Asian Fuel Subsidies Cuts: Impact on Inflation, Interest Rate & FX Policies

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That the price shocks are largely supply side in nature, traditional interest rate hikes to quell domestic inflation effectively are not going to work.

The problem is that inflationary expectations are building up, and second rounds effects are working through the system. Also, most countries are running on rather serious negative real interest rate rates.

Thus, Asian central banks may not have too many policy choices – but to raise domestic cost of funds.

Given that most of price pressures are international in nature, FX appreciation is actually a more effective tool. However, moderating growth prospects – as fuel subsidy cuts work through the system, and implication of higher cost of capital and assets prices, it appears that Asian FX direction is more of downside than upside over the next few months.

Watch developments in Vietnam. Given the slightly fragile situation in Asia, any extended adjustment on the Vietnamese dong will trigger the expected Asian FX depreciation.

Soaring oil and food prices have lifted inflation across the world. With higher weighting on both fronts as compared to developed economies, Asian headline inflation has risen beyond expectation over the past months. Now, the problem looks to further intensify as Asian governments, unable to keep subsidizing the surging oil prices, have embarked on raising their regulated prices over the last two months. That the price shocks are largely supply side in nature, traditional interest rate hikes to quell domestic inflation are effectively not going to work. However, the problem is that inflationary expectations are building up, and second rounds effects are working through the system. Also, most systems are running on rather serious negative real interest rate rates. As such, Asian central banks may not have too many policy choices – but to raise domestic cost of funds. Indeed, longer-dated 2- and 10-year government bond yields have risen sharply – a reflection of both higher short-end rates eventually, as well as questions over respective central banks' ability to manage the current inflationary pressure (in other words, credibility to manage the price surge).

Given that most of price pressures are international in nature, FX appreciation is actually a more effective tool. However, moderating growth prospects – as fuel subsidy cuts work through the system, and implication of higher cost of capital and assets prices, it appears that Asian FX direction is more of downside than upside over the next few months. The fact that the Fed is more or less done with its easing cycle is also working against further Asian FX appreciation. Note that short-end 2-yr Treasuries yields have risen some 150bps over the last three months, currently standing at round 3.05%.

Meanwhile, watch developments in Vietnam. Given the slightly fragile situation in Asia, any extended adjustment on the Vietnamese dong will trigger the expected Asian FX depreciation.

Summary of Asian Fuel Price Situation
Taiwan (May 2008): To hike fuel price 13% to NT31.95/litre (or US$1.1/litre), effective 01 Jul 2008. Market was expecting hikes of about 20%.
Sri Lanka (27 May 2008): Petrol, diesel and kerosene prices were up 14-47%.
Indonesia (24 May 2008): Raised fuel prices by average of 28.7%, with gasoline now at IDR6,000 from IDR4,500 previously. To offset the adverse effect, the govt handed out $1.5bn in cash to the poor.
India (05 June 2008): The govt announced a 10% price increase for petrol and diesel effective June 5 - biggest rise in 12 years to stem losses at its state-owned refiners. Reportedly, to allow full pass through, fuel prices would have to increase 50-60%. However, policymakers are worried about the implication on inflation in the run up towards May 2009 elections, which is already at close to 4-yr high at 8%y/y.
Bangladesh: The state-owned petroleum company has proposed to hike fuel price 37-80%. But the government reportedly will offset the adverse effect with $300mn in farm subsidies.
Malaysia (05 June 2008): The govt announced a revamp in its fuel subsidy system, raising petrol prices by 41% to MYR2.70/ liter and diesel by 63% to MYR2.58/liter effective June 5. Under huge political pressure, the government now said that there will not be further hike in retail fuel prices this year although it has earlier committed to review fuel prices monthly. To soften the impact on car owners, the govt will be giving out yearly cash rebate of MYR625 to owners of cars with a capacity below 2000 cc, equivalent to subsidizing up to 800 liters per vehicle in a year at previous price.
China (20 June 2008): Beijing increased sharply prices of gasoline by 17%, diesel by 18%, and jet fuel will climb 25%. On 1 July, China will raise power prices by an average 4.7%, but the govt capped thermal coal prices until end-2008 and more importantly, will keep public transport fares intact. The last fuel price hike was in Nov 2007. Since then, gasoline in China is about 70% of prices in the US. Price of diesel is about 40% below prices in US. The surprise in the move was timing, which was widely expected to move only after the Olympics in Aug. However, with reports of fuel shortages especially diesel beginning to hurt the transport sector, Beijing had to move earlier to ensure there is sufficient fuel products in the market.

