India: Oil shocks unequally

Firm size matters

Free to View
Economics - India

- Large firms have gained pricing power and energy efficiency, and are likely to weather the oil price shock better …
- … than small and informal firms and their employees, who have been on the receiving end of two back-to-back shocks
- The disruption in the informal sector eventually shows up in GDP, though with a lag, and can be contained with apt policies

Pranjul Bhandari
Chief Economist, India
HSBC Securities and Capital Markets (India) Private Limited

Aayushi Chaudhary
Economist
HSBC Securities and Capital Markets (India) Private Limited

The *macro impact* of the ongoing commodity price shock is significant and increasingly well known. What is not as obvious is some of the more *granular impact* on firms and consumers, which in turn could become the leading driver of growth trends.

Not all firms will be equally impacted by the oil price shock. We find that large firms have outperformed small firms through the pandemic, gaining market share and being more profitable. They are also likely to weather the oil price shock better, having become more energy efficient over time and having more bargaining and pricing power than small firms.

Even before small firms had fully recovered from lockdown-led-disruption, they were disproportionately hit by higher commodity prices. This has even forced some small manufacturers to shut shop.

It's not just the large firms that have done well, it's also their employees. Staff costs of large firms have risen meaningfully, while those of small firms have stagnated.

So what proportion of Indians work in small establishments? 20% of the labour force works in the formal sector and has benefitted from improved jobs and wages lately. 80% works in the informal sector, divided equally between agriculture and non-agriculture. The latter group, i.e. the 40% informal workers outside of agricultural fared poorly in the first half of the pandemic and was just about recovering in the second half. The commodity price shock is now threatening to reverse some of the recent gains of this group.

The impact of this may not be felt in official GDP estimates immediately. In the short run, the Statistics Office assumes that trends in the formal sector are a good proxy for the informal sector. This assumption overestimates GDP growth in periods when the informal sector has been hurt more. If the weakness in the informal sector persists, it eventually shows up as lower demand (even hurting the prospects of the formal sector) and growth.

The good news is that the right policy steps can help limit the pain endured by the informal sector. On the fiscal front, remaining generous with social welfare spending and sticking to capex plans outlined in the budget is key. It is clear from our analysis that elevated prices are a growth drag, especially for small firms. The RBI can help limit the second round impact of higher input prices by gradually tightening monetary policy.

This is a Free to View version of a report by the same title published on 28-Mar-22. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

Issuer of report: HSBC Securities and Capital Markets (India) Private Limited

View HSBC Global Research at:
https://www.research.hsbc.com

High oil prices are a meaningful terms-of-trade shock for India

Even before India's economic recovery coming out of the pandemic waves was complete[1], a large commodity price terms-of-trade shock[2] emerged as a new economic headwind. The macro impact is significant and has become well-known. But what is not as obvious is some of the more granular impact on firms and consumers, which could eventually become the leading driver of growth trends over time.

The macro onslaught

The dominant narrative is that high oil and other commodity prices will slow growth by raising the cost of production and lowering real purchasing power. The impact of higher commodity prices will be felt across all economic variables.

We agree. Our sensitivities suggest that a USD30/b rise in oil prices (from USD70/b in 2021 to say an average USD 100/b in 2022), could impact all the key macro variables significantly – lower GDP growth by 0.9ppt, raise the current account deficit by 1.2% of GDP, and raise CPI inflation rate by 1.05ppt.

The impact will be felt across the government, corporates and consumers

If the central government cuts excise duties on oil by INR2.5/ltr for petrol and INR5/ltr for diesel, which is half the quantum that it cut last year, **the burden sharing ratio between the private and public sector will be 50:50 (**see chart 1).

