The Russo-Ukrainian Conflict:

As If Covid Wasn't Enough

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Executive Summary

- The Russo-Ukrainian military conflict continues to rage on, adding fuel to the inflationary pressures currently gripping the global economy.
- The economic effects of this conflict on Indonesia however, may not be wholly negative. Indonesia's direct economic exposure to both Ukraine and Russia is limited, and higher commodity prices due to disruptions in Ukrainian and Russian commodity exports may actually bolster Indonesia's trade surplus.
- The main threat would come from rising energy prices. Although the government remains committed to keeping domestic prices under control, some adjustments may be necessary to reduce non-fiscal costs as well as to avoid an excessive surge in imports and the resultant threat of Rupiah depreciation.
- US sanctions continue to push Russia ever closer towards de-Dollarization. This however, does not necessarily point to a collapse in global trade. Instead, it highlights the bipolar nature of the modern global economy, with Russia's economic isolation from the West likely to drive it further into the arms of the US' main economic competitor: China.

- On the 24th of February 2022, the Russian government commenced military operations in Ukraine. Representatives of both countries eventually convened in Belarus a few days ago to discuss terms for an immediate ceasefire. Alas, talks have yet to achieve a breakthrough, and Russia's war in Ukraine continues, with Moscow seemingly unfazed by the increasing barrage of sanctions imposed on it by the US and its allies.

- Perhaps the most immediate economic effect of the war has been the disruption in the flow of Russian and Ukrainian commodity exports, intensifying inflationary pressures in a world already grappling with surging prices. For instance, uncertainty over oil and gas supply has driven energy prices in Europe through the roof, casting a cloud over the prospects of economic stability. Even equatorial Indonesia – far removed from the battlefields of Kyiv and Kharkiv – will not be immune to the knock-on effects of these disruptions, as inflationary pressures, particularly for food and energy, begin to make themselves felt across global supply chains.

Trials and Tribulations

- Fortunately, Indonesia's low exposure to Russian and Ukrainian investment does provide some measure of protection from some of the more direct economic consequences of the current war. Indeed, Russia's investments in Indonesia are sporadic, while Ukrainian investments are practically non-existent ***(Chart 1)*****.** The greater threat to the Indonesian economy takes a more indirect form, as exports of critical commodities from Ukraine and Russia are increasingly shut out of global markets, compounding global shortages that will eventually make their mark on Indonesia as well.

- Befitting its moniker as "the breadbasket of Europe", Ukraine commands a substantial 8% share of the global wheat and maize market. **The implied cost of Ukrainian wheat also appears lower than those of other major wheat and maize exporters *(Chart 2)***, further increasing its attractiveness to Indonesian consumers.

- Indeed, Ukrainian wheat makes up a significant 26% of Indonesia's wheat imports, second only to wheat coming in from Australia ***(Chart 3)***. Although rice is the staple grain of choice for most Indonesians, wheat is still an important foodstuff in Indonesia, especially in the food processing industry, where it is a key ingredient for products such as breads and noodles. While it is true that Indonesia could simply order more wheat from Australia or other producers as a stopgap while Ukraine's wheat vamooses off the market, reduced global supplies mean that Indonesia would still have to import this wheat at a higher price.

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- On the other side of the Donets, Russia too is a major player in the global wheat economy. But unlike the smaller Ukraine, Russia's commodity exports do not stop at wheat and other agricultural products. Indeed, Russia's commodity exports range from a panoply of energy commodities to key industrial metals that are essential to the smooth functioning of the European economies. This presents a dilemma for Europe, as the imposition of sanctions against Russian business forces it to scramble for alternatives.

- This search for alternatives however, highlights how the disruption of Russian and Ukrainian exports might, in restricting the supply of certain commodities and driving their prices up, actually benefit other commodity exporters, such as Indonesia. This is perhaps most visible in the coal industry. Italian Premier Mario Draghi's plan to reopen coal plants is only one example of how an expected shortfall of Russian gas has pushed Europe to turn to energy alternatives such as coal. **Indeed, coal prices have surged to an all-time high and would help maintain Indonesia's energy trade surplus, despite the concurrent spike in oil prices *(Chart 4)***. At coal prices of USD 160-170/MT, oil prices would need to increase up to

USD 134/bbl to offset Indonesia's coal surplus. Now that coal prices have spiked to almost double that amount, the oil price threshold would certainly be much higher.

- Moreover, Indonesia's CPO producers could also benefit from the disruption of sunflower oil exports from Ukraine. Before the conflict, Ukraine exported USD 77.79 Bn worth of sunflower oil in 2020, equal to 40% of the world's sunflower oil demand and 6.8% of global vegetable oil demand. Rising sunflower oil prices should drive up other vegetable oil prices as well due to substitutive effects, with Indonesia's CPO producers also likely to benefit from an upswing in prices as well.

