ECONOMIC ANALYSIS

Oil impact on Asia's structural current accounts

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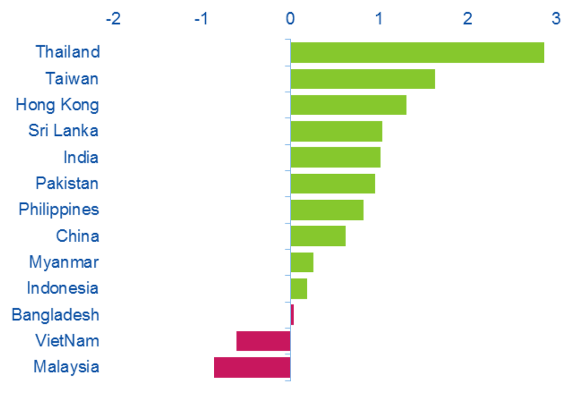
Summary

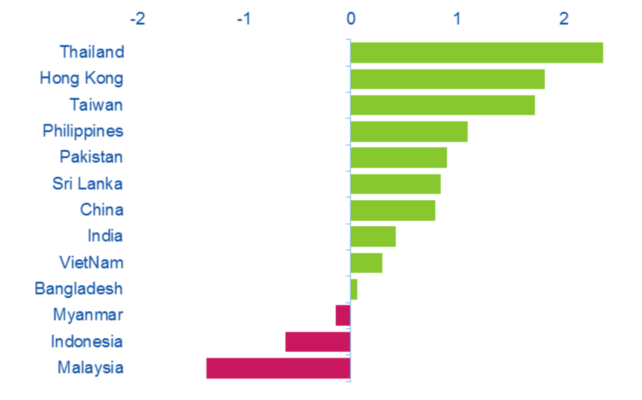
- We decompose the current account balances (CAB) of emerging market Asian economies into cyclical and structural components to examine the oil price impact on Asia's structural current accounts.
- Most EM Asian economies have emerged as significant net beneficiaries of lower oil prices since 2014 in terms of their current account balances (Figures 1A and 1B) not only in cyclical but also in structural term.
- The structural CAB gains, coming from the new oil price paradigm, will be especially important in Thailand, Hong Kong, Taiwan and Philippines. Contrary, Malaysia and Indonesia will be severely affected. That said, the net oil importer nature of the region will continue to drag on EM-Asia's structural CAB in the wake of resilient consumption, rapid urbanization, and industrial recovery.
- The rest of structural factors, other than oil prices, will also play a key role in improving EM Asia CAB. The structural CAB surplus will be supported by savings determinants, such as fiscal prudence, demographic strength, the step-up in trade liberalization and financial inclusion. The reduction in unproductive investments will also contribute positively to the structural savings and investment gap.
- Some structural factors will maintain the oil trade balance as a drag on EM-Asia's structural CAB despite the improvements. For instance, ongoing structural rebalancing in the Chinese economy from investment towards consumption has kept Chinese oil product demand buoyant, in turn partly offsetting sluggish industrial oil use.
- The EM Asian economies will need to step up efforts to rationalize their oil demand going forward in order to continue to increase the structural gains. These actions include 1) effectively phasing out fuel subsidies, 2) achieving efficiency gains in the transport sector through more mass transit projects, 3) higher use of biofuels, and 4) improving the energy supply mix through greater diversification.

Figure 1A
Cyclical effect* (2016) of the oil price decline on the CAB (in % of GDP)



Source: BBVA Research; *The cyclical effect corresponds to the cyclical contribution of the oil trade balance in 2016, driven mainly by oil prices.

Figure 1B
Structural CAB winners/losers from the oil price decline (Structural CAB change during 2012-2020 in % of GDP)



