APAC Economic Perspectives

ASEAN and India: Oil shock – second round

Economics

Asia Pacific

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Exposure to energy exporters shouldn't offset gains from lower oil prices

The lower oil price is good news for energy consumers and bad news for producers. Most analysis to date has focused on the distinction between these two groups. In Asia, we believe that Malaysia loses out from lower energy prices while the impact on Indonesia is mixed and the rest of mainstream Asia benefits. However, there will be second round impacts as energy producer economies adjust – via less spending or saving – to the new reality of lower energy prices. Exposure to energy exporters promises to dim the positive impulse from lower oil import costs for India and ASEAN-5 compared to North Asia, but the net effect of lower oil prices should still reduce downside risks to growth for Singapore, Thailand, Philippines and India.

Trade and remittances – ASEAN-5 and India more exposed than North Asia

We find that Singapore, Thailand and India stand out in Asia as exposed to energy producers via trade. India's exposure comes via exports to the Middle East. Singapore and Thailand are relatively exposed via their links to Malaysia and Indonesia – we see clear downside risks to consensus expectations for both Malaysian and Indonesian GDP growth this year on commodity price weakness. Moreover, ringgit plus rupiah currency weakness could make Indonesian and Malaysian exports more competitive. Thailand is also relatively exposed via tourism and the Philippines via remittances to energy exporters more generally. On a more positive note, Asia's trade exposure to Russia appears to be limited.

Capital flows – less petrodollars could mean less risk tolerance

Indonesia, meanwhile, may be relatively exposed to shifts in capital flows as petrodollar surpluses dry up. Current account surpluses in oil producer economies helped finance deficits elsewhere in the emerging world over recent years. As lower oil prices transfer those surpluses to oil consumers, capital flows may shift as a result of lower risk tolerance if not lower saving. US and European households, for example are likely to be more home biased and conservative in their asset allocation than oil producers' sovereign wealth funds. That may be unhelpful for emerging market economies with large current account deficits associated with energy production related spending – of which Indonesia is an example in Asia.

Still looking for lower inflation and lower rates

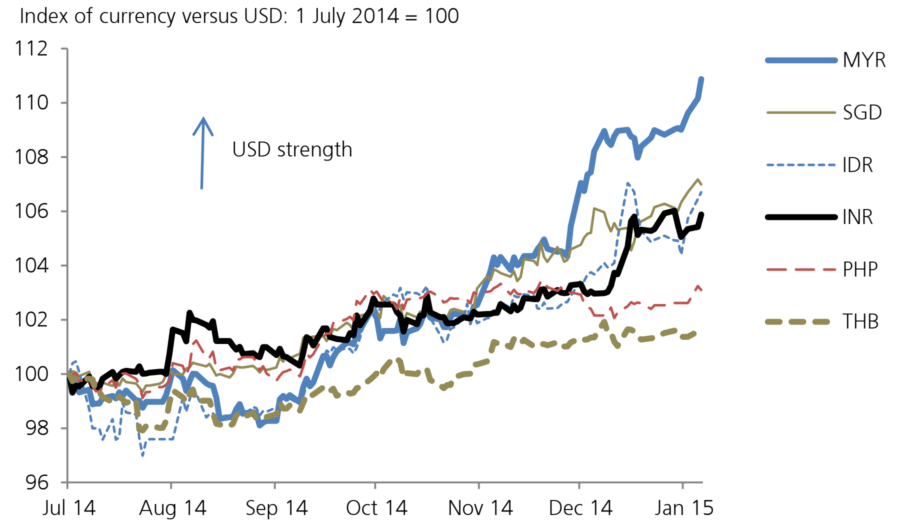
We do not change our view that the most important impact of lower oil prices will be the depressing effect on inflation and the opportunity to ease nominal monetary policy settings on the part of most Asian central banks. Even with its oil exporter exposure, the potential for lower interest rates combined with the bottoming out of its credit cycle still makes India stand out as a relative beneficiary of lower energy prices.

Lower energy prices – second round effects

Inflation falls and policy rates decline (or rise less than otherwise). Malaysian growth suffers; the impact on Indonesia is mixed; while downside growth risks are mitigated across the rest of Asia. Those are the conclusions from our recent work on the falling price of oil. Financial markets are in the process of embracing these first round effects of lower oil prices – Malaysia's currency in particular has weakened in a regional context.

However, it is also worth considering the second round effects. The decline in oil prices through end November was to some extent catching up with declines in other commodities. While UBS' view is that Brent oil averages USD 70 a barrel in 2015 and USD 80 in 2016, the decline in oil prices from USD 70 a barrel to circa USD 50 a barrel recently could drag other energy linked commodity prices lower. Moreover as income is transferred from energy producers to energy consumers, energy producers must necessarily spend or save less. To the extent that some economies will be disproportionately exposed (or insulated) from lower energy producer expenditure or saving, the second round effects from lower energy prices should matter for financial markets.

