STATE BANK OF PAKISTAN

Fuel Price Trends

An Analytical Review

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Contents

INTRODUCTION

The high degree of dependence on oil producing countries and any irregularities in prices and supplies has a pervasive effect for an economy that imports crude oil to cater to its often fragile industry. Following the sharp surge in oil prices since 2003, developing countries that rely heavily on oil imports, are now faced with an increased threat to macroeconomic instabilities, with Pakistan as no exception.

This brief note provides an overview of international oil price trends witnessed since 2002. Observations are also made on how domestic furnace and high speed diesel oil price trends move in consonance with the international oil prices. The need to focus on furnace oil and high speed diesel oil prices trends arises from the fact that of the total production by oil refineries of major components of crude oil, diesel constitutes the highest share of 31% with furnace oil comprising the second largest share of 29.4% in Pakistan (2006-07 estimates).[1]

This study will then focus on how this increasing trend in international and subsequently domestic furnace and high speed diesel oil prices, translate into creating imbalances in the economy by exacerbating the balance of payment crises, worsening current account deficit, soaring inflation and impacting the rates of other commodities and input prices. Consequently, the dire need of exploring alternate and indigenous energy potential perhaps has never been more pressing.

[1] Pakistan Energy Yearbook 2007

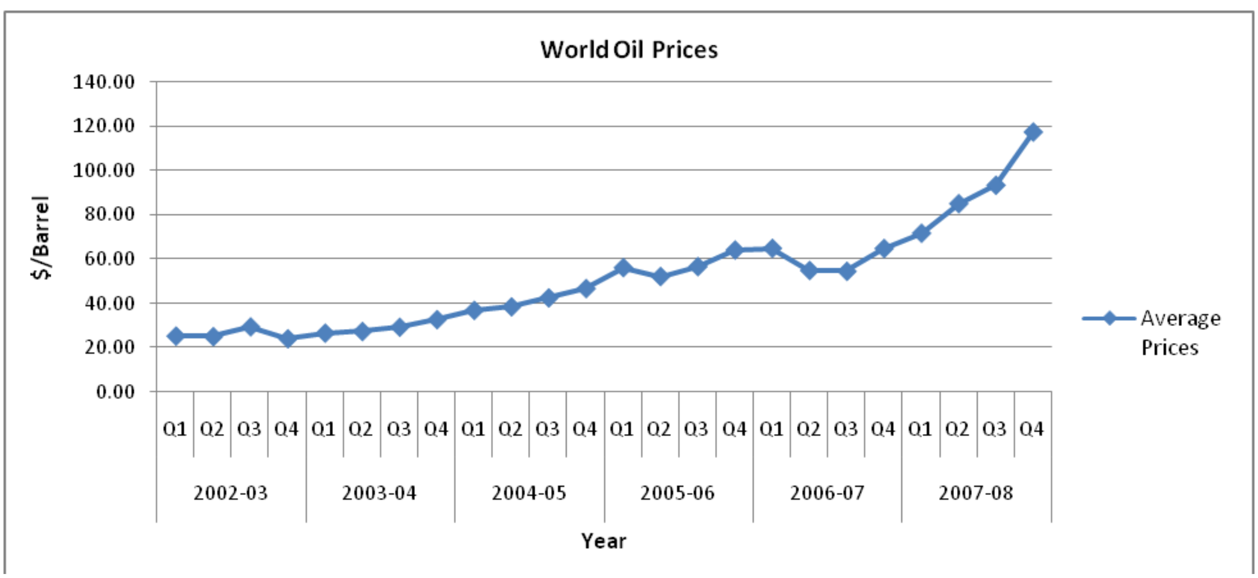
TREND ANALYSIS

International Oil Prices

The global economy has found itself in the midst of an all time oil price peak which has also surpassed the peaks experienced during the Iranian Revolution in 1970s. This surge is having a compounding effect on the existing macroeconomic challenges for countries whose domestic economy is consequentially linked with the international oil market and other product prices.

