

Middle East Conflict and Indonesia's Macroeconomic Vulnerability: Exchange Rate, Inflation, and Fiscal Space Transmission Channels

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Abstract: This study aims to develop a conceptual framework explaining how geopolitical risk from Middle East conflict is transmitted to the Indonesian economy through three main channels: the exchange rate, inflation, and fiscal space. A descriptive qualitative approach with a literature review design was employed. Relevant literature was identified through Scopus, Google Scholar, and SINTA-indexed national journals using keywords related to geopolitical risk, exchange rate pass-through, oil price shocks, fiscal space, and the State Budget (APBN). Sources were screened for thematic relevance, Indonesian context, academic quality, and substantive contribution. Analysis involved literature identification, thematic grouping, and conceptual synthesis. The review indicates that geopolitical risk transmission is neither linear nor uniform, with the three channels reinforcing one another. Holding administered energy prices down shifts pressure from consumer inflation to the State Budget; Rupiah depreciation may raise import costs and foreign currency liabilities; higher energy prices may intensify inflationary pressures and subsidy needs. Higher export commodity prices may generate additional revenues, so net effects depend on trade structure, external conditions, policy responses, and fiscal capacity. The study proposes an integrated framework linking the three transmission channels and identifies reinforcing and mitigating factors, addressing a gap in cohesive conceptualization of cross-country geopolitical shocks for Indonesia. The framework highlights the need for coordinated exchange rate, inflation, and fiscal policy responses, particularly regarding administered energy pricing and subsidy design. This research contributes a conceptual foundation for future empirical testing using VAR, SVAR, TVP-VAR, or nonlinear models with Indonesian data, supporting evidence-based policy analysis of geopolitical risk transmission.

Keywords: Exchange Rate; Fiscal Space; Geopolitical Risk; State Budget

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A. Introduction

The escalation of geopolitical risks can generate spillover effects on the Indonesian economy through financial markets, particularly as heightened geopolitical risks are associated with increased Rupiah exchange rate volatility. In the domestic financial sector, geopolitical risks have also been shown to exert pressure on banking intermediation, as reflected in slower credit growth when geopolitical risks intensify. Empirical evidence from the escalation of the Israel and Hamas conflict further indicates significant reactions across global equity, commodity, and bond markets (Martins, 2024).

More broadly, geopolitical risk can be viewed as a source of external uncertainty that shapes investor perceptions and decision making in financial markets. As global tensions intensify, market participants tend to reassess their risk exposure, leading to changes in the returns and volatility of various asset classes. This pattern is also evident in domestic markets, where geopolitical pressures are associated with weaker performance of financial instruments, including Sharia compliant equities, as well as an increased explanatory power of geopolitical risk indicators for fluctuations in asset prices. The effects extend beyond financial markets to the real sector through financing channels, as heightened uncertainty encourages banks to adopt a more cautious stance, thereby slowing credit expansion.

Nevertheless, the impact of geopolitical risk is not necessarily adverse in all respects. As a resource rich economy, Indonesia may benefit from rising global commodity prices through improved export performance of primary commodities. On the other hand, surging global energy prices may put pressure on domestic price stability, as higher oil prices increase production and distribution costs, which are subsequently passed through to consumer prices. Thus, the impact of geopolitical risk on the Indonesian economy is multifaceted and depends on the dominant transmission channels.

As an economy deeply integrated into global markets, Indonesia remains exposed to the transmission of external shocks into the domestic economy, particularly through exchange rate movements and energy commodity prices. In the Indonesian context, changes in the exchange rate can be transmitted to consumer prices through the exchange rate pass through mechanism, while increases in global oil prices can contribute to higher domestic inflation and, in turn, affect overall economic performance. These external pressures may also have important implications for the government's ability to respond through fiscal policy, as its policy capacity depends partly on the availability of *fiscal space*. In this regard, fiscal space is closely related to the fiscal behavior of the Indonesian government and represents an important determinant of its capacity to implement countercyclical measures in response to changing economic conditions. Therefore, the extent of Indonesia's fiscal space is particularly relevant in assessing the government's ability to mitigate the domestic macroeconomic effects of external shocks.

