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Crude oil impact on Indian macros

Average crude oil price of US$130/bbl in FY2023 would widen CAD to 3.2% of GDP, crossing 3% of GDP after a decade

MARCH 2022

Highlights

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Current account deficit to widen by ~US$14-15 billion (0.4% of GDP) for every US$10/bbl rise in the average price of the Indian crude oil basket

US$-INR cross rate to trade in a range of 76.0-79.0/US$ until conflict subsides

10-year G-sec yield to range between 7.0-7.4% in H1 FY2023

Downside risks seen to FY2023 GDP growth forecast of 8.0%, with higher commodity prices to decimate margins

- The international crude oil price, in Indian basket terms, surpassed the US$130/bbl mark on Mar 7, 2022, fueled by intensifying geopolitical tensions between Russia (world's third largest oil producer) and Ukraine, and the possibility of sanctions on Russia's oil exports.
- The current account deficit (CAD) is likely to widen by ~US$14-15 billion (0.4% of GDP) for every US$10/bbl rise in the average price of the Indian crude basket. If the price averages US$130/bbl in FY2023, then the CAD will widen to 3.2% of GDP, crossing 3% for the first time in a decade.
- While elevated commodity prices and pessimistic sentiments in global markets will impart a depreciating bias to the INR, large forex reserves are likely to avert a sudden sharp depreciation. We expect the US$-INR cross rate to trade in a range of 76.0-79.0/US$ until the conflict subsides.
- Our baseline forecast pegs the average CPI and WPI inflation at 5.0% each in FY2023. However, the continuous hardening of crude oil prices poses upside risks, unless there is a cut in excise duty to absorb the impact of the same (on retail inflation).
- If the Centre reinstates the excise duty on MS and HSD to the pre-pandemic rates, before April 1, 2022, followed by the budgeted rise of Rs. 2/litre each on unblended fuel in H2 FY2023, we estimate the revenue loss to the Centre in FY2023 at Rs. 0.9 trillion.
- In addition to the cut in excise duty, the GoI's budgeted fiscal deficit would also come under pressure from high fertiliser subsidy requirements and a hit to direct tax collections due to elevated margin pressure for corporates. However, a modest nominal GDP growth and tax buoyancy assumptions, and the spillover of the LIC IPO to FY2023 would provide some cushion.
- Crude oil spike could exacerbate the impact of higher-than-expected FY2023 market borrowings of the GoI on yields. We expect 10-year G-sec yield to range between 7.0-7.4% in H1 FY2023.
- Large downside risks seen to FY2023 GDP growth forecast of 8.0%, with higher commodity prices to compress margins during duration of conflict.

Escalation in geopolitical tensions between Russia and Ukraine pushed crude oil prices to $130/bbl on March 7, 2022

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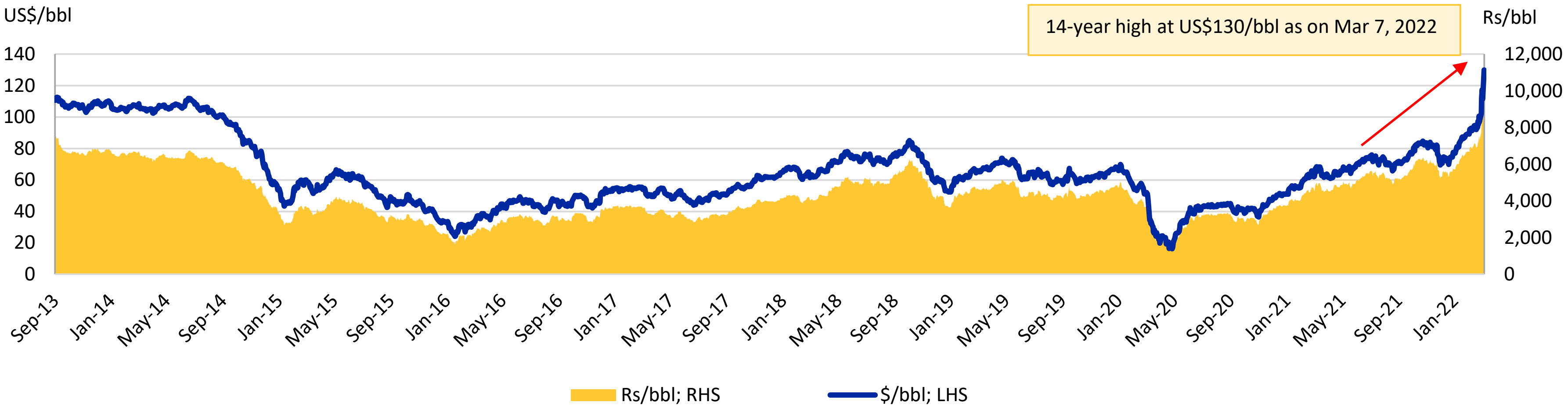
EXHIBIT: Crude Oil Price Movement of Indian Basket



