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Oil Shock and Cyclical Upturn in US Interest Rates: Implications for Asia

Fourth Major Oil Shock

The world is currently facing the fourth major oil shock in the last three decades, the previous three being in 1973-75 (the Yom Kippur-Arab-Israeli-war), 1979-80 (Iranian revolution and ensuing Iran-Iraq war) and 1990-91 (Iraq's invasion of Kuwait and the Gulf war). The current oil shock has been triggered by a confluence of factors, including the ongoing conflict and terrorist attacks in the Mid East which have threatened the region's oil infrastructure (Iraq and Saudi Arabia), strikes and turmoil in two significant non Mid East countries (Nigeria and Venezuela), the crisis in Yukos, Russia's largest exporter, along with an element of price speculation. Added to these concerns about supply disruptions is the growing recognition that that there may be little spare capacity within OPEC (the lowest since the 1970s). If this is the case, crude oil prices may be set to remain high for some time to come. Another significant factor behind the sustained oil price rise has been the rapid growth in China which is a major oil consumer and importer (see Table 1), as well as the synchronised upswing around the world (notably Japan).

The negative oil shock has ignited fears of a 1970s-style stagflation, i.e. rising inflation and cyclical downturn. Of particular concern now is not just the high price of crude oil but also the acute market instability because of the various geopolitical tensions and uncertainties.

Monetary Policy Conundrums in the US

The question that is increasingly being asked is whether central banks around the world focussed on the prospects — and exaggerated the impact — of deflation for too long, and conversely, whether they were too sluggish in responding to the pick-up in inflationary pressures. After all, as the saying goes, "inflation is like toothpaste, easy to eject, extremely difficult to push back in". Shouldn't central banks have been more preemptive and aggressive in quelling inflationary pressures and expectations? At a general level, the answer is probably no. The seeming inaction or insufficient action by many central banks around the world, including the US Federal reserve (Fed), is more so because of the various conflicting objectives and balancing acts that they have been faced with. For instance, while cyclical recovery in the US started in mid-2003, there have been well-founded concerns that the tepid upturn could easily fizzle out. In addition, despite the renewed cyclical recovery in output growth, job creation and wage growth have been anaemic. There are a couple of plausible reasons for this. One, the problem may be one of time lags, i.e. firms remain risk averse, adopting a wait-and-see attitude to confirm that the economy is back on a sustained growth cycle before they decide to start adding to their headcount. Two, while there may be significant net job creation in the latest growth cycle, there is a disconnect between the skill set required in the growth industries and the skills available by those currently searching for jobs, i.e. rising structural unemployment.

So this is the conundrum that has been facing the Fed. On the one hand, given that the balance of risks for inflation in the near term is on the upside, it calls for a preemptive tight monetary policy. On the other hand, concerns about the durability as well as the quality of growth (i.e. jobless recovery) suggest the need to refrain from raising interest rates immediately. There is yet another reason for the Fed to err on the side of caution and maintain a tightening bias. While the negative supply shocks may or may not be temporary, the structural deflationary story — increased price competition with economic globalization, leading to a reduction in the pricing power of firms (outsourcing of goods and services to low costs destinations like India and China) — remains intact.

There is another disquieting factor for the US and some other industrial countries (like the UK and

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RIS 20 Years (1984-2004)

Australia), viz. the wealth effects of consumption. The sharp run up in house prices in the 1990s in these countries following a prolonged period of easy money has led to households feeling wealthier and has alleviated their credit constraints. The International Monetary Fund (IMF) has recently studied the macroeconomic effects of the property-induced wealth effects. According to the IMF study, the correlations between house price movements and consumption in industrial countries have been increasing, indicative (but by no means conclusive) of the growing importance of wealth effects of consumption. In other words, households have been consuming out of their wealth (hence causing household savings rates to decline to record low levels). The worry is that a sudden and marked rise in interest rates will lead to a decline in real estate valuations, while also leaving a lot of highly indebted households (with outstanding mortgages) in a bind. This erosion of household balance sheets and rise in debt-servicing costs could in turn trigger a marked decline in consumption and therefore overall growth. If one adds to the mix the fact that the real estate and related consumption-driven service sectors (retail, domestic tourism, etc.) are the ones which provide employment to the "heartlanders", it is no wonder that central banks in the industrial world have appeared somewhat pensive when it comes to interest rate policy, and there is no obvious consensus among market analysts about the appropriate policy stance.

