

What Ukraine Risks Mean for EM Asia

In a Nutshell: The glaring question is **what Ukraine risks means for EM Asia**. Short answer is, despite the geographical buffer, the **impact may potentially profound and painful should worse-case outcomes be realized**. **Two key channels** of shocks are **Oil/Energy price impact** (to a lesser extent the wider commodity sphere) and **potential financial contagion**.

Oil's long-reaching and amplifying impact derives from the *compounding of sharply higher energy cost burden and higher inflation that spills over as "twin deficit" and credit risks*, which **inevitably compromise macro-stability**. Crucially, *while Russia may not be the most prominent source of direct energy imports for EM Asia*, its sheer heft as a global producer/exporter means **energy shocks emanating from Russian supply disruptions will nevertheless be disproportionately large**. **Tail risks of acute financial contagion** from more generalized "risk off", and in particular acute threat of conflict in Europe, may very well trigger indiscriminate capital outflows that result in broad-based sell-off. In which case, availability of deep *USD liquidity, stable inflation and comfortable financial buffers* will be **key to resilience and a quick recovery**.

Finally, the near-term economic/financial risks from Ukraine aside, the implication for longer-term geo-political stability of EM Asia is embedded in the inferences of implicit diplomatic/military pact with the US. So, Ukraine risks are consequential one way or another. The precise iteration is what needs watching.

Oil's Long & Strong Reach

For one, **Oil's (energy) surge on geo-political risks of Russian supply disruption will have the largest, mostly adverse impact**. Not just from **sharply higher prices**, which **inevitably drives up inflation and dents current accounts** (save for Malaysia, the only net oil exporter); but also due to potential **disruption to direct oil/coal supply** in the context of Russia's exporting ~1.4MBpd to Asia in 2021. In EM Asia, outside of China:

- India's Russian coal reliance is fairly small and substitutable, but nevertheless, risks imposing and unwelcome higher costs that accentuate inflation and energy-disruption risks.
- Korea's dependence on Russian Oil (fourth largest supplier) bloat industrial costs, exacerbating chip shortages and downstream chemical products.
- Vietnam's Russian coal reliance (largest, after Australia and Indonesia) ups the risks to energy costs and consequent state absorption of higher energy costs.

To be sure, Russia is not by any measure the largest oil exporter for EM Asia. Nonetheless, **Russia's sheer global heft in energy exports**, as the *second largest exporter of oil globally pre-pandemic* (despite slipping to third in 2020), means Russia will impose **a disproportional global crude/energy price shock** given the difficulty in compensating for Russian supply.

To some extent, this argument may be extended to aluminium, given Russia's RUSAL, the world's second largest aluminium producer that derives three quarters of its revenues outside of Russia. But oil is the uncontested "big fish" for overall macroeconomic reach and impact.

Stag-flation Type Pressures

The combination of **higher global energy prices** and **disrupted supply translate to a "stagflation"-type of impact** from simultaneously dulling activity and amplifying inflationary pressures. *EM Asia is at risk of Oil inflation seeping further and lingering longer*. And **resultant suppression of real returns/growth** will be reflected in **diminished GDP outcomes aggregated from eroded margins at the industry levels**.

Rippling Across as Macro-stability Risks

But the most acute **macro-stability vulnerabilities from Oil's spike**, emanate from **"twin deficit" economies with high consumption import reliance** (in contrast to high proportion of refining imports, where costs may be passed on in downstream exports, such as in the case of Singapore).

Especially given that that **Oil's adverse impact** will have a tendency to **ripple as deterioration in credit metrics, inflaming credit risks**. By this measure, **India, Philippines are top on the list of the usual suspects**. Indonesia, with similar risks is certainly not off the hook, but has current account vulnerabilities partly mitigated by its offsetting coal exports.

Risks by Association

Vietnam may also be subject to the risks of collateral damage from Oil-Russia association; albeit **a little more upstream**. Specifically, from the **Vietnam-Russia Joint Venture (Vietsovpetro) for Oil-field production**. *Vietsovpetro is admittedly not in the direct line of fire as things stand, but could incremental indirect pressures if the Ukraine situation blows out is a risk that cannot be brushed off.*

Financial Contagion (Tail) Risk

Second, a **wider spill-over** beyond just sanctions to **risks of a war**, may set off an **adverse financial contagion** that **inevitably rocks EM Asia**. Admittedly a "tail risk" rather than base case. Nevertheless, broad-based **flight to safe haven** juxtaposed against **higher inflation and negative shocks to the Current Account** may spare few in its path. Calmer minds may differentiate along the lines of "twin deficit" and inflation exposures. But worse case outcomes **amid intense global "risk off"** will likely trigger **"shoot first, question later" fear instincts leading to generalized capital outflows from EM Asia**.

In such an indiscriminate **sell-down in EM Asia financial assets, relative resilience and ability to recovery** quickly after, rather than being exposed to **risks of "reflexivity"** (a self-reinforcing downward spiral), is **dependent on**;

- i. **deep USD liquidity** (as USD's safe-haven appeal dominates amid forced liquidation);
- ii. **stable inflation dynamics**, and;
- iii. the ability to **endure seizures in external financing options**.

The **measured consolation is that recent history suggests that markets can digest geo-political risks fairly quickly; so long as a wider European war is avoided**. But **arresting Oil-related risks in its entirety is nevertheless a tall order**.

Strategic, Geo-political Ramifications

Finally, **even if worse-case scenarios of Ukraine are averted, EM Asia faces consequential longer-term strategic ramifications**; from an **emboldened and largely unchecked Russia, with whom China appears to have deepening ties** (and implied military alliances).

Inadvertently, this will cast doubts on US commitment to its key allies (Japan, Korea and Taiwan). And a US that is judged as being reluctant to step in and step-up may unwittingly motivate China to up the ante with Taiwan. **Accentuated China-Taiwan risks** also bring with **North Korea flash points**, given that China may encourage North Korea's agitations to disperse US/North Asia's attention in the event it looks to make a move.

Consequential, even if Not Close-by

All said, Ukraine is admittedly not an unmitigated disaster for EM Asia. But it is an **imminent economic risk** (the order of which will be determined by Russia-Ukraine outcomes) and, crucially, a **longer-term barometer of Asia's geo-political stability**. And so, Ukraine is significantly consequential for EM Asia, even if it is just not apparent watching from afar now.

Meanwhile, **high-oil import reliance** (tilted to consumption), **"twin deficits"**, **exposure to high inflation, elevated external debt exposures and pressures on USD liquidity** remain as **defining features of near-term vulnerabilities** that stem from **Ukraine's potential geo-political shocks**.

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