Source: BBVA Research

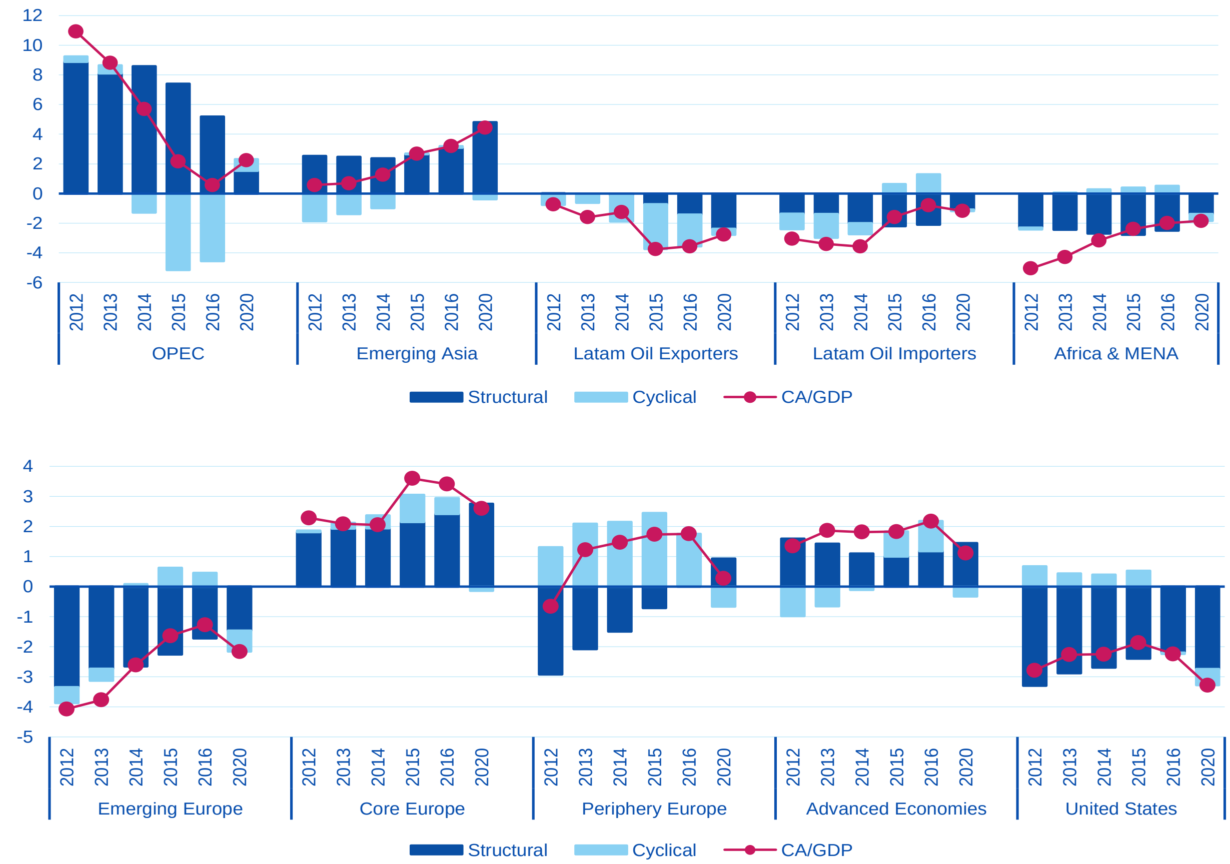
Lower oil prices continue to significantly benefit EM Asia's current account balances

Decomposing current account balances (CAB) into cyclical and structural components[1] suggests that Emerging Market (EM) Asian economies have emerged as significant net beneficiaries of lower oil prices since 2014 in terms of their current account balances (Figures 1A and 1B). Our previous piece of research (The current account balance and the oil price shock) showed us that Emerging Asia is among the most benefited region in terms of CAB improvements driven by the decline in oil prices. On average, the structural balance from EM Asia will improve from near 2% of GDP in 2013 to almost 5% of GDP in 2020. Also, given its near 0% cyclical CAB position in 2016, EM Asia's CAB surplus will be predominantly structural.

Interestingly, our model-based Inter-Regional comparison of current account dynamics yields relevant idiosyncratic inferences for EM Asia (See Figure – 2). First, EM Asia will be the key winner from the new oil paradigm. If the oil prices do not recover more than expected[2], Emerging Asia will replace even the OPEC as the main structural BoP surplus region in the emerging market arena by 2020. In fact, only the Developed

Figure 2

Decomposition of current account balance into structural and cyclical components (% of GDP)