The dynamics of energy markets and fiscal conditions throughout 2026 indicate that these transmission channels are not merely theoretical, but have been reflected in Indonesia's recent macroeconomic conditions. As summarized in Table 1, the average Indonesian Crude Price (ICP) through August 2026 reached US\$89.2 per barrel, substantially exceeding the US\$70 per barrel assumption underlying the 2026 State Budget (APBN). Over the same period, the year to date average rupiah exchange rate stood at Rp17,415 per US dollar, indicating a weaker rupiah than the APBN assumption of Rp16,500 per US dollar. These deviations from the budget assumptions are consistent with sustained external pressure and point to potential implications for domestic inflation, fiscal conditions, and fiscal space (Ministry of Finance [Kementerian Keuangan], 2026). They cannot, however, be attributed solely to the Middle East conflict, because domestic factors and other global developments also influence the rupiah, oil lifting, and budget outcomes. The Ministry of Finance reported that the 2026 State Budget (APBN) performed amid heightened global risks, including the ongoing conflict in the Middle East (Ministry of Finance [Kementerian Keuangan], 2026). Geopolitical developments and the resulting volatility in global oil prices have contributed to higher energy subsidy expenditures, thereby placing additional pressure on the fiscal position. This condition illustrates how external geopolitical shocks can be transmitted into domestic fiscal conditions through energy prices, potentially constraining the government's fiscal space to respond to subsequent economic shocks (Ministry of Finance [Kementerian Keuangan], 2026).

Table 1. Comparison of 2026 State Budget Assumptions with Realized Macroeconomic Indicators and Energy Subsidy and Compensation Expenditures through August 2026

Indicator	2026 State Budget Assumption / Benchmark	Realization through August 2026	Difference
ICP (US\$ per barrel)	70	89.2	+27.4%
Rupiah Exchange Rate (IDR per US\$)	16,500	17,415	+5.5%
Oil Lifting (thousand barrels per day)	610	575.6	-5.6%
Subsidies and Compensation (IDR trillion)	218 (Jan-Aug 2025 realization)	331.4	+52.1%

Note: The differences for ICP, the exchange rate, and oil lifting are calculated by the authors as (realization/assumption – 1); for the exchange rate, a positive value indicates a depreciation of the rupiah. For subsidies and compensation, the benchmark is realization in January–August 2025 rather than a budget assumption, so the difference is a year-on-year change, as reported by the Ministry of Finance. Source: Author's calculations based on (Ministry of Finance [Kementerian Keuangan], 2026).

The pressure from energy prices and exchange rate movements is also reflected in government expenditure. Payments of subsidies and compensation to PT PLN and PT Pertamina reached IDR 331.4 trillion as of August 31, 2026, equivalent to 74.2% of the 2026 State Budget (APBN) allocation and representing a 52.1% year on year increase

from IDR 218 trillion over the same period in 2025. The largest increase was recorded in compensation payments, which rose from IDR 68.6 trillion to IDR 154.4 trillion, while subsidies increased from IDR 149.4 trillion to IDR 177.1 trillion (Ministry of Finance [Kementerian Keuangan], 2026), as shown in Figure 1. A similar pattern was observed in 2022, when the average Indonesian Crude Price (ICP) reached US\$97 per barrel amid escalating geopolitical tensions that disrupted global energy and food supply chains. Energy subsidy and compensation expenditures reached IDR 551.2 trillion, equivalent to 109.7% of the target stipulated in Presidential Regulation No. 98/2022 (Ministry of Finance [Kementerian Keuangan], 2023). However, comparisons between the two periods should be interpreted with caution, as the 2022 figure represents full year realization, whereas the 2026 figure reflects payments recorded only through August.

