Economics

India: Falling oil prices – good or bad?

DBS Group Research | 19 January 2015

- **Low crude prices carry broad benefits for India**
- **Weak commodity prices provide the fiscal and monetary space to boost growth**
- **Positives however will quickly be overshadowed if weak demand rather than strong supply underlies the oil price decline**
- **Indian equity markets have historically moved closely with crude prices, but have diverged of late. Will this continue?**

The sharp fall in oil prices is good news for a petroleum net-importer like India. Brent prices are down 60% from USD 112pb in June 2014 to below USD 50pb in January 2015 (Chart 1). The Indian crude basket, a weighted mix of various benchmarks, is down by a similar margin. Low crude prices carry clear macro benefits for India, as discussed below (Chart 2).

Cheaper oil provides an opportunity for authorities to accelerate reforms and redirect fiscal resources to productive purposes. But this is only half the story. This positive impact may be overshadowed if weak global growth, rather than strong supply, underlies the fall in commodity prices. Is the glass half-full or half empty?

The half-full view

Improvement in India's terms of trade is likely to be felt broadly, with the sensitivity of key macro variables as follows (summary in Table 1, next page):

Chart 1: Brent prices heading to 2009 lows

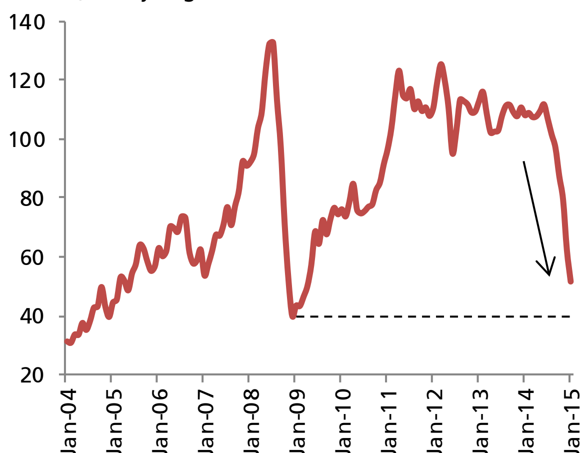
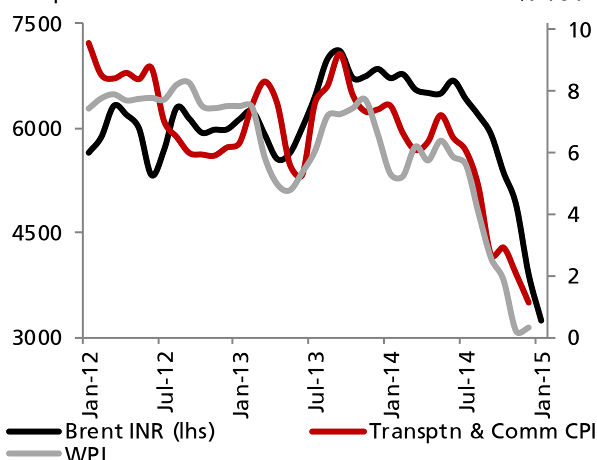


Chart 2: Low crude px to improve CPI/WPI profile



Radhika Rao • (65) 6878-5282 • radhikarao@dbs.com

Table 1: Impact of crude price decline on key economic variables*

Every USD 10pb fall in Brent prices	
Current account	To lower the current account by ~0.4-0.5% of GDP
Inflation/ Monetary policy	CPI inflation to be lower by 20bps
	WPI inflation to be lower by 30-90bps (immediate and long-run)
	Opens room for rate cuts; DBSf cumulative 75bps cuts in 2015 calendar year (includes Jan15 surprise cut)
Fiscal deficit	Lower crude prices and diesel deregulation helps shield the government's balance sheet from volatile commodity prices. Fiscal deficit to narrow by 0.5% of GDP; includes elimination of diesel subsidy (~0.3% of GDP)

*assumptions: i) all other variables are constant; ii) impact on full-FYperformance

