US-Iran Conflict

The Impact on Asia

By Tilak Doshi

Abstract

At a time when economic growth is weakening in Asia, the potential macro-economic impacts of oil supply disruption are magnified. However, the author argues one also should not make too much out of this possible sequence of adverse macro-economic impacts.

For Asian government planners and defence chiefs, the disruption of tanker traffic in the Strait of Hormuz — or worse, an extended period of the total blockade of the Strait — presents a nightmare scenario. Japan's Chief Cabinet Secretary Yoshide Suga, for instance, stated in May 2019 after the tanker attacks in the Strait that it is a "matter of life and death of our country in terms of energy security". In June, there were media reports of government officials in Japan, South Korea and Thailand convening meetings with industry representatives to take stock of inventories and preparedness for disruptions in their oil, gas and petrochemical sectors.

The implications for Asian energy security if the US-Iran conflict escalates to a military showdown, which affects shipping traffic through the Strait of Hormuz, can be dire. It is thus important that any analysis of such implications be clear and rigorous rather than a basis for offering hyperbole and over-the-top pronouncements. Sober realism and a sense of context and perspective are critical requirements for analysts and government security establishments.

The world's most important oil chokepoint

Located between Oman and Iran, the Strait of Hormuz connects the Gulf with the Gulf of Oman and the Arabian Sea. It is just over 20 nautical miles wide at its narrowest point, and has two shipping lanes — one in each direction — each about two miles wide. However, the Strait is deep enough for ships to take alternative routes if shipping lanes are blocked.

Iranian officials have often made threats to the security of the shipping, but the government has never actually attempted to close the Strait. The Strait, thus, has never been blockaded, although shipping traffic was badly affected during the "Tanker War" phase of the 1980-1988 Iran-Iraq war.

The recent spate of tanker attacks and vessel seizures has heightened the sense of vulnerability of Asian countries to disruptions of their oil and gas supplies from the Middle East. The Strait of Hormuz accounts for an estimated 30 per cent of globally traded crude oil and refined products. According to BP data, it also accounts for about 30 per cent of the global liquified natural gas (LNG) trade.

Some 80 per cent of oil exported by the Middle East via the Strait of Hormuz heads "East of Suez", of which the largest markets are accounted for by China, India, Japan, South Korea and Singapore. The Asia-Pacific region depends on the Middle East for over 60 per cent of its oil imports. Out of 45 million barrels per day (bpd) of global crude imports in 2018, Asian imports

from the Middle East account for close to 15 million bpd. Within Asia, levels of dependence on Middle East oil vary among countries. China imported 45 per cent of its crude oil imports from the Middle East; for India, Middle East dependence was 65 per cent; while for Japan, it was 87 per cent.

For imports of LNG, the Asia-Pacific region's dependence on Middle East sources is significantly less, at 30 per cent. Competing LNG from Australia, Malaysia and Indonesia within the region accounted for other major sources of Asian imports. LNG import ratios vary by country, however, with India getting 55 per cent of its LNG from the Middle East, compared to China's 18 per cent, South Korea's 42 per cent and Thailand's 48 per cent.

Potential Impacts on Asia

In short, Asia depends heavily on the Middle East for its supplies of oil and gas, the lifeblood of its economic well-being. But it is important to avoid a superficial reading of Asian dependence on the physical supply of oil from the Middle East. This fundamentally misunderstands the nature of global oil markets. Because oil is sold in fungible global markets, its price in Asia is linked to its price everywhere else. To put it alternatively, it does not matter how much of oil consumed in Asia comes from the Middle East. What matters is the global oil price, which in turn depends on global supply and demand. Any disruption of oil flows anywhere affects oil consumers everywhere.

Nevertheless, it is also important to note that the bulk of Asia's oil imports of Middle Eastern oil are based on long-term oil contracts with national oil companies of Saudi Arabia, Kuwait, United Arab Emirates (UAE) and others. Disruptions to supplies from the Middle East would impose significant costs over and above the impact of oil price increases caused by such disruptions. These include costs to switch from established term contracts with Middle East suppliers to new contracts with oil suppliers from other regions.

LNG markets are not as fungible as oil markets, given that much of the supply is based on very long term (20-25 years) contracts which specify destination restrictions and limits to flexibility in volumes being delivered over time. Thus, disruptions to LNG supply would impose greater costs relative to more fungible oil markets; inter-regional LNG prices can often diverge considerably more than those for oil markets.