Figure 1: First round impact from lower oil – a weaker ringgit



Source: UBS, Haver

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Additionally, Asian economies may be exposed to the shift in capital flows as a result of reduced contributions to the global savings pool from energy exporter (petrodollar) surpluses. While the loss of petrodollars may be offset by savings elsewhere, the petrodollar surpluses probably fed disproportionately into riskier investments in comparison to, say, European or US household saving, which are widely acknowledged to have more home bias in asset allocation. Such a capital flow dynamic might be unhelpful for emerging market economies running large current account deficits – particularly if those deficits were associated with spending on energy producing investments. In Asia, Indonesia may be most at risk.

This does not change our view that the most important impact of lower oil prices will be the depressing effect on inflation and the opportunity to ease nominal monetary policy settings on the part of most Asian central banks. Even with its oil exporter exposure, the potential for lower interest rates combined with the bottoming out of its credit cycle still makes India stand out as a relative beneficiary of lower energy prices. See also APAC Economic Perspectives - ASEAN and India: Lower oil, lower rates (3 Dec 2014)

Oil, gas, coal and palm oil – energy commodities

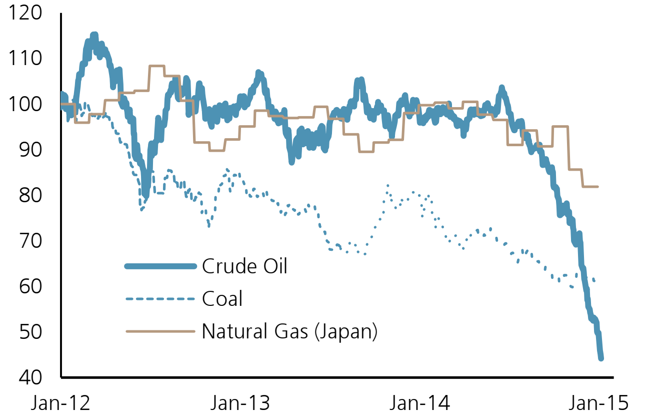
Lower oil prices are likely to put downward pressure on other commodities. Most obvious are partial substitutes like gas, coal and vegetable oils – but other commodities for which energy is an input will also be affected. In this note we focus on energy linked commodities (gas, coal and vegetable oils) that are important in India and Southeast Asia.

The overwhelming tendency in Asia is for internationally traded gas prices to be contractually linked to the oil price. This results in a lagged reaction of the gas price to movements in the oil price of 3-5 months. The conceptual link between the price of coal and oil appeared less relevant in November as the fall in the coal price pre-dated that of oil. But the recent decline in the oil price presumably puts further downward pressure on coal. Likewise the decline in the price of edible vegetable oils (used in biofuels), predated that of oil but here too oil at USD 50 may imply further downward pressure on palm oil and soybean oil prices.

As such we consider the exposure of Asian economies to net exporters of oil, coal and palm oil where those net exports may be meaningful drivers of growth.

Figure 2: Oil may drag other energy commodities lower

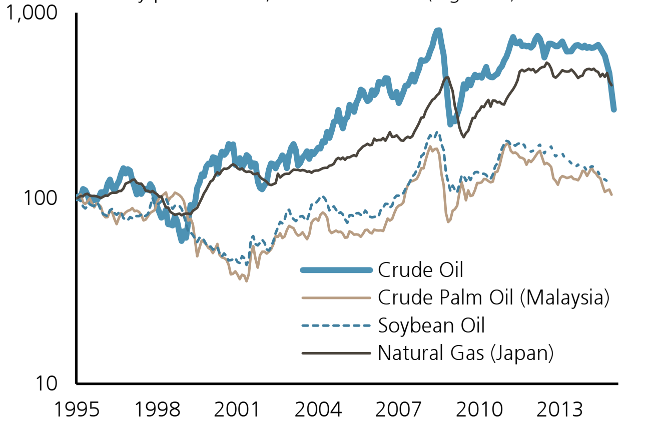
Commodity prices, Jan 2012 = 100



Source: UBS, Haver

Figure 3: Palm/soybean oil can be used for fuel

USD commodity price indices, Jan 1995 = 100 (log scale)



Source: UBS, Haver

Who are the energy exporters?

Oil and gas

The IMF's trade statistics define 26 economies as oil exporters. To that list we add another four economies where net oil and gas exports are important.

Figure 4: Oil and gas net exporters

	Net oil and gas exports, million tonnes of oil equivalent (2013)	Countries
Oil exporters (as defined by IMF)	2488	Algeria, Angola, Azerbaijan, Bahrain, Brunei Darussalam, Congo, Ecuador, Equatorial Guinea, Gabon, Iran, Iraq, Kazakhstan, Kuwait, Libya, Nigeria, Oman, Qatar, Russia, Saudi Arabia, Sudan, Syria, Trinidad and Tobago, Turkmenistan, United Arab Emirates, Venezuela, Yemen
Additional four net oil exporters	363	Canada, Malaysia, Mexico, Norway

Source: UBS, Haver, BP

Coal

The following table shows coal exporters accounting for 90% of global coal trade. We believe the importance of coal exports for Indonesia, Australia and Columbia (along with oil and gas) warrants their inclusion in the group of energy exporters.