Source: PPAC; ICRA Research

- The international crude oil price, in Indian basket terms, touched the US$130/bbl mark on Mar 7, 2022, fueled by intensifying geopolitical tensions between Russia (world's third largest oil producer) and Ukraine, and the possibility of sanctions on Russia's oil exports.
- The price of the Indian crude oil basket has averaged US$114.6/bbl so far in Mar 2022 (Mar 1-7, 2022), a steep 22.9% surge relative to US$93.3/bbl in Feb 2022.
- We expect the price of the Indian basket of crude oil to remain volatile in the near term, until the geopolitical tensions ease or OPEC decides to materially raise the magnitude of production.

Sustenance of the recent spike in crude oil prices could push CAD to 3.2% of GDP in FY2023

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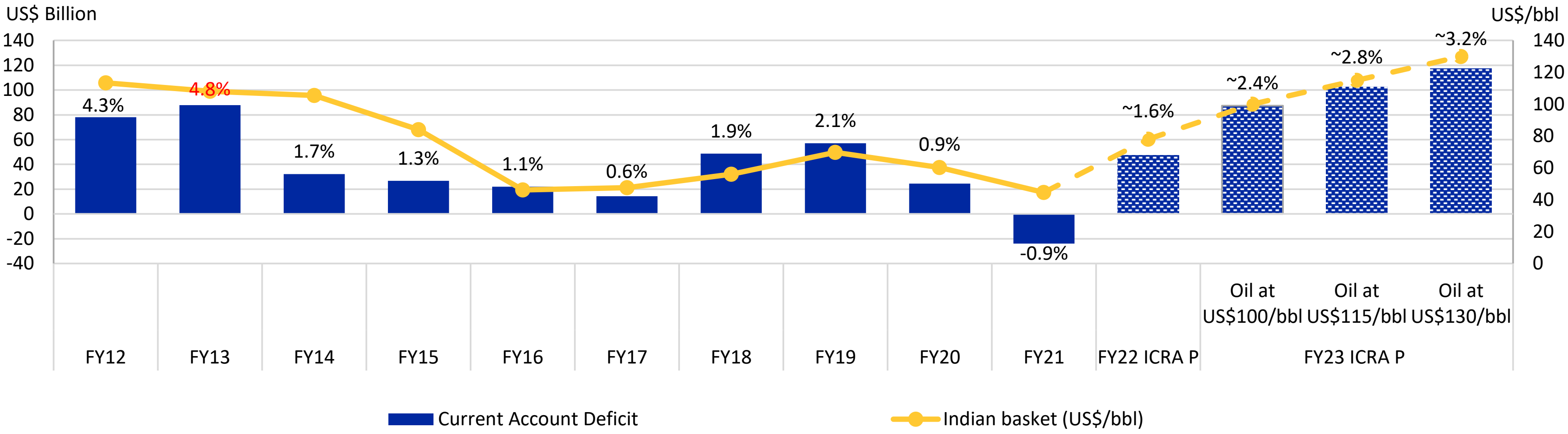
Exhibit: Trends in Current Account Deficit (US$ billion and % of GDP) and crude oil prices (in US$/bbl)



**P: Projected; Data labels correspond to CAD as % of nominal GDP; ICRA's nominal GDP Proj. has been used for FY2022 and FY2023; Source: PPAC; RBI; CEIC; ICRA Research*

- We expect the net oil imports to widen by ~US$14-15 billion (0.4% of GDP) for every US$10/bbl increase in the average price of the Indian crude oil basket. However, other imports are likely to be constrained in this scenario, reducing the deterioration in the CAD.
- Accordingly, if the ongoing geopolitical tensions between Ukraine and Russia push up the average price of the Indian crude oil basket in FY2023 to ~US$115/bbl, then the CAD is projected to widen to US$100-105 billion (2.8% of GDP).
- If crude oil price averages at US$130/bbl in FY2023, then the CAD will widen to 3.2% of GDP, crossing the 3% mark for the first time in a decade.