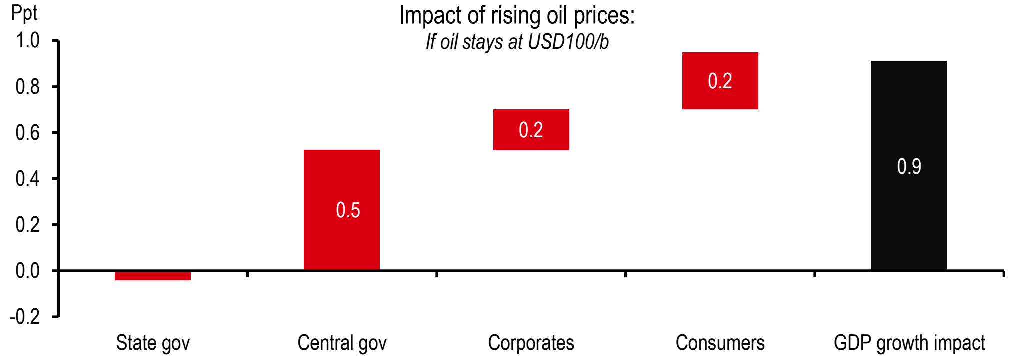
Within the private sector, **corporates tend to take 40% of the price pressures on their margin, passing on 60% to consumers.** Consumers face a double sting of high pump prices and pass-through from corporates.

How the government reacts to a fall in oil tax revenues on the back of duty cuts has implications for growth. If it runs a slightly higher-than-budgeted fiscal deficit rather than cut expenditure, it will be more supportive to growth.

The government's reaction has large implications for growth

The RBI can help alleviate some of the bond market pressure which the large government borrowing engenders. Some space for OMO g-sec purchases is emerging. An elevated current account deficit (of 3.0% of GDP in FY23) is likely to lead to a large BoP deficit. The RBI is likely to sell dollars to smoothen the adjustment in the rupee, thereby draining rupee liquidity, and creating the space for bond purchases. **See table 1 for our key macro forecasts.**

Chart 1: The growth cost of oil prices averaging cUSD100/b in 2022



Source: HSBC estimates. Note: Negative reading indicates a gain.

1 We estimate that by December 2021, GDP was 3% above pre-pandemic levels, but 7% below the pre-pandemic trend.
2 In this report we are using oil price shock and commodity price shock interchangeably

Table 1: India: Our key macroeconomic forecasts

	Unit	FY22f (Apr'21-Mar'22)	FY23f (Apr'22-Mar'23)	FY24f (Apr'23-Mar'24)
Real gross domestic product (GDP)	%y-o-y	8.6	6.8	5.7
Consumer price index (CPI)	%y-o-y	5.5	5.6	5.0
Central government fiscal balance	% GDP	-6.9	-6.5	-6.0
Current account balance (C/A balance)	% GDP	-1.8	-3.0	-2.9

Source: CEIC, RBI, HSBC estimates

So far so good. But this is not the full picture. The true impact on the economy is much more nuanced. And getting the subtle shades right is at the heart of understanding the true impact of the oil shock and the trajectory of GDP growth.

Firm size matters

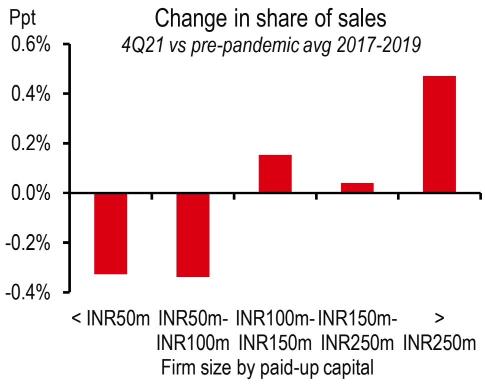
Large firms have outperformed small firms in the pandemic period …

While we did touch upon the impact of oil prices on corporates and consumers, all of them will not face the impact equally. Through the pandemic, large and listed firms and their employees have performed relatively better than small and informal firms[3]. **And early indicators show that the oil price shock is intensifying this divergence.**

Our study of the RBI's database of c2,700 firms shows that through the pandemic period, large firms have taken away market share from smaller firms (see chart 2). Through this time, the profitability of large firms has risen while that of small firms has not (see chart 3).