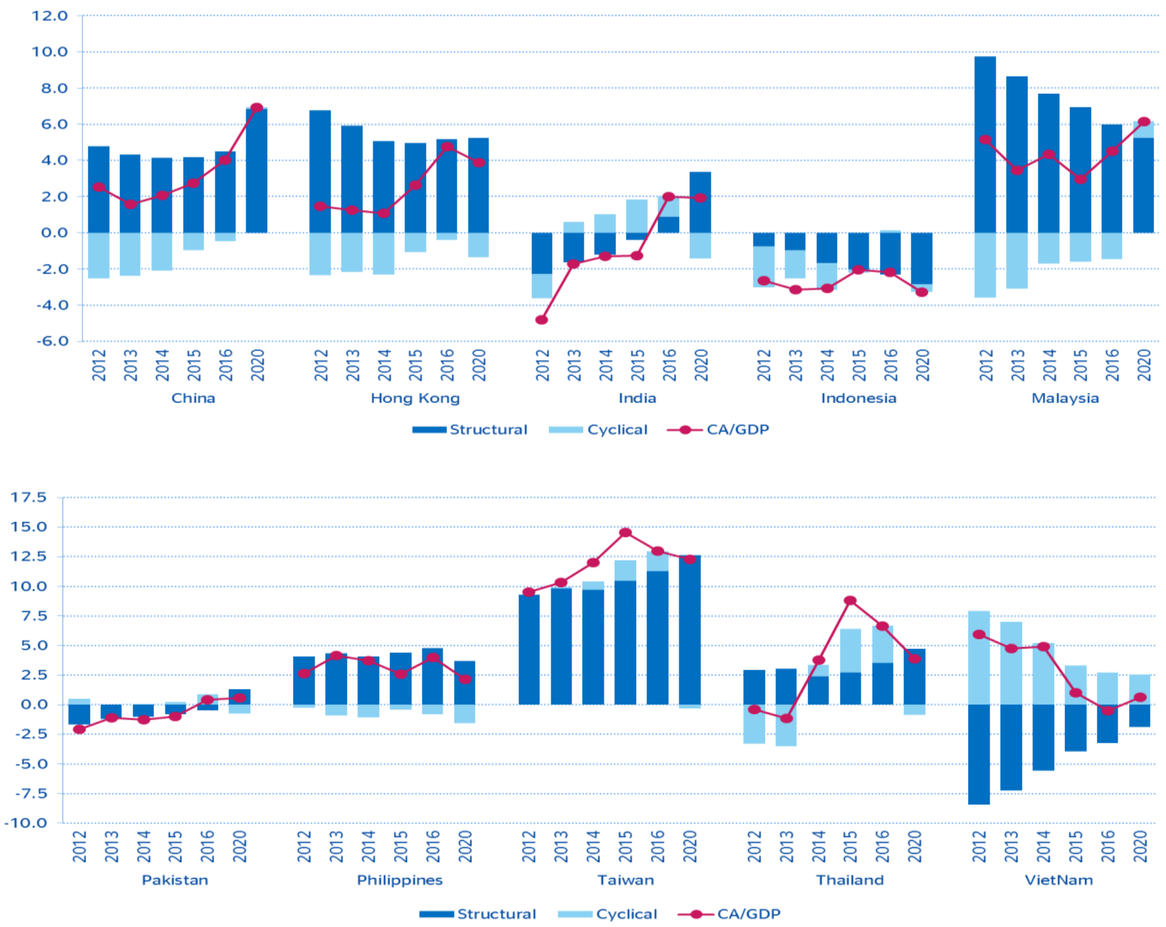
Source: BBVA Research

[1] Structural factors are those having a permanent or long-lived effect) . Our model studies the variability of current account in its structural and cyclical components using combination of 1) Panel data model and 2) Bayesian time series model. For details refer to our recent Economic Watch.

[2] BBVA's baseline Brent Crude Oil Price ($/bbl) estimates current stands 30.3 in 2016, rising gradually to 59.6 in 2020.

Western Central European countries' CAB would remain slightly above these structural surplus levels. Second, low oil prices will be one, but not the only factor, driving EM Asia's structural CAB surpluses in the medium to long term. In fact, as we will discuss in the latter half of this watch, EM Asia's structural CAB will uniquely benefit from several savings determinants and investment imperatives, apart from the oil price impact. This significant structural improvement in external balances would act as an important buffer against potential external vulnerability risks for emerging Asia, in turn augmenting the region's sovereign credit profile.