World Petrol Prices as of 22 April
(National average prices per litre of regular unleaded petrol)

Country	Gasoline
Britain (London)	$2.15
Singapore 92-Ron (announced on 03 June)	$1.58
Japan (Tokyo)	$1.50
Sri Lanka 90-oct	$1.46
Australia (Sydney)	$1.39
India (Delhi) (effective 05 June)	$1.19
USA ***	$1.00
Bangladesh **	$0.97
Vietnam 92-Ron	$0.90
Singapore fob ^ (announced on 03 June)	$0.85
Malaysia (effective 05 June)	$0.83
Indonesia ***	$0.65
China (Beijing) 90-Ron	$0.61
Named city prices as on 14 May	

^ Market price of benchmark 92 Ron gasoline in Singapore
** Latest recorded change
*** Prices on 26 May

Source: Reuters

Asian Subsidy Program					
% of GDP	Total Subsidy	% of Total Expenditure	Fuel	Food	Remarks
Malaysia	3.30%	13.00%	2.60%	0.70%	Based on prices after June 08 hike
India	4.10%	-	1.60%	2.50%	The govt announced a 10% price increase for petrol and diesel effective June 5
Indonesia	2.90%	13.70%	2.70%	0.20%	Fuel prices were raised in late May 08
China	1.9%	9.50%	1.50%	0.38%	Fuel prices were raised in mid June 08
Taiwan	1.30%	6.80%	1.30%	0.00%	To hike fuel price 13% to NT31.95/litre (or US$1.1/litre), effective 01 Jul 2008
Philippines	3.60%	4.30%	0.20%	3.40%	Fuel subsidy for public transport sector for 3 months starting April, and cut import duties on oil.
Thailand	0.90%	2.50%	0.80%	0.10%	Diesel subsidy for 3 months ending July, subsidy for rice farmers to raise production.
Korea	0.40%	1.50%	0.40%	0.00%	-
Singapore	0.00%	0.00%	0.00%	0.00%	-
Hong Kong	0.00%	0.00%	0.00%	0.00%	-
Source: CEIC, UOB					

Asian Government Fiscal Position				
(% of GDP)	2006	2007	2008F	2009F
Singapore	-0.6	2.7	-0.3	0.5
Malaysia	-3.5	-3.2	-3.1	-3.1
Thailand	2.3	-4.6	-4.8	1.5
Indonesia	-0.9	-1.3	-2.0	-2.2
Philippines	-5.1	-0.7	-3.5	-1.0
Vietnam	-1.3	-1.2	-2.2	-2.0
China	-0.8	0.7	0.3	0.4
Hong Kong	3.9	7.5	4.5	3.8
Taiwan	-0.6	-0.2	-0.1	-0.1
South Korea	0.4	3.8	1.5	1.5
India	-5.0	-5.0	-4.5	-4.0
Source: CEIC, UOB				