Elevated crude oil prices likely to impart a depreciating bias to the INR

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Exhibit: Movement in USD/INR exchange rate

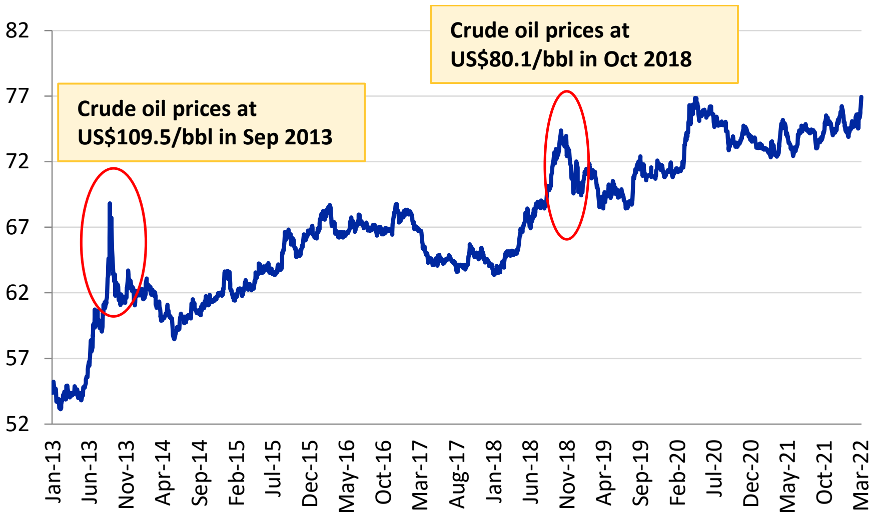
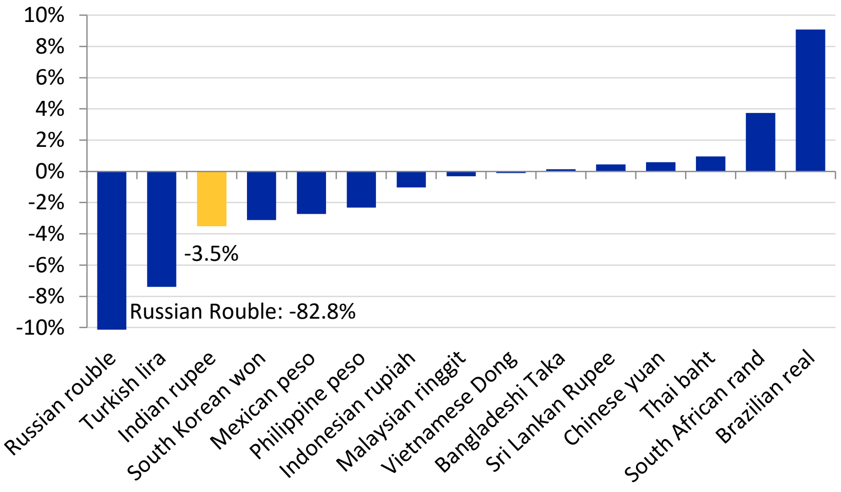


Exhibit: Exchange rate movements of various EM currencies relative to the US Dollar in CY2022 so far



- The INR depreciated to a record-low 76.94/US$ intraday as on Mar 7, 2022, led by the steep rise in crude oil prices.
- The INR has been amongst the worst performing EM currencies so far in CY2022, after the Russian Rouble and the Turkish Lira, led by the heavy dependence on imports for meeting its energy needs.
- Going forward, elevated crude oil and commodity prices, ongoing geopolitical tensions between Russia and Ukraine, and pessimistic sentiments in global markets, along with a stronger US$, could further have a negative impact on the INR.