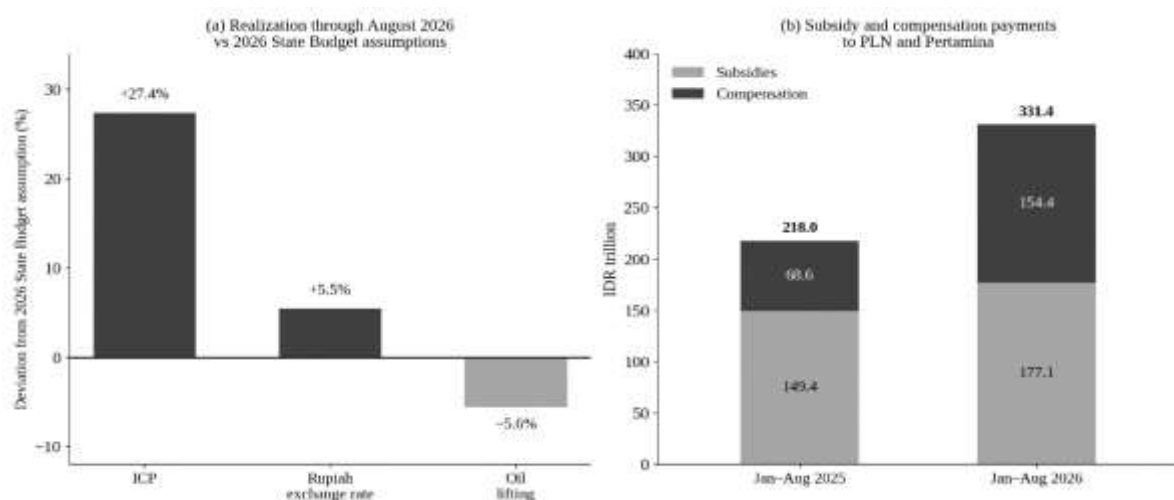


Figure 1. (a) Deviations Of Realized Indicators From The 2026 State Budget Assumptions And (b) Energy Subsidy And Compensation Payments

Note: Panel (b) shows cumulative payments from January to August. Subsidy and compensation components are rounded, so their sum may differ slightly from the reported total. Source: Author's calculations based on (Ministry of Finance [Kementerian Keuangan], 2026).

Nevertheless, the impact of higher oil prices on the State Budget (APBN) is not unidirectional. The Ministry of Finance stated that higher oil prices also contributed to increased government revenues, including through taxes paid by production sharing contract contractors, thereby partially offsetting the additional expenditure on energy subsidies. However, realized oil lifting of 575.6 thousand barrels per day remained below the APBN assumption of 610 thousand barrels per day (Ministry of Finance [Kementerian Keuangan], 2026), so, production volumes have not increased in line with the rise in oil prices. This condition highlights that the magnitude of fiscal pressure is jointly determined by energy prices, exchange rates, production volumes, and domestic pricing policies, which therefore need to be examined within an integrated analytical framework.

This study examines how geopolitical risk arising from the escalation of conflict in the Middle East is transmitted to the Indonesian macroeconomy through the exchange rate, inflation, and the fiscal space of the State Budget (APBN). The descriptive data in Table 1 and Figure 1 are presented as illustrations of the problem rather than as tests of causality, in line with the literature-based design adopted here. Three research questions guide the analysis:

RQ1: Through what channels does geopolitical risk transmit to Indonesia's macroeconomy?

RQ2: What factors amplify or mitigate these transmission channels?

RQ3: What policy implications follow for strengthening macroeconomic resilience?

A growing body of research has examined the relationships among geopolitical risk, financial markets, commodity prices, inflation, and Indonesia's macroeconomic conditions (Fitrasari et al., 2026). Some studies analyze the transmission of geopolitical risk to Indonesia's financial and commodity markets using a Vector Autoregression (VAR) approach, while Khaliq (2022) examines the relationship between geopolitical risk and exchange rate volatility in Indonesia. Research on exchange rate transmission shows that exchange rate movements pass through to domestic prices and affect price stability, and changes in fuel prices have also been associated with inflation dynamics (Agustina & Permadi, 2023). On the fiscal side, fiscal space is a key determinant of the government's capacity to conduct countercyclical policy, including through the management of subsidies (Putri et al., 2022).

These strands have, however, largely developed in parallel, and few studies examine how administered energy prices link the inflation and fiscal channels in the Indonesian context. This article addresses that fragmentation by synthesizing the three channels within a single analytical framework, which matters because the channels do not operate independently. Exchange rate depreciation can raise import costs and intensify inflationary pass through; inflationary pressure can trigger adjustments in domestic pricing and subsidy policy; and fiscal responses can in turn influence market expectations, financing needs, and external resilience. The article makes three contributions. First, it proposes a conceptual framework that treats the exchange rate, inflation, and fiscal channels as interdependent. Second, it identifies factors that amplify or mitigate each channel in light of Indonesia's energy structure, external resilience, policy credibility, and subsidy design. Third, it translates the synthesis into short term and medium to long term policy agendas and an agenda for empirical research. The article does not produce new causal estimates; its contribution is a conceptual synthesis that connects the literature on geopolitical risk with the literature on Indonesia's macroeconomic conditions.