World oil average prices during 2003-04 were over 11% higher than the average prices during 2002-03. End of the 2004-05 experienced a sharp upward swing in prices, with an increase of over 41% compared to the average price/barrel in the preceding year. Newer peaks were reported in price/barrel during 2007-08 when a 53.4% increase in prices was witnessed, compared to 2006-07. Overall, there has been a 360% increase in price/barrel of oil since the first quarter of 2002-03 to the end of 2007-08, with the first quarter of 2008-09 opening into even higher average prices and etching newer records with prices over $140/barrel on a given day. Figure 1 graphs the recent trends in world oil prices.

Figure 1



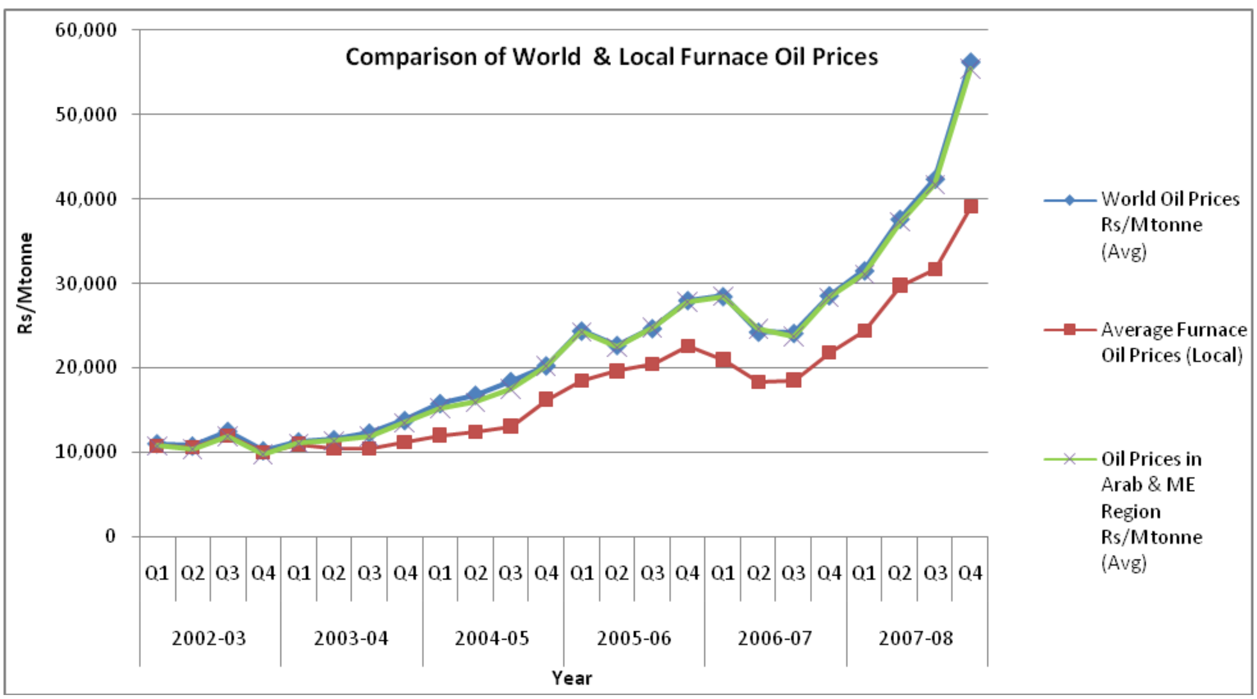
Source: Energy Information Administration, 2008

As evident from the figure, a rising trend did set in during 2003-04. After a temporary fall in prices in the second quarter of 2005-06 there is a sharp upward swing from the third quarter of 2006-07 and onwards. Analysts suggest an interplay of wide-ranging factors to have caused this recent upsurge in the world oil prices. Strong growth of the world economy after 2003 with China and India as major players, undoubtedly have created exceptional demand for oil.[2] In face of increased demand, supply rigidities not only continue to persist but are seemingly compounding over time. According to a recent IMF paper on oil movements and its impact on the global economy, even with increasing demand-side pressures, the magnitude of price increase is most likely resulting from oil supply factors, with OPEC's spare capacity diminishing. Additionally, exploitation of untapped reserves is significantly falling short of global production of crude oil. [3] According to the IMF, the supply side rigidities, along with geopolitical scenario have caused oil supply to become markedly binding, thus making it extremely vulnerable to even minor disruptions. The fall in US dollars has also led producers to increase the dollar price in order to maintain their oil income in terms of stronger currencies like Euro. Lastly, the off-late speculative role of investment banks and key oil market players has also been accused of driving up world oil prices.