**Data till Mar 7, 2022; Source: Bloomberg; RBI; ICRA Research*

Nevertheless, large forex reserves to prevent a disorderly depreciation of the INR

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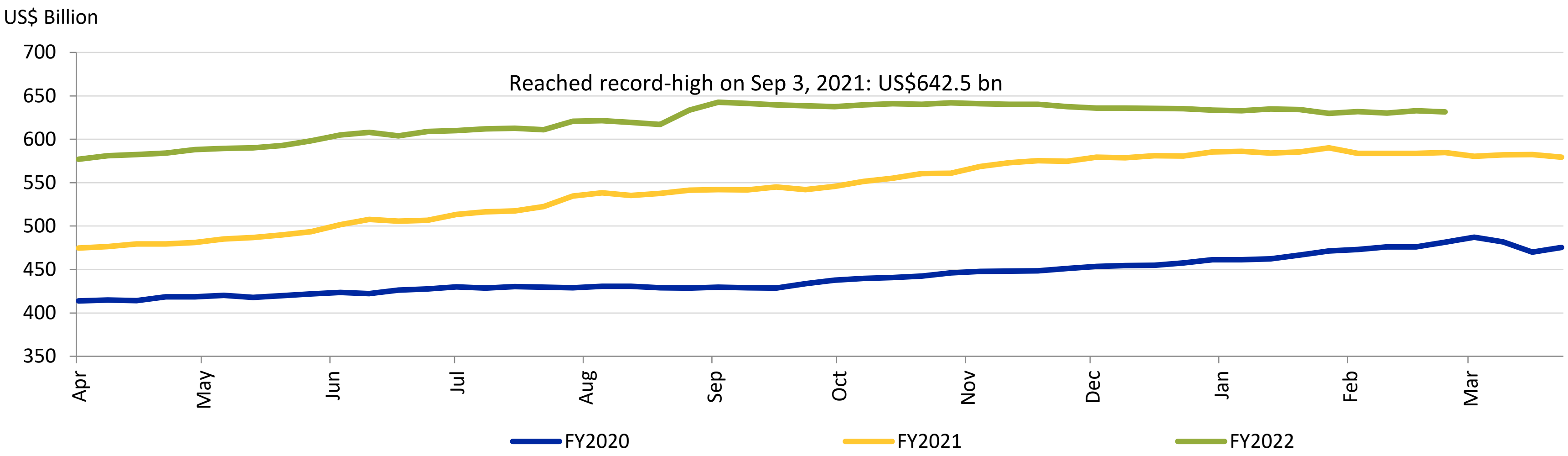
Exhibit: Forex reserves in FY2020, FY2021 and FY2022

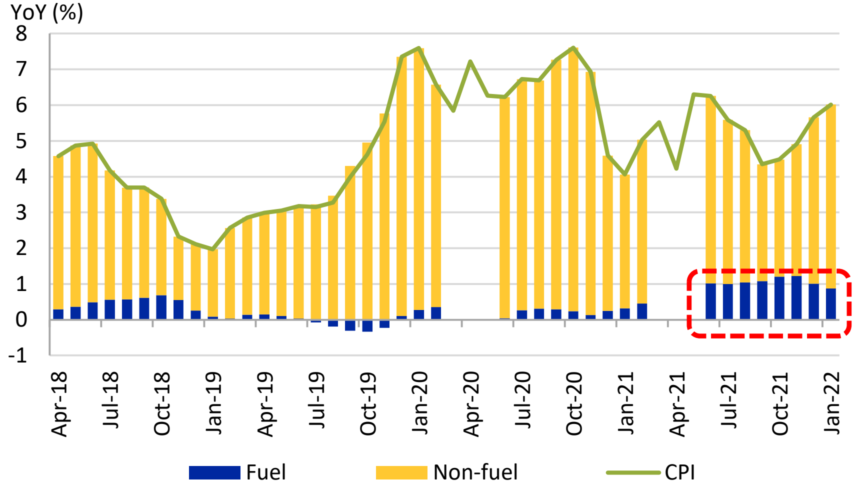


Source: RBI; ICRA Research

- Large forex reserves (US$631.5 billion as on Feb 25, 2022, equivalent to 12.6 months of TTM imports) are likely to avert a sudden sharp depreciation in the INR.
- Following the escalation in geopolitical tensions, we now expect the US$-INR cross rate to trade in a range of 76.0-79.0/US$ until the conflict subsides.