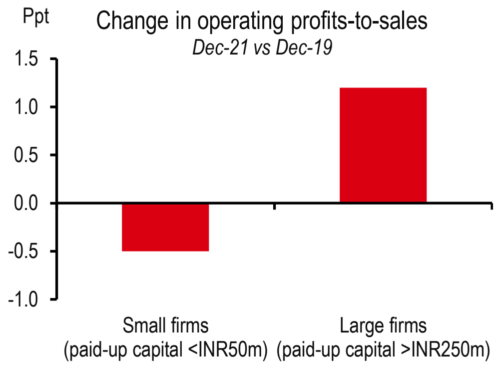
The outperformance of large firms through the pandemic is likely to be a result of several factors – cost cutting, a lower interest rate environment, access to buoyant capital markets, and ongoing formalisation.

Chart 2: Large firms have taken away market share from small firms



Source: CEIC, HSBC calculations

Chart 3: The profitability of large firms has risen while that of small firms has not



Source: CEIC, HSBC calculations

… and the commodity price shock will likely intensify this divergence

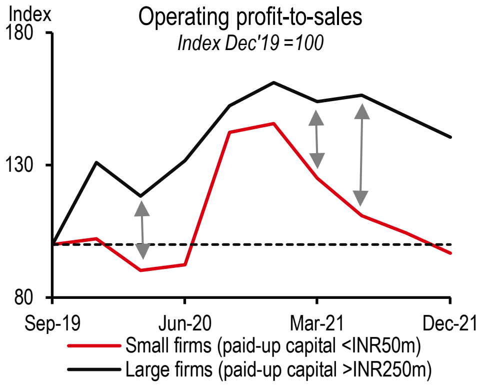
The underperformance of small firms comes in two distinct parts – one, the lockdown period (during the two COVID-19 waves in early 2020 and early 2021, respectively), and two, the commodity price shock period (commodity prices have been rising since mid-2021, see chart 4). Small firms, particularly in the informal sector, typically have smaller cash buffers to withstand long periods of shock[4]. Several weeks in lockdown is likely to have hurt them much more than it hurt large firms. And just as they were reviving, the commodity price shock hit and pushed them back into underperformance.

3 For small firms we only use listed small firms because we do not have rich data on unlisted small firms. Our assumption is that if the smaller firms have underperformed in the listed space, that may also be true for the unlisted space, particularly for the small informal firms.
4 India's informal sector has a large number of small firms.

Large firms have gained market share and energy efficiency; small firms have not

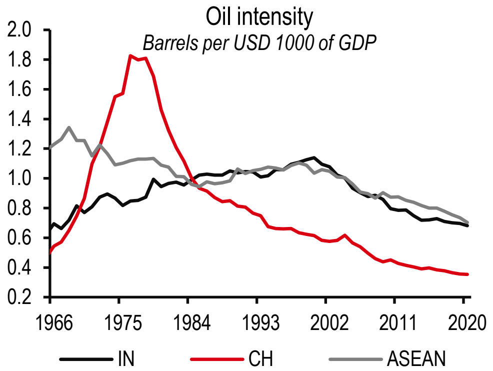
For three reasons, we think **the commodity price shock will hurt small firms more than large firms**. **One**, India has become more energy efficient over time (see chart 5), and this has been led more by the large firms who have taken more efficiency enhancing steps than small firms (see chart 6)[5]. **Two**, large firms, by their sheer size, may have more bargaining power than small firms, when buying raw materials. **Three**, large firms have gained pricing power over the last two years and are able to pass on more of the input cost increases to consumers (see chart 3).