Domestic Prices

Being an importer of oil, the domestic furnace oil prices in Pakistan follow the rising trend witnessed in international prices.

Figure 2.1

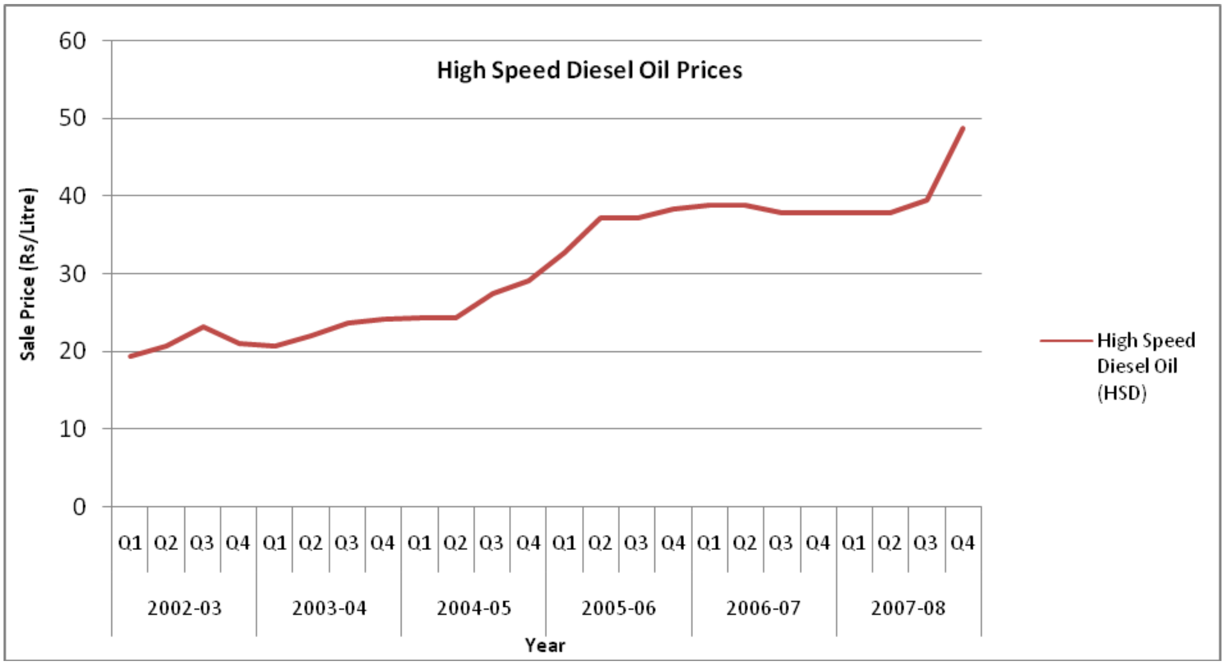


[2] The BP Statistical Review of World Energy June 2008, reports a growth of 7.7% in energy consumption by China. China also accounted for half of global energy consumption growth during 2007. Indian consumption grew by 6.8%, the third-largest volumetric increment after China and the US.

[3] It takes on an average 11 years before an oil discovery is ready for production (Elekdag, Selim, Rene Lalonde, Douglas Laxton, Dirk Muir, and Paolo Presenti. "Oil Price Movements and the Global Economy: A Model-Based Assessment." IMF Staff Papers 55 (2008): 297-311)

Figure 2.1 shows that domestic prices of furnace oil rose by 25% during 2004-05 and over 50% by year end 2005-06. With a slight deceleration in prices during 2006-07 (-1.98%) prices during 2007-08 posted a record increase of 57.36%. Holistically, it can be observed that domestic furnace oil prices have been following very closely the general price trend observed in the international oil market.