- While it is clear then, that the Russo-Ukrainian conflict would further stoke the fires of global inflation, moderating the growth potential of many other economies; Indonesia, as a commodity-driven economy, might just come out of this maelstrom relatively unscathed. The current commodity boom would be enough to offset the increase in commodity imports, prolonging Indonesia's string of trade surpluses. Finally, it is also important to point out that the Indonesian government as of now remains committed to protecting domestic consumers from imported inflation, as perhaps best attested by its recent export restrictions and price controls of coal and CPO. Questions remain however, regarding how far the government is willing to bear the costs of such policies. We must turn next then, to a consideration of whether the government will cross its Rubicon: removing energy subsidies.

Another Test of Endurance

- The shale revolution in the early 2000s transformed the US into a major energy player and led to the creation of OPEC+, uniting two major oil producers – Saudi Arabia and Russia – to influence the global oil market. Sanctions against Russia however, have left Saudi Arabia as the lone swing producer in OPEC+. With Russian oil out of the picture, OPEC+'s efforts to increase its production quota, one of the necessary conditions to control swelling oil prices, will grow increasingly difficult. Increasing oil prices, in turn, inflate the prices of other energy commodities, exacerbating the energy crisis and global inflationary pressures.

- Although the government is still committed to shielding domestic consumers from imported inflation, the continuous increase in commodity prices would jeopardise Indonesia's current account and trade balance if no adjustments were to be made to the current policy arrangement ***(Chart 5)***. Clinging on to an increasingly expensive price control regime could result in unpalatable consequences as price controls allow consumers to continue buying up cheap, subsidized oil despite high global prices. This combination of still-high consumer demand for oil (due to subsidies), as well as rising global prices, risks exacerbating the deficit, which could put significant pressure on the Rupiah in the medium-term. The recent

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adjustment in the prices of the top tiers of gasoline, diesel fuel, and LPG (Pertamax Turbo, Dexlite, pink & blue LPG) is likely a response to these concerns, but this is tinkering at the margins as those fuels make up a comparatively small portion of household fuel consumption.

- Embracing austerity while the trauma of the pandemic recession still lingers of course, could suck out the air out of the recovery. At the same time however, keeping energy subsidies intact could widen the deficits of energy SOEs. Such adjustments however, could lead to inflation far exceeding Bank Indonesia's inflation target corridor, which could – in extremis – force BI to take a more dramatic path towards policy normalisation.

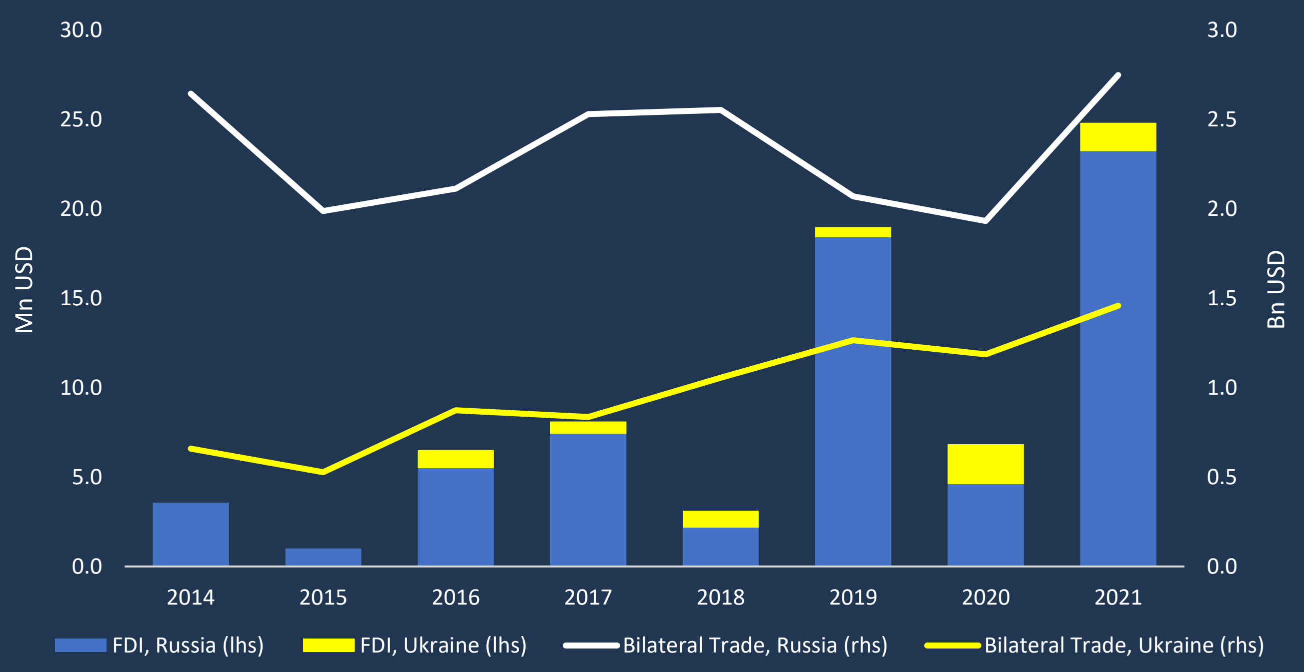
Time's Up for King Dollar?