Figure 5: Top coal exporting countries

Million tonnes (2013e)	Total	Steam	Coking
Indonesia	426	423	3
Australia	336	182	154
Russia	141	118	22
USA	107	47	60
Columbia	74	73	1
South Africa	72	72	0
Canada	37	4	33

Source: World Coal Association

Edible oils

The group of energy exporters is not much changed by looking at the production of edible (or flammable) oils. The two producers for whom net exports of edible oils are most significant – Malaysia and Indonesia – we already recognise as energy exporters.

Net energy exporter exposure: where and how?

As always, cross border exposures manifest themselves via the physical trade in goods and services, flows of labour, capital flows and sentiment. We consider the linkages via trade in goods, tourism, remittances and capital flows.

Goods exports

The table below shows linkages in terms of merchandise goods exports to energy exporters. The first column of data shows the exposure to the traditional oil exports as defined by the IMF (Gulf States, Russia, etc…). The second column shows exposure to the additional energy exporters we highlighted above. The third column shows the aggregate exposure as a share of total exports. Columns seven to nine put that data in the context of GDP.

India stands out as disproportionately exposed to the traditional oil exporters as defined by the IMF –because of its proximity to the Middle East. Singapore stands out via its exposure to Indonesia and Malaysia. Thailand stands out via its exposure to the Malaysia, Indonesia and, to a lesser extent, the Middle East.

Figure 6: Goods export exposure to net energy exporters

	To oil exporters as defined by IMF (% tot. export)	To other energy exporters* (% tot. export)	To oil and other energy exporters (% tot. export)	of which Indonesia (ppts.)	of which Malaysia (ppts.)	of which Russia (ppts.)	Goods exports value added (% GDP)	Implied value added exports to energy exporters (% GDP)	Implied impact of 10% fall in importer demand (% of GDP)
HK	2.3	3.8	6.1	0.5	0.8	0.5	2.1	0.1	0.0
Philippines	1.2	6.0	7.2	1.2	1.8	0.1	10.0	0.7	0.1
Euro area	5.8	3.1	8.9	0.2	0.3	2.1	4.9	0.4	0.0
Indonesia	4.3	9.4	13.7	na	5.6	0.5	16.1	2.2	0.2
Malaysia	4.3	10.3	14.6	4.2	na	0.3	37.3	5.5	0.5
Japan	5.6	9.5	15.1	2.2	2.1	1.4	5.9	0.9	0.1
Vietnam	4.9	10.5	15.4	2.1	3.3	1.5	32.1	5.0	0.5
Brazil	9.9	6.0	15.9	1.0	0.6	1.4	16.5	2.6	0.3
Korea	7.8	8.4	16.3	2.0	1.4	2.0	12.1	2.0	0.2
China	9.1	8.5	17.6	1.7	2.0	2.3	6.3	1.1	0.1
Thailand	5.5	15.7	21.3	4.2	5.7	0.5	31.6	6.7	0.7
India	20.4	5.6	26.0	1.5	1.4	0.7	6.5	1.7	0.2
Singapore	3.0	26.3	29.3	9.4	12.4	0.1	22.9	6.7	0.7
o/w non-oil domestic				6.6	7.8				
US	6.3	38.3	44.6	0.5	0.8	0.7	4.1	1.8	0.2

Source: UBS, IMF, OECD, WTO Note: Table uses trade data in 12 months to October 2014 and 2013 GDP
*Norway, Canada, Mexico, Malaysia, Indonesia, Australia, Columbia

The exposures in Figure 6 are likely overstated. The global production network of which ASEAN is part leads to intermediate goods crossing national borders multiple times with final demand often residing elsewhere. That will inflate Singaporean and Thai energy exporter exposures more than most. The non-oil domestic export figures for Singapore we include in the table partially adjust for this. Estimates from the WTO and OECD which try to more fully adjust for this phenomenon indicate that Singapore and Thai exposures to Malaysian and Indonesian final demand could be as little as half or two-thirds the level suggested in Figure 6. However, the evidence is that Singapore and Thailand are still a good deal more exposed to Malaysian and Indonesian demand than most economies.

Also of note, the weight of exports in the economy exaggerates the GDP implications for Thailand and Singapore of weaker energy exporter demand. However, the same export weight also implies the ability to benefit from any improvement in global spending power more generally from lower oil. Nonetheless, both Thailand and Singapore still appear disproportionately exposed to energy net exporters.

Services exports (Tourism)

We do not have much data on services exports directed towards the traditional oil exporters. One area where data is available is tourism. Figure 7 below shows Thailand's tourism sector is relatively important to the economy and has relatively strong links to the Middle East and Russia. However, most of the exposure is down to links with Malaysia. Singapore is also exposed, but to a lesser extent and for similar reasons – although links with Indonesia are more important for Singapore. It is possible that where tourism and trade links are strong, as in Thailand and Singapore, other services links to energy exporters may also be meaningful.

