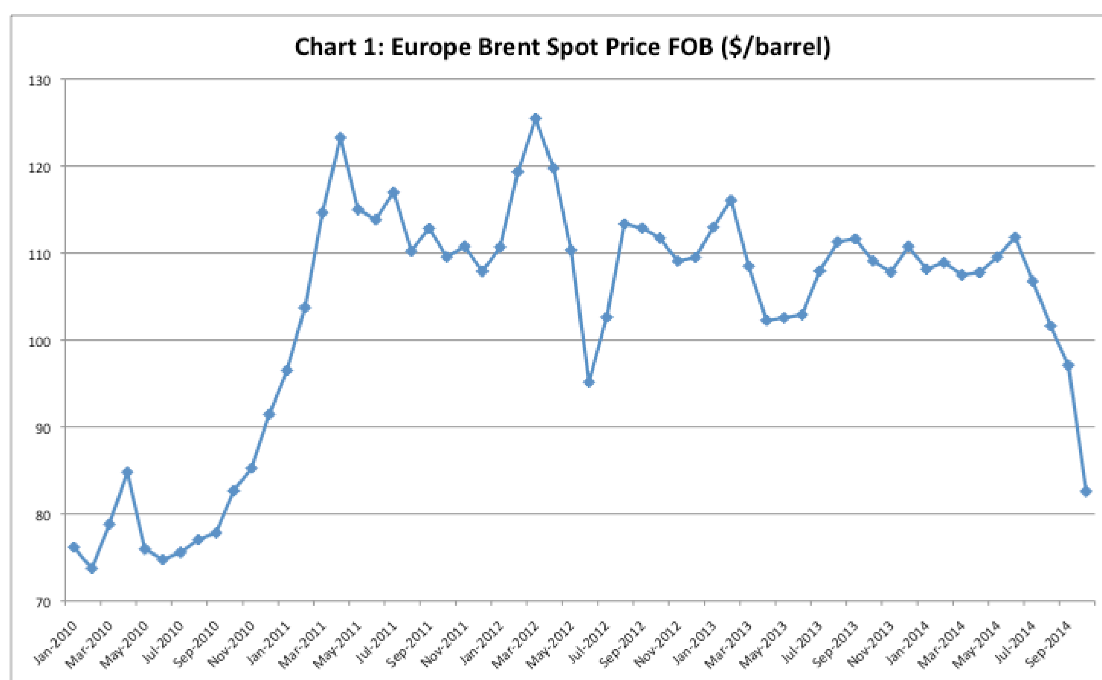
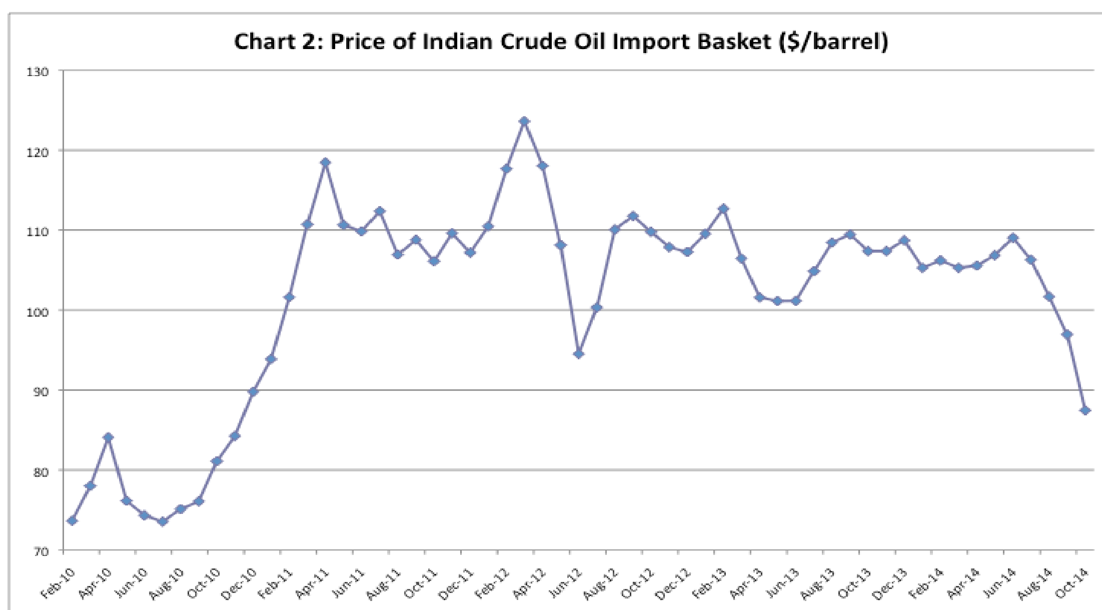
Exploiting the Oil Price Crash*