- A common refrain of President Putin's is that there is an urgent need to revisit the role of the Dollar in the global economy, claiming that trust in the Dollar is on the decline and that the US government tended to use the Dollar to pressure other countries to follow their agenda. These concerns take on greater significance in light of Russia's current war, and raise an important question: would the constant use of sanctions to punish opponents eventually erode global trust in the Dollar?
- It comes as little surprise that this de-Dollarization agenda is shared by other geopolitical rivals of the US, although their attempts to circumvent the Dollar has had mixed results. While countries such as Venezuela or Iran don't exactly have the scale or resources to face the Dollar head-on however, Russia might have the resources, influence and political will to throw its weight behind the push for de-Dollarization. Indeed, in the period before the crisis in Ukraine escalated, Russia had already reduced the USD share of its FX reserves ***(Chart 7)***, voluntarily consigning themselves to the margins of the global financial system before sanctions kicked them completely out to the woods.
- However, Russia's detachment from the Dollar-backed global financial system does not exactly herald the beginning of a retreat from global trade or globalization as a whole. The current global economy is bipolar, dominated by two global superpowers – the US and China – which allow other, more peripheral economies to interact with one or the other according to their interests. Hostile actions from the US and its European allies then, is more likely to push Russia and other countries with similar predicaments closer to China's sphere of influence rather than having them jettisoned completely from the global economic system.
- Indeed, the utilization of the US Dollar in central bank reserves has been in decline over the past decade, while the use of the Chinese Renminbi has been steadily increasing ***(Chart 9)***, albeit at a rather glacial pace. Does this herald then, the beginning of the end of King Dollar's dominance, to give way to the aspirations of the upstart prince Renminbi? Not necessarily. The current dip in USD use is more likely a function of the expansion of central bank swap agreements – of which Renminbi is certainly a major beneficiary – and higher international liquidity (which dampened investors' flight to safety) rather than a precipitous decline in Dollar

dominance. Demand for the USD is likely to increase as the global economy moves closer to policy normalization, and indeed in the short-term as Russian asset holders seek a way out of the sanction. In fact, it is plainly evident that the Dollar index has strengthened ever since the Russian invasion started.

- It is nonetheless likely that a prolonged sanction against Russia would trigger some kind of change in the global financial plumbing. One immediate refuge that Russia's financial institutions might run into is China's Cross-Border Interbank Payment System (CIPS), long advertised as an alternative to the western-backed SWIFT. Financial innovation could also offer salvation for the Russian; just as the "Iron Curtain" prompted enterprising European banks to create "Eurodollars" to finance trade with the Communist Bloc, the descent of a new payment wall against Russia would prompt the creation of a new mechanism to bypass it. It may be based on blockchain rather than traditional bank-to-bank settlement, which SWIFT is based on. And it could be either Dollar-based (stablecoin-like) or completely detached from the Dollar, and instead be based on either the Renminbi or the intrinsic value of Russia's commodities. If this happens, we could expect counter-moves by the Fed, perhaps by promoting the Dollar as a CBDC (central bank digital currency). At any rate, we may expect the next decade to be a busy time for financial and payment system innovations.