B. Methods

Research design

This study adopts a descriptive qualitative approach based on a literature review. The design suits the research objective, which is to synthesize existing evidence on how

geopolitical risk is transmitted to the Indonesian economy rather than to estimate causal effects statistically. The phenomenon involves several interrelated mechanisms that have been studied separately in different strands of the literature, and a narrative synthesis allows these strands to be compared and integrated into a more comprehensive understanding that a single empirical model would be unlikely to provide. All data are secondary, drawn from scholarly publications and official institutional reports.

Data source and search strategy

Literature was retrieved from three sources: Scopus, Google Scholar, and national journals indexed in SINTA. Because SINTA is a national journal index rather than a searchable database, Indonesian-language journals listed in SINTA were searched through their publishers' portals and Google Scholar. Searches proceeded from broad to narrow terms and were then refined for each transmission channel. Table 2 summarizes the search strings. Official budget data were drawn from the (Ministry of Finance [Kementerian Keuangan], 2023, 2026) and used only to describe recent conditions.

Table 2. Search Strategy by Transmission Channel

Channel	Search string	Databases
General	("geopolitical risk" OR "geopolitical conflict" OR "Middle East conflict" OR "military conflict") AND ("macroeconomic vulnerability" OR "macroeconomic stability" OR "economic uncertainty") AND (Indonesia OR "emerging markets")	Scopus, Google Scholar, SINTA
Exchange rate	("geopolitical risk" OR "geopolitical conflict" OR "Middle East conflict") AND ("exchange rate volatility" OR "exchange rate depreciation" OR "exchange rate pass through" OR "currency volatility") AND (Indonesia OR Rupiah)	Scopus, Google Scholar, SINTA
Inflation	("geopolitical risk" OR "Middle East conflict" OR "oil price shock" OR "energy price shock") AND (inflation OR "inflation dynamics" OR "price stability" OR "exchange rate pass through") AND (Indonesia OR "emerging markets")	Scopus, Google Scholar, SINTA
Fiscal space	("geopolitical risk" OR "Middle East conflict" OR "oil price shock" OR "energy price shock") AND ("fiscal pressure" OR "fiscal space" OR "fiscal sustainability" OR "state budget" OR "government expenditure" OR "fuel subsidies") AND (Indonesia OR "emerging markets")	Scopus, Google Scholar, SINTA

Inclusion and exclusion criteria

A source was included if it (a) addressed geopolitical risk or a macroeconomic transmission mechanism relevant to at least one of the three channels; (b) focused on Indonesia, ASEAN countries, or emerging economies, or offered global evidence that clarifies the mechanism; (c) came from a credible outlet and described its

methodological approach clearly; and (d) provided empirical findings or a theoretical framework explaining at least one of the three channels. Sources were excluded if they had no direct connection to the transmission mechanisms examined, lacked a traceable methodological basis, or were not available in full text. Most included sources were published between 2021 and 2026; several earlier studies were retained because they provide important theoretical or empirical foundations (Forbes et al., 2018; Ito & Sato, 2008). Only publications in English and Indonesian were considered.

Selection process

Records were first screened by title, abstract, and conclusion, and the remaining records were then assessed in full text. Table 3 reports the selection stages in a PRISMA-style format. A total of 25 sources were retained for the synthesis. The thematic grouping serves as an organizing device for comparing findings; the study is not presented as a systematic literature review.

Table 3. Source Selection Flow

Stage	Number of Records
Records identified from Scopus, Google Scholar, and SINTA	200
Duplicate records removed	50
Records screened (title, abstract, conclusion)	150
Records excluded at screening	97
Full-text articles assessed for eligibility	53
Full-text articles excluded (with reasons)	28
Sources included in the synthesis	25

Records excluded at screening had no apparent relevance to the transmission mechanisms examined, judging by their titles, abstracts, or conclusions. Full-text articles were excluded because they had no direct connection to the transmission mechanisms, lacked a traceable methodological basis, or were not available in full text.