C.P. Chandrasekhar and Jayati Ghosh

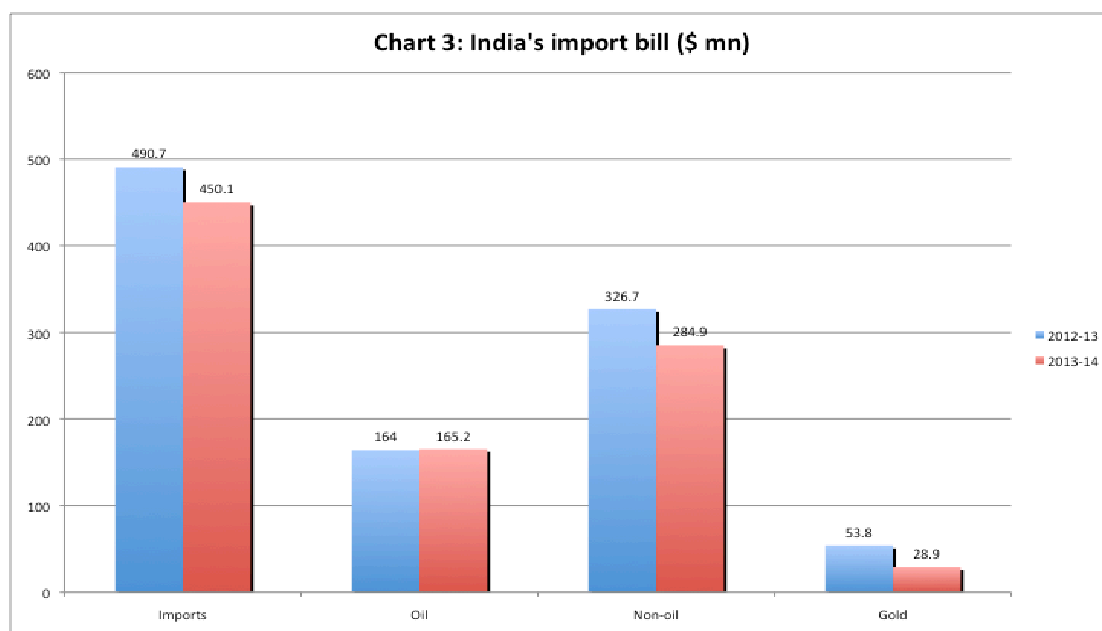
Depressed demand induced by the still persisting global recession and enhanced supplies as a result of the shale boom in the US have brought global oil prices down. The spot price (FOB) for Brent crude had fallen from $112 per barrel in September last year to $97 this September (Chart 1). The downward trend has persisted and the price was reported at $82.6 a barrel in mid-October, its lowest since November 2010. In fact, as a result of the recent decline in prices much of the rise in the months following June 2010 has been wiped out.



So long as the current price decline persists, oil importers are likely to benefit. India is among them, with the average price of the Indian crude import basket having fallen from $109.5 per barrel in September 2013 to $97 a barrel in September this year and a low of $87.5 in mid-October (Chart 2). That can make a big difference to the trade and current account deficits. Oil imports accounted for a third of India's oil bill in 2012-13 and a higher 37 per cent in 2013-14 (Chart 3). That was more than 85 per cent of the trade deficit in 2012-13 and 120 per cent of the deficit in 2013-14, when gold imports fell dramatically because of government curbs and higher duties. If the average price of crude imports falls by a quarter or more, the deficit would decline dramatically, even if gold imports rise, as they have after the recent relaxation of import restrictions.



