

STUDENTS' ECONOMIC FORUM

A monthly publication from South Indian Bank



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CRUDE OIL & ECONOMY

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Theme No: 350: **CRUDE OIL & ECONOMY**

"When learning is purposeful, creativity blossoms. When creativity blossoms, thinking emanates. When thinking emanates, knowledge is fully lit. When knowledge is lit, economy flourishes."

- Dr. A.P.J. Abdul Kalam

The "SIB Students' Economic forum" is designed to kindle interest in the minds of younger generation. We highlight one theme in every monthly publication. Topic of discussion for this month is "**Crude Oil and Economy**".

Introduction

Crude oil is a liquid fuel source located underground. It is extracted through drilling. Between 50% and 97% of oil is hydrocarbons. Between 6% and 10% of it is nitrogen, oxygen, and sulfur. Less than 1% is metals such as copper, nickel, vanadium, and iron. Oil is called a fossil fuel because of its origin. It was created 400 million years ago when the remains of prehistoric algae and plankton fell to the bottom of the ocean. It combined with mud and then was covered by layers of sediment. The intense pressure heated the remains over millions of years. It first became a waxy substance called kerogen. It was transformed to liquid oil with more pressure and heat. Crude oil is a base component of transport fuel, plastics, chemicals, and petroleum products. It is used in carbon fiber in aircraft, PVC pipes, and cosmetics. Around 40% of textiles contain some petroleum byproduct. The early-2020 oil price war and the COVID-19 pandemic drove oil prices to record lows. As a result, oil markets have become extremely volatile, and global production has changed significantly.

The World's Top Oil Producers

According to recent data collected by the Energy Information Administration (EIA), total oil production averaged more than 100.61 million barrels per day (b/d) in 2019. The top five oil-producing nations are responsible for nearly half of the world's production of crude oil, lease condensate, unfinished oils, refined products obtained from the processing of crude oil, and natural gas plant liquids. According to the recent data published by EIA, the top five oil-producing nations are

1. United States

The United States is the top oil-producing country in the world, with an average of 19.47 million barrels per day (b/d), which accounts for 19% of the world's production. The U.S. has held the top spot for the past six years. US also tops the consumer side with around 20% share of world total.

2. Saudi Arabia

The Kingdom of Saudi Arabia contributes 11.62 million b/d, representing 12% of the world's total production. Saudi Arabia is the only member of the Organization of the Petroleum Exporting Countries (OPEC) to have made it to this list.

3. Russia

Russia ranks third with an average production of 11.49 million b/d in 2019, accounting for 11% of total world production. The oil industry in Russia was privatized after the fall of the Soviet Union, but after a few years, the companies were reverted to state control.

4. Canada

Canada holds the fourth spot among the world's leading oil producers, with an average production of 5.50 million b/d in 2019, accounting for 5% of global production. According to the EIA International Energy Outlook 2019, Canada's production could double by 2050, rising 126%, topping growth from any of the other non-OPEC countries. This increase is expected to come primarily from oil sands production, one of the costliest ways to extract crude. However, technological advancements are bringing down costs significantly.

5. China

China produced an average of 4.89 million b/d of oil in 2019, which accounts for 5% of the world's production. That being said, China is a net importer of oil, as the country consumed an average of 13.89 million b/d in 2018, which made it the second-largest oil consumer in the world (14% of the total world share) after the United States.

b/d = barrels per day, 1 Barrel = 159 L

Oil includes crude oil, all other petroleum liquids, and biofuels. Production includes domestic production of crude oil, all other petroleum liquids, biofuels, and refinery processing gain.

Source: International Energy Statistics, Total oil (petroleum and other liquids) production, December 1, 2020

India- Crude Oil Statistics

Oil production in India happens primarily in three onshore states, Assam, Gujarat and Rajasthan, which together account for more than 96 per cent of oil from onshore fields, and from the aged offshore Mumbai High Field. India produces only 20% oil of its requirement and rest is imported from other countries like Saudi Arabia and Iraq. India ranks third in the world for crude oil consumption with about 4.7 million barrels per day which accounts to around 5% share of world total.

How does crude oil prices impact Indian market and what are its effect on different segments of the economy?

1. Impact on Current Account Balance

India imports nearly 84% of its domestic demand and it is one of the largest importers of oil in the world. Indian Oil imports account for nearly 27% of its total imports. Therefore, a fall in the prices of oil will reduce the cost of importing oil from other countries. And this in turn has a direct impact on the current account deficit (the amount that India owes in foreign currency). Therefore, in the current crisis time (COVID-19 pandemic and economic slowdown), reduced crude oil prices have been a blessing in disguise to the Indian economy. In general, a 5 % increase in oil prices will impact the trade deficit by nearly \$4 billion.

2. Impact on Fiscal Deficit

The price of the oil is fixed by the government and it is at a subsidized rate. And then the government compensates the companies for selling the oil at lower prices. These losses are also called under-recoveries. Therefore, the losses incurred because of compensating the companies losses, adds to the Fiscal deficit of India. But with the reduction in oil prices, the compensation to be paid to these companies also reduces and which in turn helps to

narrow the fiscal deficit.