Upturn in the US Interest Rate Cycle and Impact on Asia

Against this backdrop, and having weighed the various tradeoffs, the Fed chose to raise interest rates by a total of 75 basis points between the June 30 and September 22 Federal Open Market Committee (FOMC) meetings. However, the actual Fed funds rate still stands at only 1.75 per cent and real market interest rates are close to negative (just for comparison, Fed funds rate this time five years ago was about 5.25 per cent). US monetary policy therefore remains largely expansionary. For comparison, note that the Reserve Bank of Australia (RBA) on its part chose to keep the official cash rate steady at 5.25 per cent in the August 3 meeting. This rate has remained unchanged since December 2003. This may be because Australia is relatively less susceptible to inflationary pressures currently (being a net commodity exporter) and housing prices have softened, particularly in the major cities. The inaction is also partly attributable to the looming domestic national elections.

Nonetheless, both the Fed and the RBA have signalled that if inflationary pressures continue unabated we can expect a prolonged period of measured tightening. This is of course predicated on the assumption that energy prices may remain high but will not skyrocket and derail the current growth momentum. Indeed, the balance of risks suggests that despite some concerns about durability of growth and weakness in the job market, the Fed may choose to maintain a hardening bias towards interest rates as it needs to ensure there is sufficient room for a sharp monetary policy stimulus in the future in the event of significant negative shock (such as a major terrorist attack, global liquidity crisis a la the Russian crisis in 1998 and the ensuing LTCM debacle, etc.). Assuming this to be the case, what does it portend for the rest of Asia?

We consider three broad categories of countries in Asia: (a) China (US dollar pegger); (b) India and Singapore (successful effective or trade weighted exchange rate targeters); and (c) South Korea, Indonesia, Thailand and the Philippines (the official inflation targeters).

China: Hard versus Soft Landing

As is commonly known, China has been facing persistent problems with excess capacity and overheating in certain segments of the economy since last year if not before. Given the heavy dependence by China on oil and commodity imports, inflationary pressures on a macro scale have also become apparent recently. Presumably the country will continue with efforts to engineer a gradual economic slowdown via administrative measures to curb lending and investment (though there are growing concerns that the ongoing policy austerity initiated in mid-2003 may not be producing the desired effects). Nonetheless, the emergence of inflation at the macro level and consequent low (even negative) negative real interest rates could perpetuate existing financial imbalances that will be hard to unwind in an orderly manner later. This in turn suggests the need for an interest rate hike and an eventual currency revaluation at some stage in China. The weaknesses and inefficiencies in the domestic financial system that is unable to appropriately price risk remains a worry, particularly during a period of rapidly altering price dynamics.

India: Fiscal Measures to Contain Inflation

While India's recent output and export growth record has been quite impressive, cost-push inflation because of commodity and oil price surges has been exacerbated by a faltering monsoons in mid-2004. Inflation (annual wholesale price-based inflation rate) in India has jumped to 7-8 per cent, causing some concern to the Reserve Bank of India (RBI) and the newly elected Congress-led government. There has been some attempt to offset the negative supply shocks by bringing down import duties on petroleum-related products (diesel, petrol, kerosene, and LPG). — Possible loss of tariff revenues and continued subsidisation of petroleum-related products makes accelerated fiscal consolidation even more critical. (This is relevant to Indonesia and the Philippines as well). — Recognising the temporary