Chart 1. Indonesia has limited economic exposure towards Russia and Ukraine



Source: BPS, BKPM
Last update: 02/03/2022

Chart 2. Ukraine has a cost advantage in the global wheat market…

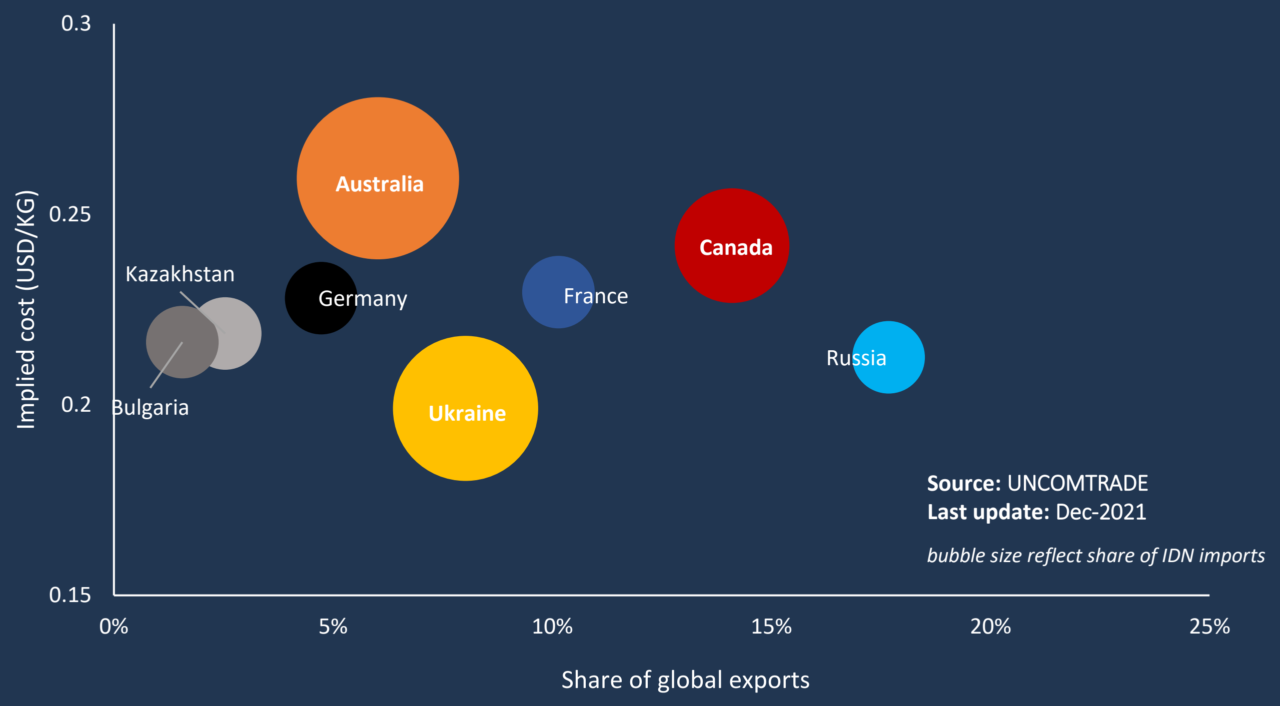