Chart 4: Small firms have been hit twice – first by lockdowns (across two waves), followed by the commodity price shock



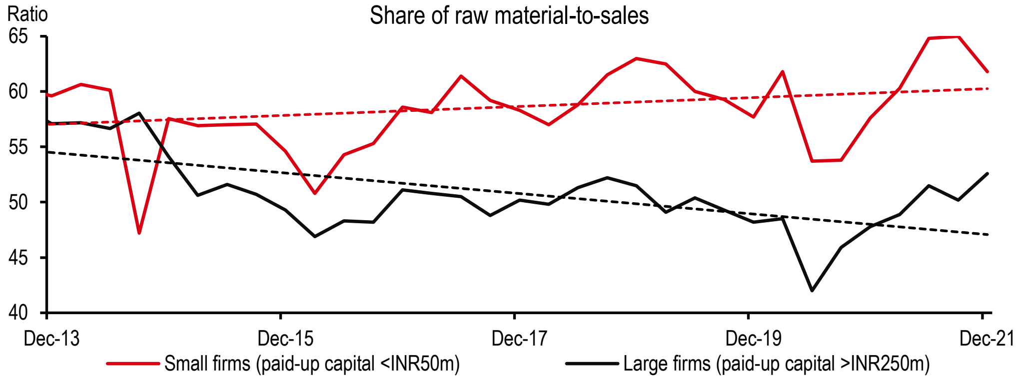
Source: CEIC, HSBC

Chart 5: India has become more energy efficient over time



Source: BP, World Bank, IMF, HSBC

Chart 6: There seems to have been more technological innovation at large firms than small firms



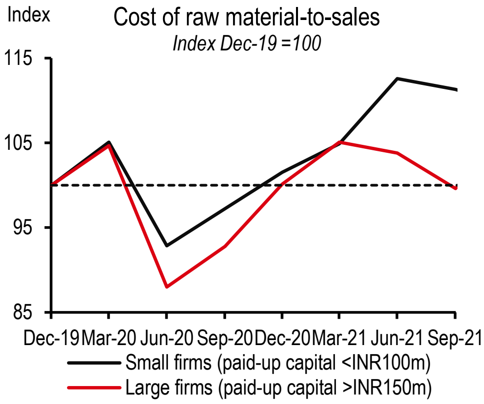
Source: CEIC, HSBC

In fact, it is clear that the burden of rising input costs since mid-2021 has been higher for small firms (see chart 7). In fact, this has even pushed many small firms to shut shop (see chart 8). All of this may show up even more starkly when the March 2022 corporate results data becomes available.

To summarise, the oil shock will hurt, but large corporates have become more energy efficient and have gained pricing power over the course of the pandemic, and as such may not suffer as much as they would have if faced with a similar shock a couple of years ago. On the other hand, small firms with lower bargaining and pricing power and lower technological efficiency, will likely take more of a hit on their profitability.

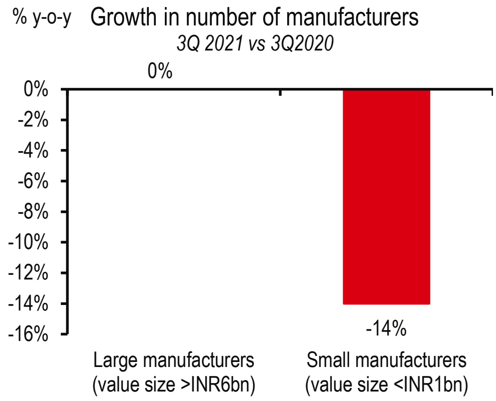
5 Typically, small firms do not have adequate capital to invest upfront in energy efficiency. There are also information and access to technology issues.