Global Inflation is Expected to be Significantly Higher this Year					
	2006	2007	Jan-May 2008	2008F	2009F
Singapore	1.0	2.1	7.0	6.0	2.5
Malaysia	3.6	2.0	2.9	4.6	3.8
Thailand	4.7	2.2	5.8	6.2	3.5
Indonesia	13.1	6.4	8.5	10.7	8.0
Philippines	6.2	2.8	6.9	7.5	4.0
Vietnam	7.7	8.3	19.2	26.0	13.0
China	1.5	4.8	8.1	5.2	4.5
Hong Kong	2.0	2.0	4.9	3.6	2.5
Taiwan	0.6	1.8	3.7	2.5	2.2
South Korea	2.2	2.5	4.1	4.9	3.5
India *	6.7	6.0	6.7	6.1	5.5
* FY data					
Source: CEIC, UOB					

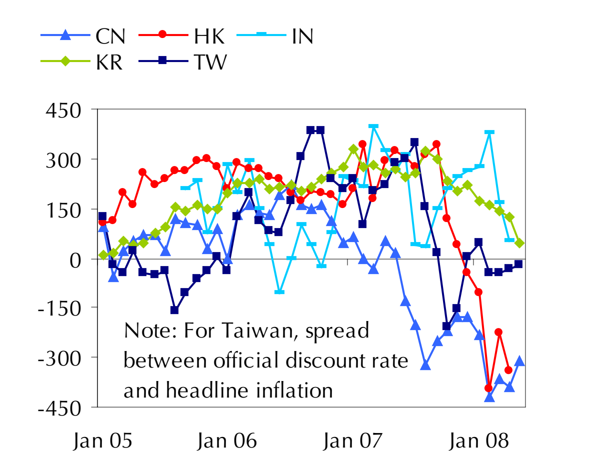
Asian Inflation: When will it Peak and Which Level ?				
	May 08 (y/y change)	Market Forecast (May figure)	When and Where will Inflation Peak?	Official Inflation Target or Forecast
Singapore	7.5	6.9	May/Jun (basis effect)	5.0-6.0
Malaysia	3.8	3.4	Sept/Oct	4.2
Thailand	7.6	6.5	Aug/Sep (when diesel subsidies are lifted)	5.0
Indonesia	10.4	9.9	Dec	6.5
Philippines	9.6	8.9	May/Jun	3.0-5.0
Vietnam	25.2	-	4Q08	-
China	7.7	8.0	Second half of 2008	4.8
Hong Kong	5.6	5.5	3Q08	3.4
Taiwan	3.7	4.1	3Q08	3.3
South Korea	4.9	4.4	Sept/Oct	4.8
India	7.8	-	4Q08	5.0
Source: CEIC, Bloomberg				

Weights in the CPI Basket			
	Food & Non Alcoholic Beverage	Housing, Utilities & Other Fuels	Transport
Malaysia	31.4%	21.4%	15.9%
Indonesia *	38.0%	26.4%	9.4%
South Korea	14.0%	17.0%	10.9%
Singapore	23.4%	21.3%	16.7%
Thailand	38.5%	25.9%	13.1%
China	36.0%	20.0%	13.0%
Philippines	48.8%	23.8%	7.5%
Hong Kong	26.9%	29.2%	9.1%
Taiwan	26.8%	28.0%	10.6%
* 2002 base year			
Source: CEIC			

Policy Responses
Inflation and Interest Rate Policy

Strictly speaking, traditional interest rate policy is not suitable for the current supply side shocks. Thus, it is really not necessary for policy makers to respond. However, the current episode is becoming a longer-term issue, and secondary effect is increasingly visible. If left unattended, a one-off shock could introduce permanent elements as a result. Note that the high inflation environment in Vietnam has resulted in workers heading for the streets, demand wage increase, which could trigger an inflation spiral. Adding in traditional risks related to negative real interest rates are becoming more apparent, Asian central are beginning to respond. Indeed, most of the Asian yield curves have steepened significantly, pricing in CBs respond as well as their ability to manage inflation expectation. Going forward, our take is that Asian interest rates are likely to edge higher, with countries such as Indonesia, Philippines, Thailand, and Vietnam likely to respond more.

