Economics

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Impact of Iran Crisis

Iran has become the focus of attention for the global economy with wider ramifications of the political issue surrounding Iran's nuclear capabilities snowballing into an economic crisis on account of oil-economics. The price of crude in international markets has already started pacing upwards to cross the $ 120 mark on fears of this crisis escalating to dangerous proportions.

The political view is that Iran's claims of their nuclear forays being for peaceful purposes, is not believed by the rest of the global community. There is a prophecy of war in which case there would be severe dislocations in the oil economy. While a war can emanate from Israel which will be supported probably by the US and its allies, the stance of the Arab nations is unclear. While they are opposed to the Iranian bomb, as it would make their own states vulnerable, Israeli intervention will not be acceptable. This means that even nations like Saudi Arabia would be drawn not just into the nuclear war but into an oil war as well.

Economic sanctions

Presently the western world has imposed sanctions on Iran so that it does not have the financial strength to purchase nuclear material. USA imposed sanctions by targeting any institution that does business with Iran's central bank.

The European Union has imposed an embargo on Iranian oil. The oil ban agreed by the European Union, which will be phased over a period of 4-6 months to reduce the impact on some of the weaker European economies, is the most significant toughening of sanctions to date. The EU is also to bring in restrictions on the Central Bank of Iran and to expand a range of other existing measures intended to constrain Iran's ability to do business abroad. Europe accounts for about 20% of Iran's oil exports. Greece is heavily dependent on Iran, from which it buys about one third of its oil. Italy and Spain each buy a little over 10% of their oil from Tehran. They will all now have to seek supplies elsewhere.

Impact on Iran

Oil exports account for around a half of the government's revenue. The oil embargo is to take place fully not before July which will affect around 20-25% of Iran's exports or roughly 600,000 barrels a day (BPD). European customers have already started looking elsewhere. Iran exported around 2.154 mn bpd of oil in 2010. China (20%) and India (16%) are the only nations that continue to buy oil from Iran. The US has to persuade South Korea and Japan to scale back their imports of Iranian crude. China, which buys over one- fifth of Iran's oil, is clearly the key and has sent conflicting signals. It appears to have significantly cut back on orders from Iran and sought to bolster its ties with other Gulf producers. Tehran is trying to sell an extra 500,000 barrels a day of oil, or nearly 23% of what it exported last year, to Chinese and Indian refiners. If it cannot find customers by mid-March for the oil, which is equal to the amount European refiners bought last year, Iran would be forced to put unsold barrels into floating storage in supertankers, or reduce output. Either measure could push oil prices higher.

Iran's economy is shaky today and the Iranian rial has lost half its value since December. This is coupled with food shortages and slowing down of investments. Iran's own exports are otherwise quite small relative to global requirements which have been projected by IEA to be about 90 mn bpd for 2012.

Present Oil Matrix

In January, non-OPEC supply was 53.2 mn bpd on lower global biofuels output, an escalation of conflict in Syria and between Sudan and South Sudan, and continuing outages in the North Sea. North American light tight oil production and NGLs, as well as increasing production in Latin America, offset declines elsewhere, supporting an expected 0.9 mn bpd rebound in non-OPEC supply in 2012. OPEC crude oil supply in January rose to 30.9 mn bpd on a steady ramp-up in Libyan production and sustained output from Saudi Arabia and the UAE. Suppliers like the Saudis, despite Iranian threats are willing to step up to cover the additional output required.