Chart 7: The burden of rising input costs has been higher for small firms…



Source: CEIC, HSBC

Chart 8: … pushing many small manufacturers to shut shop



Source: Nielsen Survey, HSBC

Mapping firms to consumers

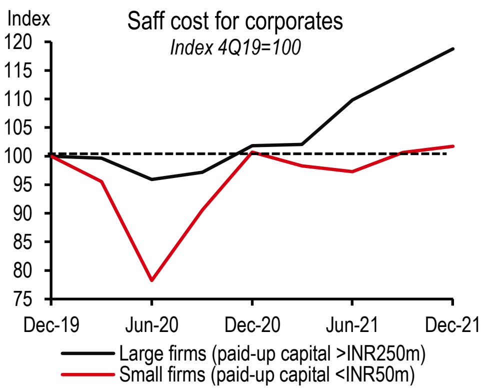
We also find that it's not just the large firms that have done well, it's also their employees. **Staff costs of large firms have overshot pre-pandemic levels** by a meaningful margin (especially after the second wave of COVID-19 ended in mid-2021).

Large firm employees have earned more than small firm ones

On the other hand, staff costs of small firms have stagnated at pre-pandemic levels, implying a fall in the real purchasing power of their employees (see chart 9). The recently conducted ICE survey shows that the poorest 20% have seen a 53% decline in their income between 2016 and 2021, while the richest 20% have seen an 39% increase (see chart 10).

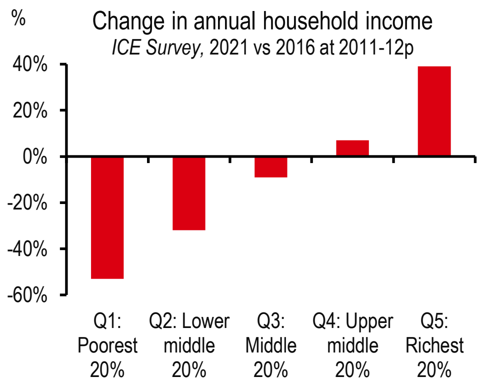
What is the proportion of people working in big versus small firms? How many amongst these groups have done well and how many have not? This matters for demand dynamics and economic growth in upcoming quarters.

Chart 9: The wages of small firm employees have stagnated and large firm employees have risen quickly



Source: CEIC, HSBC

Chart 10: Income inequality has risen since 2016 as per the ICE survey



Source: ICE Survey, HSBC

A pivot from agriculture to non-agriculture … will it last?

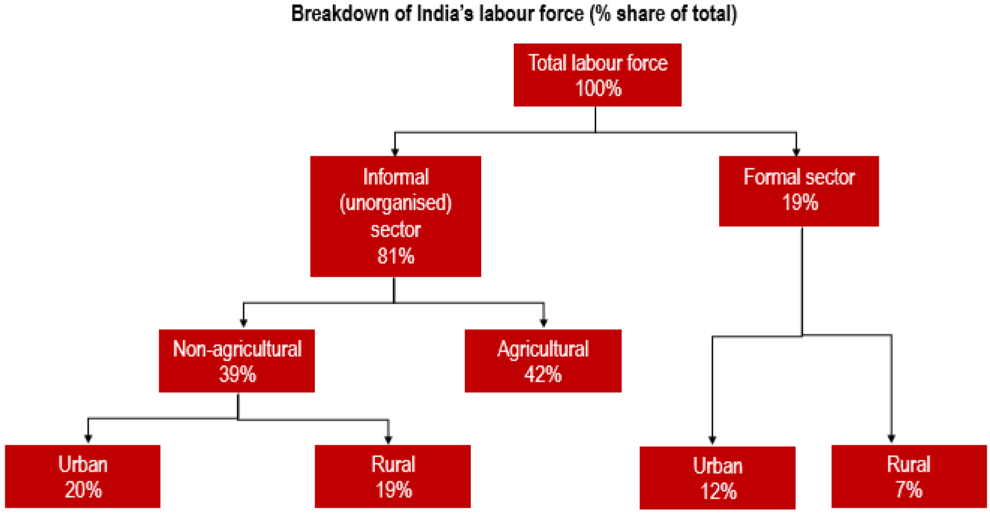
But first, a quick recap on the structure of India's labour force.