The other effect of the decline in oil prices would be that consumer price inflation that has been ruling high will moderate. The Fuel and Light category carries weights of 10.4, 8.4 and 9.5 per cent respectively in the rural, urban and rural and urban combined indices. And since oil is a universal intermediate, oil prices have a cascading effect on the prices of commodities and the general price level. Thus, an oil price decline is obvious good news for a government harried by inflation. So, it is to be expected that the government would adjust domestic prices downwards in keeping with the decline in international oil prices.



However, while exploiting these benefits the government seems to be throwing caution to the winds. To start with, even before the oil price hike, the government began relaxing its vigil on the gold import front, easing some of the quantitative restrictions on gold imports. The result has been a sharp spike in imports over the last couple of months. If the confidence generated by declining oil imports leads to further liberalisation of gold imports, much of the balance of payments benefits of the oil price reduction could be neutralised. And if the price decline is reversed and oil prices increase to their historic highs, India would again be vulnerable on the BoP front.

On inflation too, the government may be taking on a risk by adding diesel to the list of commodities whose prices have been deregulated. Under a framework of

regulation, changes in the domestic prices of commodities are at the government's discretion. It could have quite easily reduced diesel prices in keeping with international prices by administrative decision. That would be positive given the importance of diesel in transportation, irrigation with pump sets and other areas that influence the costs of production of commodities entering the consumer price index. If the price increase reverses itself, the government could choose to keep prices steady or raise them marginally and find other ways of financing the oil importers and suppliers while holding diesel prices and keeping cost-push inflation at bay.

What the government is ignoring are signs that the oil price decline may be temporary. The reasons for the recent decline are obvious. US producers are pushing the 'fracking' envelope to extract and supply as much shale oil and gas as possible. Shale optimists predict that the US would become the world's largest oil producer. On the other hand, in the face of falling prices, the world's largest oil exporter, Saudi Arabia has refused to cut production in order to shore up oil prices. Rather, argue analysts, it is using its large oil and foreign exchange reserves to retain market share at the expense of low prices.

One consequence of this would of course be a loss of the competitiveness of shale. The shale boom was driven not only by new discoveries and improved technology, but by the high price of international oil that rendered shale cost-competitive. If the price fall is sustained, US investors would be forced to cut back. According to an International Energy Agency estimate quoted by Bloomberg, "extracting oil from shale costs $50 to $100 a barrel, compared with $25 a barrel for conventional supplies from the Middle East." For Saudi Arabia, keeping production constant and allowing prices to fall will not only put paid to America's ambitions to become the world's largest oil producer, but would also hurt Iran and Russia, who would find it difficult do without the high revenues that high oil prices imply.

If shale production is held back and major oil producers such as Russia, Iran and Venezuela are hurt, a new deal within OPEC and between OPEC and the US is likely in which Saudi Arabia would be assured of its market share but aggregate production would be kept down to hold prices above the $100 mark. In fact, given the geopolitical uncertainties in West Asia because of the United States' failed diplomatic and military strategy, supplies from other nations could be affected adversely triggering a further spike. The sudden fall in prices should not be taken as evidence that the era of high oil prices has ended.

This suggests that the decisions to drop administered pricing and deregulate petrol prices earlier and diesel prices more recently could prove to be mistakes. By doing so the government has given up the capacity to manage inflation to the extent that it is being driven by developments in the international oil market resulting from a change in production shares and levels or by the geopolitical manoeuvres. Being hostage to the policy decisions of external forces is worse than being hostage to price movements in distorted markets. But driven by its desire to liberalise and reform that seems to be the decision that the NDA government has made.

*** This article was originally published in the Business Line on October 27, 2014.**