effects of these fiscal measures, the RBI chose eventually hike the Cash Reserve Ratio (CRR) by 50 basis points in two stages (fortnight ended September 18 and fortnight ended October 2). The RBI has also been mopping up excess liquidity using the Market Stabilisation Bonds (MSBs). Early indications suggest that inflation rate has begun to decline. If inflation remains persistent, an eventual interest rate hike may be called for. If the RBI chooses to resist hiking interest rates (because of concerns on bond prices, financial system and overall industrial growth), the Rupee can be expected to come under selling pressures. India has accumulated nearly US$ 120 billion of reserves over the last few years. The RBI might choose to keep imported inflation under check by using its stockpiles of reserves, though such a strategy is clearly not advisable or sustainable over too long a period. The government is also planning to mobilize a part of the reserves for funding infrastructural development.

Korea: Weak Domestic Consumption and Lop-sided Growth

Korea is particularly vulnerable, being the world's fourth largest oil importer (see Table 1). In addition, Korea's relatively strong labour unions render the economy quite susceptible to higher nominal wage demands and a wage-price spiral. In addition, despite Korea's good growth since recovering from the 1997-98 crisis, the expansion in recent years has been lopsided. While the export sector has performed well thus far, domestic consumption growth has been disappointing, a consequence of the credit card bust and sharp rise in default rates among Korean households. Not surprisingly, consumer confidence remains low and has become a drag on overall growth. Against this background, Korea is particularly averse to hiking domestic interest rates. Indeed, the policy decision on August 12 by the Bank of Korea (BOK) was actually to lower the overnight call rate by 25 basis points to 3.5 per cent, reflecting the extent of concern about domestic demand. The BOK has clearly signaled that combating domestic sluggishness is of more importance at the current time. While the BOK's action does nothing to curb cost push inflation, one way of ensuring the country achieves its core (i.e. excluding food and energy) inflation target would be to allow for a stable if not slightly appreciating currency by tolerating a decline in its foreign exchange reserves (which stood at US$ 168 billion as of end July 2004, the fourth largest in the world).

Thailand: Relatively Strong Domestic Economy but Uncertainties Remain

Notwithstanding some emerging financial imbalances in Thailand (overheating real estate, especially premium properties), overall economic growth has been quite balanced. Both domestic and external demand have been robust, while the Thai baht has been rather weak in 2004. One would expect, therefore, that the Bank of Thailand (BOT) would be willing to pursue a mix of some degree of interest rate tightening along with active reserve management (to keep the US dollar value of the baht stable to cushion against imported inflation). This said, the BOT initially chose to keep the 14-day repurchase rate at 1.25 per cent on July 21, weighing the inflationary concerns against other risks, including the wild card of possible reemergence of avian flu which may act to check growth. The BOT statement did make clear that it would "stand ready to respond once inflation showed a clearer sign of acceleration." True to this statement, in the presence of persistently high oil prices which threatened to feed into domestic prices, the BOT raised its key benchmark interest rate for the first time in three years in August 2004 to 1.5 per cent to reduce pressure on the Thai baht and thus curb imported inflation.

> "The volatility of oil prices is a highly destabilizing factor for the world economy. It is more devastating for oil importing developing countries than for other countries. Given the strong cartel in the form of OPEC operating in this market, it is not possible to rule out oil price shocks of the type faced in the early 1970s, early 1980s, early 1990s and 2000 or even in the future. It is imperative for international community to create a mechanism to regulate and stabilize oil prices at a certain reasonable and sustainable level. The intervention should bring the OPEC and other oil producers to observe some international discipline. Further, there should be a special fund to moderate the impact of volatility in oil prices for the poorer developing countries."
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> **RIS, *South Asia Development and Cooperation Report 2001/02.* New Delhi, 2002.**