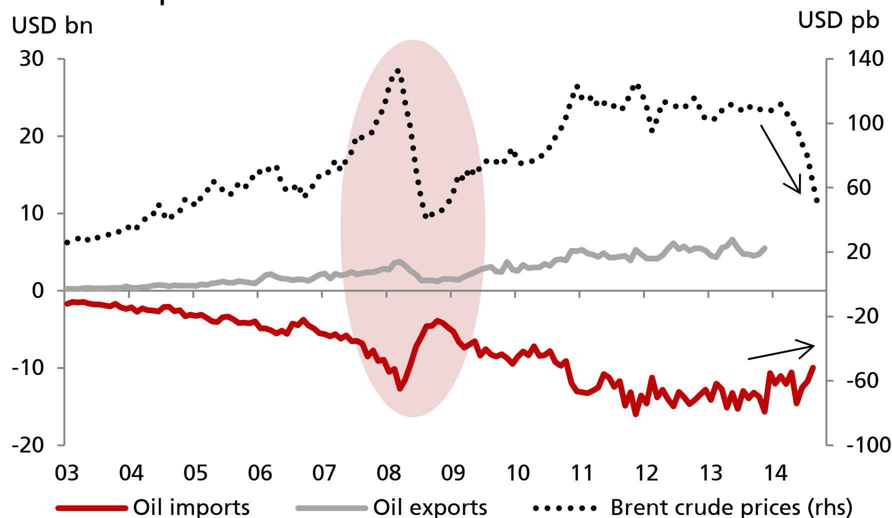
a) Fiscal balance: The fall in global oil prices and decision to deregulate diesel prices in October 2014 will help eliminate part of the fuel subsidies, amounting to 0.3% of GDP. Petrol prices are already market-determined, with cooking gas and kerosene still under the administered list.

Notably, immediate relief to the FY14/15 Budget will be limited as budget assumptions already factor in about a 0.3% of GDP reduction in fuel subsidies. The full benefit may not appear until FY15/16, where low crude prices and deregulation of domestic prices could lead to savings of 0.4%-0.5% of GDP for every USD 10pb reduction in Brent prices. Further out, the government's balance sheet would be shielded from volatility in global crude prices.

b) Growth: Lower crude prices (helped further by deregulation of subsidised fuel) will provide a positive growth impetus, through higher discretionary incomes for households and lower input costs for business/ manufacturers' alongside agricultural production.

c) Inflation/Rates: Direct impact of low crude prices on CPI inflation will be marginal given the higher weightage of food and non-tradable non-food products in its basket. A USD 10pb movement in crude oil prices will lower headline CPI by 20bps, as noted by the central bank. In contrast, WPI Inflation has a higher

Chart 3: Fuel prices vs oil trade balance



weightage of tradables, with the impact likely to be more pronounced at 30-90bps in short and medium-term.

We look for 50bps more Repo cuts by June 2015

Easing inflation and an improvement in the twin deficits provide room for monetary and fiscal stimulus. This was demonstrated by the Reserve Bank of India's decision to surprise with a 25bps intermeeting cut in mid-Jan15. We expect 50bps of further cuts by June.

d) Current account: Oil imports made up more than one-third of total imports in FY13/14, i.e., 8.8% of GDP (see Chart 3). Our analysis shows that for every USD 10pb fall in global prices the current account balance should improve by 0.4-0.5% of GDP.

e) Currency: Lower crude prices are unlikely to have a significant direct impact on the rupee. A strong rupee is also undesirable from the angle of promoting an exports-oriented manufacturing policy, and is constrained by the central bank's aim to raise FX reserves.

Low oil prices present an opportunity

The pullback in commodity prices presents the government with an opportunity to take crucial reform decisions. For a start, diesel prices were completely deregulated in October 2014, with the wheels already in motion by staggered price rises since early-2013.

Low oil prices help tame inflation, repair fiscal books and lower the current account deficit, providing comfort to the Reserve Bank of India (RBI) to kick start the rate cutting cycle. CPI inflation is expected to average 6.1% next year, with downside risks if crude prices remain soft.

At the same time, it is important that fiscal savings are redirected towards capital spending (~1.7% of GDP) instead of funding higher food subsidies (~0.9% of GDP). February's FY15/16 Budget should outline plans to re-allocate funds, with a hand from the draft recommendations of the Expenditure Commission.

