October 5, 2021

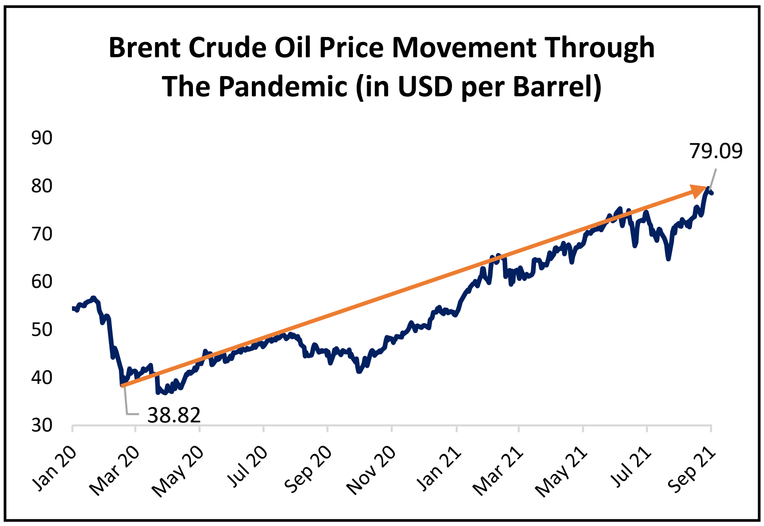
HDFC Mutual Fund's Tuesday's Talking Point: Rising Crude Oil Prices - A Signal Requiring Attention!

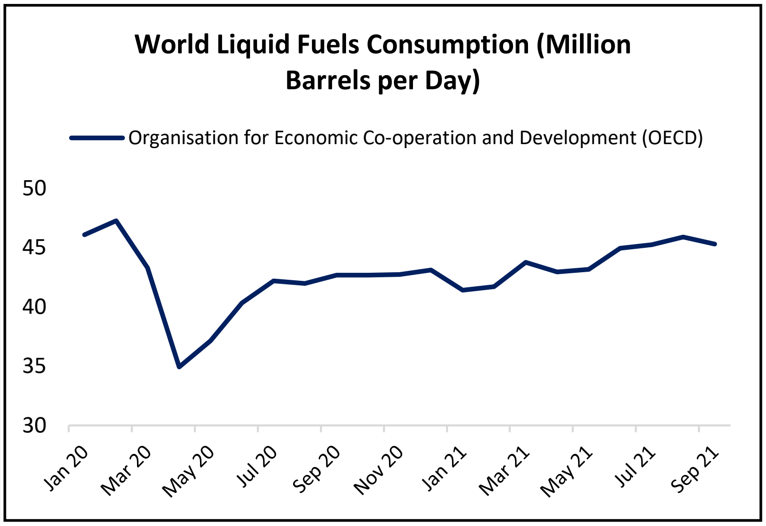
While the world continues to struggle to shake off the impact of COVID-19, Crude Oil prices have risen significantly in the recent times, with Brent at its highest since October 2018, at $80 per barrel.

A key reason for this surge in oil prices is due to Organization of the Petroleum Exporting Countries and its allies (OPEC+) continuing to maintain its position of adding to the previously agreed conservative output of 400,000 barrels per day each month. Moreover, in the United Kingdom (UK) and the Euro Region, a surge in wholesale power and gas prices has prompted concerns of high winter energy bills, and shortages already forcing a crunch in energy supplies. Additionally, in UK, with a shortage of Heavy Goods Vehicle drivers, supply of fuel to petrol pumps has become a challenge, forcing the British military personnel taking charge of supplying fuel to petrol stations.

To understand the rise to such levels, we should go back to the start of the pandemic. At the start, oil prices had seen a slump due to a drop in demand, while producers continued pumping crude oil. To add to this slump was the oil price war between Saudi Arabia and Russia, that started in March 2020 after the two countries failed to agree on the optimal oil production levels to restore prices to normal levels. This month-long price war ended in April, when the OPEC+ agreed to cut overall crude oil production from May 2020 onwards.

On the consumption side, a drop had been noticed globally in 2020, but as economies started to emerge from the pandemic in 2021, the consumption of liquid fuels started to recover gradually. But a shortfall in supplies led countries to put pressure on OPEC+ to raise output levels. With such pressure and OPEC+ continuing to be conservative at raising its current output levels, it remains to be seen how the crude oil prices will move, especially considering the ongoing energy crisis causing factories in China to ration power, due to soaring natural gas prices, shortfall in its supply and higher dependence on coal.





Source: Bloomberg, US Energy Information Administration

Elevated crude oil price levels could have ripple effects on the emerging economies like India too. In India, crude oil finds its application in various sectors like lubricants, tyres and multiple others. Hence, a rise in input costs could impact the profitability of the sectors of application. As per the Petroleum, Planning and Analysis Cell (PPAC), India depends on 80% of the imports for its fuel consumption, as of August 2021. Thus, it is believed that the rising crude oil prices could be contributing to petrol and diesel prices rising to record high levels across the country in addition to higher tax component imposed on fuel. Moreover, it is believed that the rising crude oil prices could impact the following:

- Rupee against the Dollar
- An increase in supply-side inflation

Now, with the Reserve Bank of India (RBI) maintaining its stance of prioritising growth over inflation, it might find it difficult to control the variables, like oil prices, causing inflation, while promoting growth. Hence, it will be interesting to observe how the RBI addresses this challenge in the next meeting of its Monetary Policy Committee to be held from October 6 to October 8, 2021.

Sources: Petroleum, Planning and Analysis Cell (PPAC), Bloomberg, US Energy Information Administration, Reserve Bank of India, and other publicly available information

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