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The Third Oil Shock: The Path Forward for Bangladesh

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Oil is now traded at nearly US$140 a barrel.[1] The real price of oil is already at an all-time high.[2] Goldman Sachs, the United States-based investment bank, which correctly predicted three years ago that the oil prices would exceed US$100, has recently forecasted that US$200 a barrel could be a reality in the not-too-distant future.[3] A 170 percent price hike[4] over a three-year period (from US$47 a barrel in May 2005 to US$127 May 2008) and, more importantly, a relentless rise in fuel prices has resulted in the current scenario being termed "the third oil shock".[5] This is certainly true from the perspective of the least developed countries. The term was, in fact, used by Gordon Brown, the British Prime Minster, who, in a recent article, stated that the global economy is facing the "third great oil shock" of recent decades.[6] The Economist has dubbed the phenomenon a "slow-motion oil shock". Worse still, Joseph Stiglitz, economics Nobel laureate, is concerned that oil is underpriced relative to the cost of carbon emissions.[7] Apparently, the price of the black gold will continue to swell until it finds equilibrium where alternative energy becomes viable.

Bangladesh, a least developed country with a per capita income of US$419 (US$1119 in purchasing power parity terms),[8] faces severe challenges in the wake of astounding oil price hikes. Like most economies in Asia, the domestic prices of petroleum products in Bangladesh are capped. In recent years, favourable developments in the country's external sector, particularly the steady growth of export and remittance, and its sizeable stock of natural gas[9] had cushioned the Bangladesh economy from the ongoing oil price hike until recently.

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1 Light, sweet crude for July 2008 delivery settled at $127.35 a barrel on the New York Mercantile Exchange in May 2008, according to the Wall Street Journal.

2 Wolf, Martin, "The Market Sets High Oil Prices to Tell us What to Do", Financial Times, 13 May 2008.

3 Analyst Warns of Oil at $200 a Barrel, Financial Times, 6 May 2008.

4 Energy Information Administration < http://tonto.eia.doe.gov/dnav/pet/hist/wepcagsaw.htm >

5 The world economy observed two oil shocks in 1974 and 1979.

6 The Guardian, < http://www.guardian.co.uk/commentisfree/2008/may/28/gordonbrown.oil >

7 New Limits to Growth Revive Malthusian Fears, Wall Street Journal, 24 March 2008.

8 World Development Indicator Online.

9 Natural gas serves as close substitute of oil to some extent. Natural gas constitutes 68 percent weight in Bangladesh's energy basket followed by oil (30 percent) and hydro (two percent).

However, the higher than expected level of oil prices, coupled with fertilizer and food subsidies, have pushed the economy to the brink of a fiscal problem, if not a crisis.

Natural gas constitutes 68 percent of Bangladesh's energy basket, followed by oil (30 percent) and hydro (two percent).[10] The country produces 10 percent of its oil requirement while the rest is procured from international markets. It imports 3.8 million tonnes of oil annually, including 2.1 million tonnes of diesel. Bangladesh has had a long history of fuel subsidy and the exchequer absorbs a significant part of price hike in international markets. In April 2007, the government raised diesel prices by about 21 percent when crude oil was US$67 per barrel.

The Bangladesh government traditionally borrows from the state-owned banks and the Islamic Development Bank (IDB) to finance the Bangladesh Petroleum Corporation (BPC), the energy entity that imports fuels from international markets and distributes them in the domestic market at a subsidised price. The government has asked the IDB to double its annual loan to US$2 billion for the next year.[11] In the current fiscal year (2007/2008) to June, Bangladesh will require US$4.5 billion for oil import and repayments of loans which are 30 percent higher than the past fiscal year's oil bill.

A sharp increase in subsidies following the rise in oil prices, among others, is widening the country's fiscal deficit. The Asian Development Bank (ADB) forecasts that the fiscal deficit in the country in FY2008 is likely to increase to 4.8 percent of gross domestic product compared to 3.2 percent in the preceding year.[12] The Economist Intelligence Unit has also projected a five percent budget deficit for 2008 for the economy. But if oil prices continue to rise, the fiscal deficit will augment accordingly.

Crude Measures: Who Gains from Fuel Subsidies?

Economic theories state that subsidies do not serve the purpose of efficient allocation of resources as such mechanisms distort the relative prices of goods and services. Subsidies compete with an economy's scarce resources that could be used for some other productive purposes. But reality is often contrasted with theory. From political economy perspectives, subsidies seem to be based on political expediency rather than economic considerations. Bangladesh is no exception.

According to the ADB, based on the average domestic and international prices of diesel, kerosene, and octane at the end of April 2008, the implicit subsidy for diesel in Bangladesh was US$0.52/litre, for kerosene US$0.51/litre, and for octane US$0.09/litre.[13] An estimate shows that the cost of subsidy is about US$730 million per year.[14] But this amount is also on the rise in line with higher oil prices. The ADB estimates that the BPC would lose US$1.1 billion this fiscal year due to soaring oil prices.

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[10] Based on data of Regional Energy Security for South Asia, Regional Report, South Asia Regional Initiative for Energy (SARI), 2006

[11] The Economic Times, 28 May 2008.