The half-empty view

Falling oil prices won't be so beneficial if it turns out they are driven by weak demand rather than a surge in supply. As discussed in the 'Daily Breakfast Spread of 14 Jan 2015', the surge in US shale oil production in 2014 amounts to but 1% of total global demand – how that could trigger a 60% fall in prices remains a very open question. It is not coincidental that commodity prices have

Chart 4: Global imports vs India exports moves

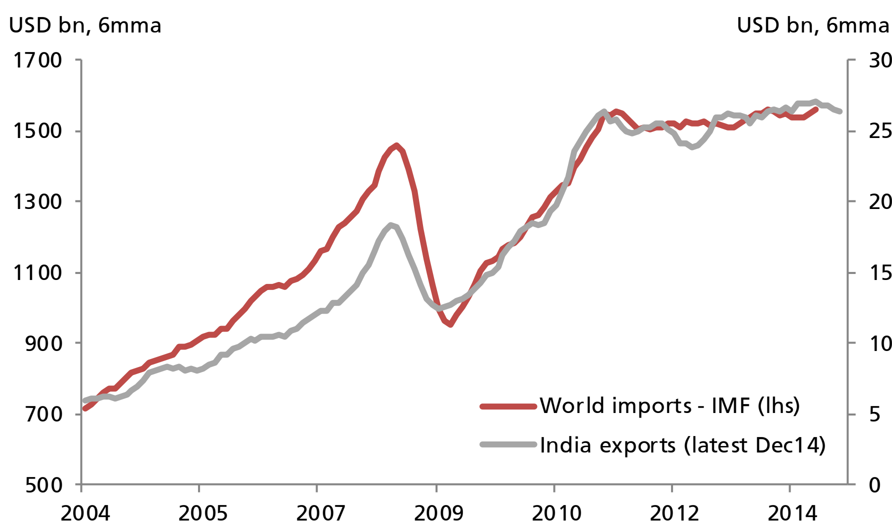
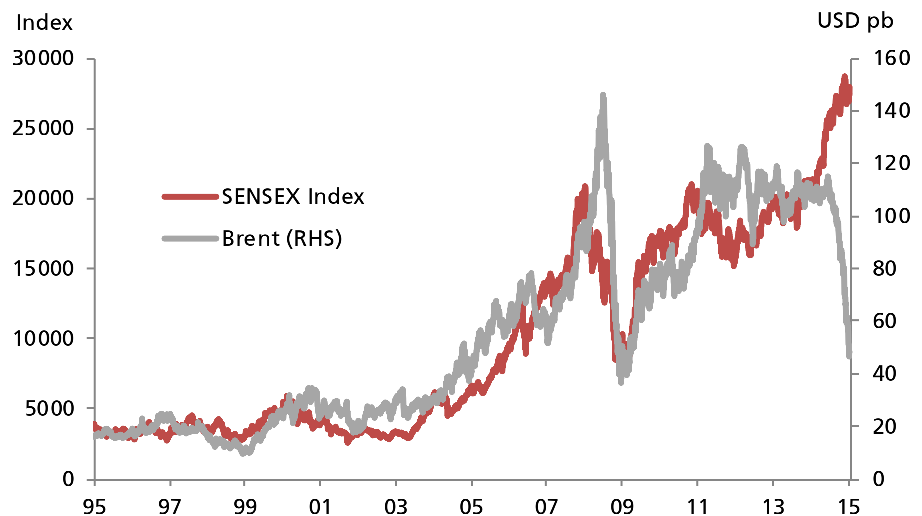


Chart 5: SENSEX stock index vs Brent: what gives?



eased at a time when Eurozone and Japan are stagnating, China mulls over a lower growth target and the US continues to grumble along at broadly a 2.25% growth pace.

To the extent the decline in crude prices owes to weak demand, the risks to India's export growth and trade balance could outweigh the benefits. Plainly, India's exports depend on global demand and if oil prices are low because no one is buying it the implications for external demand are clear (Chart 4).

Any sharp rebound in crude prices will test the government's resolve

Next, the durability of lower commodity prices remains a question mark. A sharp rebound in crude prices would filter through as a negative trade shock, especially as petrol and diesel prices are now market-determined. Such an event would test the government's resolve in keeping prices market-linked and not reviving state interference.

Finally, contagion from financial market volatility is still a risk for India, as witnessed in December 2014. Indian equity markets have historically moved in lockstep with crude prices but have diverged of late (Chart 5), much due to accommodative global central bank policies. This divergence however is at risk when either the markets recognise that weak demand underlies the easing commodity cycle or if US rate hike expectations are brought forward. The resultant global volatility can impact domestic markets and the real economy.