Chart 3. …which explains it attractiveness among Indonesian consumers

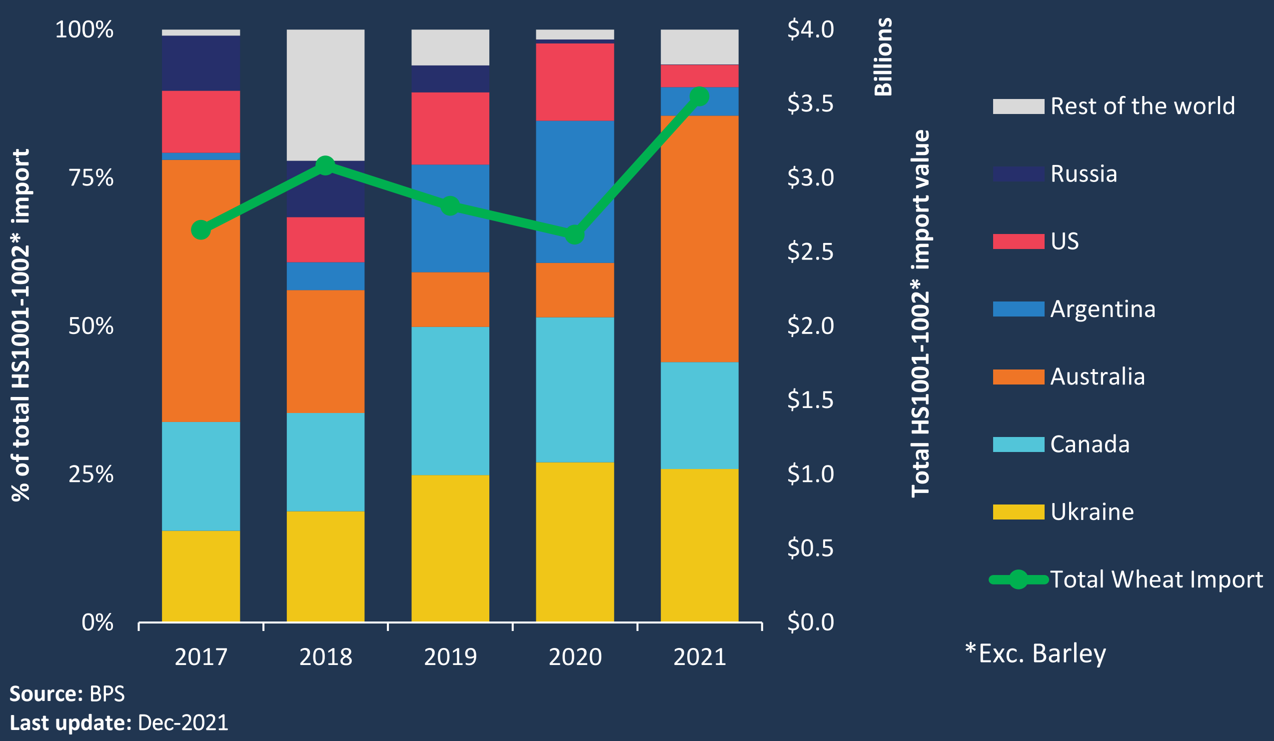
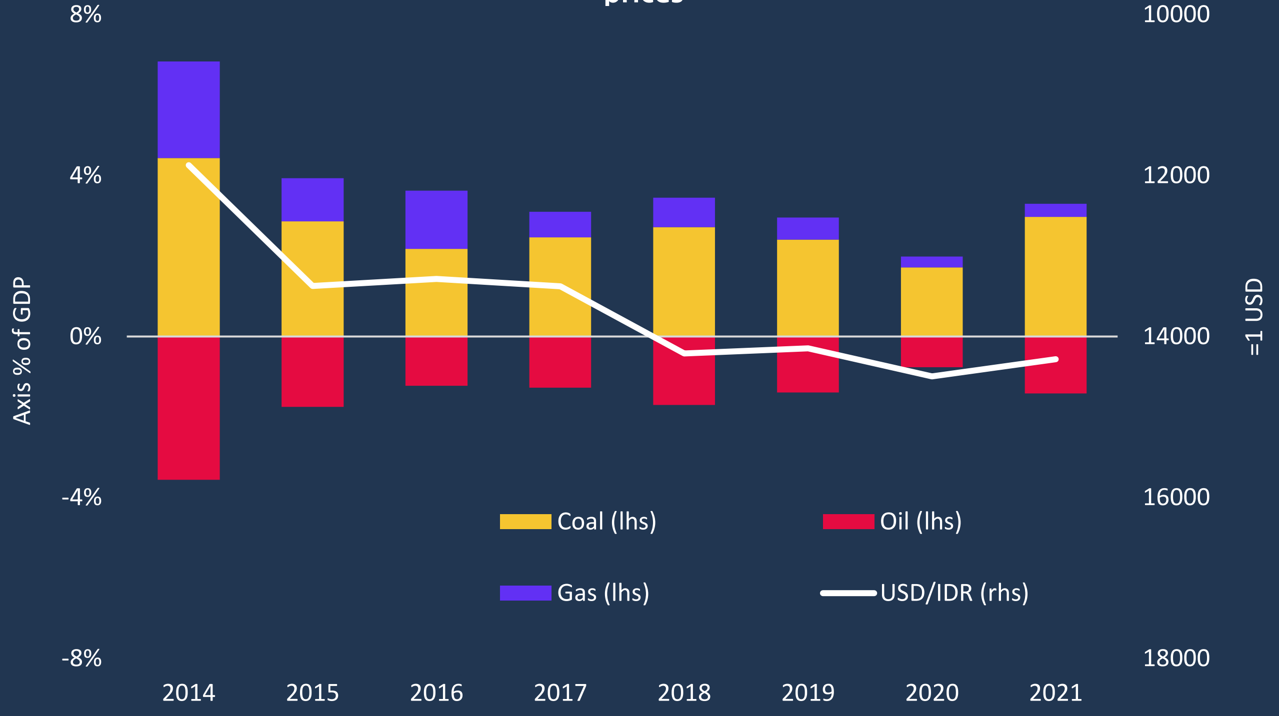
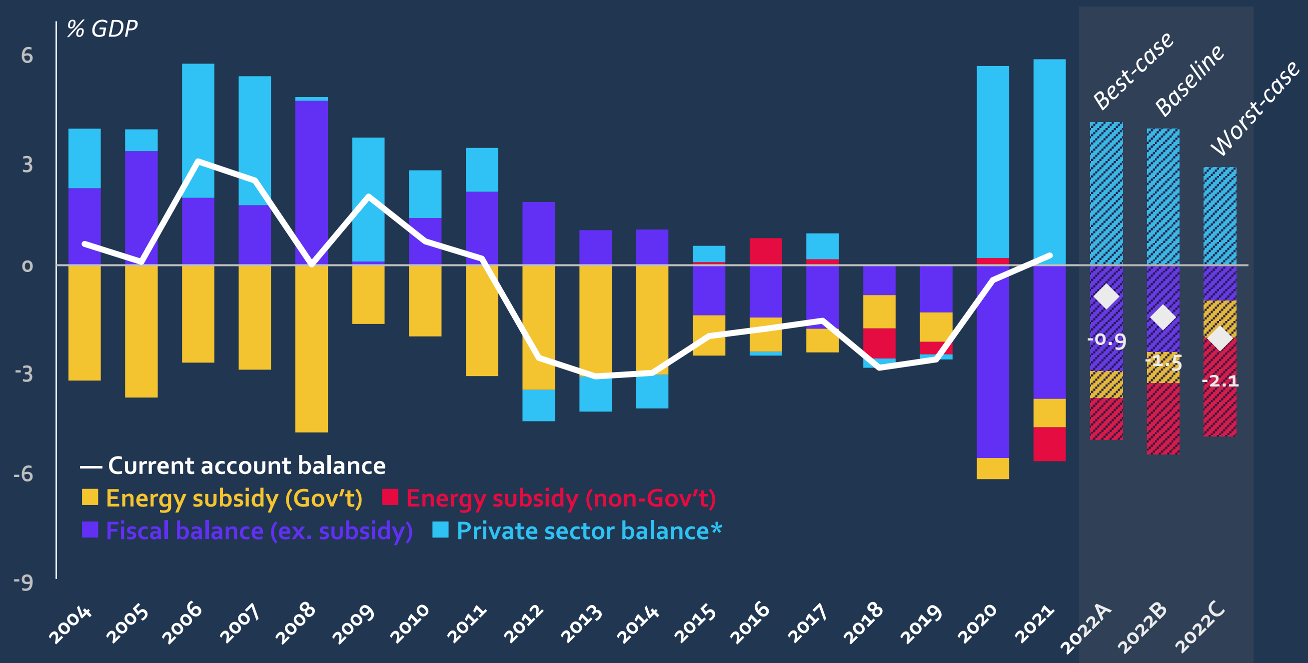