[12] Asian Development Bank, Quarterly Economic Update, March 2008.

[13] Ibid.

[14] Subsidised Oil Prices: Are They Sustainable? Available at < http://www.doe.gov.ph/e percent20summit/ presentation/Mr. percent20Neil percent20Atkinson.pdf >

The question is who benefits from fuel subsidies? The traditional view is that poor people cannot afford higher oil prices and, as such, they should be protected through subsidy. But the real picture is different. An International Monetary Fund study of five emerging economies shows that the richest 20 percent of households received, on average, 42 percent of total fuel subsidies and the bottom 20 percent received less than 10 percent.[15] Further, in countries such as Bangladesh, the poorest of the poor in many instances use traditional bio-mass and do not have access to electricity and other public utilities. The increasing need of resources for fuel subsidies is indeed hurting the poor people most. The ADB has cautioned the country of late that huge subsidies for fuel might be hindering the government's targeted interventions to protect the poor.

However, Bangladesh's agricultural sector that depends on energy-intensive irrigation, especially during the dry season, badly needs subsidised fuel. Over 70 per cent of Bangladesh's 144 million people depend on agriculture. Public transport is another area that relies on subsidised fuel. The apparel and other labour intensive manufacturing sectors that absorb millions of low-income people also depend on fuel subsidies. To remain competitive in this highly distorted global fuel subsidy regime, economies such as Bangladesh can ill-afford to pass the full oil bill to its consumers. For instance, petrol is sold as low as five cents per litre in Venezuela and as high as US$2.35 per litre in Germany.[16] This means that the price of oil should be set keeping in mind the fact that the country's industrial output remains competitive while, at the same time, ensuring that the economy does not produce subsidised products for external consumers.

Cross-country Experience: Lessons for Bangladesh

Countries across Asia are adopting multi-prong approaches to cope with higher oil prices. The Indian government raised retail prices of petrol, diesel and liquid petroleum gas by 8 to 17 percent recently despite inflation risk. Malaysia has also announced a 41 percent fuel price hike. Sri Lanka, Indonesia and Taiwan have also increased their prices and more countries, including China, are expected to do so as well. The exchange rate policy, particularly domestic currency appreciation, is also widely used by Singapore and some other countries to manage oil price increases. Apart from these, fuel conservation and energy rationing are some other options that could be employed to address the problem.

The full or significant pass through of oil prices pose huge political risk for the current caretaker government in Bangladesh as the economy is already in the midst of a double-digit inflation. Moreover, from food security perspectives, the government cannot afford to withdraw subsidy for the agricultural sector considerably. The following measures can be of consideration for the Bangladesh economy to partly weather the oil shock:

a) Gradual increase of oil prices should be the most viable policy at this stage. Full or significant pass-through could destabilise the country, both politically and economically.

b) The concerned authorities should also devise an appropriate means to disburse the subsidised fuel to farmers so that the country's agricultural output is not affected. To

[15] The Economist, 29 May 2008.
[16] Ibid.

offset the impact of fuel price hike on farmers, cash transfers through social safety-net programmes could be initiated.

c) To discourage the use of private transport, a higher tax should be levied on private vehicles so that people find public transport a more economic and viable way to commute.

d) The exchange rate policies should also be used prudently – an undervalued currency can import inflation from abroad. Bangladesh's domestic currency has remained fairly unchanged vis-à-vis the United States dollar for a year but the latter has lost significant value against the Euro dollar and other major currencies, known as the United States Dollar index, in the recent past. If undervalued, the domestic currency should be appreciated so that it can contain the currency-induced energy inflation.

e) As Bangladesh's close neighbour, India, is adjusting oil prices, it also needs to do so. In the presence of an underground economy in the India-Bangladesh border, some subsidised resources can benefit the wrong side of Bangladesh's border.

f) The country needs to increase investment in its gas sector so that this relatively clean form of fossil fuel can be increasingly used as a close substitute of oil.

g) Greater regional energy cooperation is needed in terms of clean energy, particularly hydro electricity, as Bangladesh's neighbouring countries (India's northeastern region, Nepal and Bhutan) have huge hydro potential.

h) Energy conservation should be another policy option that can economise Bangladesh's fuel cost.

i) As oil prices are skyrocketing, alternative energy might become viable in the near future. The country should also invest in clean energy so that its energy basket is diversified.

Conclusion

As discussed, oil price hike in international markets poses severe risk to Bangladesh's macroeconomic stability. If not tackled prudently, the oil shock could derail the country's hard-earned macroeconomic stability. In the short run, the economy needs to phase out fuel subsidies gradually. At the same time, there should be safety nets for the low-income people, and the agricultural sector should be protected from fuel price adjustment. In the medium term, market and technology should be allowed to spur the solution with minimal state intervention. Following the two oil shocks in the 1970s, people changed their energy consumption pattern and industries were forced to enhance fuel efficiency. Both short-term and medium-term policies should be applied so that the economy is able to contain oil shocks. As many Asian countries, including its next-door neighbour India, are withdrawing fuel subsidies gradually, the region may witness a new consumption and production regime. Bangladesh needs to be better prepared to adjust its regime in the new environment.

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