Figure 2.2



A similar analysis of High Speed Diesel Oil (HSD) price trends since 2002-03 reveals that rises in HSD's prices have been relatively less driven by international oil prices. Prices rose by only 7.4%, 16.2%, and 5.28% during 2003-04, 2004-05, and 2006-07, respectively. Prices rose sharply only during 2005-06 by 38.15% and during the last quarter of 2007-08 by 22%. The reason why HSD did not closely follow international price trends was due to the fact that the government has been giving subsidy on diesel to reduce the impact of soaring oil prices on common man as majority of transport fleet in Pakistan consumes diesel.

IMPACT ON ECONOMY

Impact on Balance of Payment (BOP)

The impact of high oil price in international market has reverberated well into Pakistan's economy and has exacerbated the already existing imbalances. The effect of increase in international oil prices remained relatively limited until early 2003-04. This was due to favorable global conditions, sustainable level of world prices to domestic consumers, and increase in capital inflow especially remittances. Furthermore, this can also be attributed to the increase in international oil prices, which was gradual.

The recent sharp increase, however, severed through the balance of payments in Pakistan, creating a substantial gap between exports and imports (Figure 3).

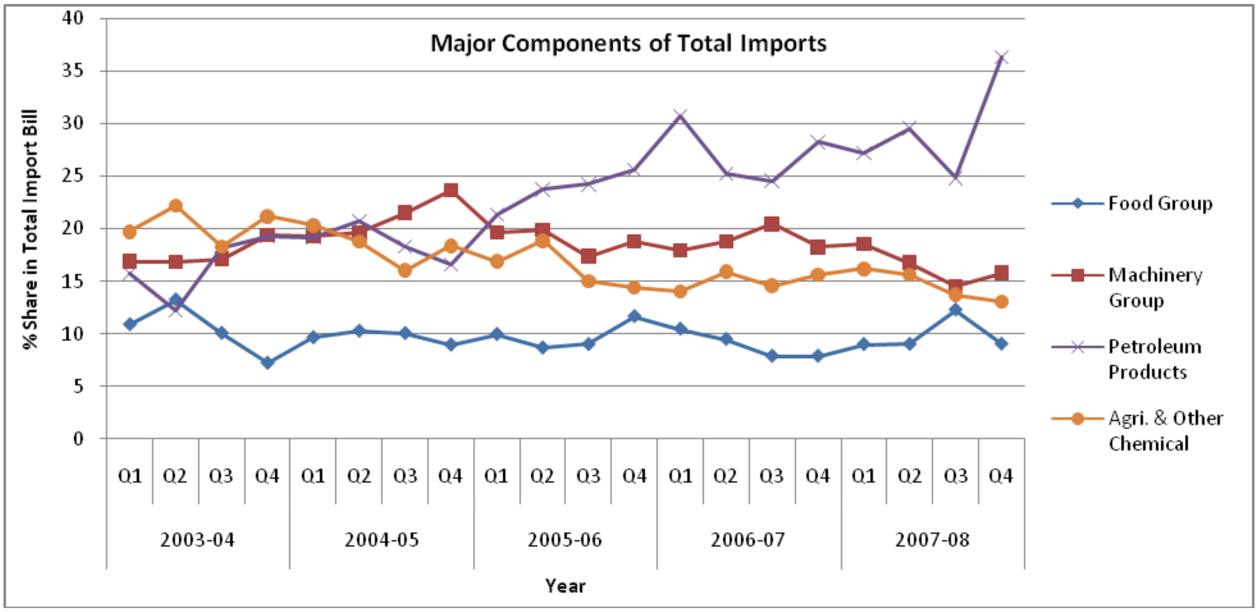
Figure 3

Source: SBP

Impact on Exports and Imports

Exports have increased by only 72% since 2002-03, whereas imports have increased by 227%. This widening gap has caused the current account to persistently report a deficit, which is growing at alarming levels. By the end of 2007-08, total imports stood at around $40 billion; more than twice that of exports. The acceleration seen in imports is largely being driven by the surge in international oil prices and the fact that Pakistan is heavily dependent on oil imports. This is further substantiated by Figure 4, which shows that the oil import bill constitutes over 35% of the total import value during the last quarter of 2007-8 compared to 25% in the preceding quarter. This share has increased drastically when compared to the share of 15% in early 2003-04. This, along with pressure from increased food prices has constantly come at a cost of shrinking shares on other items such as Machinery and Agricultural & Other chemicals.