Figure 7: Share of tourists and tourism income from energy exporters

2013 data	Tourists from Indonesia (% total)	Tourists from Malaysia (% total)	Tourists from Russia (% total)	Tourist from Middle East (% total)	Sum	Direct contribution of tourism to GDP	Of which from foreigners (% of total)	Implied contribution to GDP from energy exporter tourism	Implied impact of 10% drop in energy exporter tourism (% GDP)
Thailand	2.2	11.5	6.6	2.4	22.6	9.0	71.9	1.5	0.1
Singapore	19.9	8.2	0.5	1.0	29.6	5.3	70.3	1.1	0.1
Malaysia	9.9	0.0	0.2	1.0	11.1	7.2	55.0	0.4	0.0
Indonesia	0.0	16.3	1.1	2.1	19.5	3.1	21.7	0.1	0.0
Taiwan	2.1	4.9	0.1	0.2	7.3	2.1	48.4	0.1	0.0
Philippines	1.0	2.4	0.8	1.5	5.8	4.2	23.5	0.1	0.0
Japan	1.3	1.8	0.5	†	3.5	2.2	6.9	0.0	0.0
Korea	1.6	1.7	†	0.2	3.5	2.1	30.4	0.0	0.0

Source: UBS, Haver † Data unavailable assumed negligible

Remittances

Government wealth arising from net oil exports often results in significant government welfare programmes for the indigenous population. The associated dis-incentives to work can result in elevated demand for immigrant labour. The Philippines is most exposed in terms of the economic weight of remittances from Middle Eastern oil exporters, followed by India. However, the experience of the global financial crisis suggests that Indian remittances may be at more risk than those of the Philippines since the latter showed remarkable resilience in 2008-2009. One reason could be that Filipinos working overseas may hold higher skilled jobs (say in medicine) that might be less easily cut.

Figure 8: Remittance flows

2012 data	Total inward remittances (USD bn)	o/w from energy linked economies (USD bn)	Total inward remittances (% GDP)	o/w from energy linked economies (% GDP)	Impact of 10% decline in oil exporter linked remittances (% GDP)
US	4.5	1.9	0.0	0.0	0.0
Brazil	4.9	0.3	0.2	0.0	0.0
Japan	2.7	0.4	0.1	0.0	0.0
Malaysia	1.3	0.2	0.4	0.1	0.0
Hong Kong	0.4	0.2	0.1	0.1	0.0
China	60.2	7.5	0.6	0.1	0.0
Euro Area 4*	50.5	7.9	0.5	0.1	0.0
Korea	11.0	1.1	0.8	0.1	0.0
Thailand	4.1	0.9	1.1	0.2	0.0
Indonesia	7.2	5.0	0.8	0.6	0.1
Vietnam	10.0	1.8	5.9	1.1	0.1
India	69.3	37.4	3.7	2.0	0.2
Philippines	24.5	9.4	9.0	3.5	0.3

Source: World Bank, Haver, UBS *Germany, France, Italy, Spain

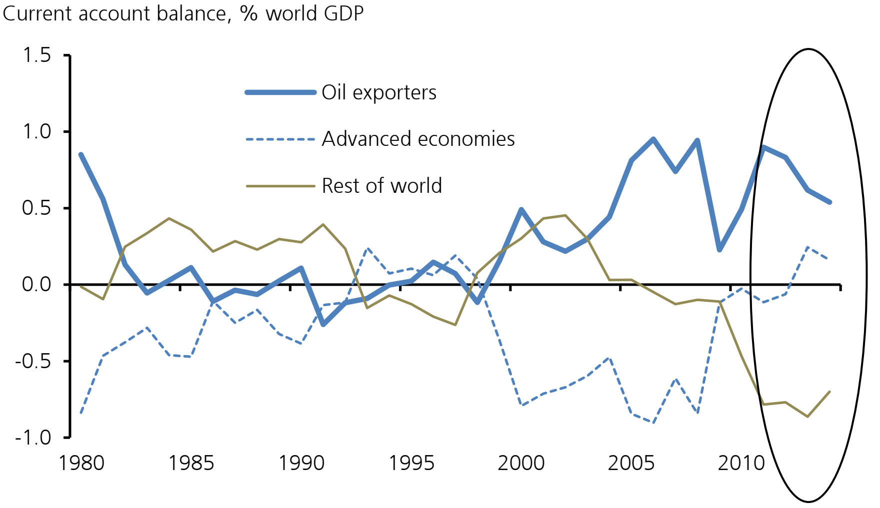
Capital flows from oil exporters[1]

The influence of the energy and specifically the oil exporting countries goes beyond the demand for goods and services and the demand for labour. The concentration of net energy exports to a narrow group of countries has led to energy income surpassing domestic demand by some margin for that group. The resulting surplus savings have flowed into global financial markets to drive domestic demand elsewhere. Indeed, the surpluses from the commodity producing countries in general were blamed for a global savings glut by Former Federal Reserve Chair Ben Bernanke in 2005.

The chart below shows the single best macro measure for capital flows at the country level – the current account balance. A current account surplus indicates an economy is lending surplus savings to the rest of the world while a deficit implies borrowing from the same. In Figure 9 the world is divided into three – oil exporters, the advanced economies and the rest of the world (i.e. most emerging markets). The chart implies that oil surpluses supported advanced economy borrowing prior to the global financial crisis and supported an emerging market credit boom subsequently.