Thematic analysis and conceptual synthesis

The analysis followed four steps. First, findings were coded by shock source, affected variable, and transmission mechanism. Second, the coded findings were grouped into three themes: the exchange rate, inflation, and the fiscal space of the APBN. Third, findings were compared across country context, observation period, variables examined, and estimation method; where results diverged, the differences were reported and examined in terms of data, methods, and underlying economic conditions rather than forced into a single conclusion. Fourth, the themes were integrated into a conceptual framework that maps the interactions among the channels and identifies amplifying and mitigating factors. Evidence from other countries or groups of emerging economies was used cautiously, as comparative support for a mechanism rather than as direct evidence about Indonesia.

Trustworthiness and limitations

Credibility was supported by relying on peer-reviewed and official sources, verifying each substantive claim against its original source, and citing transparently. Several limitations apply. Coverage is restricted to the databases searched, so some relevant studies may not have been captured. Source selection and synthesis also involve researcher judgment, and the design cannot estimate the magnitude of effects. The conclusions should therefore be read as an indicative conceptual synthesis rather than definitive causal evidence, to be validated through quantitative analysis in subsequent research.

C. Results and Discussion

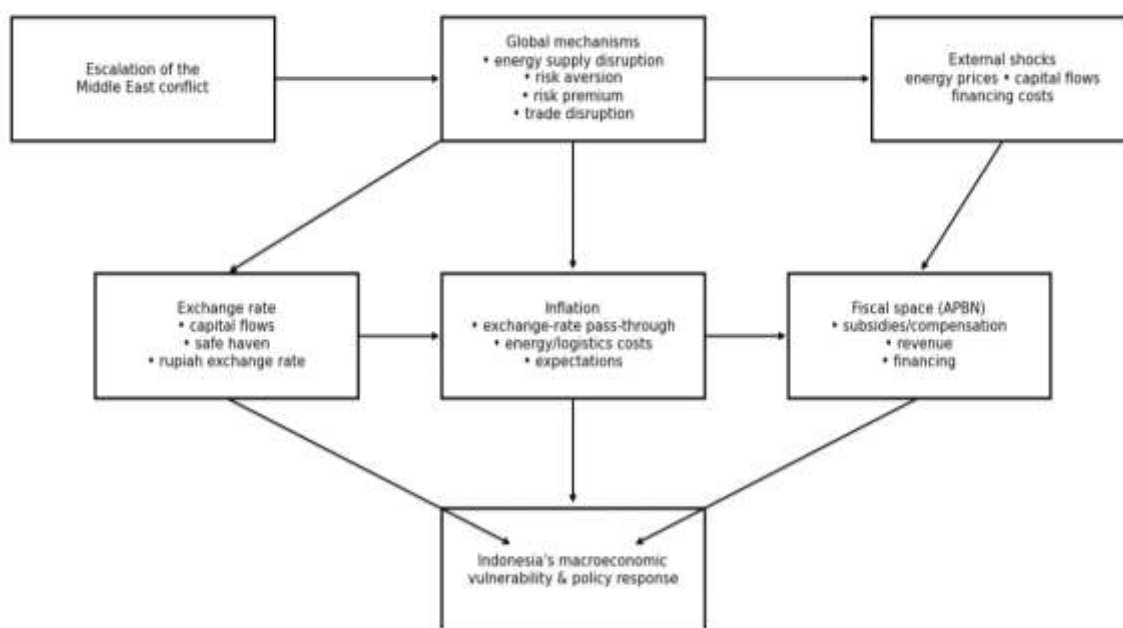
1. Results

Geopolitical risk and the conceptual framework

In the literature, geopolitical risk is generally conceptualized as uncertainty arising from wars, threats of armed conflict, diplomatic disputes, terrorism, and heightened tension between states (Caldara & Iacoviello, 2022). Its economic effects do not require physical destruction or direct economic disruption; rising geopolitical uncertainty alone can alter investment decisions and shift international capital flows. Feng et al. (2023) show that heightened geopolitical risk is associated with a decline in aggregate capital flows, with emerging economies responding more strongly.

In financial markets, heightened geopolitical risk can also increase uncertainty and asset price volatility. Sherlim & Ekaputra (2025) show that geopolitical risk indicators have predictive power for financial asset volatility, which suggests that emerging economies may face pressure through capital flow and financial market channels as uncertainty intensifies. Commodity-exporting economies may respond differently, however, because geopolitical conflicts are associated with changes in global commodity prices (Khan et al., 2024). Higher commodity prices can raise export revenues for countries such as Indonesia, although the effect depends on export volumes and trade structure. The impact of geopolitical risk on Indonesia therefore cannot be understood as uniform or linear.

