

Oil shock's impact on India's BoP

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Uncertainty and shortages have roiled India's oil markets following the unwarranted bombings of Iranian civilian and military targets launched by the United States and Israel and Iran's predictable response to that unprovoked attack.

With India heavily reliant on oil imports and anywhere between 30 and 40 per cent of its crude imports and 80-90 per cent of its liquified petroleum gas (LPG) imports sourced from and transiting through the Gulf region, the impact the war is having on the physical supply of oil and LPG and the prices of those supplies is a major shock to the economy.

Globally the war has shaken the world's oil markets for multiple reasons. First, the bombing of Iran threatens to shut down its oil production facilities for quite some time. Since Iran hosts a large oil reserve and was a major supplier to global markets till US sanctions were imposed on the country, that consequence does influence calculations of long-run supply and can therefore impact oil price trends.

Second, since Iran's response includes shutting off the Strait of Hormuz that is the easiest and most cost-effective route to service anywhere between a fifth and close to a third of the world's gas and oil demand, the impact on global supply is immediate. More so because the targets of Iran's retaliation include oil facilities in many oil- and gas-exporting Gulf states, which are seen as implicitly or explicitly facilitating US-Israeli aggression.

Third, large trading firms, like Vitol, Trafigura, Glencore and Gunvor, which are not necessarily large oil producers, dominate the global physical trade in oil, and are known to be secretive speculators for profit in commodity markets. This concentrated trade and speculation leads to an amplified impact of the war on oil prices, far beyond what is warranted by any supply shortfall. This speculative impact is highlighted by the huge volatility that oil prices have displayed around a rising trend.

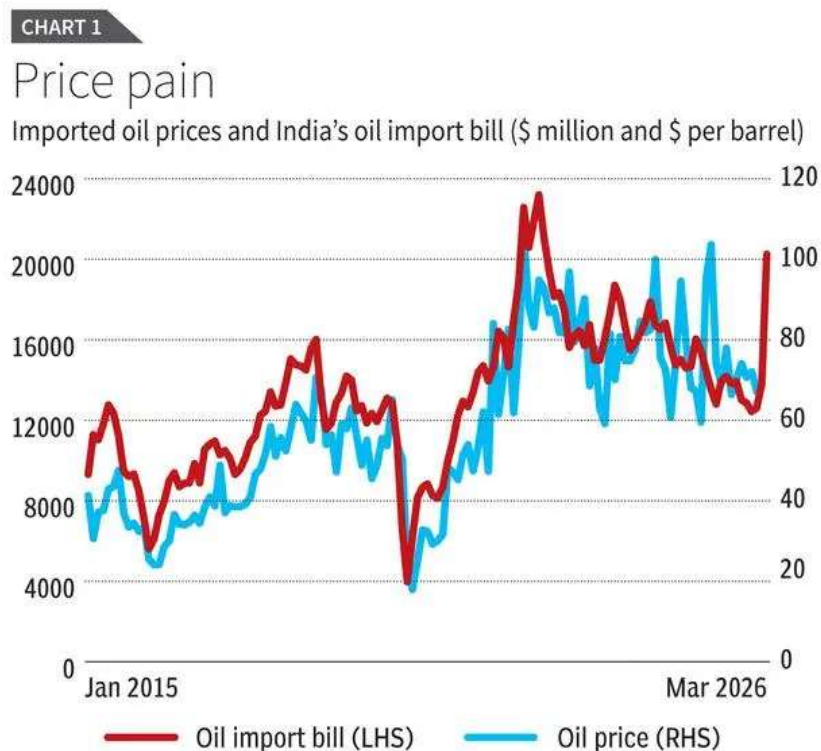
Finally, this dominance of speculators means that any effort to redress demand-supply imbalances, as is sought to be done through the release from strategic reserves of 400 million barrels of oil by the members of the International Energy Agency, only sends out a signal that the crisis is serious and intensifies speculative activity. So long as uncertainty prevails, oil prices would soar to levels way beyond the so-called \$100 psychological barrier.

Impact on India

The impacts from these consequences transmit to the Indian economy through multiple routes. Given India's import dependence for crude and gas, there is already talk of shortages that would affect, among others, households using LPG and oil-based means of transportation, truckers, and farmers using oil based fertilizers.

The rise in the price of a universal intermediate like oil would trigger “imported” inflation both because of the rise in the dollar price of oil and the depreciation of the rupee it precipitates. And the current account of India’s balance of payments, crucial to sustaining the ‘confidence’ of foreign financial investors, which has been shored up by remittances and receipts from IT and IT-enabled services exports, will be hit by falling remittance inflows and a widening trade deficit.

Chart 1 illustrates the relationship between the price of India’s oil import bill and the price of the Indian basket of crude (a weighted average of Oman, Dubai and Brent crude prices). The import bill has clearly been driven primarily by the average import price, with some signs of divergence. Since import data are yet to be released, the impact of the recent spike is yet to show itself, though a sharp rise is inevitable.