[1] See also Asian Economic Perspectives – ASEAN and India: Debtopia Driven Deficits (29 Apr 2013)

Figure 9: Global capital flows as implied by current account balances



Source: UBS, IMF

We do not mean to argue that oil exporter surpluses were necessarily directly invested in Asia; merely that they contributed to the pool of substitutable capital willing to fund relatively risky emerging markets. Our subsequent point is that, with lower oil prices, oil exporter surpluses will fall – reducing or reversing some of the capital flows originating from oil exporters into emerging markets. IMF publications suggest current account deficits in all Middle Eastern oil exporters except Kuwait below Brent oil at 55-60 dollars a barrel.

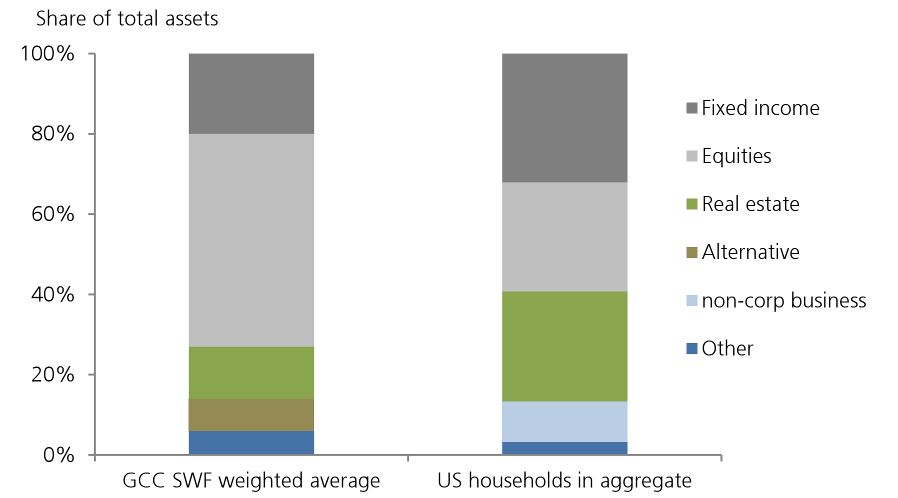
Naturally, lower energy exporter surpluses will mean offsetting changes in current account balances elsewhere in the world - oil surpluses down, advanced economy and/or rest of the world surpluses up. Globally, the balance of payments must balance. It could be that all the resulting trade and financial flows offset nicely. Net oil exporter country surplus savings could be replaced with European or US surplus savings. Indeed, UBS US Economist Maury Harris finds that, in the US, savings from fuel will flow disproportionately to higher income households who are more likely to save. See - Macro Keys: Costs and Benefits of Lower Oil Prices (12 Dec 2014).

However, energy consuming households and firms – even if they save the income freed up by lower oil prices – will probably not direct the funds to the same assets as investors or sovereign wealth funds based in oil exporting economies. The following chart compares an estimate of Gulf Cooperation Council GCC sovereign wealth fund asset allocation to aggregate US household assets. The data suggests US household wealth is typically more domestically orientated real estate home equity and own proprietor businesses. Meanwhile Gulf Sovereign Wealth Funds take, proportionally, more financial market risk.

This said, one should not overstate the impact on global asset markets of diminished oil exporter wealth since assets under management by GCC sovereign wealth funds are estimated to amount to USD 1-3tn in 2013 compared to 90tn for US household assets. However, in the much smaller arena of cross border capital flows, the shift in income and savings from a lower oil prices could have an impact.

We believe the pressure could be all the more significant on economies where the current account is in deficit in large part because of high investment in the energy producing sector. Here, lower energy prices may not help close the current account deficit while funding may become more difficult due to less petrodollars. In Asia Indonesia is the most obvious economy in this position.

Figure 10: Sovereign wealth fund allocations adopt more financial market risk



Source: UBS, Federal Reserve, EIB, Investment Company Institute, Mercer

A case study – Malaysia's sovereign wealth allocation

Extending the logic on sovereign wealth flows to Malaysia, we note that Malaysian state oil company Petronas and state holding company Khazanah have contributed overseas distribution of surplus savings from Malaysia's oil and gas sector. We estimate overseas investment by Khazanah and Petronas averaged MYR 24bn per annum from 2010-2013 – equivalent to about half Malaysia's outward FDI. The government has recently instructed these state actors to slow down overseas investment. That is helpful at the margin for Malaysia's balance of payments, but also an example of how changes in oil surpluses can alter the flow of capital.

Capital flows to oil exporters

In addition to a major source of capital flows, oil exporters have also been recipients. Evidence on the geographical distribution of capital outflows is hard to come by for India and ASEAN, but outflows to oil exporters appears to be modest. However, with reference to the above case study, we note that Indonesia has been a favourite destination, amongst others, for Malaysian investment. 8.3% of Khazanah's Realisable Asset Value is in Indonesia (the second largest country allocation after Malaysia) while 6% of Malaysian bank loans have been directed towards Indonesia. Meanwhile, Singapore banks have meaningful balance sheet exposure to Malaysia – consistent with trade and other links (Figure 11). We also note that Brunei, another energy exporter in ASEAN has linked financial to Singapore, but should not pose a risk (see appendix).