Figure 3
Decomposition of current account balance into structural and cyclical components (% of GDP)

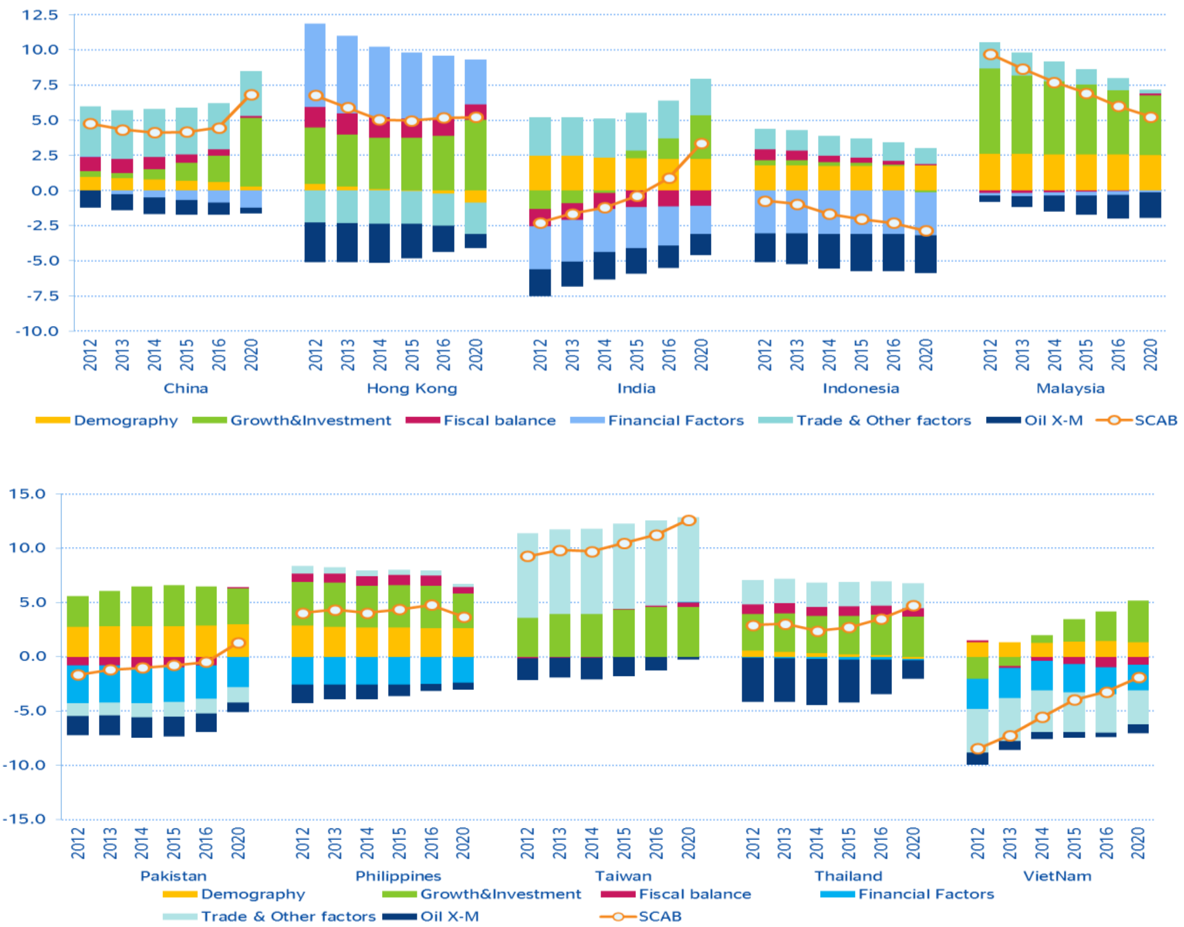


Source: BBVA Research. Note: Notice that years 2017 to 2019 are not depicted in the Graph.

While EM Asia's structural CAB prospects look bright at an aggregate level, country specific trends will be heterogeneous. The impact of oil price decline on EM Asia's structural CAB benefits Thailand, Hong Kong, Taiwan and Philippines the most, while adversely affecting Malaysia and Indonesia. Meanwhile, the aggregate impact of structural factors in driving CAB surpluses across EM Asia are most pronounced for China, Hong Kong, Malaysia, Philippines and Taiwan (see Figure – 3). We also observe, that the cyclical contribution of lower oil prices in improving CAB of India and Thailand is likely to be higher than its structural counterpart in the near to medium term, but the later will take over by 2020.

Notwithstanding, the positive impact of lower oil prices, we find that the oil trade balance will continue to remain a drag on EM-Asia's structural CAB, amid rapidly rising oil demand even as low oil prices continue to aid the region's CAB (See Figure – 4). For instance, ongoing structural rebalancing in the Chinese economy from investment towards consumption has kept Chinese oil product demand buoyant, in turn partly offsetting sluggish industrial oil use[3]. Meanwhile, for the rest of EM Asian economies, oil product demand is expected to trend higher going forward in light of resilient consumption demand, rapid urbanization, and a pickup in industrial growth. That said, despite the drag from oil trade balance, we find that structural rather than cyclical factors will play a leading role in improving EM-Asia CAB going forward.