Chart 4. Gain from coal exports should be more than enough to offset the impact of rising oil prices



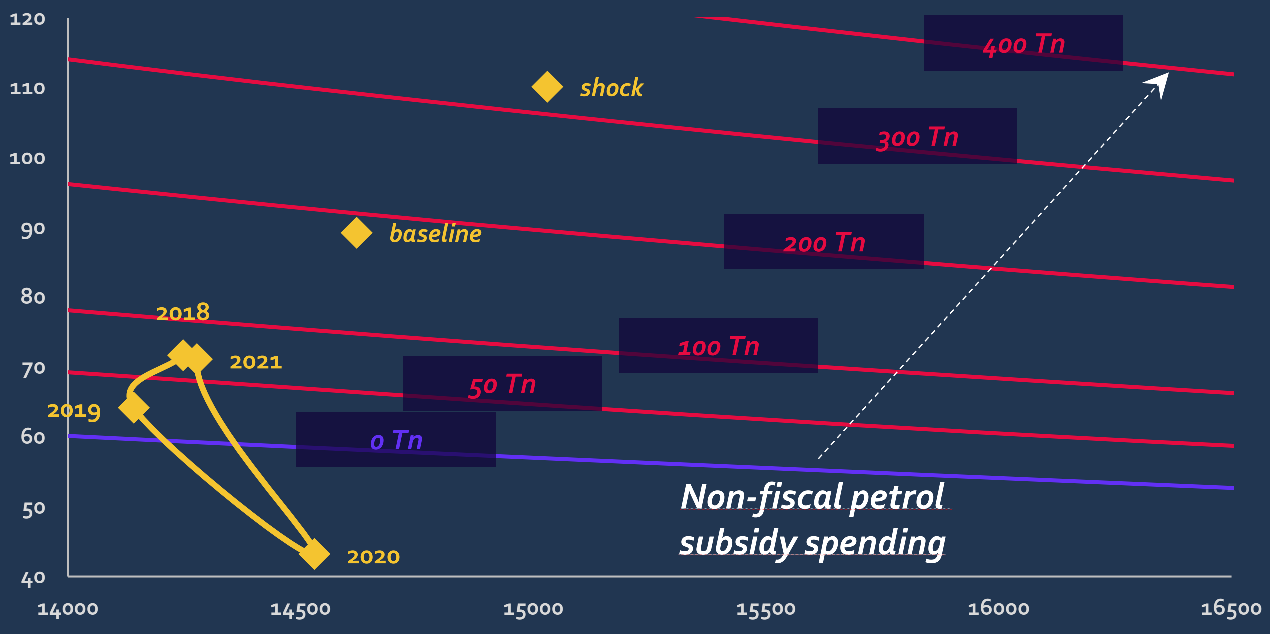
Source: BPS, Bloomberg
Last update: Dec-2021

Chart 5. Surging oil prices, when not accompanied with domestic price adjustments, could hurt Indonesia's current account balance



