ECONOMIC IMPACT OF OIL PRICES

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International oil prices started to increase sharply in 2004 and reached to historically high levels in early 2005. The price of Brent crude oil increased to US dollars 56 per barrel in March 2005, compared to the previous highest price of US dollars 52 per barrel in October 2004. The average crude oil import price of Ceylon Petroleum Corporation (CPC) during the first quarter of 2005 has increased by 20 per cent to around US dollars 45 per barrel compared to the average price of US dollars 38 per barrel in 2004. If the average oil price continues to remain at this level in 2005, it will force Sri Lanka to spend US $ 1,350 million in 2005 on oil imports, compared to US $ 1,210 million spent in 2004 and US $ 838 million spent in 2003.

The high and rising oil prices in the international market are affecting the Sri Lankan economy, through its effect on the balance of payments (BOP) and on domestic prices through various channels. The oil price hike could lead to severe external and internal imbalances, which needs to be addressed through both corrective domestic adjustments and new financing for balance of payments support. On the external front, rapid increase in oil price will widen the trade balance leading to a worsening of the overall balance of payments (BOP), a loss of country's foreign reserves and exerting pressure on the exchange rate. The domestic imbalance will depend on whether a full pass-through of the high oil prices is allowed. Complete pass-through will result in a one-off inflation, which has been estimated to be around 1.2 per cent (based on Colombo Consumers' Price Index – CCPI) for a 10 per cent increase in diesel price. However, absorption of high oil prices by the government through the payment of subsidies will lead to compounded economic issues such as widening budget deficit, rising public debt and interest rates, crowding out private investments, widening inequality as well as causing long-term inflation.

Sri Lanka imported around 30 million barrels of petroleum products in 2004. Of this about 50 per cent was in crude form and the balance comprised various types of refined products, dominated by auto diesel. Annual consumption of major petroleum products, i.e. petrol, kerosene and auto-diesel amounted to 2.6 billion litres. The transportation sector is the leading petroleum consumer followed by the power, industrial and household sectors. The demand for petroleum consumption in the transport sector has shown steady growth with the increasing number of vehicle registration. Similarly, the use of petroleum products in power generation has also been rapidly increasing due to increased use of thermal power, in the absence of alternative energy sources and non-implementation of planned coal power and hydropower projects.

The current retail prices of petrol, auto-diesel and kerosene are Rs. 68.00, Rs. 42.00 and Rs. 25.50 per litre, respectively. These prices are about Rs. 13.00, Rs.21.00 and Rs. 32.00 per litre, respectively, below the retail prices that correspond to current international prices. The current subsidy therefore amounts to about Rs. 2.0-2.5 billion per month. The government has incurred a cost of Rs 18 billion or about 0.9 per cent of GDP, as subsidy payments due to non-adjustment of domestic petroleum prices in 2004. Subsidy obligation during the first quarter of 2005 has been estimated at around Rs. 5.3 billion.

Though petroleum demand is relatively inelastic with respect to price changes, domestic price increases will lead to economical use of fuel and reduction of consumption at least by inefficient users thus helping to mitigate the adverse impact high oil prices to some extent.