Spread Between 3mth Interbank and Headline Inflation have Widened Significantly



Source: CEIC, UOB

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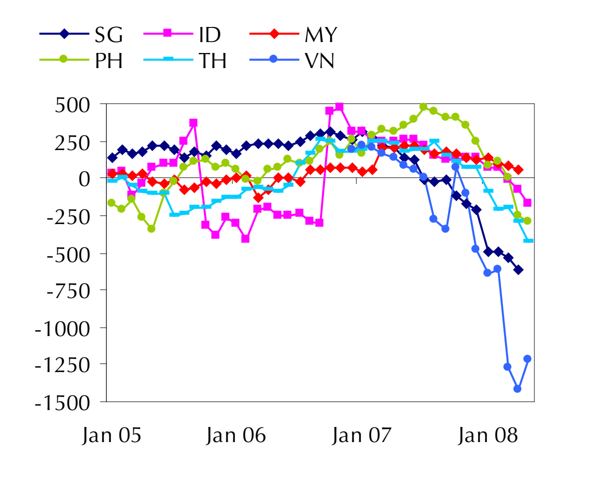


Source: CEIC, UOB

Most of the estimates are that inflation should ease, as fuel subsidies cuts bite into domestic spending, and that global crude and food-related prices should ease into 2009. Risk is that inflation could remain alleviated, and that Asian CBs could be forced to hike rates by greater extent in 2009, which would weigh on Asian investment prospects.

FX Policy: A More Effective Tool But Asian FX Looks Set to Weaken

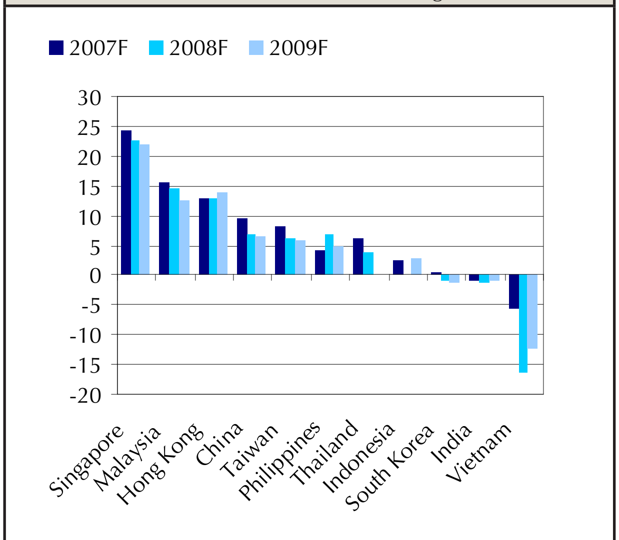
FX is actually a more suitable policy tool given that the supply shocks are global in nature. However, global growth prospects remaining subdued, and renewed risk premiums surrounding Asian economies promise to push respective currencies weaker. THB, PHP and INR have already taken the lead, depreciating 7-12% since Jan 2008. With the on-going interest rate hike and possible social backlash as a result of the recent fuel price increase, IDR looks vulnerable from here. KRW is also looking fragile. Besides similar issues as other Asian economies, political uncertainty promises to weigh on the MYR and THB. Market is closely watching developments in Vietnam, which could trigger the next round of Asian FX weakness.

Even SGD looks to be vulnerable, despite the last two rounds of monetary tightening. Thus, we would not be surprised that SGD would trade closer to the weaker end of the policy band, as questions arise over Asian central abilities to manage the current inflationary environment. Also, that investors have been long Asian FX over last few years, some sort of unwinding should not surprise.

One currency that stands out, or perhaps some positive spillover to the other Asian FX, is the RMB. Since Jan-08, the local unit has appreciated 5.5%, and our call is that the RMB would appreciate some 11% this year. This means that while Asian FX would be edging slightly over the next three months, most Asian currencies should end around current levels – or slightly stronger at year-end.