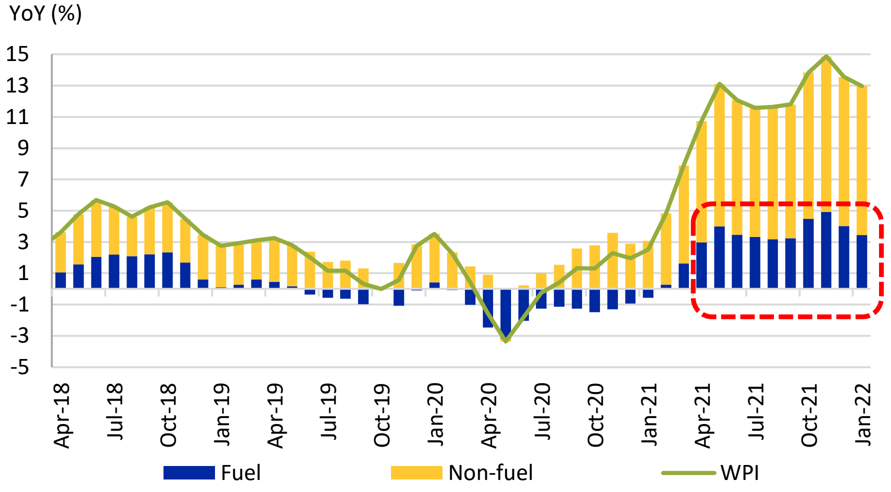
Hardening of crude oil prices poses upside to our CPI inflation forecast of 5.0% for FY2023

Exhibit: Contribution of fuel and non-fuel inflation to the headline CPI



**Since the detailed data for March-May 2020 is not available, we have not calculated the contribution of fuel and non-fuel to headline CPI inflation for March-May 2021; Source: NSO; CEIC; ICRA Research*

Exhibit: Contribution of fuel and non-fuel inflation to the headline WPI



Source: Office of the Economic Advisor, Ministry of Commerce and Industry, GoI; CEIC; ICRA Research

- Fuel accounts for 4.2% and 10.4%, respectively, of the CPI and WPI baskets by weight.
- Since June 2021, fuel inflation has contributed ~1.0 percentage point (~20% on average) to the headline CPI inflation number. However, fuel inflation has added a much higher ~3.5 percentage points (~29% on average) to the headline WPI inflation since April 2021.
- Higher commodity prices and a weaker INR pose upside risks to our baseline forecast that the base effect will moderate the average CPI and WPI inflation to 5.0% each in FY2023 from 5.4% and 12.0%, respectively, in FY2022.
- **The transmission of higher commodity prices to the WPI inflation will be relatively rapid. However, in an uncertain demand scenario, output prices may adjust slowly. Moreover, a cut in excise duty could absorb a portion of the impact of higher crude on the CPI inflation.**

RSPs of petrol and diesel have not been revised since Dec 2021

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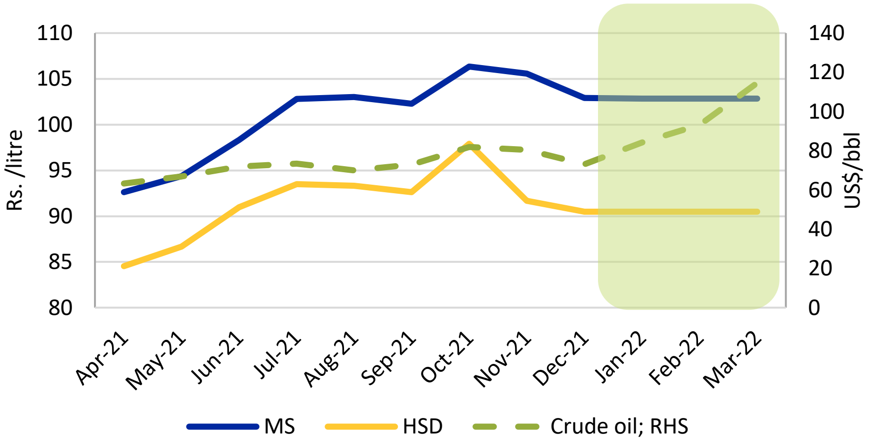
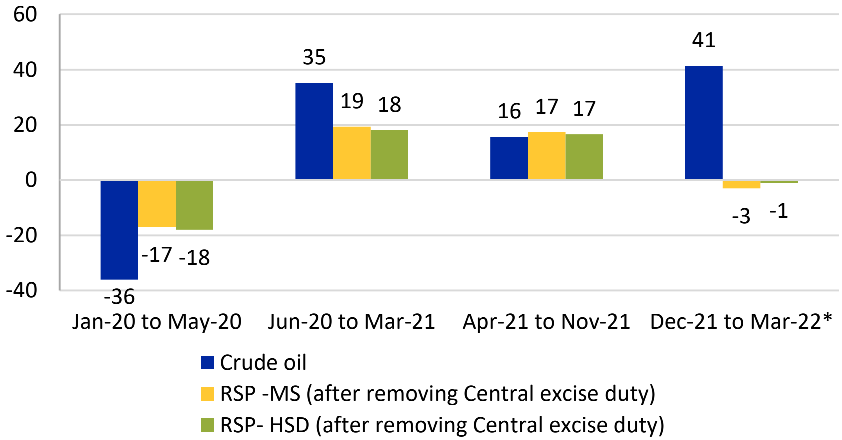
EXHIBIT: Average Retail Selling Prices (RSPs) of MS and HSD in four metro cities* and Crude Oil Price of Indian basket