Around 80% of India's labour force is employed in the informal sector, and the remaining c20% in the formal sector (see chart 11). Of the c80% informal sector workforce, half work in agriculture (c40% of total workforce), and the remaining in non-agricultural sectors (c40% of total workforce).

Of the c40% non-agricultural informal sector workers, about half live in rural India[6] and the remaining in urban India[7].

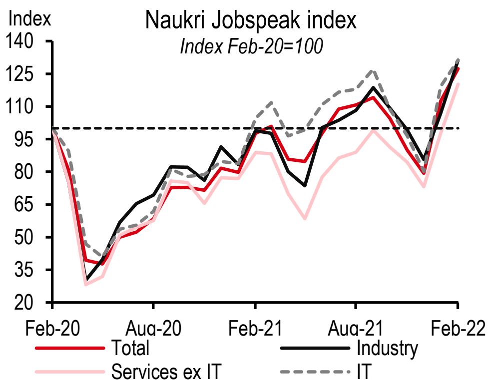
The 20% formal sector employees have done relatively better (than the 80% informal sector employees). Both the outperformance of the larger formal sector firms (discussed above) as well as wealth effects from buoyant stock markets have played a role. Job listings at agencies like Naukri have recently overshot pre-pandemic levels (see chart 12).

Chart 11: Breakdown of India's labour force (% share of total)



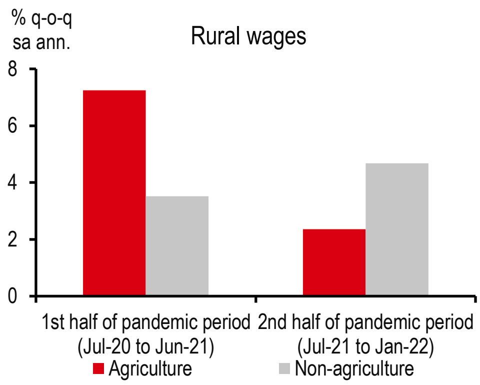
Source: PLFS, NSS and census data; HSBC calculations

Chart 12: Job listings have overshot pre-pandemic levels in recent months



Source: CEIC, HSBC

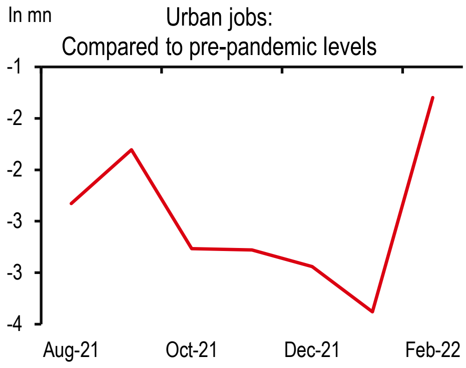
Chart 13: Rural agriculture wages have been slowing



Source: CEIC, HSBC

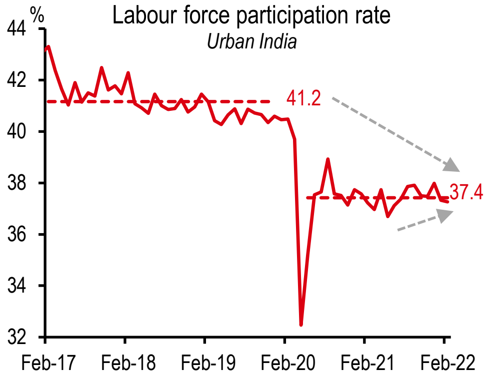
6 Working largely in the construction sector, followed by trade, transport and manufacturing
7 Dispersed widely across trade, hotels, transport, manufacturing, and the construction sector

Chart 14: In urban India, more jobs were created as lockdowns ended …



Source: CMIE, HSBC

Chart 15: … But LFPR is still well below pre-pandemic levels



Source: CMIE, HSBC

20% of the labour force is in the formal sector and has benefitted from labour market improvements

The fortunes of the 80% in the informal sector have not been as buoyant; and have also been more varied, seeing a pivot from agriculture to non-agriculture over the last year.