Figure 4



Source: SBP

This certainly has had a negative impact not only on the BOP but also poses as a threat to the level of industrialization and technological improvements to the manufacturing sector which then translates into deteriorating exports. Imports of textile machinery have witnessed a negative growth rate of 17% and 36 % during 2005-06 and 2006-07, respectively. Similarly, large-scale manufacturing growth too has experienced a slump with recording only 4.8% growth during 2007-08 as opposed to 8.6% during 2006-07. [4]

Fiscal imbalances have also been created by GoP's continued policy of providing subsidy on oil products to protect poor households and the domestic industry. The burden of subsidies in face of ever increasing international prices rise, along with the depreciation of the rupee against the dollar and the debt service burden is adding to the pressure on government budgets and increasing political and social tensions.

Impact on Inflation

Higher oil prices directly lead to increase in food prices. As a result there was a substantial increase in head line inflation. The recent need to import food items like wheat, sugar etc, and depreciation of Pakistani rupee further led to an increase in food prices. Due to increase in global oil prices and import

[4] Economic Survey of Pakistan 2007-08

bill of food group, headline inflation is constantly going upwards. The impact of inflation would have been even worse, had the government not offered subsidies on oil products and food commodities. Figure 5 shows the inflation experienced in food prices since 2002-03 in major groups.

Figure 5

Similar to other developing countries (Ethiopia, Sri Lanka and Ukraine), Pakistan too faced inflationary impact of rising food and oil prices which is likely to be amplified by continuing demand pressures. Other than increase in oil prices, the surges in food prices is due to withdrawal or reduction of subsidy on food as existing subsidy became too costly for the government.

Soaring oil prices with increased food prices inevidently have a negative impact on growth and drive up the cost of inputs. Both these factors are posing a great challenge to the macroeconomic situation of Pakistan. Faced with such a situation, the low-income households find it very difficult to protect themselves against inflation, especially those living in urban areas.

Impact on Electricity Price

Presently, around 30% of the country's installed generation capacity is based on furnace oil. It is high time now that the country should review its energy mix and start making genuine progress for utilizing alternate energy sources like wind and solar and for enhancing the share of hydel, as continued high reliance on furnace oil is becoming more and more expensive. To date, GoP has been giving subsidy to utilities for not passing on the impact of high fuel prices to customers. However, since the budget deficit has now gone beyond sustainable limits, the government is now moving away from subsidy and utilities are now being asked to pass on the impact of fuel prices to the customers. Recently, Nepra has approved an increase in electricity price up to 60% for distribution companies, which will be implemented shortly. Since electricity is one of the major components of manufacturing cost, this will not only increase the CPI further but would also hurt the competitiveness of our exports.

CONCLUSION

Oil prices and its fluctuations continue to pose as a consequential macroeconomic concern for both developed and developing countries. For oil importing countries like Pakistan the impact of irregular and unexpected price hikes quickly seeps into the domestic economy, threatening the already existing macroeconomic imbalances. Oil price hikes are aggravating the energy shortage in Pakistan which is now feeding into increased general prices, transportation cost, slowing down agricultural and industrial productivity and aggravated water shortages for the rural economy. This is having an enormous financial impact on our competitiveness in the external sector, creating record trade and BOP gaps and depleting our foreign exchange reserves. In order to move towards attaining fiscal stability and sustainability, the need for tilting away from heavy reliance on oil imports towards alternative energy and fuel options now becomes increasingly important.

End of Review