3. Impact on Stock Market

Now, if research and history are to be believed, then there is an inverse relationship between the oil price and the Indian equity market. This is because the Indian oil industry is majorly an importer of oil. Therefore, industries like tyre, lubricants, logistics, refinery, airlines, paints, etc are directly affected by a change in oil prices. Further, as we are aware, energy stocks have nearly 12.5% weightage in Nifty 50 and nearly 15% weightage in Sensex. So, strength in crude oil prices adversely affects these oil-dependent industries and a plunge in oil prices, usually signals strength in these companies' stock prices. If we were to take an example of the paint industry, companies like Asian paints, Nerolac, etc use oil as a major ingredient in their paints. So, any movement in oil prices directly impacts their performance in the stock market. Now, we all should have expected our equity market to have really outperformed when the oil prices crashed to sub-zero levels. But the global pandemic (COVID-19) has slowed down all global economies and we are no exception to it.

4. Impact on Exchange Rate

Rupee, being a free currency (value of rupee depends on the demand in the currency market), its value depends on the current account deficit. Therefore, if the oil prices are high, then the country will have to sell rupees and buy dollars to pay for oil bills. Similarly, if the price of the oil is low, then the current account deficit is low and the amount of dollars required to pay for oil bills are also low.

5. Impact on Inflation

India, being a vast country, transportation of goods from one place to another is a major factor that impacts trade. And oil is a very important catalyst in the movement of vehicles from one place to another. A rise in oil prices leads to a direct increase in the price of goods and services. And it has a direct bearing on the prices of petrol and diesel. And hence it contributes to the rise in inflation in the country. Therefore, a reduced price of oil comes as a boon to the economy of India. Experts believe that a \$10 change in the oil price, impacts inflation by 0.3%.

Mechanism of oil price determination in India

Historically, the price of petrol and diesel in India was regulated, i.e. the government was involved in deciding the retail price. The government deregulated the pricing of petrol in 2010 and diesel in 2014. This allowed oil marketing companies to determine the price of these products. Retail prices of petrol and diesel in India are linked to the prices of these fuels in global markets. But with our tax component still high, consumers may not get the desired relief. There is a debate in every corner of the country as to why the prices of diesel and petrol in India are higher when compared to neighbouring countries.

Crude Oil Price Drop 2020

- The impact of the COVID-19 pandemic hammered the oil industry in 2020, forcing U.S. oil prices to go negative for the first time on record. Brent crude oil prices also tumbled, closing at \$9.12 a barrel on April 20, a far cry from the \$70 a barrel crude oil fetched at the beginning of the year.
- The COVID-19 pandemic triggered an unprecedented demand shock in the oil industry, leading to a historic market collapse in oil prices. Demand for oil cratered as governments around the world shuttered businesses, issued stay-at-home mandates, and restricted travel. By April the impact of reduced

economic activity created an oversupply and oil producers were faced with a glut of crude oil that left them scrambling to find space to store the oversupply and prices plunged dramatically.

- An oil price war between Russia and Saudi Arabia erupted in March when the two nations failed to reach a consensus on oil production levels.
- By the summer of 2020, oil prices began to rebound as nations emerged from lockdown and OPEC agreed to significant cuts in crude oil production.
- By year's end, optimism over the possible rollout of multiple COVID-19 vaccines buoyed the market; by December 2020, Brent crude oil spot prices increased to an average of \$50 a barrel.
- The U.S. Energy Information Administration (EIA) expects average oil prices will further increase in 2021. This higher forecast is dependent upon two variables that could prove problematic: rising global demand in the coming year and OPEC's commitment to restrained oil production.

Bottom Line

The crude oil prices across the globe have a significant impact on global economies directly or indirectly. However, the increase in the crude oil prices results in increase in almost all the consumable and non-consumable commodities. The Indian economy is not an exception to the impact of change in crude oil prices. In India the demand for petroleum related products is increasing at a rapid pace which results in increase in crude oil imports. This paves way for strengthening energy efficient mechanisms in order to reduce the dependency on petroleum products. As mentioned earlier, oil prices have a major say in the financial markets of our country. Strong oil prices have a very positive effect on incomes, balance of payments, and financial markets of other oil exporting nations too. Despite the increasing proliferation of alternative energy sources, oil production continues to play an important role in the global economy.

Extra Read

The Organization of the Petroleum Exporting Countries (OPEC)

OPEC was organized in 1960 for the purpose of negotiating with oil companies on matters of oil production, prices, and future concession rights. Together, the OPEC members at the beginning of 2019 held about 72% of the world's total proved crude oil reserves, and the OPEC members in 2019 accounted for about 39% of total world crude oil production. OPEC and Persian Gulf countries are not the same. In 2019, the seven countries in the Persian Gulf produced about 31% of total world crude oil, and they held about 48% of world proved crude oil reserves. Of the 13 OPEC member countries, only 5 of them are Persian Gulf countries.

References: U.S. Energy Information Administration, OPEC, Investopedia, www.thebalance.com, Trade Brains, Business line, Business Standard



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