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Bracing for a crude shock

The "Jasmine revolution" does not smell too sweet right now, at least not to Indian policy makers and certainly not to us poor analysts! One of the key debates over the past few weeks has been the effect of oil prices on the fiscal deficit and subsidies in the country, driven by the potentially transformational but also incendiary situation in the Middle East. We submit that the impact of oil persisting at ~US$110/bbl, while significant for the subsidy levels, is also very important in the context of inflation. The momentum of crude prices is getting stronger than ever, with the situation in Libya getting murkier by the day while the signals are getting stronger for a revival in the US economy, the world's biggest consumer of crude oil. In this environment we look at the possible scenarios the Indian economy may be confronted with over the next twelve months.

- The obvious impact is the increase in the net import bill for crude and crude products. At a Brent price deck of US$110/bbl, the import bill for FY12E (net of exports of refined products) could reach US$116bn! That's a whopping 45% increase yoy over FY11 estimates. While this is a significant burden, crude imports as a percentage of nominal GDP would expand only 130bp yoy to 5.8% in FY12E (v/s 4.5% in FY11E) – a sign of the resilience of the Indian economy.
- The other significant impact is that on inflation, which has anyway been a source of much headache for policy makers for most of last year. In the current scenario, we think there are twin threats to inflation due to crude;
    - The direct impact that is expected to accrue is due to the unavoidable price increases needed in at least petrol and diesel. With under-recoveries for petrol rising to ~Rs3.5/liter and that for diesel rising to ~Rs11/liter, we believe that the Government will have little choice but to raise prices at some time. We tried to look at three cases in our crystal gazing exercise and have arrived at a potentially very damaging 8.7% peak inflation rate for FY12E, if there is up to 15% price increase in both petrol and diesel prices as warranted by current levels of crude and no respite in the food inflation. Though the base case inflation estimate for FY12E remains comforting at 6.5%, factoring in a 6% price increase in petrol and diesel and decelerating food inflation.
    - The other impact, which is much more difficult to compute, is the indirect impact of an increase in diesel price, wherein food prices and manufactured products inflation rise as a result of a material change in transportation and logistics cost. Without trying to hazard a guess on the exact impact, we would reckon that the number is a material one as the effect of a big increase in transport costs goes beyond just the percentage change; it impacts the overall cost of living and, therefore, consumption expenditure too.
- Lastly, if crude prices remain high forcing the Government to increase petrol and diesel prices, the operational costs of India Inc are likely to inch up, impacting overall profitability. Also, rising crude implies a higher import bill, which would suppress real GDP in FY12E. But we remain optimistic of 8%+ FY12E real GDP growth on the back of a strong private consumption expenditure.

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Broadly, if crude stays at current levels for the full year, an expansion in inflation by 60-150bp and an increase in crude import bill by ~40% are real possibilities and imply more tremors in the Indian growth story in the near term. However, we also note that, with ~US$300bn of forex reserves, a nominal GDP of more than Rs78trn slated to grow to ~Rs90trn by FY12E, and real GDP growth rate in excess of 8% over FY11-12E, the Indian economy is definitely better equipped to live through an "oil shock" if that transpires over the next twelve months.

Inflation scenarios

			FY12E (%)		
	Weight (%)	FY11E (%)	Base	Moderate	Worst
Primary articles	20.1	15.0	13.0	13.0	16.0
Manufactured products	65.0	4.5	3.5	3.5	5.0
Fuel inflation ex petrol and diesel	9.0	10.0	10.0	10.2	10.2
WPI ex petrol and diesel		6.8	6.1	6.2	7.8
Impact of petrol and diesel price increase on WPI	5.9	0.7	0.4	0.9	0.9
WPI	100.0	7.5	6.5	7.1	8.7

Source: Mospi, IDFC Securities research

Assumptions for worst case scenario

- Food inflation does not come off sharply, resulting in primary articles inflation of 16%.
- Manufactured inflation remains high at 5% (average manufactured inflation of the past 12 months).
- Fuel ex petrol and diesel remains at 12 month average of 10.2%.
- Petrol price increase of 15% and diesel price increase of 15%.

Assumptions for base case scenario

- Food inflation drops as supply side constraints ease.
- Manufactured inflation drops as there are no spillage effects.
- Fuel ex petrol and diesel remains steady at 10%.
- Petrol price increase of 6% and diesel price increase of 6%.

Crude price as a percentage of nominal GDP

		FY05	FY06	FY07	FY08	FY09	FY10 (P)	FY11E	FY12E
Nominal GDP	Rs bn	32,392	37,065	42,840	49,479	55,826	65,503	78,779	90,596
Crude price (Indian basket $/bbl)		39.8	55.6	62.2	80.0	82.4	68.2	82.3	107.0
Crude & product import bill	INR /USD rate	44.9	44.3	45.2	40.3	46.0	47.5	45.6	45
Crude & product import bill	Rs bn	1,132	1,612	1,971	2,441	3,043	2,917	3,546	5,238
Crude & product import bill	*as a % of GDP*	*3.5*	*4.3*	*4.6*	*4.9*	*5.5*	*4.5*	*4.5*	*5.8*

Source: CSO, Bloomberg, IDFC Securities research

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Explanation of Ratings:

1. Outperformer: More than 5% upside to Index
2. Neutral: Within 0-5% to Index (upside or downside)
3. Underperformer: More than 5% downside to Index

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