Oil and LNG differ in another important way. Oil is far more easily stored as emergency supplies compared to LNG. LNG is usually transported at a temperature very close to its boiling point at atmospheric pressure (approximately minus 160C). While most countries in Asia have some level of emergency stocks (of crude oil and/or refined products), few have the wherewithal to store natural gas, either in its liquified or gaseous forms. While storing gas as LNG is expensive (given that it needs to be stored cryogenically, that is at a very low temperature so that it remains liquid), natural gas is usually stored underground in depleted gas reservoirs, aquifers, and salt caverns.

The impact of oil supply disruptions has been a subject of intensive study among economists since the oil price shocks of the 1970s. One early study on the oil price impact of supply disruptions in Asia (in 2004) by the Asian Development Bank estimated that a sustained US$10/barrel price increase would reduce gross domestic product (GDP) in China by 0.8 per cent, in Singapore by 1.7 per cent, and in Thailand by 2.2%. Consumer prices would increase by 0.5 per cent, 1.3 per cent and 1.5 per cent respectively in these three countries.

Global GDP growth has weakened, and the International Monetary Fund's recent forecast has downgraded its projected growth for 2019 to 3.2 per cent. Global growth for 2018 is estimated at 3.6 per cent. Growth has weakened most notably in Europe and Asia. While economic growth in Asia slowed in 2018 to 5.9 per cent, it is expected to slow further to 5.7 per cent this year and 5.6 per cent in 2020. China, in particular, is showing signs of economic weakness, as the US-China trade conflict escalates. Domestic factors in India also point to a slowdown in its economy. Analysts

suggest that the chance of a global recession has markedly increased as the damage of the US-China trade war has now worsened with the charge of Chinese currency manipulation by the US Federal Reserve.

At a time when economic growth is weakening in Asia, the potential macro-economic impacts of oil supply disruption are magnified. Higher crude oil prices due to disruption to tanker traffic in the Strait of Hormuz would lead to the weakening in the balance of payments of vulnerable economies such as India, Indonesia and the Philippines. The inflationary impact of higher international energy prices and weakening currencies would place central banks in the difficult role of trying to balance reduced GDP growth rates and rising inflation. It would also lead to pressures on governments to re-introduce fuel subsidies in some developing Asian countries to protect poorer segments of their populations.

Yet one should not make too much out of this possible sequence of adverse macro-economic impacts. When reports of attacks on two tankers in the Gulf were reported on 13 June this year, oil prices spiked up 4 per cent the next day. However, the focus quickly shifted back to the anxiety over an impending global recession and fears of falling oil demand. Oil prices now are at their lowest levels since January, with Brent crude recently trading at below US$57/barrel.

Apart from concerns about falling oil demand and fears of global recession, there is a structural feature of the current "bear" oil and gas markets that limits risk premiums related to potential supply disruptions. This refers to the US shale revolution which has upended energy geopolitics and catapulted the US into the world's largest oil producer and one of the world's largest emerging exporters of LNG within a remarkably short period of time. The hydraulic fracturing — or "fracking" — process of injecting liquids at high pressure into subterranean shale rock to widen fissures and extract oil and gas has led to one of the most profound transformations of the global energy industry in modern times.

While Saudi Arabia and its Organization of the Petroleum Exporting Countries (Opec) allies to a lesser extent are the "swing" producers, managing the market by strategically curtailing or increasing production to attain a "target" price range, the US has emerged as the world's marginal oil producer. It supplies the marginal barrel of oil and hence, its shale oil producers are key to determining global oil prices. It is also a rapidly emerging major exporter of LNG, as new export projects lead the US to challenge current leading suppliers Qatar and Australia.

The downsides of energy security hysteria

Forty-two years ago, President Jimmy Carter delivered his Address to the Nation on National Energy Policy, better known as the "Moral Equivalent of War" (Meow) speech. He offered a litany of dark predictions which never came to pass. The hysteria over energy security led to energy policies in the US that, in hindsight, were counter-productive and hugely wasteful.

It is therefore critical to learn from the history of energy analyses which has had its share of false prophets. From the Club of Rome's doom-laden prognostications in the 1970s to US Congresswoman Alexandria Ocasio-Cortez's Green New Deal and "12 years left", there has been a surfeit of poor, if not foolish, policy advice.

To be sure, the US-Iran conflict and its potential impact on the free passage of shipping in the Gulf bears close watching. It requires careful preparations for mitigating fuel supply disruptions and an active involvement of key Asian countries in providing security in the Gulf. It also requires sound economic policies which harness the power of free markets and unhindered capital flows to support needed investments in the oil and gas sectors. But, above all, we need to keep our wits about us.

About the Author

Dr Tilak K Doshi is a consultant specialising in energy economics and public policy. Dr Doshi is an industry expert with over 25 years of international work experience in leading oil and gas companies and in thinktanks.