Box 1

MACROECONOMIC IMPLICATIONS OF HIGH OIL PRICES FOR EMERGING MARKET ECONOMIES

Persistently high oil prices have affected emerging market economies through their impact on external balances, inflation, monetary and exchange rate policies, and fiscal balances in the past few years. The rise in oil prices since 2002 has led to significant improvements in the external and fiscal balances of most net oil exporters, while it appears to have had little impact on the inflation and real exchange rates of many countries. Perhaps even more remarkably, the external and fiscal balances of most emerging market economies that are net importers of oil have proven to be broadly resilient to higher oil prices, and the pass-through to domestic inflation remained very limited until 2004. Since 2005, however, the external and fiscal performance of some of the net oil-importing economies – notably that of countries in Emerging Asia – has started to deteriorate, which appears to be partly related to the further increase in oil prices.

Impact on external balances

The current account positions of many oil-importing and oil-exporting economies in Latin America, Asia and the Middle East have been robust in recent years. Net oil-exporting economies have generally experienced a sizeable improvement in their trade and current account surpluses since 2002. This has resulted in a more favourable GDP growth outcome, particularly in those countries where the oil sector accounts for the bulk of economic activity.

Current account, inflation and fiscal balance in selected emerging market economies

	Current account % of GDP			CPI [1] Year-on-year, end-of-period			Fiscal balance % of GDP		
	2002	2004	2005 [2]	2002	2004	2005 [3]	2002	2004	2005 [2]
Net oil exporters									
Argentina	8.5	2.0	1.3	41.0	6.1	10.8	-11.7	-1.6	0.2
Malaysia	8.4	12.6	13.5	1.7	2.1	2.0	-5.6	-4.3	-3.5
Mexico	-2.1	-1.1	-1.1	5.7	5.2	3.8	-1.6	-0.3	-0.7
Russia	9.0	10.3	13.2	15.0	11.7	11.9	1.3	4.4	8.6
Saudi Arabia	6.3	20.5	32.4	0.2	0.3	0.6	-5.9	9.6	17.5
Venezuela	8.2	12.7	15.9	31.2	19.2	20.4	-6.0	-3.8	-1.4
Net oil importers									
Brazil	-1.7	1.9	1.7	14.7	6.1	4.0	-0.8	-1.5	-3.8
Chile	-0.9	1.5	0.3	2.8	2.4	2.7	-1.2	2.2	2.8
China	2.8	4.2	6.1	-0.4	2.4	2.3	-3.3	-1.7	-1.7
India	1.4	-0.1	-1.8	6.0	5.3	5.5	-6.1	-4.5	-4.5
Indonesia	3.9	1.2	-0.4	10.0	6.4	7.8	-1.5	-1.4	-1.6
Korea	1.0	4.1	2.0	3.7	3.0	2.7	2.3	2.3	2.2
Thailand	5.5	4.5	-2.5	1.6	2.9	3.0	-2.3	0.3	0.5
Memorandum									
Latin America + Caribbean	-0.9	0.9	0.9	8.7	6.5	6.3	-3.1	-1.5	-2.1
Emerging Asia	3.7	4.1	3.7	1.8	4.0	3.9	-3.5	-2.2	-2.3
Middle East + North Africa	4.0	11.0	19.0	5.7	7.3	8.4	-2.1	1.6	5.9
Advanced economies	-0.8	-1.0	-1.3	1.5	2.0	2.2	-2.4	-2.8	-2.6

Sources: WEO and IIF databases.
1) Annual average for Saudi Arabia and regional aggregates.
2) WEO September 2005 projections.
3) IIF 2005 projections.

It could have been expected that net oil-importing economies would have experienced a deterioration of their external balances due to the significant increase in oil prices. However, most countries have continued to record strong, and even rising, trade and current account surpluses relative to 2002 (see table). Strong export growth in net oil-importing countries in 2003 and 2004 more than offset the rise in oil imports. Over that period exports were buoyed by stronger global growth, higher non-oil commodity prices (which benefited Latin American economies, in particular) and strong demand for IT goods (benefiting mainly Emerging Asia).

In 2005, however, export growth declined noticeably across much of Asia, due both to the slowdown in the growth of demand for IT goods and to the significantly lower growth of China's imports. Non-fuel commodity prices, although still high, trended down relative to 2004 and domestic demand rebounded in several of these countries. Coupled with a sustained high import bill and the potential slowdown of demand from mature economies, the current account surpluses of most Emerging Asian economies (except China) are expected to decline significantly in 2005 and beyond (see table). To a lesser extent, this also holds true for many Latin American economies.