Informal sector *agricultural* workers. The 40% agricultural workers did well in the first half of the pandemic (around mid-2020 to mid-2021), led by good monsoons, exemption from lockdown and government welfare spending in rural India.

The fortunes of the 80% in the informal sector haven't been as buoyant

Thereafter, wages in this sector began to slow from mid-2021, led again by a variety of factors – some slowdown in the growth of NREGA outlays (since mid-2021), volatile monsoon rains, weaker construction wages (with erratic rains hurting construction plans), and higher rural inflation (hurting purchasing power). Putting all of this together, rural agriculture wages have been slowing (see chart 13).

Informal sector *non-agricultural* workers. The 40% non-agricultural workers didn't do well in the first half of the pandemic. But their fortunes began to improve gradually thereafter. In rural India, non-agricultural wages, particularly construction-led, began to pick up (see chart 13). In urban India, more jobs were created as lockdowns ended, individuals got vaccinated and demand for services began to rise (see chart 14).

Non-agricultural informal sector workers had begun to see some improvements, which risk being reversed

To be sure, the pivot from agriculture to non-agriculture in mid-2021 was still nascent. For instance, the LFPR in urban India rose, but is still well under pre-pandemic levels (see chart 15).

And with the coming of the commodities shock, the risk is that this nascent improvement reverses. And **40% of the informal workers who work outside of agriculture, and are associated with small and informal firms, take a hit once again**. This group, divided equally between rural and urban India, is perhaps the most vulnerable at this point.

The less visible growth drag

Bringing it together, the impact of the commodities price shock will manifest itself across various channels, some clearly visible, others hidden.

The macro impact of the oil price shock is clear – the negative impact on government finances (if the government cuts oil excise duties further), on corporates (who can't pass on all cost increases), and consumers (who face a double sting of higher pass-through and pump prices).

The more granular impact of the price shock is less visible – large firms and their employees will be relatively less impacted (than they would have been under a similar shock a decade ago); while small firms and those associated with them (especially the 40% non-agricultural informal sector labour force of India) will be doubly disrupted[8].

The disruption in the informal sector shows up in GDP estimates with a lag

There are implications for GDP growth numbers. We have a lot of good data in India to help track the formal sector. But we don't have as much real time good data for the informal sector. In the short run, the Statistics Office assumes that the trends in the formal sector are a good proxy for the informal sector. But in periods when the informal sector underperforms the formal sector, this assumption can lead to an overestimation of GDP. Meanwhile, if the weakness in the informal sector persists, it eventually shows up as lower demand (even hurting the prospects of the formal sector) and growth[9].

We do think that economic activity will be buoyant in the short run, led by pent-up services demand and the ability of large firms to withstand the commodity price shock better than before.

But growth could begin to slow thereafter if the weakness in the informal sector persists. The good news is that the **right policy steps can help limit that pain**.

What are these steps?

The role of fiscal and monetary policy

Careful policy steps now can help limit the informal sector drag

Both fiscal and monetary policy can play a key role in limiting the disruption caused to small firms and the informal sector.

On the fiscal front, it is important for the government to remain generous with social welfare programmes for the informal sector (such as the rural NREGA scheme) for longer. India doesn't have an equivalent urban social welfare scheme, and government capex doubles up as one, providing short term jobs. As such, we think that the expenditure plans announced in the budget earlier this year should continue, and not be cut in the face of any revenue or expenditure pressures.

In addition, reforms are needed to help small businesses grow and over time naturally graduate from informal to formal - for example, lowering the regulatory burden associated with growing firms.

Inflation control is important for improving the fortunes of small and informal firms

On the monetary policy front, inflation control should come centre stage. It is clear from our analysis above that the commodity price shock is a growth drag, especially for small firms. And while the RBI cannot control the direct impact of this globally determined shock, it can help limit the second round spread (for instance the rise in inflation expectation).