**Namely, Delhi, Mumbai, Chennai and Kolkata; Till March 7, 2022; Source: PPAC; ICRA Research*

EXHIBIT: Change in Average Crude Oil Price (US$/bbl) and RSPs of MS and HSD (in INR; after removing respective Central excise duties)



Till March 7, 2022; Assuming crude oil price to average 95/bbl in Feb 2022; Source: PPAC; CBIC; ICRA Research

- The monthly average RSPs of MS and HSD in the four metro cities have remained unchanged at Rs. 102.9/litre and Rs. 90.5/litre, respectively, in March 2022 (till March 7, 2022) for the fourth consecutive month, in spite of a considerable US$41/bbl increase in crude oil prices in this period (Dec-Mar FY2022).
- After removing the Central excise rates levied on MS and HSD from their RSPs, the transmission of the rise in crude oil prices during Apr-Nov FY2022 appears to have been higher than what was undertaken during Jun-20 to Mar 2021, suggesting some buffer to compensate for the recent rise in crude oil prices.
- The total cesses levied on MS and HSD by the GoI stand at Rs. 27.9/litre, and Rs. 21.8/litre, respectively, at present. These are higher than the rates levied during the pre-pandemic period of July 2019-Mar 2020 by Rs. 8/litre and Rs. 6/litre, respectively.

A reduction in excise duty on MS and HSD to pre-pandemic rates would entail a total revenue loss to the Centre of Rs. 920 billion in FY2023

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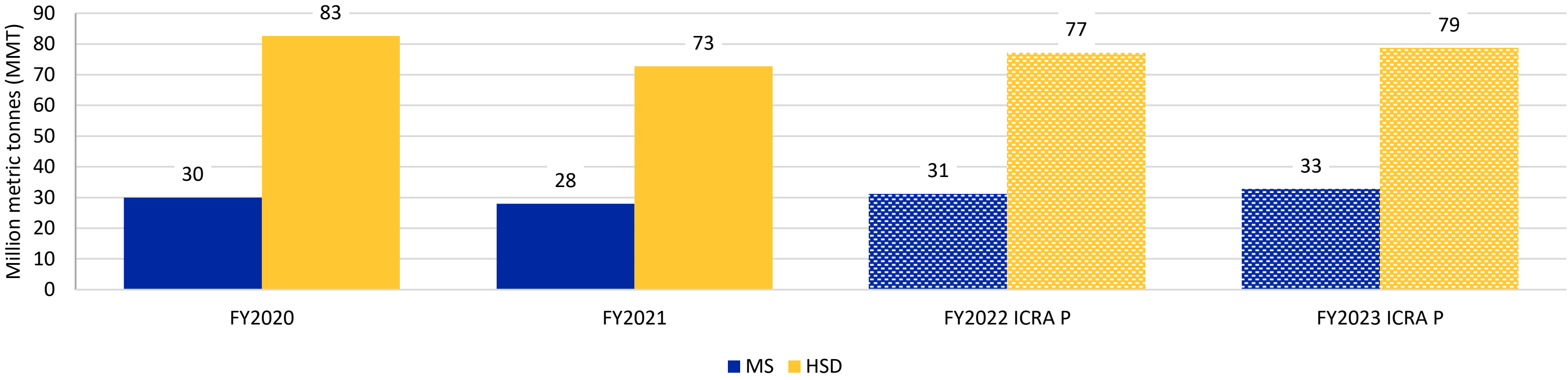
EXHIBIT: ICRA's Estimated Consumption of MS and HSD in FY2022-23