Figure 11: Geographic asset exposure for selected Singapore banks

% total assets	DBS	UOB	OCBC
Singapore	66.5%	61.3%	56.1%
Other ASEAN	4.2%	20.1%	19.7%
o/w Malaysia	na	12.5%	16.8%
o/w Indonesia	na	2.5%	na
o/w Thailand	na	5.0%	na
Greater China	26.0%	9.9%	18.3%
Other	3.3%	8.7%	5.9%
Total assets	100.0%	100.0%	116.8%
Memo: Total assets (SGD mn)	*424,383*	*298,563*	*391,588*

Source: UBS, Company data

Lower oil price still good for India and ASEAN-5

Placing the impact of lower oil prices on trade balances in the context of the exposure to energy exporters in terms of trade, remittances and capital flows, we find the lower oil price should still dominate. However, energy exporter exposure looks like a relative drag for India and ASEAN-5 compared to North Asia. In a similar vein we note that while the underperformance of Malaysia's ringgit makes sense given the fall in oil prices, the depreciation of the ringgit and rupiah could become a source of competitive pressure within ASEAN.

Oil import exposure revisited

The following table shows the sensitivity of the balance of trade income for Asian economies in each of the energy linked commodities discussed above. Echoing our prior work, the table suggests Malaysia loses out from lower oil prices, while the impact on Indonesia is more mixed and the rest of Asia benefits.

Figure 12: Trade balances in key energy commodities

	Trade balance (4qtrs to Q3 2014, USDbn)			Sensitivity of trade balance to a 10% fall in price (% of GDP)			Implied impact of current oil, coal, edible oil price* (% of GDP)	Current account balance, (4qtrs to Q3 2014, % GDP)
	Oil and gas	Coal	Vegetable oil	Oil and gas	Coal	Vegetable oil		
Indonesia	-12	22	20	0.1	-0.3	-0.2	-0.3	-2.9
Malaysia	19	-2	13	-0.6	0.1	-0.4	-3.7	5.5
Philippines	-12	-1	†	0.4	0.0	†	2.3	3.6
Singapore	-17	0	-1	0.6	0.0	0.0	2.8	19.4
Thailand	-36	-1	0	1.0	0.0	0.0	4.9	2.7
India	-106	-17	-9	0.6	0.1	0.0	3.2	-1.3
China	-270	-22	-9	0.3	0.0	0.0	1.4	2.0
Hong Kong	-14	-1	0	0.5	0.0	0.0	2.6	2.7
Taiwan	-40	-6	0	0.8	0.1	0.0	4.1	12.3
South Korea	-115	-12	-1	0.8	0.1	0.0	4.3	6.1
Japan	-241	-22	-1	0.5	0.0	0.0	2.6	-0.1

Source: UBS Estimates, CEIC, Haver * assumes 50% decline in oil and gas prices, 20% decline in coal and 20% decline in palm oil – the approximate change in prices between the average of the 4 quarters to Q3 2014 and now. † Data unavailable assumed negligible

In large part because of this commodity exposure, our standing real GDP growth projections for growth in Southeast Asian net energy exporters Malaysia and Indonesia are already close to half a percentage point below consensus at our working assumption of 70 dollar oil. A simple application of the sensitivities in Figure 12 suggests another 1-2 percentage points of Malaysian national income could be lost at 50 dollar oil, putting downward pressure on real GDP (Figure 13).

Figure 13: Current account balances under USD 70 and USD 50 oil

% GDP	2013 current account balance (actual)	2015 current account based on USD 70 oil** (standing forecast)	2015 current account implied by USD 50 oil*** (scenario)
Indonesia	-3.3	-2.2	-2.0
Malaysia	4.1	3.4	1.7
Philippines	3.8	4.9	5.8
Singapore	18.3	21.4	22.5
Thailand	-0.7	2.0	3.9
India*	-1.7	-0.2	1.0

Source: UBS Estimates, Haver *Fiscal year ** USD70/barrel oil; USD 730/ton palm oil; USD 63/ton coal
*** USD50/barrel oil; USD 700/ton palm oil; USD 62/ton coal

Indonesian growth should be under less downward pressure unless coal and palm oil prices correct significantly in sympathy, but income pressures from lower energy prices put spending power under downward pressure across the energy exporter group. We suspect growth expectations are also under downward pressure in the Gulf States, Russia. Those countries more exposed to oil exporters may catch some of the cold.