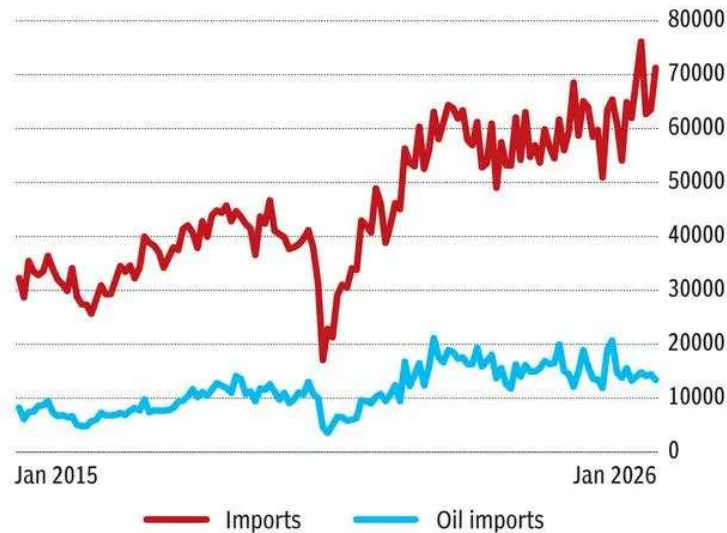


That rise can be damaging because India’s aggregate imports have risen at a much faster rate than its oil imports since the end of the Covid pandemic (Chart 2). Clearly non-oil imports, including imports of non-necessities such as gold, have been rising, not least because of continuous liberalisation in the import trade and the associated reductions in import tariffs. A sharp rise in the oil import bill will only add to the vulnerability resulting from that longer term tendency.

CHART 2

Import profile

Oil in India's import bill (\$ million)



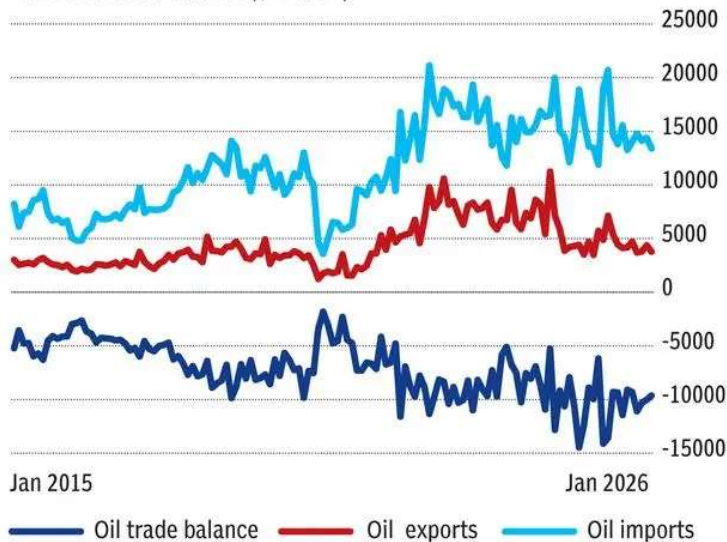
Trade balance impact

In the past there had been one factor mitigating the impact of oil import dependence on India's trade balance. With excess refinery capacity, India has been exporting refined products manufacture with imported crude, generating export revenues from its oil sector. In fact, as Chart 3 shows, the rise in imports of oil and products has been closely followed by export revenues in that category.

CHART 3

Export impact

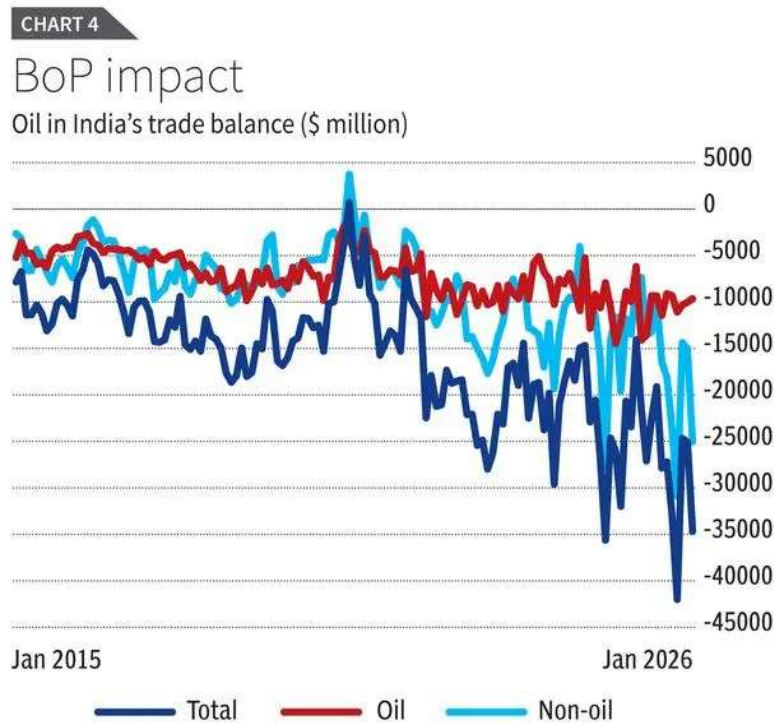
India's oil trade balance (\$ million)



Given value addition through refining in India, the export revenues generated from these related oil imports would be large than the value of those imports. So, the deterioration in the oil trade balance following the pandemic would have been greater than reflected in Chart 3 if these exports had not occurred.

But, given the current loss of physical access to crude imports, the Indian government would possibly retain available imported supplies for domestic consumption, adversely affecting the export of refined products from private facilities. This would mean that the influence of the widening import bill on the oil trade balance would be significantly higher and the deterioration in the balance of payments larger.

The significance of this for the balance of trade comes through from Chart 4 which presents the relative roles of the oil and non-oil trade balances in determining India's overall trade balance. Much of the post-pandemic deterioration in the trade balance was on account of the worsening of the non-oil trade balance, with oil contributing only marginally to that downturn. That would change now, with adverse consequences.



In sum, the fact that the oil crisis, precipitated by the unwarranted attack on Iran, is resulting in both a physical shortage of supply as well as a spike in prices, would amplify its adverse effects on India's balance of payments, given the nature of its integration into global oil markets.

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