Gradual but immediate monetary policy tightening could do the trick and help create a balance between inflation control and growth support.

8 First during the lockdowns, and now with higher input costs
9 This happened in the demonetization periods

Disclaimer

The following analyst(s), who is(are) primarily responsible for this document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Pranjul Bhandari and Aayushi Chaudhary

This document has been issued by HSBC Securities and Capital Markets (India) Private Limited, which has based this document on information obtained from sources it believes to be reliable but which it has not independently verified. Neither HSBC Securities and Capital Markets (India) Private Limited nor any member of its group companies ("HSBC") make any guarantee, representation or warranty nor accept any responsibility or liability as to the accuracy or completeness of this document and is not responsible for errors of transmision of factual or analytical data, nor is HSBC liable for damages arising out of any person's reliance on this information. The information and opinions contained within the report are based upon publicly available information at the time of publication, represent the present judgment of HSBC and are subject to change without notice.

This document is not and should not be construed as an offer to sell or solicitation of an offer to purchase or subscribe for any investment or other investment products mentioned in it and/or to participate in any trading strategy. It does not constitute a prospectus or other offering document. Information in this document is general and should not be construed as personal advice, given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on it, consider the appropriateness of the information, having regard to their objectives, financial situation and needs. If necessary, seek professional investment and tax advice.

The decision and responsibility on whether or not to purchase, subscribe or sell (as applicable) must be taken by the investor. In no event will any member of the HSBC group be liable to the recipient for any direct or indirect or any other damages of any kind arising from or in connection with reliance on any information and materials herein.

Past performance is not necessarily a guide to future performance. The value of any investment or income may go down as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may have an adverse effect on the value, price or income of that investment. In case of investments for which there is no recognised market it may be difficult for investors to sell their investments or to obtain reliable information about its value or the extent of the risk to which it is exposed. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors.

This document is for information purposes only and may not be redistributed or passed on, directly or indirectly, to any other person, in whole or in part, for any purpose. The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions. By accepting this report, you agree to be bound by the foregoing instructions. If this report is received by a customer of an affiliate of HSBC, its provision to the recipient is subject to the terms of business in place between the recipient and such affiliate. The document is intended to be distributed in its entirety. Unless governing law permits otherwise, you must contact a HSBC Group member in your home jurisdiction if you wish to use HSBC Group services in effecting a transaction in any investment mentioned in this document.

Certain investment products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. Investors should consult with their HSBC representative regarding the suitability of the investment products mentioned in this document.

HSBC and/or its officers, directors and employees may have positions in any securities in companies mentioned in this document. HSBC may act as market maker or may have assumed an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell or buy securities and may also perform or seek to perform investment banking or underwriting services for or relating to those companies and may also be represented on the supervisory board or any other committee of those companies.

HSBC will from time to time sell to and buy from customers the securities/instruments (including derivatives) of companies covered in HSBC Research on a principal or agency basis.

From time to time research analysts conduct site visits of covered issuers. HSBC policies prohibit research analysts from accepting payment or reimbursement for travel expenses from the issuer for such visits.

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking, sales & trading, and principal trading revenues.

Whether, or in what time frame, an update of this analysis will be published is not determined in advance.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at www.hsbcnet.com/research.

HSBC Securities and Capital Markets (India) Private Limited is registered as "Research Analyst" (Reg No. INH000001287), Merchant Banker (Reg No. INM000010353) and Stock Broker (Uniform Reg. No. INZ000234533) and regulated by the Securities and Exchange Board of India.

Additional disclosures

1. This report is dated as at 28 March 2022.
2. All market data included in this report are dated as at close 24 March 2022, unless a different date and/or a specific time of day is indicated in the report.
3. HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking, Principal Trading, and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.
4. You are not permitted to use, for reference, any data in this document for the purpose of (i) determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments, (ii) determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument, and/or (iii) measuring the performance of a financial instrument or of an investment fund.

[1189638]