Trade and remittance exposure to energy exporters summarised

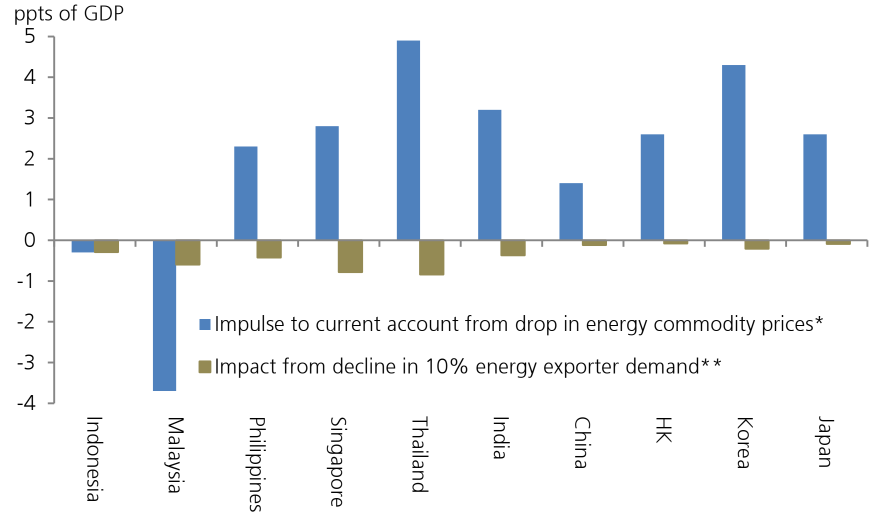
The table below puts the results from our analysis of remittances, goods trade exposure and tourism exposure to energy exporters in the context of the income gains from lower oil. The key message is that energy export economies would have to get very weak to offset the positive impulse from lower oil prices. Nonetheless, the relative exposure of Thailand and Singapore is in stark contrast to the lighter exposure towards energy exporters in Philippines and North Asia.

Figure 14: Implications of energy exporter exposure

	Implied impact of current oil, coal, edible oil price* (% of GDP) (1)	Current account balance (4qtrs to Q3 2014, % of GDP) (2)	Implied impact of 10% decline in energy exports goods trade (% of GDP) (3)	Implied impact of 10% decline in energy exporter tourism receipts (% GDP) (4)	Implied impact of 10% drop in remittances from energy exporters (% of GDP) (5)	Aggregate impact from energy exporter exposure (% of GDP) (6 = 3 + 4 +5)
Indonesia	-0.3	-2.9	-0.2	-0.0	-0.1	-0.3
Malaysia	-3.7	5.5	-0.5	-0.0	-0.0	-0.6
Philippines	2.3	3.6	-0.1	-0.0	-0.3	-0.4
Singapore	2.8	19.4	-0.7	-0.1	†	-0.8
Thailand	4.9	2.7	-0.7	-0.1	-0.0	-0.8
India	3.2	-1.3	-0.2	†	-0.2	-0.4
China	1.4	2.0	-0.1	†	-0.0	-0.1
HK	2.6	2.7	-0.0	†	-0.0	-0.1
Korea	4.3	6.1	-0.2	-0.0	-0.0	-0.2
Japan	2.6	-0.1	-0.1	-0.0	-0.0	-0.1

Source: UBS, Haver † Data unavailable assumed negligible

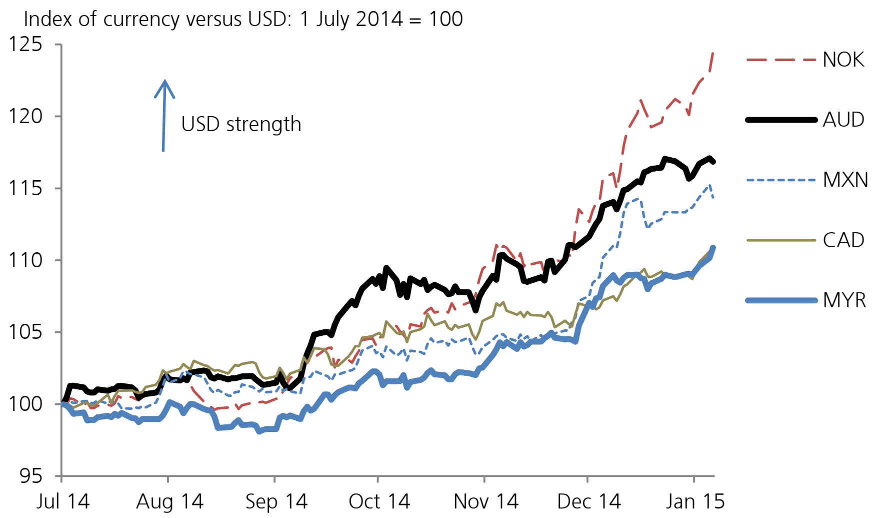
Figure 15: ASEAN more exposed to energy exporters than North Asia



Source: UBS Estimates * Price drop from average of year to Q3 2014 to current prices for oil, coal and palm oil (column 1 in Figure 14) ** sum of impact of 10% decline in energy exporter imports from, tourism to and remittances to country in question (column 6 in Figure 14)

It follows that the ringgit's weak performance against Asian peers but in line with some other energy exporters is justified.

