Oil Crash of 2014 v/s 1998: Impact on India

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OIL CRASH OF 1998

From $24 in 1997, oil prices had crashed almost 50% to near $13 per barrel in 1998 causing extreme panic in oil exporting countries. The key reasons for crash were excessively high levels of oil inventories and fears of a prolonged Asian financial crisis.

Background

Oil-exporting countries had been going on a ‘production binge’ in 1990s. Venezuela had planned and implemented production increases since 1994 in the belief that the expansion of demand in the world market would absorb these increases without adverse effects on prices. And prices did rose in 1996 to levels not attained since the Iraq-Kuwait war of 1990. Saudi Arabia observing demand growth and supply increases by other producers in a situation of stable and sometimes rising prices decided, both to produce more and to legitimize the increase through an OPEC decision. Neither did Saudi Arabia want, nor did it expect prices to fall but the oil price fell, not because of a price war but because producers created new capacity at different times during the 1990s without appearing to give much thought to the price implications.

Efforts to Halt Price Fall

After price crash, moves were made by oil-exporting countries to reach an accord on production cuts. A number of oil-exporting countries began to express fears that the oil price decline would cause them serious damage. The Venezuelans agreed in Miami to a meeting with the Saudis with a view to reach an understanding on a joint production policy on production cuts. Prices started stabilizing after these efforts.

Impact on Oil Exporters

Russia was one of the major sufferers of 1998 oil price crisis as oil exports were its major source of revenue. On 17 August 1998, the Russian government had devalued the Ruble, defaulted on domestic debt, and declared a moratorium on payment to foreign creditors. Russian inflation in 1998 reached 84 percent and welfare costs grew considerably. Many banks were closed down as a result of the crisis. Russia bounced back from the August 1998 financial crash with surprising speed due to recovery in oil prices during 1999–2000 and devaluation of Ruble.

Is 2015 different from 1998?

Crude has dropped over 50 percent since June to below $50 a barrel, squeezing exporters from Venezuela to Russia and Nigeria. Credit default swaps show a 97 percent probability that Venezuela will default on its bonds within five years, according to data compiled by Bloomberg. The Russian economy, which is under sanctions by the U.S. and the European Union over the Ukraine conflict, will contract as much as 4.7 percent next year if oil remains near $60. Countries with large current account deficits, including Turkey, South Africa and Brazil, are vulnerable. So are nations such as Malaysia, where foreign investors account for 30 percent of local government debt.

Compared to 1998, Russia is in financially much stronger position now. Russia's looking at a healthy $200bn trade surplus for 2014. Russia also has more than $400bn in foreign reserves. And until recently the diving Rouble almost cancelled out the plummeting oil price, for Russia's finances, at least. These days, Russia's reserves and finances are in a far better state, but with the Rouble in freefall and a Central Bank apparently failing to respond, the problem is sentiment.

IMPACT ON INDIA

Impact on India in 1998 was mainly due to the Asian financial crisis affecting its currency. The current oil collapse is essentially due to oversupply of oil caused by new found shale oil. Till now there is no move to show that will be a supply control by oil producing countries. Russia, which was one of the biggest sufferers in 1998 may not be that badly impacted this time due to its stronger economy compared to the 1998 period. Even apart from Russia most oil exporting countries except a few are in financially strong positions and can withstand this crisis.

Most of the oil exporting countries are big investors in India and any weakness in their economies will negatively impact FII inflows. Additionally, in case of higher risks to economy, global funds move away from equities towards safety of US treasury bolstering the US Dollar which will weaken Rupee (along with other emerging market currencies).

Considering the facts that majority of oil exporting countries are financially better off now compared to 1998, India's foreign currency reserves are in healthy positions, there is no global financial crisis as was in 1998, India has a strong, stable and pro growth government, and that the oil price fall is a great boon to India's reserves – the overall impact this time will quite subdued compared to as seen in 1998 when the Nifty had fallen over 35%.

In worst case scenario, if oil falls further and stays at lower levels then Nifty may fall near 7700. It has already fallen nearly 5% and a fall to near 7700 will be about 11% drop from top which is a reasonable correction, fully discounting this crisis for which India is in a far better position to tackle compared to its 1998 situation.

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