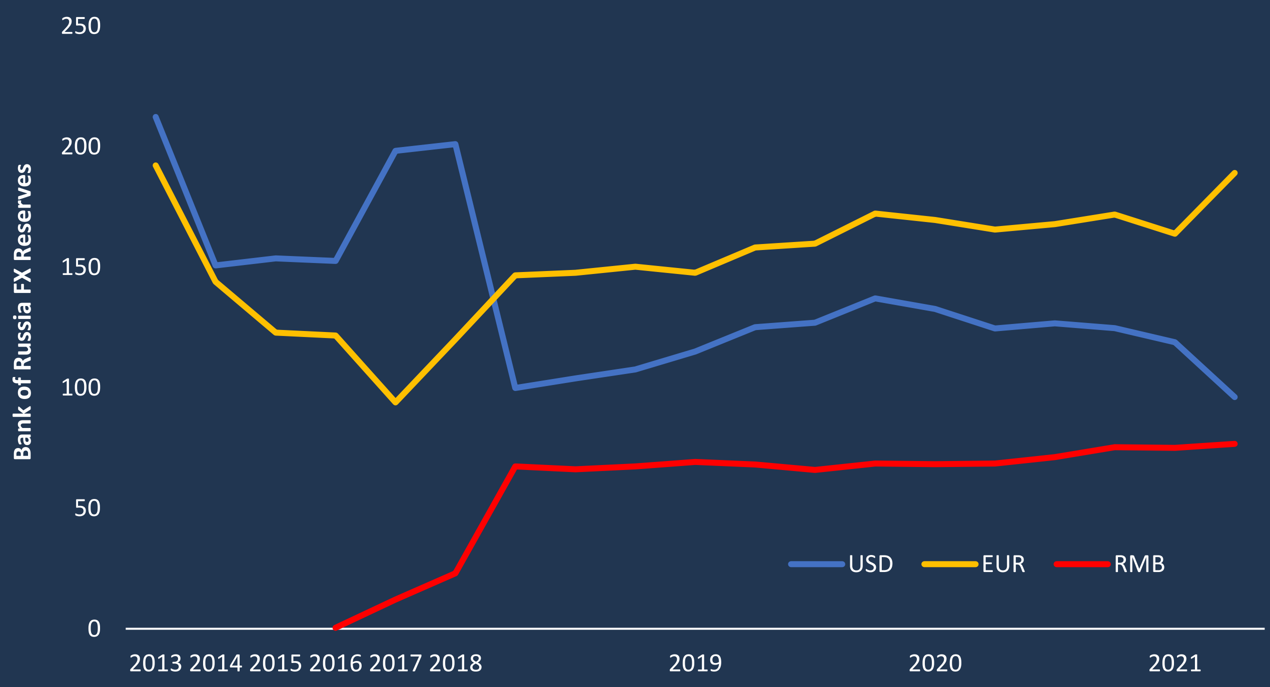
*Include households, companies, and SOEs outside of the non-fiscal subsidy burden
Source: Bank Indonesia, PLN, Pertamina, MoF, Bloomberg, BCA Economist calculation
Last update: Jan-2022

Chart 6. Without adjustments, energy SOEs' subsidy burden could exceed IDR 300 Tn in the worst scenario



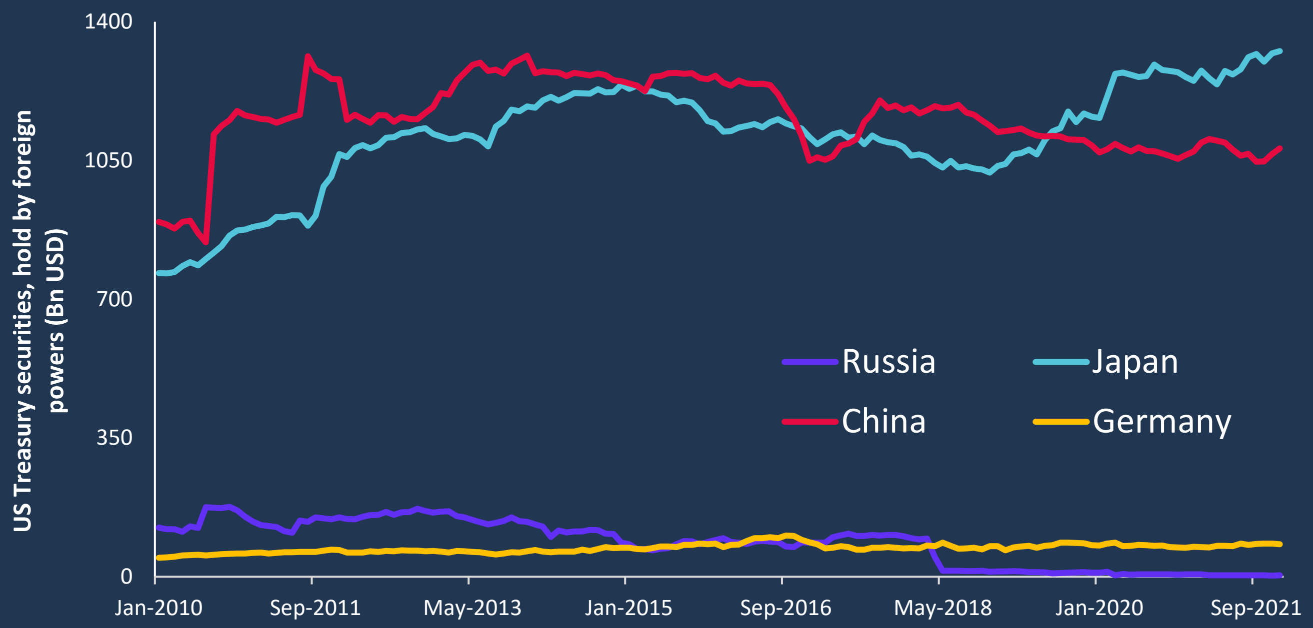
Source: Bank Indonesia, MoF, Pertamina, Bloomberg, Calculations by BCA Economists