Figure 16: Ringgit has weakened with other commodity currencies



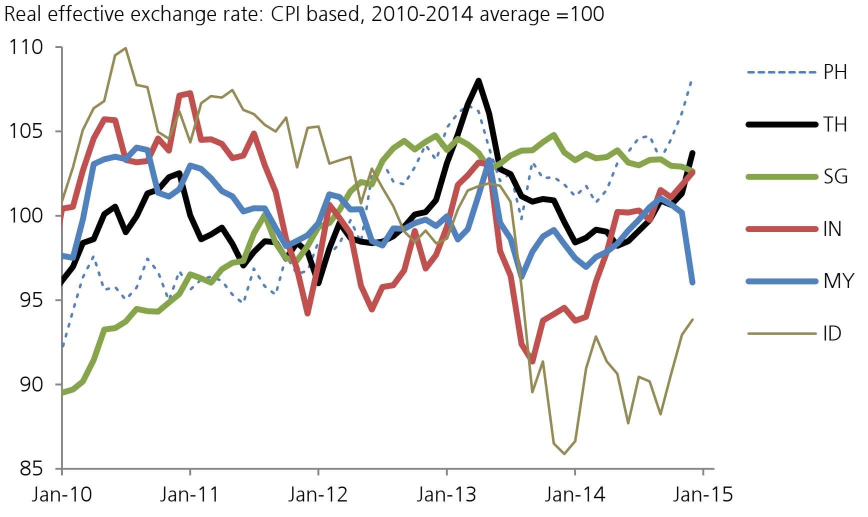
Source: UBS, Haver

Pressures from a more competitive ringgit and rupiah

However, while these relative moves may make sense given the commodity exposures discussed above, the fact remains that both Malaysia and Indonesia have sizable manufacturing sectors. These sectors could become more competitive vis-a-vie Thailand, Philippines or India if the relative currency weakness persists. Indeed that may explain why Malaysia's ringgit, while weak, has not been as weak as some of the energy exporters currencies.

Figure 17 shows the divergence in real effective exchange rates, which can be thought of as measures of cost competitiveness. Indonesia's competitive position has improved for some time but could improve again (via a weaker rupiah) if our analysis of capital flows plays out. Meanwhile the change in Malaysia's competitive position as a result of currency weakness has only just occurred.

Figure 17: Real effective exchange rates



Source: UBS Estimates

It may take some time for the competitive effects to show in the real economy. Nonetheless, that and energy exporter exposure more generally leaves us comfortable looking for more weakness in the baht and Singapore dollar than seen to date relative to North Asian currencies. Especially if oil prices remain at current levels, in which case our assumptions for the IDR and MYR may also prove too optimistic. If energy commodity prices recover later in the year as UBS' Oil Team expects, then the ringgit and rupiah may recover some lost ground – reducing the competitive threat to other ASEAN economies.

Potentially protecting against dramatic downside for the ringgit and the associated competitive pressures that might arise in the rest of the region, we note that

1) Malaysia has international assets to fall back on, in addition to foreign exchange reserves. See APAC Economic Perspectives – ASEAN: Are the SGD and MYR overshooting? (10 Dec 2014)

2) China's FX swap lines with Southeast Asian economies could be utilised. Unlike the Chang Mai initiative or other international emergency funding options, the access to Chinese funds may be positively encouraged by the donor. We expect China will be keen to use any opportunity to improve its influence in the region – see also 'ASEAN – A friend in need is a friend indeed' (3 Oct 2013)

Appendix: What about Brunei?

Brunei is a small, oil rich, economy situated next to East Malaysia on the Island of Borneo. Its estimated GDP of USD 17bn in 2014 affords its 420,000 population a high standard of living. However, the economy is highly dependent on oil and gas production, which accounts for two thirds of nominal GDP, 98 percent of exports, and 93 percent of government revenues according to the IMF. The IMF also reports that those oil revenues allow the government to employ 56% of the working citizens and permanent residents.

Based on exports of around USD 11bn, Brunei's trade surplus was around USD 8bn in the 12-months to October 2014 after USD 8bn in 2013 and the current account is estimated by the IMF to be around USD 5bn in 2013 and 2014 on average. A halving of oil revenues would bring the current account close to breakeven. That loss of income could put downward pressure on growth, but financial problems should be contained by the resources of the Brunei Investment Authority – the country's sovereign wealth fund – which is reported by a number of estimates to have assets of over USD 30bn.

At less than 4% of Malaysian or Singaporean GDP, Brunei's domestic demand is too small to matter much in terms of overall trade flows volumes. However, Brunei is linked to Singapore financially by i) a currency board arrangement whereby 1 Singapore Dollar is set equal to 1 Brunei Dollar and ii) a Currency Interchangeability Agreement under which the Monetary Authority of Singapore and Monetary Authority of Brunei agree to redeem the respective currency notes at par to the local currency. The monetary base of Brunei is more than fully backed by official foreign exchange reserves of USD 3bn (let alone the sovereign wealth fund). Meanwhile Brunei's entire monetary stock of Brunei Dollars 14.4bn is only 2.7% of that in Singapore. As such gyrations in Brunei's economy as a result of sustained low oil prices should not weigh unduly on the economies of Singapore or Malaysia.

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