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India's gains from lower oil prices at risk

Paper:III

Topic :Indian economic development, International trade, OPEC oil deal, Impact on India.

Relevance and use of the article in UPSC prelims and mains examination: *This article is About the recent oil production deal done between the OPEC countries to stabilize the oil production in order to neutralize the fluctuations in crude oil prices. However this decision is done to benefit OPEC nations but it has many other implications on consumption led economies, so is india The Organization of the Petroleum Exporting Countries (Opec) has finally got a deal with it's production target at 32.5 million barrels per day. After Opec announced its intention at September-end to cut production, crude oil prices had rallied. But news reports on old disputes resurfacing among some Opec nations, highlighting the fragile nature of the organization's agreements, weighed on prices after some time, the fact that a deal is sealed is a positive development. It will help bring forward the rebalancing of oil markets. But having said that, it won't be surprising if prices follow a similar trend yet again.*

Introduction:

- Public discourse is largely focused on the economic impact of the ongoing currency exchange drive of the government, there is another important development that India needs be concerned about. The monetary policy statement of the Reserve Bank of India on Wednesday highlighted that crude oil prices may firm up in the coming months and could be a risk to the year-end inflation target.
- Oil prices touched a 16-month high on Monday and have gone up by about 15% since 29 November. Prices spiked after the Organization of the Petroleum Exporting Countries (Opec) on 30 November decided to cut production for the first time in eight years. It will reduce output by about 1.2 million barrels per day from January 2017. Non-Opec members, including Russia, are expected to cut production by another 600,000 barrels per day.

Orientation of this decision:

- The decision comes after two years of a supply glut and significant hardship in several oil export-dependent countries. For instance, while foreign exchange reserves of a country like Saudi Arabia have dwindled, Venezuela's economy has virtually collapsed and it is facing severe shortage of essential commodities with high triple-digit inflation.
- However, the real impact of the deal in the medium term will depend on how it is implemented and whether Opec is able to build on this agreement. Most analysts are of the view that oil prices will not sustain at higher levels because of multiple reasons.
- For one, global demand continues to remain weak and growth is unlikely to accelerate in the near term. Further, at higher levels, US shale oil production, which suffered because of lower prices, will once again become attractive. Also, Opec members have a tendency to cheat in order to take advantage of higher prices. Even if Opec is able to keep a watch on the production levels of its members, it will be difficult to track a non-member country like Russia.

Real actors of the decision:

- But what is perhaps important at this stage is the fact that Opec has actually managed to reach an agreement to cut production with the support of non-members. Until recently, Opec's most influential member Saudi Arabia was not willing to reduce production as it didn't want to lose

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market share to other producers. But a deteriorating economic situation seems to have forced a rethink. John Kemp of Reuters in a recent column highlighted another important reason behind the agreement. He noted that Saudi Arabia's optimal strategy at this stage is to cut output and increase prices as most other Opec members are struggling to maintain current production, which limits the scope of cheating.

- How things actually play out will be keenly watched all over the world. It is possible that Opec will at least be able to set a floor for oil prices—that means the days of oil at around $40 may be over for now. Some analysts who were predicting that prices will fall to $10 per barrel may have to revisit their assumptions and calculations.

Iraq last-minute hitch

- But Opec would not be Opec without a last-minute quarrel threatening to derail the deal. Iraq became a problem. As ministerial talks got underway, Opec's second-largest producer insisted it could not afford to cut output, given the cost of its war against Islamic State.

India a gainer or a looser:

- India was a major gainer of the fall in crude oil prices as it depends on imports to cover over 75% of its requirement. While on the one hand, the low prices helped in containing the current account deficit and lowering inflation, on the other hand it augmented revenues—the government used the opportunity to impose higher taxes on petroleum products—which was instrumental in narrowing the fiscal deficit. In the last fiscal year, indirect tax revenue was estimated to have exceeded the target by over Rs 54,000 crore.
- However, if oil prices sustain at present levels or manage to move up, some of those gains will be reversed. When oil prices were coming down in 2014, economists at Nomura estimated that every $10 fall in oil prices reduces inflation based on Wholesale Price Index and Consumer Price Index by 0.5 and 0.2 percentage points, respectively.
- The impact on current account deficit is 0.5% of the gross domestic product (GDP) and it improves fiscal balance by 0.1% of GDP. A price reversal is likely to have an opposite impact.

The conclusion:

- If prices continue to rise, the government may have to roll back a part of the tax hike on petroleum products. This will adversely affect the fiscal math and the ability of the government to push capital expenditure.
- Private consumption could also get affected because of higher fuel bills. So higher oil prices can affect the two important drivers of economic growth—government spending and private consumption.
- Companies that benefited from lower oil prices may also see a margin erosion as passing higher input cost to the consumer could be difficult at this stage. In fact, oil prices have risen at a time when economic activity in India is expected to take a hit in the short run because of the ongoing currency crunch in the system.
- Higher oil prices will also widen the current account deficit while the rupee has been under pressure because of a strengthening dollar.
- Although oil prices have not reached threatening levels, Indian policymakers will do well to prepare for the underlying shift in the way prices are determined.

Question for prelims:

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Consider the following statements:

1. The Organization of the Petroleum Exporting Countries (OPEC) was founded in Baghdad, Iraq, with the signing of an agreement in September 1960 by five countries namely Islamic Republic of Iran, Iraq, Kuwait, Saudi Arabia and Venezuela.
2. The OPEC Secretariat is the executive organ of the Organization of the Petroleum Exporting Countries (OPEC). Located in Vienna,

Which of the following is correct:

A. Only 1
B. Only 2
C. Both 1 and 2
D. None of the above is correct.

<u>Questions For mains:</u>

Form last 2 years indian economy is riding on lower crude oil prices in international market but the recent decision by OPEC countries to stabilize the production will increase the price of crude, How will higher crude oil prices affect India and will Higher oil prices can affect government spending as well as private consumption. discuss.

<u>Suggested points for answer:</u>

1. Discuss about the recent decision of OPEC countries to cut down its production label to maintain equal price label in international market.
2. Strategy of OPEC countries behind this rate cut.
3. Why india was enjoying the prior situation.
4. What are the effects of this decision on india.
5. Discuss about the label of government spending and private consumption by this decision.
6. Status of budgetary measures.
7. Viability of this decision.
8. What india should do in this case. Strategy.
9. Suggetions.
10. conclusion.

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