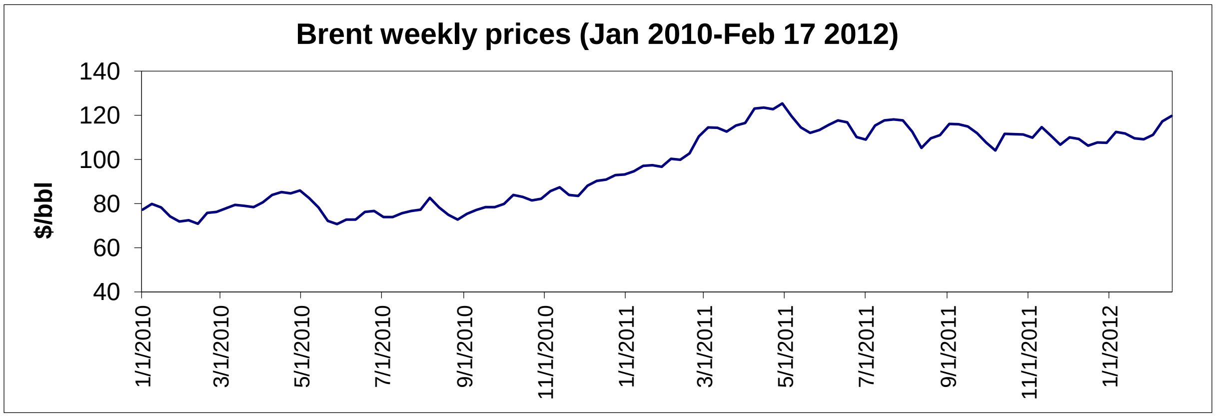
Saudi Arabia could increase production to around 11.8 mn bpd in a matter of days, or about 2 mn bpd greater than the current production estimate of 9.85 mn bpd. Angola, the UAE, Libya and Iraq are all expected to bring on new production capacity over the course of 2012, potentially as much as 850,000 bpd, while non-OPEC supply is expected to rebound to the tune of nearly 1 mn bpd in 2012.

What can Iran do?

Is there any chance that these actions would prompt Iran to halt its uranium enrichment programme? Given the political set up, it is unlikely to compromise on the same as its nuclear installations are scattered and protected heavily. It can theoretically close the Strait of Hormuz through which 35% of the world's seaborne oil passes. This can be done by attacking ships that come along, though it is felt that this will directly involve the USA for a counter attack.

How has crude moved so far?

Brent crude hit an eight-month high of $120.70 a barrel on Friday, the 24th February, amid worries about Iranian supplies and production disruptions in South Sudan and Yemen. In what appeared to be an effort to pre-empt the embargo Tehran announced it was cutting crude sales to French and British companies though both have already all but stopped buying Iranian crude, suggesting the move may turn out to be largely symbolic. Even so, this is the first real action by Tehran after weeks of threats and could still have a psychological impact that may push up oil prices as the market worries that Iran could halt exports to other nations.



How about oil companies?

European oil companies including Total of France, Royal Dutch Shell, Repsol YPF of Spain and Eni of Italy have either stopped buying Iranian oil or have halted spot purchases. Iranian lawmakers have called for an immediate halt in the country's exports of oil to all EU states to hurt the region's economy and demonstrate the country's determination to go ahead with its nuclear ambitions. Iran tensions have worsened the global oil supply outlook, which is already stretched by lower output from South Sudan, Syria and Yemen.

What are the future plans?

The International Energy Agency (IEA), which advises 28 oil consuming countries, has drawn up a plan to release up to 14 million bpd of government-owned oil stored in the United States, Europe, **Japan** and other importers. Action on this scale would be more than five times the size of the biggest release in the agency's history made in response to Iraq's 1990 invasion of Kuwait. The maximum release, some 10 million bpd of crude and about 4 mn bpd of refined products, could be sustained during the first month of any coordinated action, the plan says.

Impact on India

India consumed about 3.6 mn bpd in Q4-2011 and this number is increasing. Higher price of crude oil has a dual impact. First it increases the trade deficit which has foreign exchange rate implications, which by itself would pressurize the price level.

Second, on account of the high subsidy provided by the government on oil products, there will be pressure on the government to either increase the subsidy level or increase market prices of controlled products. If the government prefers the former, the fiscal deficit is bound to expand, and if it opts for the latter an inflationary impact is unavoidable. The petroleum subsidy bill was projected to be Rs 23,640 crore in FY12 and would increase even further depending on the level of subsidy being given. Mineral oils have a weight of 9.4% in the WPI of which the controlled products have a weight of 6.4%. Higher inflation will definitely come in the way of the expected interest rate easing path of the RBI during the course of next financial.

The oil marketing companies too would be under pressure depending on the extent to which they have to bear the burden of sharing of the overall cost.

Concluding remarks

The Iranian crisis and the impact on oil prices pose probably the biggest risk to global economic growth this year. While the link between higher oil prices and global growth has diluted over time, the pressure on prices and hence economic policy is still significant. The easing of monetary policy will have to be reviewed in case prices start increasing. India in particular will be affected by just not higher inflation and trade deficit but also on subsidies which seems to be a fairly sticky account in the Government's Budget.

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