Conclusion

The drop in crude prices is a key positive for India. But it needs to be balanced against the risks that low prices owe to weak global demand. As the developed world grapples with the onset of a deflationary environment, worries are bound to grow.

Sources:

Data for all charts and tables are from CEIC Data, Bloomberg, RBI and DBS Group Research (forecasts are transformations).

Recent Research

IN: RBI cuts rates, more to come	15 Jan 15
CN: Restarting SOE reforms	13 Jan 15
JP: mixed impact of low oil prices	12 Jan 15
UST yields: Downward distortions	12 Jan 15
Asia: vulnerability dashboard	19 Dec 14
Qtrly: Economics-Markets-Strategy 1Q15	10 Dec 14
CNH: To break fresh ground in 2015	17 Nov 14
CNH: Conversion cap finally lifted	12 Nov 14
JP: The impact of QQE2	7 Nov 14
CN: Significant easing remains unlikely	5 Nov 14
Asia export race: Who's winning?	30 Oct 14
ID: Watching external debt	30 Oct 14
MY: Assessing the GST impact	29 Oct 14
IN: Reviving manufacturing	28 Oct 14
HK-ASEAN trade prospects	24 Oct 14
JP: Policy intentions lack clarity	24 Oct 14
HK: Initial impact of Occupy Central	16 Oct 14
SG: Growth struggles continue	14 Oct 14
IN: Inflation and shifting policy dynamics	10 Oct 14
KR: Weakness exaggerated	9 Oct 14
EZ: Rates are firmly anchored	9 Oct 14
SG: Restructuring pain	8 Oct 14
CN: Price deregulation in motion	25 Sep14
TH: Stronger consumption is key	24 Sep 14
US: The water rate addendum	23 Sep 14
IN: Forging global ties	19 Sep 14
US Fed: The water rate	16 Sep 14
Qtrly: Economics-Markets-Strategy 4Q14	11 Sep 14
IN: Market too dovish on 3M rate, 2Y fwd	25 Aug 14
KR: Housing recovery	21 Aug 14
IN: Increasing resilience	20 Aug 14
ID: Beyond 2014	8 Aug 14
CN: SOE reform challenges	6 Aug 14
Asia cylical dashboard: EU disappoints	25 Jul 14
US: the inflation non-problem	23 Jul 14
SG: Downgraded	23 Jul 14
KR: Unleashing services	17 Jul 14
US: The search for a new policy rate	14 Jul 14
India budget: hits and misses	11 Jul 14
UST: 10Y yields downside limited	8 Jul 14
India budget: setting its sights longer	3 Jul 14
ID: Fiscal prudence still warranted	2 Jul 14
JP: Abe's reform plan, V2.0	27 Jun 14
MY: Foot on the brake	27 Jun 14
Qtrly: Economics-Markets-Strategy 3Q14	12 Jun 14
CNH: Offshore loans set to grow	4 Jun 14
JP: Looking beyond the volatility	30 May 14
CN: In search of a new consensus	30 May 14

Disclaimer:

The information herein is published by DBS Bank Ltd (the "Company"). It is based on information obtained from sources believed to be reliable, but the Company does not make any representation or warranty, express or implied, as to its accuracy, completeness, timeliness or correctness for any particular purpose. Opinions expressed are subject to change without notice. Any recommendation contained herein does not have regard to the specific investment objectives, financial situation and the particular needs of any specific addressee. The information herein is published for the information of addressees only and is not to be taken in substitution for the exercise of judgement by addressees, who should obtain separate legal or financial advice. The Company, or any of its related companies or any individuals connected with the group accepts no liability for any direct, special, indirect, consequential, incidental damages or any other loss or damages of any kind arising from any use of the information herein (including any error, omission or misstatement herein, negligent or otherwise) or further communication thereof, even if the Company or any other person has been advised of the possibility thereof. The information herein is not to be construed as an offer or a solicitation of an offer to buy or sell any securities, futures, options or other financial instruments or to provide any investment advice or services. The Company and its associates, their directors, officers and/or employees may have positions or other interests in, and may effect transactions in securities mentioned herein and may also perform or seek to perform broking, investment banking and other banking or financial services for these companies. The information herein is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation.