Macro Keys
Asia: From Petro-Dollars to Patro-Dollars

Economics & Macro Strategy

Global

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Patronomics: A big change in capital flows

A significant shift in capital flows is underway. For most of the last decade, surplus savings from the petroleum exporting countries have funded current account deficits in the rest of the world. Now, those petro-dollar flows are dwindling with the lower oil price. IMF estimates suggest that oil exporter surpluses will fall from USD 506bn in 2013 to just circa 40bn in 2015. At the global level this is just one side of a shift in income from oil producers to oil consumers. However, that matters because the way in which this income shift unfolds has implications for economic activity and asset prices. In particular, China and Japan, both amongst the world's largest energy importers, appear to be strategically encouraging investment in South East Asian Infrastructure – a theme we call *Patronomics*. Patro-dollars are replacing petro-dollars.

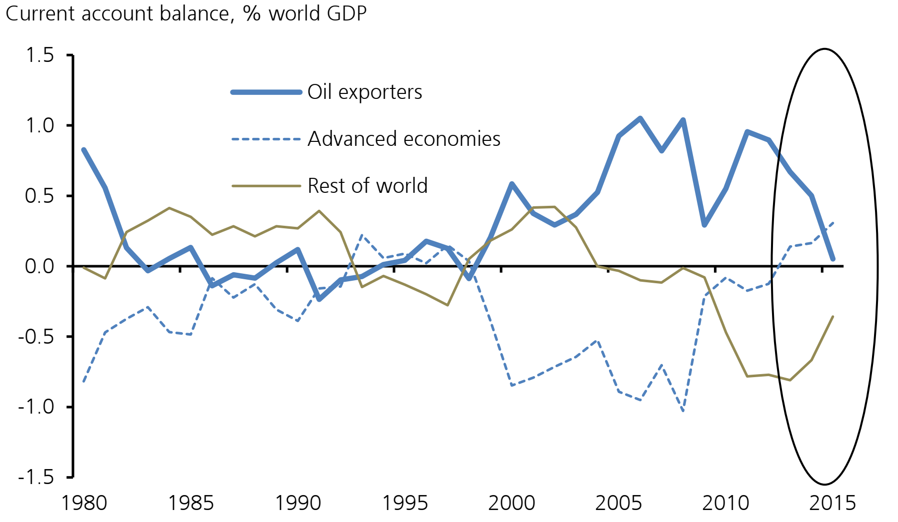
Petro-dollar flows evaporating

The single best way to look at capital flows between regions or countries is via current account balances. A current account surplus reflects the net acquisition of financial assets abroad while a deficit reflects the accruing of net financial liabilities. Figure 1 shows how the oil producing country surpluses funded the deficits of the advanced economies prior to the global financial crisis and the deficits of the non-oil emerging markets since the global financial crisis. Now, with oil prices having fallen, petro-dollars are funding neither. The IMF estimates the breakeven oil price for most prominent oil exporters – i.e. the level at which the current account falls from surplus to deficit – lies above USD 60 a barrel. Consistent with this Saudi Arabia posted a current account deficit in Q1 2015, recorded a USD 77bn decline in FX reserves since August 2014 and, earlier this year, issued sovereign bonds for the first time since 2007. These may not be temporary phenomena; UBS' oil analyst projections do not foresee Brent oil above USD 60 a barrel until 2017.

Follow the flow – patro-dollars

At the global macro level the shift in incremental spending power from oil exporters to oil importers due to changes in the oil price must offset each other. However, the route capital flows take through international financial markets has important implications for asset prices. Incremental dollars available for consumption or investment originating from the Middle East, a US household, from China or from Japan will each have different implications for consumption and capital flows. Figure 2 shows that Chinese and Japanese current account surpluses have risen as that of oil exporting Saudi Arabia has fallen – implying a shift in the source of capital flows. Figure 3 shows the different composition of capital flows from China and Japan compared to a selection of oil exporting countries. Historically, Japan's flows have been more FDI orientated and China's capital outflows have been skewed towards accumulation of foreign exchange reserves (held disproportionately in USD assets) while oil exporter flows (via Sovereign Wealth Funds) have been more portfolio orientated. In coming years we expect China and Japan to increase their patronage of infrastructure projects in the rest of Asia and specifically ASEAN – further altering the flow of capital. In APAC Equity Strategy – China, Japan and the Emergence of Patronomics and APAC Economic Perspectives: Patronomics – China's railway diplomacy in ASEAN we argue it will reward investors to follow the flow of patro-dollars. Possible macro implications for increased patro-dollar flows focused on ASEAN include i) lower ASEAN interest rates that might otherwise be the case (not least in the context of potentially rising USD interest rates) and ii) support for growth via expanded infrastructure. Our colleagues draw out further implications in the above notes.

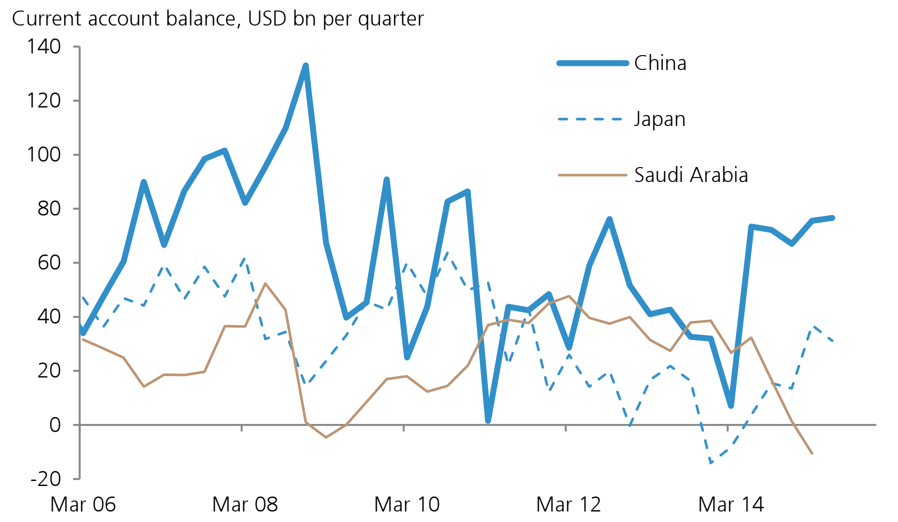
Figure 1: Petro-dollar surpluses evaporating



Source: IMF Estimates Note: Oil exporters defined as Venezuela, Trinidad and Tobago, Ecuador, Yemen, UAE, Syria, Saudi Arabia, Qatar, Oman, Libya, Kuwait, Iran, Iraq, Bahrain, Turkmenistan, Russia, Kazakhstan, Azerbaijan, Nigeria, Gabon, Equatorial Guinea, Congo, Algeria, Angola and Norway

The lower oil price has wiped out oil exporter surpluses and, as a result, depressed petro-dollar capital flows.

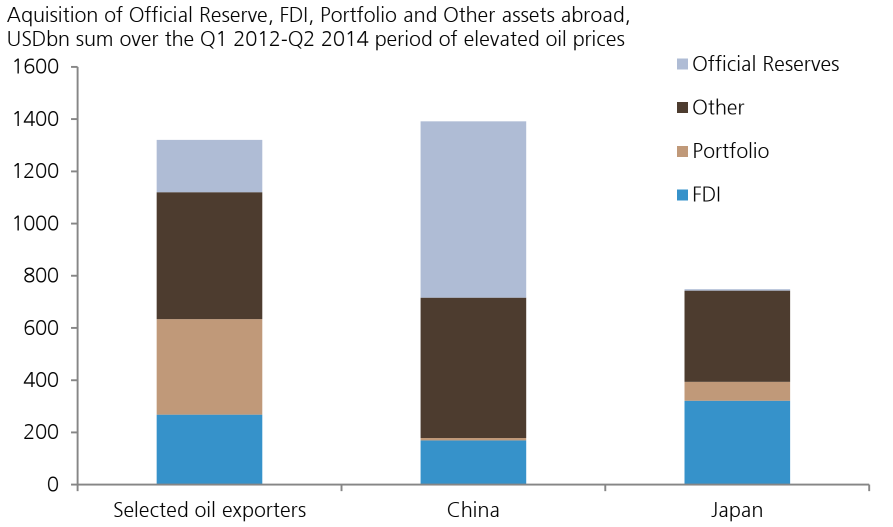
Figure 2: Japanese and Chinese surpluses up, Saudi Arabia down



Source: UBS, Haver, CEIC

Concurrently, the surpluses of Japan and China – two of the world's largest energy importers have risen. The combined Japanese-China surplus has risen from USD 189bn in 2013 to 440bn annualised in H1 2015. That means Chinese and Japanese capital is going some way to offset the estimated 466bn reduction in petro-dollar flows.

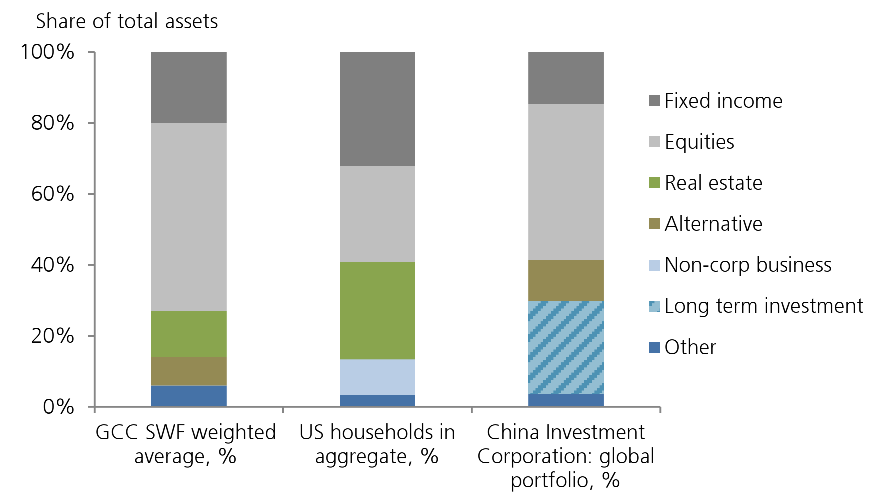
Figure 3: Different sources for capital flows mean different types of flow



Source: UBS, Haver, CEIC Selected oil exporters are Russia, S. Arabia, Venez., Norway, Qatar, Kuwait, Kazakh'n

This figure shows that not all flows are the same. The mix of capital flows from oil exporter countries is more portfolio orientated than that from Japan and China. This said, some of China's foreign exchange reserve accumulation may have behaved like broader portfolio flows.

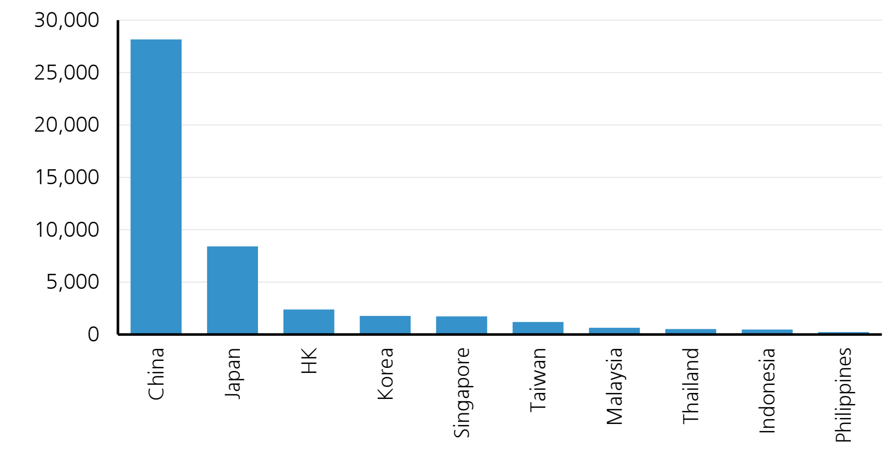
Figure 4: The source of capital matters: asset holdings differ by investor



Source: UBS, Federal reserve, EIB, Investment Company Institute, Mercer, CIC Note: Chart reflects 2014 asset holdings for US households and CIC. GCC data is a stylised estimate rather than the specific allocation at a specific point in time.

SAFE, China's primary reserve management institution, invests in equities. Meanwhile China Investment Corporation manages circa 5-20% of PBoC's reserve assets and, as Figure 4 shows, holds some assets in a similar way to a Gulf Sovereign Wealth Fund. Nonetheless, this does not alter the broader conclusion – the source of flows matters. Again, the US data shown here implies a marginal dollar saved by US households will be deployed quite differently to a marginal dollar deployed in a Gulf Sovereign Wealth Fund.

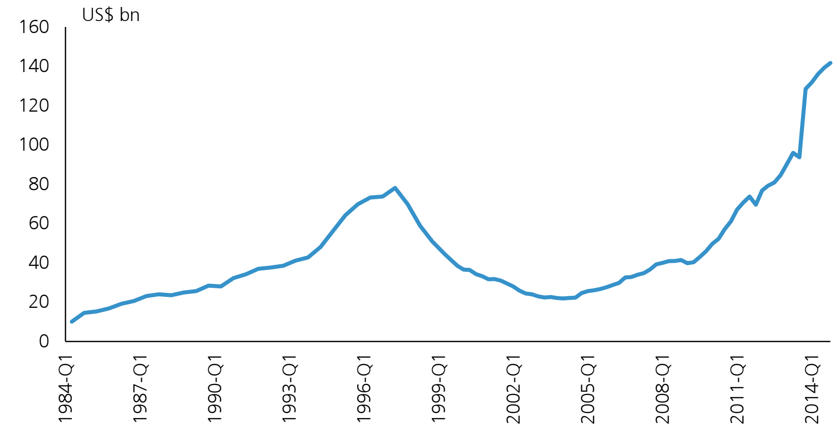
Figure 5: Relative size of Asian banking markets, USDbn at YE14E



Source: Central Banks, CEIC, UBS Banks team

As part of its One Belt, One Road initiative, China has already i) established the Asian Infrastructure Investment Bank with up to USD 100bn of authorised capital and ii) Established a Silk Road Funds with USD 40bn of capital. Beyond this UBS Asian bank's analysts expect Chinese Banks to commit hundreds of billions of USD to support these initiatives.

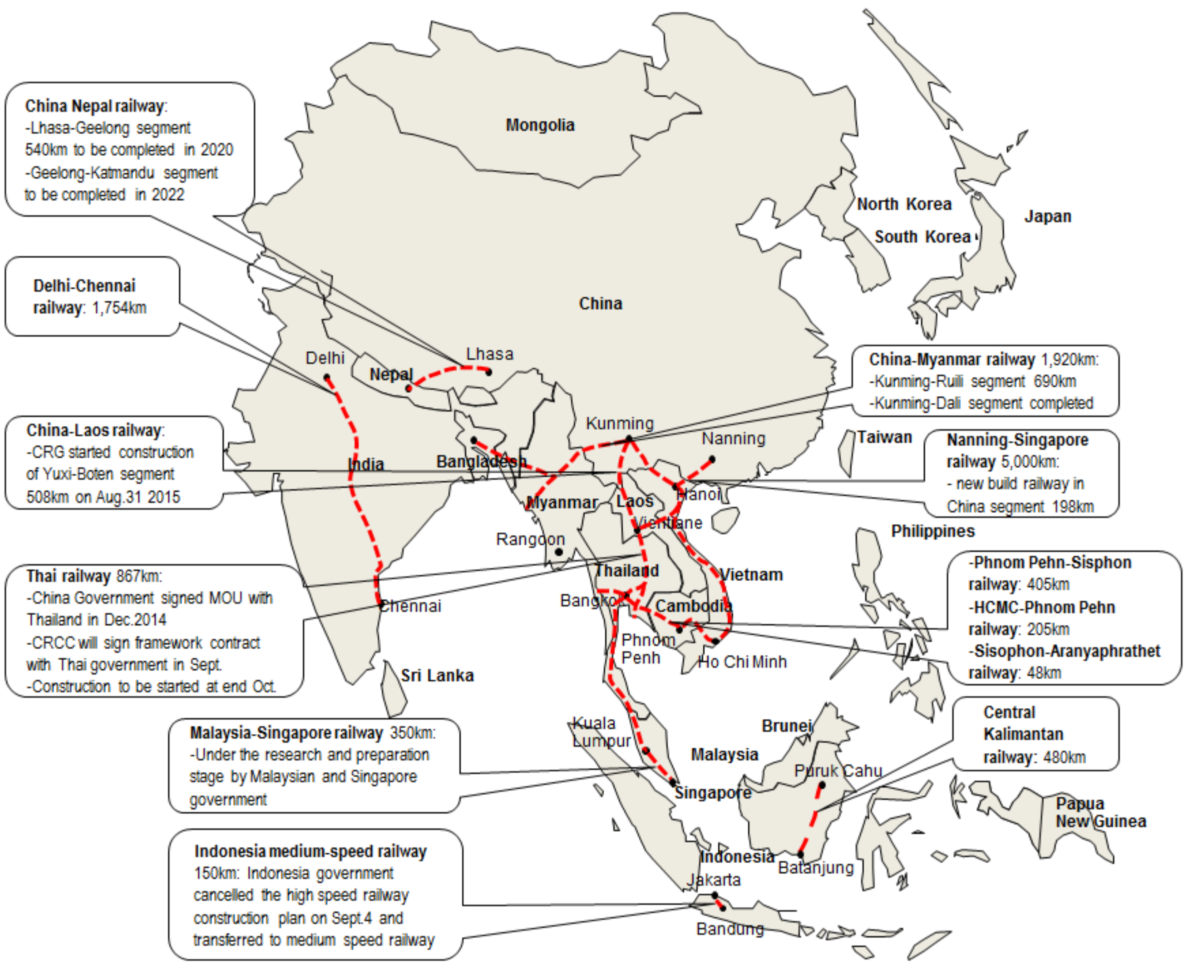
Figure 6: Japanese bank lending to ASEAN* is on the rise



Source: BIS, UBS *Thailand, Malaysia, Indonesia, Philippines

This Figure shows increased lending by Japanese banks to ASEAN. Additionally, in May, the Japanese government, which along with the US is not a founder member of the AIIB, announced its intention to expand assistance to Asian countries (in collaboration with the Asia Development Bank), by providing an additional US$110bn over five years.

Figure 7: Chinese railway plans in South-East Asia



Source: UBS estimates, UBS China Railways team Note: Press reports, boundaries are not authoritative.

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