Figure 4
Decomposition of structural current account balance into large economic factors (% of GDP)



Source: BBVA Research. Note: Notice that years 2017 to 2019 are not depicted in the Graph.

Structural factors remain the predominant driver of EM Asia Current Account Balances

Our model emphasizes the role of structural rather than cyclical factors in improving EM-Asia CAB over the medium to long term. We believe that the improving structural CAB outlook for the region will be led by a series of factors including not just lower oil prices, but also fiscal prudence, demographic strength, step-up in trade liberalization, financial inclusion and cuts in unproductive investments. Having said that, the mix of

[3] IEA data shows Chinese gasoline demand grew 10.4% y/y in first 10 months of 2015, offsetting lower industrial oil use. www.iea.org

structural components influencing CAB differs significantly across EM Asia, and we expect it to remain dynamic for each economy going forward. For some, particularly India, Indonesia, Philippines and Vietnam, the convergence with the developed world in terms of income per capita would help boost financial savings, while for others such as China, Hong Kong and Taiwan, reductions in over-investments would yield productivity gains.

China's structural CAB surplus will be driven mainly by an improvement in China's quality of growth in the wake of structural reforms and economic rebalancing from investments towards more domestic consumption. At around 43%, China's investment to GDP ratio remains substantially high and unsustainable given the challenging macro backdrop and China's current income level. Meanwhile, structural CAB improvements for the rest of EM Asia would be led by a series of factors including demographic strength, characterized by a low dependency ratio, stepped-up trade liberalization; fiscal prudence and deeper banking penetration, which would help mobilize financial savings. EM Asia's demographic dividend will play a significant role as a larger proportion of working-age population means less economically-dependent inactive individuals, and higher savings. However, this trend is disparate across the region. India, Indonesia, Philippines and Malaysia will benefit the most, while regions such as China, Hong Kong and Taiwan, which are already struggling with an ageing population, will see this drag on their structural CAB. Meanwhile, concerted efforts towards fiscal consolidation (e.g. through fuel subsidy reforms), particularly in India and Indonesia, is also aiding structural CAB through lower government borrowings.

Furthermore, we believe that ongoing trade and investment liberalization measures will help improve EM Asia's structural CAB going forward, particularly if these measures are accompanied by an improvement in 'Ease of Doing Business' at the domestic level. Reassuringly, most EM Asian economies today are led by pro-reform business oriented government regimes, which are keen on pursuing investment reforms, even as the pace of such reform implementation has lagged expectations. Vietnam's exceptional growth over the past two years has been powered by robust foreign direct investments, which jumped 17.4% y/y in 2015 to USD 14.5 bn, and concentrated chiefly at the export oriented processing and manufacturing sector.

Finally, the region's favourable demographics, high mobile adoption rate and deepening internet penetration have opened opportunities for banks to leverage on technology for bridging a widening financial inclusion gap – a key factor hindering mobilization of household financial savings for the economy. Malaysia has the largest share of banked population (81%), followed by Thailand (78%), India (53%), Indonesia (36%), Vietnam (31%), and the Philippines (28%). Thus, on average, more than 50% population across most emerging Asian economies is still unbanked. This requires policymakers to step up regulatory reforms and enhance efforts to remove barriers to financial inclusion, all of which will have favourable impacts on savings.

EM Asian economies need to step up efforts to rationalize oil demand going forward

We expect the effects of oil trade balance to continue having a negative impact on Asia's CAB as a number of factors will continue to drive up oil demand, led predominantly by rapidly converging disposable income levels. As EM Asia becomes more affluent on a per capita basis, this ought to boost consumption looking forward, particularly for oil-intensive goods and services such as vehicles and travel, exerting upward pressure on oil demand going forward. Besides industrial growth, rapid urbanization will also support this trend, requiring higher investments in infrastructure which will also increase oil demand. According to the IEA, Thailand and Philippines, with rising oil demand and limited production, are set to see their dependence rise strongly going forward, while in Indonesia, the dependence on oil imports is projected to rise sharply, from 48% in 2014 to 78% by 2040. With the oil trade balance posing a key drag on EM-Asia's structural CAB, policy efforts to rationalize oil demand are crucial going forward. These actions include 1) effectively phasing out fuel subsidies, 2) achieving efficiency gains in the transport sector through more mass transit projects, 3) higher use of biofuels, 4) improving the energy supply mix through greater diversification.

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