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Note Released: 14-Feb-08

India Economics

Macro Impact of the “Token” Oil Price Hike

- **Auto Fuels Adjusted by 3-4%:** After keeping prices on hold since it cut them in February 07, when oil prices were US\$58bbl, the long awaited fuel price hike was effected today. The government raised prices of transport fuels – petrol and diesel by Rs2/ltr and Rs1/ltr – representing a rise of 4% and 3% respectively. Prices of cooking fuels – LPG and kerosene- remain unchanged.
- **Impact on Inflation:** As petrol and diesel have a weight of 3% in the WPI index, the fuel price hike would have a direct impact of 11bps on inflation while the indirect impact would be another 11bps. We expect inflation as measured by the WPI currently at 4.11% for the week ended Jan26, to trend higher but remain at sub 4.7% levels till the end of this fiscal year. For FY09, given that this is a pre-election year, we expect inflation to be “*managed*” at 4% levels.
- **Price Rise is less than Required:** The adjustment in transport fuels is far less than needed. To be in line with international trends, auto fuels need to rise 8% for petrol and 22% for diesel, driving up inflation a further **52bps**. If one takes a look at the cooking fuels, these need an adjustment of 95% in LPG and 300% in kerosene. However given political compulsions we do not see this happening in the near future
- **Oil Bonds:** As the price adjustment is less than international prices, gross under-recoveries by oil companies are estimated at Rs718bn in FY08. To compensate oil companies for the retail marketing losses, the government is likely to issue oil bonds to the tune of Rs402bn, **higher than initial estimate** of Rs240bn earlier this year.
- **Impact on Fiscal Deficit and Rates:** Similar to the past three years, oil bonds will likely remain off balance sheet so the headline deficit estimate should remain unchanged. If all off-balance sheet items are added, it would raise the headline deficit ~120bps to 4.5% of GDP v/s the target of 3.3%. While full adjustment in transport fuels will still likely result in inflation being sub 5%, given the RBI’s priority on inflation over growth, risks of an extended pause in policy rates remains.

The Government’s Subsidy-Sharing Mechanism (Rs Bn)

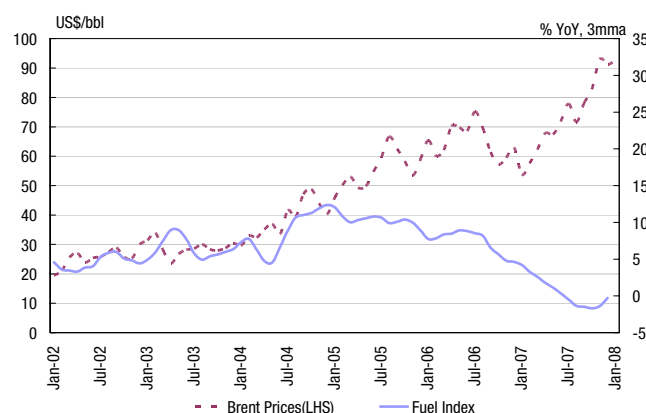
	FY06	FY07	FY08BE
Gross under-recoveries	403	495	718
less: Oil Bonds	115	241	402
less: Upstream contribution	140	204	237
less: Refineries sharing	30	-	-
Net under-recoveries	118	50	79

Impact of FULL adjustment of Oil Prices on Inflation

	Weight in WPI	Price chg reqd	Impact on Inflation
Liquefied petroleum gas	1.84%	95%	1.75%
Kerosene fuel	0.69%	300%	2.07%
High speed diesel	2.02%	22%	0.44%
Petrol	0.89%	8%	0.07%
Overall impact	5.44%		4.33%

Source: Citi estimates, Ministry of Petroleum, Office of the Economic Advisor

Trends in Brent Prices and the Fuel Index (%YoY, 3mma; US\$/bbl)



Source: Bloomberg, Office of the Economic Advisor

Disclosure Appendix A1

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