Source: PPAC; ICRA Research

- ICRA expects the consumption of MS and HSD to grow by 5% and 2%, respectively, on a YoY basis to 33 MMT and 79 MMT, respectively, in FY2023. While the MS consumption is likely to exceed the pre-Covid level of FY2020 by ~9%, that of HSD will trail the same by ~5%.
- Based on our forecast of volumes, a continuation of the status quo on excise rates would entail collections in line with the FY2023 BE of Rs. 3.35 trillion.
- **If the Centre reinstates the excise duty on these fuels to the pre-pandemic rates of Rs. 19.9/litre and Rs. 15.8/litre, respectively, on MS and HSD, before April 1, 2022, followed by the budgeted rise of Rs. 2/litre each on unblended fuel in H2 FY2023, we estimate the cess collections in FY2023 at Rs. 2.4 trillion, around 27.5% lower than the BE of Rs. 3.35 trillion.**
- **Accordingly, we estimate the revenue loss to the Centre in FY2023 from a rollback in cesses to the pre-pandemic level at Rs. 920 billion**.

Excise duty cuts and higher fertiliser subsidy to exert pressure on FY2023 fiscal target; low nominal GDP assumption and LIC spillover to provide some cushion

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Exhibit: Factors that will impact the GoI's budgeted fiscal deficit for FY2023

Positives

- **Low nominal GDP assumption:** The nominal GDP for FY2023 assumed in the FY2023 Union Budget (Rs. 258.0 trillion) is only 9.1% higher than the NSO's 2nd Advance Estimate for FY2022 (Rs. 236.4 trillion).

- **Modest growth assumed in tax revenues:** The gross tax revenues are set to exceed the FY2022 RE by Rs. 0.5-0.9 trillion (absorbing LIC delay and preventing fiscal deficit overshoot), which suggests that the growth embedded in the FY2023 BE is modest.

- **LIC IPO may be postponed to FY2023:** The likely spillover of the LIC IPO to FY2023 would augment the GoI's non-debt capital receipts in that year.

Negatives

- **Revenue losses due to excise duty cuts:** The revenue loss to the Centre in FY2023 from a rollback in cesses to the pre-pandemic level is estimated at Rs. 920 billion.

- **Need for higher spending on subsidies:** Fertiliser subsidy for FY2023 has been budgeted at Rs. 1.1 trillion. Given the surge in input costs, this would need to be enhanced appreciably during the course of the year.

- **Hit to direct tax collections:** High oil and commodity prices will lead to margin pressure for corporates, adversely impacting direct tax collections.

Source: ICRA Research

Crude oil spike to exacerbate impact of higher-than-expected FY2023 market borrowings of the GoI; 10-year G-sec yield to range between 7.0-7.4% in H1 FY2023

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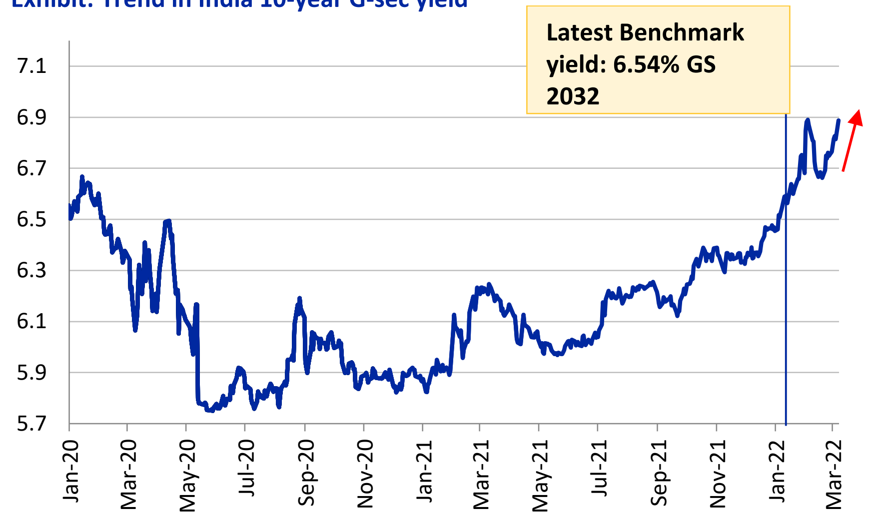
Exhibit: GoI's Long-Term Market Borrowings in FY2022 RE and FY2023 BE

