India

Who will bear the burden of oil?

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- If oil averages cUSD100/b for a prolonged period, the drag on GDP growth could be up to 0.9ppt, inflation could rise by around 1ppt, and the current account deficit could widen by 1.2ppt
- Half of the growth drag is already at play; the other half will likely show up clearly when domestic pump prices are raised later in March
- By cutting excise duties, the public sector has borne the majority of the growth drag; if further duty cuts do not materialise, the private sector will have to pick up the incremental cost

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What if oil stays at USD100/b?

What happens if oil remains in the ballpark of USD100/b? This is the number one question we are getting these days. Based on our previous research, we present our thoughts in this report.

Global oil prices averaged cUSD70/b in 2021 and have soared since, recently surging well above USD100/b. If prices were to average, say, USD100/b in the coming months, this would constitute a USD30/b oil price shock.

We divide this shock into two parts. The first part is the rise in oil prices from USD70/b to USD85/b, i.e. a USD15/b increase in prices. Following soon after an excise tax cut by the government on November 3, India's domestic oil pump prices were frozen. The global oil price prevailing then was cUSD85/b (see chart 1). So in some sense much of the macroeconomic impact of that increase in oil prices is already at play.

The second part is the move from USD85/b to USD100/b, again a USD15/b increase. We expect domestic pump prices to be revised up in March, and the overall impact of the recent escalation in global prices will begin to show up more clearly in subsequent months.

How are these big increases in oil prices likely to impact the various economic agents (the government, corporates and consumers) and macro variables (GDP growth, savings, inflation and the current account)? What impact has already been felt and what remains? And does it have implications for financial conditions? We explore all of these questions using our bottom-up model.

While quantifying the impact, we assume a scenario of oil prices staying around USD100/b for several months.

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The full cost of higher oil (incurred + remaining)

Our sensitivities suggest that the USD30/b rise in oil prices, **from USD70/b to USD 100/b**, could impact all the key macro variables significantly –

- Lower GDP growth by 0.9ppt
- Raise the current account deficit by 1.2% of GDP
- Raise CPI inflation rate by 1.05ppt

Various economic agents are likely to feel the pinch –

Central government cut taxes, lost revenue. In the wake of rising oil prices in 2021, the central government had cut the oil excise duty on November 3 (by INR5/ltr for petrol and INR10/ltr for diesel), and taken a hit on its tax revenues. We estimate that this cost the central government **0.4% of GDP** in tax revenues. We assume no further cuts for now (more on this later).

State governments stand to benefit. About a fourth of India's states lowered VAT rates in 2021, but still benefitted from rising oil prices in aggregate (since they levy an ad-valorem tax on oil, tax revenues increase when oil prices rise). Overall they are likely t**o gain 0.1% of GDP** in tax revenues.

Combining the centre's pain and the states' gain implies a **loss of 0.3% of GDP** in tax revenues.

Corporates suffer some, pass on more. We estimate that a 10% rise in domestic oil price will shave 0.25ppt from the profit-to-GDP ratio. In the past we have calculated that for every 1ppt rise in input costs, profits tend to fall by 0.4ppt, and the remaining 0.6ppt tends to be passed on to consumers as higher prices. Using these sensitivities, we estimate that corporate profits could fall by **0.3% of GDP.** The corresponding pass-through of higher prices to consumers would then be 0.45% of GDP.

Consumers face a double sting. Not only do they have to grapple with higher pump price of petrol and diesel, but they also face higher price for non-oil products which corporates pass on to them. Petrol and diesel make up 2.3% of the consumption basket. An 11% rise in domestic pump prices[1] will lead to a 0.25ppt fall in purchasing power. Scaling this with GDP (note that consumption makes up 60% of GDP) implies a 0.15% of GDP cost to consumers.

Add to this the higher price on goods and services that corporates pass onto to consumers (i.e. 0.45% of GDP), and the total cost to consumers adds up to 0.6% of GDP. This cost could then be divided between a cut in consumption and a cut in household savings. Assuming a 70:30 ratio, the fall in consumption would be around **0.4% of GDP**, while the fall in savings would be **0.2% of GDP**.

Adding it all up implies a **0.9ppt fall in GDP growth** and a 0.2% of GDP fall in savings, if oil stays at USD100/b for a prolonged period (see chart 2).

