Implications for Asia: Russia-Ukraine conflict

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We see the impact on Asia coming via trade, commodity price shocks, interest rates and geopolitical alignment. The direct impact on Asia appears relatively contained in the near term with China's pro-growth policies acting as a buffer. In the meantime, any potential slowdown in the Fed's rate hike trajectory can help to stabilise markets.

Russia launched a full-scale military attack on Ukraine on February 24th, escalating what it described as security concerns and the potential encroachment of NATO closer to its borders. Russia's invasion of Ukraine has caused significant loss of lives as well as great suffering and destruction and we wish for a swift and peaceful resolution.

Nevertheless, we have a responsibility to help clients and investors understand any sustained impact from this geopolitical event and what it might mean for Asia.

LIMITED TRADE EXPOSURE, BUT ENERGY AND AGRICULTURE ARE POTENTIAL WILD CARDS

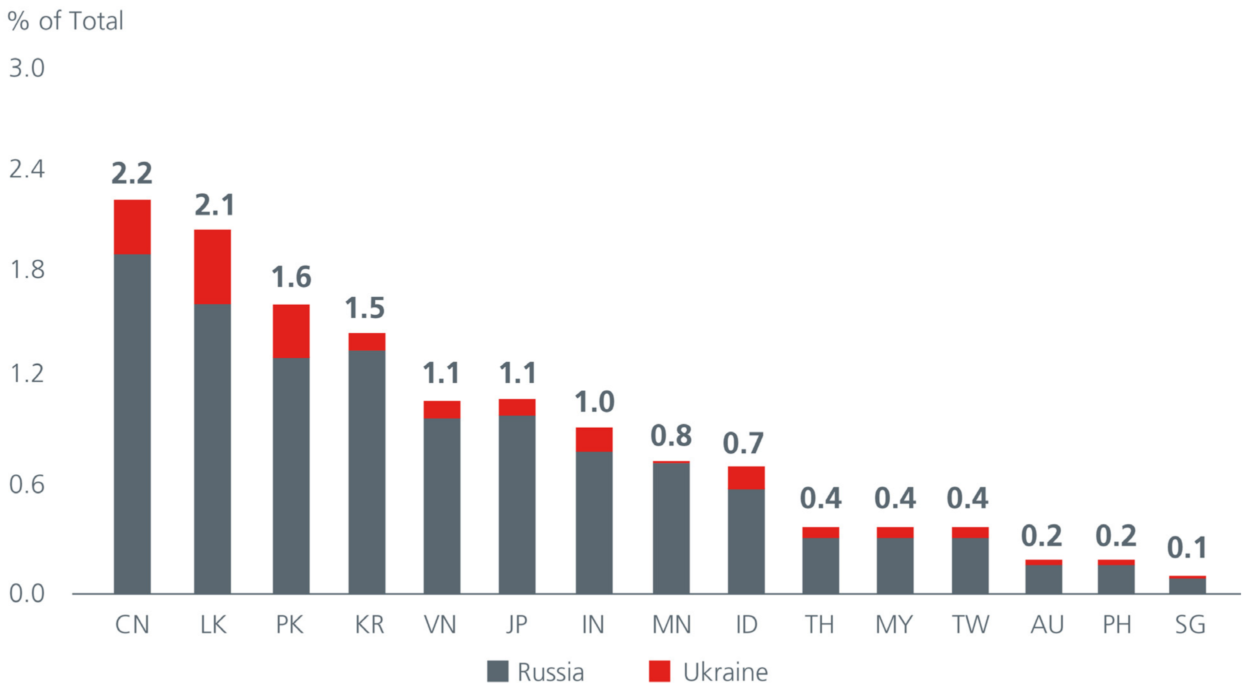
In terms of direct exports to Russia and Ukraine, Asia's exposure appears relatively modest. See Fig. 1. China appears to have the largest exposure, with these two countries accounting for 2.2% of China's total exports. China's total trade with Russia is about USD122 bn, largely dominated by Russia's energy exports to China, and manufactured goods from China. This is small in comparison to China's trade with the United States (US) and the European Union (EU) which amounts to USD572 bn and USD699 bn respectively. On the trade front, given that Russia trades much more with the EU than with Asia, the impact is likely to be more significant for Europe. That said, any impact on the European economy would have repercussions for Asia, given the sizeable trade relationship between the two regions.

Energy

Russia is one of the world's largest oil producers and oil prices have surged nearly 30% on the back of the Russian-Ukrainian tensions. At the time of writing[1], the US, EU or other NATO members have not implemented a full-scale embargo on Russian oil. While Russian oil is expected to trade at a deep discount to Brent Crude for some time, the Kremlin remains open to sell oil in the international markets, at least for now. The reluctance to ban Russian oil exports completely appears to arise from the potential adverse impact on the European economy.

Source: [1]2 March 2022.

Fig. 1: Asia Pacific's Exports to Russia and Ukraine (% of total)



Source: Citibank. As at 28 February 2022.