Amount in Rs. Trillion	FY2022 RE	FY2023 BE	FY2023 Adjusted*
Gross Market Borrowing	10.5	15.0	14.3
Redemptions	2.7	3.8	3.1
Net Market Borrowings	7.8	11.2	11.2

**Adjusting for switch of G-sec of Rs. 0.63 trillion on January 31, 2022, the redemptions and gross borrowing would be Rs. 3.1 trillion and Rs. 14.3 trillion, respectively;*
Source: GoI Budget Documents; ICRA Research

Exhibit: Trend in India 10-year G-sec yield



Source: Bloomberg; ICRA Research

- With a large borrowing programme for FY2023 reducing the likelihood of repeated cancellations to drive down bond yields, we expect the 10-year G-sec yield to cross 7.0% in April 2022 and rise to as much as 7.4% over the next two quarters, especially if crude oil prices do not retreat meaningfully.

Large downside risks seen to FY2023 GDP growth forecast of 8.0%, with higher commodity prices to decimate margins

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EXHIBIT: GDP growth (at constant 2011-12 prices)

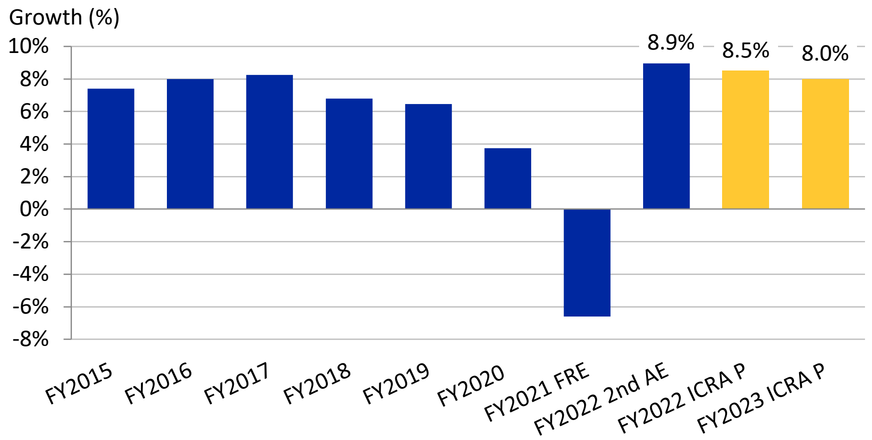
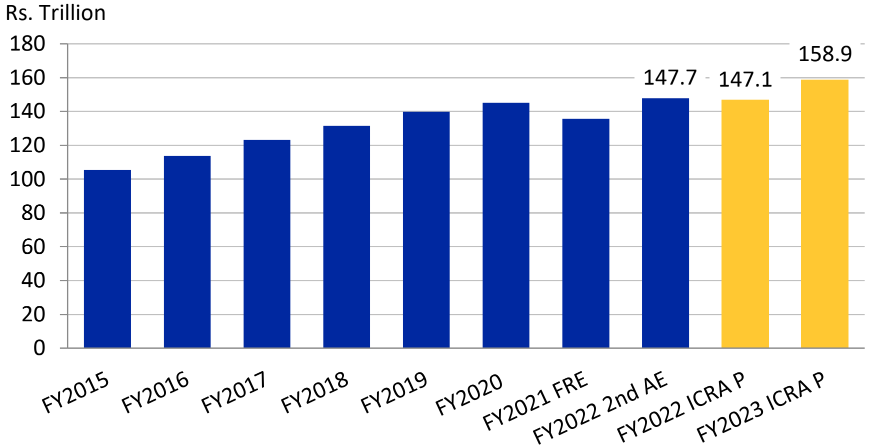


EXHIBIT: GDP (at constant 2011-12 prices; Rs. trillion)



FRE: First Revised Estimates; AE: First Advance Estimates; P: Projected; Source: NSO; CEIC; ICRA Research

- We had expected the Indian GDP to grow by 8.0% in FY2023, boosted by a low base in H1, albeit contingent on the GoI’s budgeted capex kicking off early.
- However, protracted geopolitical tensions and high commodity prices pose large downside risks, with margin compression set to squeeze value added growth during the period of the conflict.

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