Another currency is the TWD, which has benefited from the return of Kuomintang to the government, and thus, improving cross straits relationship. Indeed, it has been the best performing Asian currency unit this year, even better than the RMB appreciation of 5.5% since Jan 2008. This positive economic outlook should help offset the less favourable external environment, thereby keeping the TWD slightly firmer if not stable for the rest of 2008.

Current Account Surpluses have Declined and in some Cases Turned Negative



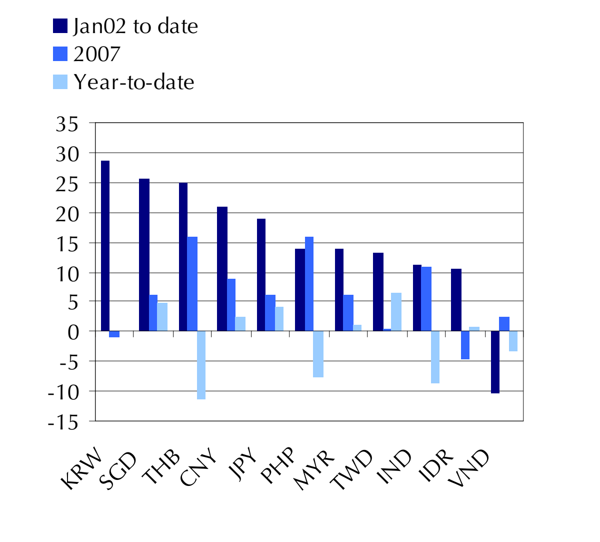
Source: CEIC, UOB

Asian Growth Prospects

So far, Asian growth has continued to hold up (as seen on 1Q-08 figures), even with the alleviated global crude and food-related price, and effects of the US sub-prime and credit markets woes. Indeed, most estimates are that Asian prospects, albeit moderate, continue to be decent into 2009. However, the risk is that ongoing fuel subsidy cuts, and the weakness in the US economic environment could bite more materially as we head towards end-2008, and early 2009. This could dampen growth prospects, keeping Asian FX weak even into 2009.

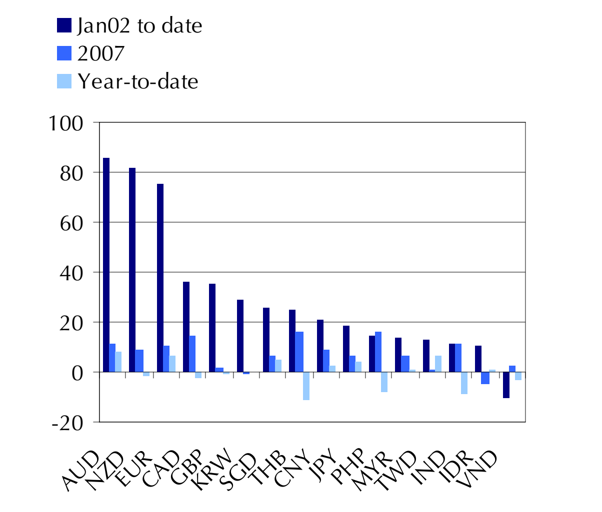
▪ Asia

Asian FX will Struggle Over the Next Few Months as Inflation and Growth Threats Become More Apparent



Source: CEIC, UOB

Longer-term: Asian FX will Continue to Appreciate Beyond the Current Episode Impart of Second Leg of Broad USD Weakness