Chart 7. Russia accelerated de-dollarization of their reserves in 2020-2021 in favour of RMB and gold...



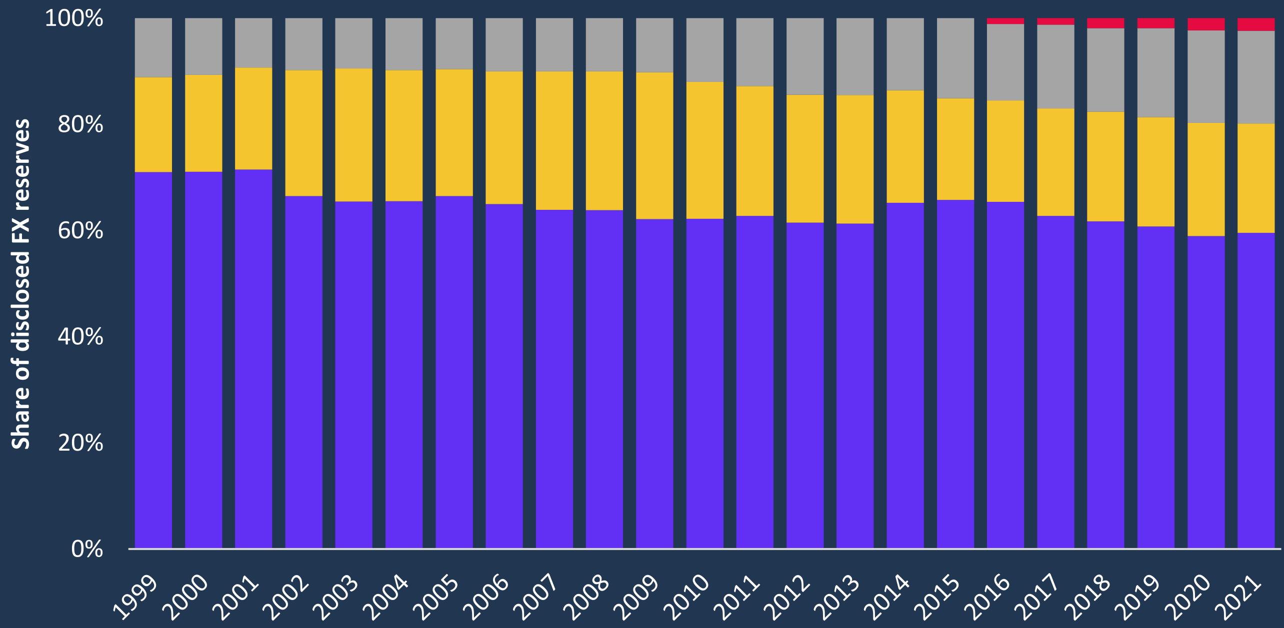
Source: IMF
Last update: Jan-2022

Chart 8. ...while US Treasury securities sell-off by Russian investors further demonstrated their distrust in the US Dollar



Source: Bloomberg
Last update: Dec-2021

Chart 9. RMB is gaining ground as a reserve currency, but USD could make a comeback just like in 2014-2016



Source: IMF
Last update: Jan-2022

Indonesia – Economic Indicators Projection

	2017	2018	2019	2020	2021	2022E
Gross Domestic Product (% YoY)	5.1	5.2	5.0	-2.1	3.7	5.2
GDP per Capita (US$)	3877	3927	4175	3912	4350	4640
Consumer Price Index Inflation (% YoY)	3.6	3.1	2.7	1.7	1.9	3.7
BI 7-day Repo Rate (%)	4.25	6.00	5.00	3.75	3.50	4.0
USD/IDR Exchange Rate (end of year) **	13,433	14,390	13,866	14,050	14,262	14,680
Trade Balance (US$ billion)	11.8	-8.5	-3.2	21.7	35.3	18.3
Current Account Balance (% GDP)	-1.6	-3.0	-2.7	-0.4	0.3	-0.9

** Estimation of Rupiah's fundamental exchange rate

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