An additional factor behind current account developments is the relative oil intensity of emerging market countries. Most of these countries remain less efficient energy consumers than the G7 economies. However, in some countries, a much smaller share of oil in their total domestic energy consumption has limited the impact of higher oil prices on external balances. China and India, for example, which rank third and ninth in the list of the world's largest net oil importers and are the two emerging markets where oil demand grew fastest in 2004, rely on oil for only 20% of their total energy needs compared with around 40% in the G7 economies. Furthermore, the disproportionate reliance on coal as the main energy resource in both China and India means that both economies consume less oil per unit of GDP (in purchasing power parity terms) than advanced economies like the United States. Many Latin American countries – including some major net oil exporters such as Venezuela – also rely on hydropower rather than oil for most of their electricity generation.

Impact on inflation

Higher oil revenues have not led to higher domestic inflation in most net oil-exporting countries. On the contrary, inflation rates declined from 2002 to 2004 in many of these countries. Although the rise in oil prices has resulted in a substantial increase in current account surpluses in many countries, this has not led to nominal exchange rate appreciation. Countries that have managed to control inflation relatively well and have pegged their currencies to the US dollar have in fact experienced real effective exchange rate depreciation. Several of these countries have also used the higher oil proceeds to reduce foreign debt, thus limiting the impact of oil-related inflows on domestic monetary growth. However, a few countries, such as Russia, have indeed seen a real effective appreciation since 2002, or have experienced such pressures in the course of 2005 (as in the case of Colombia and Mexico).

In net oil-importing emerging countries, the impact of high oil prices on inflation has thus far been remarkably benign. Although inflation increased in some countries between 2002 and 2004 (in Thailand and Peru, for example), it decreased in others (in Brazil, India, Indonesia, Korea and Chile, for instance). The reasons for the decline in inflation in these countries

between 2002 and 2004 are varied and include factors unrelated to oil prices, such as weak domestic demand (Korea), a phase of monetary policy tightening (Brazil), nominal exchange rate appreciation (Chile) and slower growth in food prices (Indonesia and India). To some extent, the pass-through to domestic prices was also contained by fuel subsidies and other protracted administrative measures. However, the pass-through of high oil prices to domestic inflation has increased in 2005, especially in those parts of Emerging Asia where fuel subsidies have been cut and currencies have depreciated against the US dollar (Indonesia and Thailand, for instance).

Impact on fiscal balances

With regard to the impact of higher oil prices on fiscal balances, net oil-exporting economies have generally experienced large improvements in public accounts, even though some have continued to post fiscal deficits in spite of the rise in oil prices (Malaysia, Venezuela and Mexico, for instance). In most cases, strong fiscal surpluses have tended to provide the anchor for macroeconomic restraint, particularly in countries with tightly managed exchange rates. In addition to bringing down overall debt levels, some net oil-exporting countries (notably in Latin America) have also engaged in strategic debt management to improve the maturity and amortisation profile of their public debt. This development has also been supported by favourable financing conditions in emerging markets.

In net oil-importing economies, the impetus to government revenue provided by strong growth and (in some cases) by the rise in non-fuel commodity exports also helped to improve fiscal balances between 2002 and 2004, in spite of the sometimes high cost of maintaining fuel subsidies. However, fuel subsidies and price caps – which are widespread among net oil-importing countries and, particularly so, in Emerging Asia – are becoming increasingly costly to maintain. In 2005, the cost of financing these subsidies is estimated to reach 5.5% of GDP in Indonesia, 3.1% of GDP in Malaysia and 1.1% of GDP in India. Fuel subsidies have translated into increased public expenditure in countries where they are directly financed by the government (in Indonesia, for instance) or into lower corporate profits in countries where price caps transfer the cost to the balance sheets of state-owned refineries (in China and India, for example). In some countries, including China, there have been signs that this policy has led to shortages in the supply of refined products as some suppliers have been hesitant to serve the domestic market at prices below those prevailing internationally. The implicit fiscal vulnerabilities associated with these fuel subsidies and administrative measures in an environment of persistently high oil prices have prompted many economies in Emerging Asia to scale these measures back (in Indonesia, Malaysia, Thailand, China and India, for instance).

These policy changes are also in line with the recent G7 statement of September 2005 calling on countries to avoid using subsidies and price caps that artificially lower the price of domestic fuel and contribute to persistently high global oil demand. In addition, the statement stressed the importance of increasing energy efficiency in developing countries. These calls may be of specific relevance to some emerging market economies that currently appear to be significantly less energy-efficient than the G7 countries.