Higher oil prices can pass to consumers through the energy component of the Consumer Price Index (CPI) basket. Within Asia, Thailand appears to have the largest share of energy in its CPI basket, where a USD10 hike in the price of oil can potentially lift CPI by up to 1.2%[2]. Fig. 2. A further surge in oil prices could lead some Asian governments to cushion the impact for consumers, further weakening their fiscal positions. That said, in an environment of sustained high oil prices, other OPEC countries are likely to maintain earlier commitments to increase production in the event of a supply disruption and the US will also continue to rebuild its local oil and gas fracking rig capacity to try to close the supply gap.

Agriculture

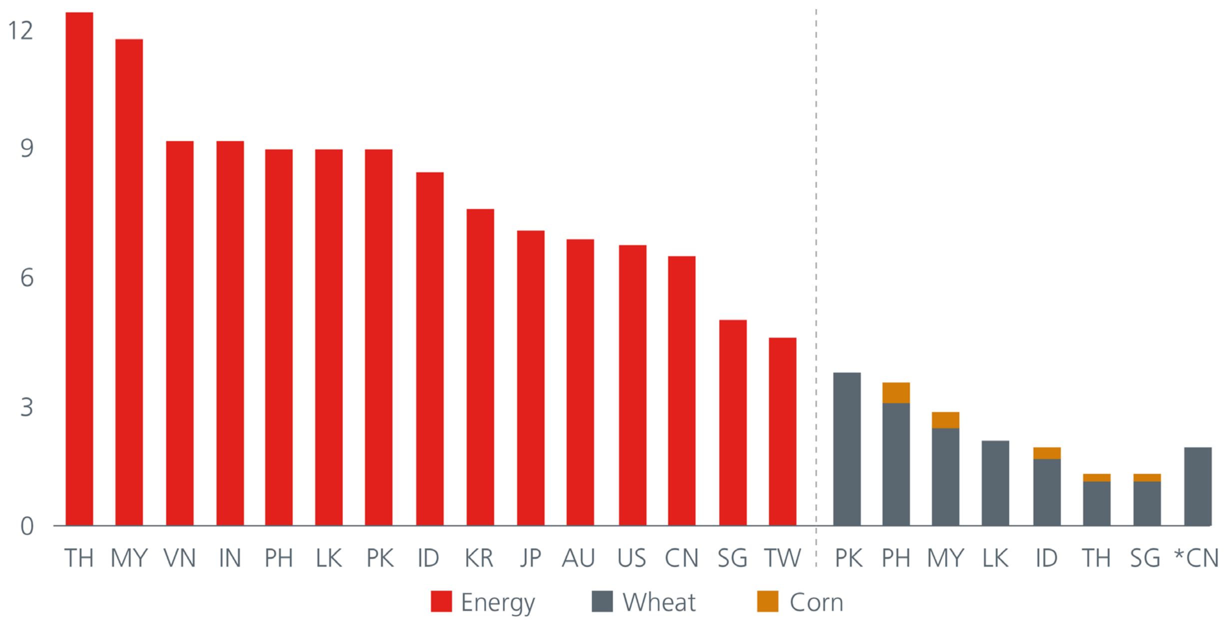
Ukraine is the second largest supplier of wheat and other grains to China. A disruption to these supplies could result in higher food prices in China. China takes up to 30% of Ukraine's corn exports, which is largely used as pig feed. China's latest CPI reading in Feb 2022 at 0.9% has been more tempered than other Asian countries primarily due to the higher weighting of food prices, especially pork prices, which have fallen significantly.

Other manufactured products

Another area of concern is Ukraine's large production of industrial gasses used in the global memory chip production. It is estimated that Ukraine supplies up to 40% of the neon gas used in memory chip production in Asia. Major Asian chip manufacturers such as Hynix and Samsung have indicated they have enough short-term inventory and will look to source from alternative suppliers in China and elsewhere.

Source: [2]Source: Morgan Stanley.

Fig. 2: Share of "Energy", "Wheat" and "Corn" in the CPI basket



Source: Citibank. As at 28 February 2022. *Weight of grains in China's CPI basket as China does not provide a breakdown of wheat and corn.

WATCH THE IMPACT OF INFLATION AND THE SHIFT TO A MULTI-POLAR WORLD ORDER

The direct near-term macroeconomic impact on Asia appears contained for now. Some countries, such as China, possess the ability to implement counter-cyclical measures to buffer their economies. We expect China to maintain an accommodative monetary policy – along with other pro-growth policies – which were already in place before the start of the Russia-Ukraine tensions.
The longer-term outlook for inflation would affect interest rates and have a significant impact on markets. This would depend on how long the tensions last, and how much damage has been inflicted on Russia's energy infrastructure and Ukraine's production capacity in its key exports. This has yet to be determined.

If inflation is sustained around the current 7% level in the US and economic growth weakens materially as consumer confidence fades on the back of this exogenous shock, the US Federal Reserve (Fed) could slow the pace of expected rate hikes and delay the unwinding of its balance sheet. This may help to stabilise markets. The Fed is likely to watch inflation and growth data closely in the coming months and any rate action will be data dependent.

Importantly, the Russian invasion of Ukraine has further accelerated the shift to a multi-polar world order that will be less dominated by the US and its allies. How the different countries in Asia navigate this shifting geopolitical landscape would have long term implications on risk premiums and country allocations in investor portfolios.

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