Source: CEIC, UOB

Asian Economic Growth Still Holding up Despite High Oil and Food Prices

Real GDP (% change)	2006	2007	1Q08	2008F	2009F
US	2.9	2.2	2.5	1.7	1.2
Japan	2.4	2.0	1.1	1.6	1.3
EU	2.9	2.7	2.2	1.6	1.5
Australia	2.8	3.9	-	3.2	3.0
UK	2.9	3.0	2.5	1.9	1.7
Singapore	8.2	7.7	6.7	5.5	5.8
Malaysia	5.8	6.3	7.1	5.2	4.6
Thailand	5.1	4.8	6.0	4.7	4.5
Indonesia	5.5	6.3	6.3	5.7	5.4
Philippines	5.4	7.2	5.2	4.6	5.5
Vietnam	8.2	8.5	7.5	7.0	6.0
China	11.1	11.4	10.6	10.0	9.5
Hong Kong	7.0	6.3	7.1	5.2	5.0
Taiwan	4.9	5.7	6.1	4.9	4.8
South Korea	5.1	5.0	5.8	4.4	4.0

Source: CEIC, UOB, Asia Pacific Consensus Forecast

Summary of Respective Fuel Subsidy, Inflation, Interest Rate & FX Policy

Thailand's newly-elected government reintroduced a diesel subsidy in March 2008 that would last till July. The National Energy Board approved a subsidy of 0.90 baht (US$0.2) per litre of diesel that would take immediate impact. The price of diesel would be capped at 30 baht per litre (US$0.94). The measures recall Thailand's fuel subsidies in Jan 2004-July 2005, which cost the Treasury 92bn baht (US$2.9bn), and were dropped due to the fiscal burden. We expect inflation to peak around Aug/Sep, when the diesel subsidy is lifted, and upgrade our annual inflation forecast to 6.2% y/y for 2008.

We expect the BoT to hike its 1-day repo rate by 25bps in 3Q08, to anchor rising inflationary expectations. After the hike, we expect the BoT to maintain rates at 3.50%, as cost-push inflation would not be significantly mitigated by interest rate hikes. Moreover, further rate hikes would trigger a sharp downturn in growth.

In **South Korea**, inflation came in near decade high of 5.5%y/y in June. The high inflation rate has put to rest the government's call for monetary loosening to boost the domestic economy. We are maintaining our forecast for rates to remain on hold in 3Q08 the next two quarters but the chance of a rate hike has increased given the recent hawkish comments. Longer-term, there is prospects for some monetary loosening in late-2009.

Indonesia's inflation rate hit its highest in 21 months at 11.0%y/y in June after the govt hiked fuel prices by an average of 28.7% from May 24. There is prospect of further fuel price hikes in Indonesia if fuel prices continue to rise.

We are calling for the benchmark overnight rate to reach 9.00% by end-3Q08, as the headline inflation rate could reach 12% in coming months. We have upped our 2008 inflation forecast to 10.7% from 6.8% following the latest fuel price hike. The last time that retail prices of fuel prices was hiked was in Oct-2005when prices doubled which brought domestic inflation rate to 18.4%y/y in Nov that year. To soften the impact on poor Indonesians, the government will be disbursing US$1.5 bn in cash with around 19mn families receiving US$10 per month for the next 1 ½ years.

Malaysia's headline inflation rose to near two-year high of 3.8%y/y in May even as the fuel subsidy shielded Malaysians from the sharp increase in global oil prices. We expect to see inflation significantly higher in coming months after the govt announced a revamp in its fuel subsidy system, raising petrol prices by 41% to MYR2.70/liter and diesel by 63% to MYR2.58/liter effective June 5. From July 1, power tariffs would increase by as much as 26% for industrial and commercial users and gas prices to the power industry would be more than doubled. Independent power producers and palm oil millers would be charged a windfall tax. To help mitigate the impact, the govt will be giving out yearly cash rebate of MYR625 to owners of cars with a capacity below 2000 cc, equivalent to subsidizing up to 800 liters per vehicle in a year at previous price.

The domestic retail petrol prices was last hiked by 18.5% in Mar 2006 and since than, international oil prices have already doubled. As a result of the revamp, we expect the subsidy cost to be reduced to around 2.6% of GDP this year from as much as 7% of GDP otherwise.