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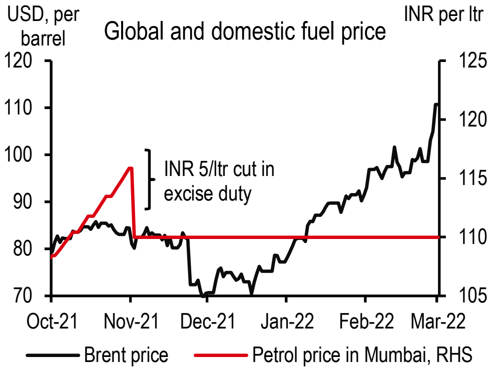
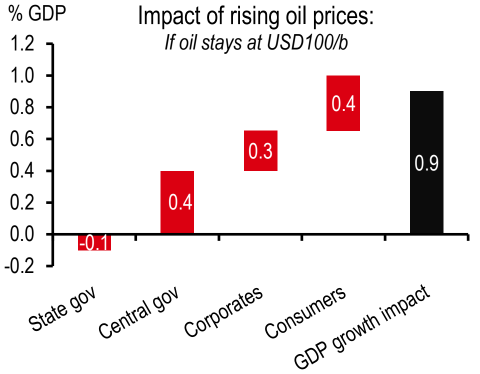
[1] It is worth noting that a 43% rise in global oil prices (from USD70/b to USD100/b) will likely culminate in an 11% rise in domestic oil prices. The reason is that there are many levies and taxes added to the port price of oil before arriving at the pump price (e.g. transportation cost, commission, excise duty). Most of these add-ons (barring the state VAT) are fixed costs (per litre of oil), and as such don't undergo any automatic increase as global oil prices rise, resulting in the percentage rise in pump prices being lower than the rise in port prices.

Chart 1: India's domestic oil pump prices were frozen in November when global oil prices were at USD85/b



Source: CEIC, Bloomberg, HSBC

Chart 2: The growth cost of oil prices rising by USD30/b will be shared by various economic agents



Source: HSBC estimates. Note: Negative reading indicates a gain.

Table 1: Half the growth cost of higher oil prices is in the system, another half is yet to be incurred

	Period 1	Period 2	Total
In percentage points (ppt)	USD70-85/b	USD85-100/b	USD70-100/b
Total fall in GDP growth	0.45	0.45	0.90
Central government	0.4	0.0	0.4
State government	0.02	-0.1	-0.1
Coorporate	0.03	0.2	0.3
Consumer	0.04	0.3	0.4

Source: HSBC estimates

Note: Period 1 is the timeframe over which domestic oil prices were increased in line with global oil prices rising from USD70-85/b (mid 2021 – Feb 2022). Period 2 will begin when domestic prices are allowed to capture the rise of global oil prices rising above USD85/b (Mar 2022 onwards).

Burden sharing ratios

This scenario also shows that the **burden sharing ratio of the growth drag between the private and public sector is 70:30**[2].

In an alternative scenario, if the central government cuts excise duties again, and by a similar quantum as the cut on November 3, the burden sharing ratio could flip, with the public sector picking up 70% of the burden and the private sector picking up the remaining part.

Having outlined the cost that high oil prices could inflict, it is important to distinguish between what's already been incurred, and what remains.

[2] We assume here that the government and the corporates cut current spending on the back of the oil price shock while consumers spread it out between lower consumption and dissaving.

The remaining cost of higher oil

As explained earlier, domestic pump prices are expected to be raised in March after being frozen since November when global oil was at USD85/b. In short the macroeconomic pain of oil rising from USD70/b to USD85/b is already in the system and the incremental impact of oil going from USD85/b to USD100/b remains to be felt (see table 1).

How much pain will this second round cause?

Incremental growth drag. Of the 0.9ppt overall growth drag, about half remains to be felt over the next few months. If the government does not cut excise duties further, it should not face any meaningful additional cost. And in fact state governments will earn higher VAT revenues, making the public sector a net beneficiary (gaining 0.1ppt higher revenues). **This means that the private sector may have to take a growth hit of about 0.5ppt.** Based on what has happened in the past, we assume the corporates and consumers will split this in a 40:60 ratio.

Incremental inflation hit. If pump prices are now adjusted to a global oil price of USD100/b, the *direct* addition to inflation would be about 0.2ppt (this is calculated as a product of the rise in domestic pump prices and the share of petrol and diesel in the CPI basket). The indirect impact could be even more meaningful as higher input costs feed into food and core inflation over time. Adding across the direct and indirect channels suggest that **inflation could rise by 0.6ppt over time** if oil remains at USD100/b.

A wider current account and BoP deficit. The current account has been widening and is likely to widen further, with or without further excise duty cuts (in line with our sensitivity that for every USD10/b higher oil prices, the current account deficit widens by 0.4% of GDP).

The only silver lining here is that the balance-of-payments (BoP) is likely to go into deficit after three years of hefty surplus. This means that the RBI would not be forced to buy a large quantum of dollars. Instead, it may have to sell dollars in order to lower the volatility in the rupee. And that would likely open up space for the RBI to buy government bonds without adding to system-wide liquidity, and help ease some of the pressures in the bond market.

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