Top World Oil Consumers and Importers (Million of barrels per day), 2001

	Total Oil Consumption[a,d]		Total Oil Imports[b,d]		Oil Dependency Ratio[c]	
Rank	Country	Amount	Country	Amount	Country	Ratio
1	United States	19.7	United States	10.8	Japan	1.00
2	Japan	5.4	Japan	5.4	South Korea	1.00
3	China	4.9	Germany	2.7	France	1.00
4	Germany	2.8	South Korea	2.1	Germany	0.96
5	Russia	2.5	France	2.0	India	0.65
6	Brazil	2.2	Italy	1.7	United States	0.55
7	South Korea	2.1	China	1.6	China	0.33
8	France	2.0	Spain	1.5	Brazil	0.25
9	Canada	2.0	India	1.3	Russia	0
10	India	2.0			Canada	0

Notes: a) Includes only countries which consumed at least 2 million barrels per day in 2001.
b) Includes only countries which imported at least 1 million barrels per day in 2001.
c) Oil Dependency Ratio defined as Imports of oil/Consumption of oil.
d) Seven of the nine top oil importers are also among the top ten oil consumer, the exceptions being Spain and Italy. China and India are the only two non-OECD countries among the top oil importers.

Source: Mohan G. Francis (2003), "The World Oil Market", mimeo (March).

Indonesia and the Philippines: Uncertainty and Sluggish Investment

Indonesia has become a net oil importer recently. It is true that Indonesia may be slightly more averse to interest rate hikes than Thailand given continued sluggish domestic growth. However, on the one hand, Bank Indonesia (BI) is keen on keeping the rupiah stable in the midst of continued political uncertainties and to prevent pass through to domestic prices, while at the same time it is reluctant to sacrifice its reserves to stabilize the currency. Thus, the BI appears to have limited options but to eventually raise interest rates. This is particularly so in view of the fact that headline inflation in Indonesia is over 7 per cent and could rise if timely steps are not taken to contain it. However, the recent bombings in Jakarta and investment and growth sluggishness have led the BI to keep rates on hold for the time being.

Broadly similar reasoning may be relevant to the Philippines as well which is potentially faced with a fiscal crisis and modest domestic growth. Like Indonesia, the central bank of the Philippines (BSP) has also been cautious about raising interest rates despite surging inflationary pressures, and unlike Indonesia and other Asian countries, the Philippines has not been stockpiling reserves since the late 1990s. Nonetheless, if oil prices remain firm and passes through into domestic prices, persisting with the accommodative monetary policy may not be appropriate or sustainable.

Singapore: An Appreciating Currency Stance

After having virtually stagnating in the last three years, the Singapore economy is expected to grow robustly in 2004. The Monetary Authority of Singapore (MAS) was somewhat ahead of the curve when it moved to a modest appreciation of the nominal effective exchange rate (NEER) in April 2004 against the backdrop of a sharp recovery in domestic growth and an anticipation of the threat of higher imported inflation. Going forward, on the one hand, imported inflation remains a potential threat to the city-state, suggesting the need for a tighter exchange rate policy. On the other hand, there is a general expectation that other regional currencies will not be faced by significant upward pressures in the near term, and there is a need to ensure that the ongoing buoyancy of the macroeconomy is sustained for its own sake as well as if further inroads are to be made in reducing domestic unemployment. This being the case, the MAS might be expected to pursue a neutral to slightly appreciating exchange rate policy stance.

Concluding Remarks

Asian countries are walking a tightrope between keeping inflation under wraps while not derailing overall growth. Indeed, stabilisation policy more generally involves balancing of various objectives and making informed guesses so as to anticipate future events. No one should need convincing that the underlying macroeconomic situation can change quite radically in a fairly short period of time. The persistence of a large number of global structural imbalances and geopolitical uncertainties in the Mid East makes this a real possibility. In view of this, as well as other possible global wildcards (hard landing the China, property bubble burst in industrialised countries, etc.), the foregoing analysis may not have too long a shelf life! At the very least, the current oil shock serves as a further reminder of the need for a longer-term strategy involving economising on energy utilisation and intensifying the search for alternative energy sources.

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