Following the fuel price hike, the govt expects inflation to rise to 4-5% this year. We have raised our 2008 inflation forecast to 4.6% from 2.9% previously and expect inflation to remain firm at 3.8% in 2009. While there were calls to hike the OPR by as much as 75bps, Bank Negara's procrastination suggest it is willing to do at most 25-50bps hike this year. The benchmark overnight policy rate (OPR) has been at 3.50% since Apr 2006.

Singapore's headline CPI kept to a 26-year high of 7.5% y/y in May. Core CPI also remained not far behind at 6.7% y/y. For the first 5 months of 2008, CPI averaged 7% y/y, prompting the Ministry of Trade and Industry to raise its full-year 2008 CPI forecast to 5.0-6.0% y/y, from 4.5-5.5% y/y previously. Inflation surged on the back of higher food, car, petrol prices and taxi fares - but was pushed up largely by high electricity tariffs and housing rentals. At such elevated levels, the fear is that with inflation resulting in further cost pressures, consumer spending could be dampened and exports further weakened.

We have raised our 2008 annual inflation forecast to 6% y/y, as we anticipate inflation to peak near 8% in the coming months, and to ease to an average of 5% in the second half of the year, due to the basis effect from last year's 2ppt hike in Goods and Services Tax. The risk to inflation remains on the upside, given the uncertainty regarding the direction of oil and other commodity prices, coupled with the 20% exposure of the CPI basket to fuel-related prices.

To combat imported inflation, the MAS tightened exchange rate policy in Oct 07 (by allowing steeper slope of S$NEER policy band) and Apr 08 (recentred S$NEER upwards at then-prevailing level; amounting to a 2.5% one-off upward revaluation of S$NEER, according to our estimates). We expect the MAS to remain on hold at its Oct 08 monetary policy meeting, given that inflation is likely to come off its 1H08 highs in the second half, and also as export growth slows in the coming quarters.

In **Taiwan**, headline inflation rose sharply to 3.5%y/y in the Jan-Apr period from 1.8% in 2007. The govt has price controls on oil products and electricity prices. However, the newly elected KMT govt on 27 May 2008 ordered an increase of these prices ranging from 10.8% to 31.1%, as crude oil prices hovered around US$130 per barrel. With the price hikes, the govt is likely to be able to cut down on the fuel and electricity subsidies in 2008 from around NT$220bn (approx. 1.7% of GDP) to NT$100bn (approx. 0.8%). There are indications that the govt would in the near future lift the cap on fuel prices entirely, as crude oil prices continue to hover at record levels.

The TWD is expected to maintain its firm tone in the second half of 2008, both due to improved outlook with new KMT govt as well as inflationary pressures. On the interest rate front, CBC should continue to hike at least two times this year (once in 3Q and another one in 4Q), in order to bring real interest rate into long-term average of 2.8%.

In **China**, consumer prices grew a sharp 8.1%y/y in the first five months of the year, partly exacerbated by the snow storms at the beginning of the year and the devastating earthquakes in Sichuan in May are expected to put further upward pressure on inflation. The added factor is the sharp fuel price hikes on 20 Jun, which saw increases of fuel price by an average of 15% and commercial/industrial electricity tariffs by 4.7%. One saving grace is that the Chinese government will allocate subsidies to those that are impacted the most by these hikes such as low income families, as well and will hold public transport fares unchanged despite the higher fuel prices.

The RMB has strengthened about 5% YTD against USD and on track to match our 11% gain this year vs USD. However, one policy tool that the PBoC has not used in 2008 is the interest rate and we expect the central bank may have to move interest rate as well since real depo rate is now deeply negative: nominal depo rate 4.14% and average inflation in Jan-May is nearly twice that. In addition to the reserve requirement ratio hikes and strengthening RMB, we anticipate the PBoC to hike twice on interest rates, bringing the benchmark nominal 1Y working capital rate to 7.83% by end 2008, from 7.47% currently.