Figure 2 presents a conceptual framework that links global mechanisms (energy supply disruption, risk aversion, and higher risk premia) to three domestic transmission channels (the exchange rate, inflation, and fiscal space) and to their policy implications. The framework stresses that the three channels interact rather than operate independently. For example, exchange rate depreciation can influence the magnitude of exchange rate pass through to domestic inflation, which in turn may affect the need for energy subsidies and intensify pressure on fiscal space.



Note: transmission channels interact with each other; the exchange rate can amplify inflation pass-through, while inflation and energy prices affect the need for fiscal stabilization.

Figure 2. Conceptual Framework of Geopolitical Risk Transmission to Indonesia's Macroeconomic Vulnerability

Exchange rate transmission channel

Through the exchange rate channel, heightened risk aversion can trigger capital outflows and exert depreciation pressure on the rupiah. Empirical evidence indicates that both global and domestic sources of geopolitical risk are consistently associated with volatility in the rupiah to U.S. dollar exchange rate (Khaliq, 2022). A similar pattern has been observed in other emerging economies, although the sensitivity of exchange rates to geopolitical risk varies with prevailing market conditions (Yeboah et al., 2025). Depreciation can in turn raise the domestic prices of imported goods, the local currency burden of foreign currency liabilities, and the input costs of imported oil, machinery, raw materials, and capital goods. The relationship between geopolitical risk and the rupiah is nonetheless not one directional, as higher export commodity prices may generate additional foreign exchange earnings and improve the trade balance, although this effect is not tested here.

Rupiah dynamics reflect the interaction of several macroeconomic and external factors. Pratiwik & Prajanti (2023) show that changes in the rupiah are associated with inflation, money supply, foreign exchange reserves, inflation expectations, and interest rates. Commodity prices and capital flows are also closely related to the exchange rate: Nurcahyaningsih et al. (2025) find that coal and other commodity prices had a causal relationship with the exchange rate before the pandemic, whereas after the pandemic, government bond portfolio inflows became a more dominant explanatory factor.

Inflation transmission channel

Through the inflation channel, exchange rate depreciation is transmitted to domestic prices via exchange rate pass through. When the rupiah depreciates, the domestic currency cost of imported goods, intermediate inputs, and energy products rises, which can increase production and distribution costs and ultimately consumer prices. Maharani et al. (2022) show that exchange rate shocks in Indonesia have a direct transmission effect on the Consumer Price Index. Agustina & Permadi (2023) likewise find a positive relationship between changes in the rupiah exchange rate and Indonesia's inflation rate. Anh et al. (2021) show that exchange rate shocks affect producer prices in the short run across the ASEAN countries they examine, including Indonesia, and that pass through is incomplete, with producer prices responding more strongly and quickly than consumer prices.

The magnitude of pass through is not constant. Evidence from ASEAN indicates that the transmission of exchange rate shocks to inflation varies across periods and economic conditions, including between the short and long run. Pham et al. (2023) identify asymmetric effects of exchange rate shocks on inflation in Indonesia within the ASEAN-5 context. These findings suggest that the inflationary consequences of depreciation depend not only on the size of the exchange rate movement but also on the prevailing economic environment. In addition, Yahya & Pamuncak (2023) confirm the relevance of geopolitical risk as a determinant of long run inflation in ASEAN, including in Indonesia and Malaysia.

Historical experience points the same way. In the period after the Asian financial crisis, Indonesia exhibited relatively strong pass through, particularly when the rupiah depreciated substantially and the credibility of the monetary policy anchor weakened (Ito & Sato, 2008). Because Indonesia has since adopted inflation targeting, this evidence is best read as a historical upper bound rather than a current estimate. Forbes et al. (2018) show that the degree of pass through depends on the type of shock driving the exchange rate. A depreciation caused by a global risk-off shock may therefore generate different inflationary pressure from one caused by weaker domestic demand. Geopolitical risk can affect domestic inflation not only through direct disruption to commodity and energy markets but also indirectly, through exchange rate movements and their subsequent pass through to domestic prices.

In Indonesia, the inflation channel is also shaped by administered prices. When the government holds retail prices of fuel, LPG, or electricity below market levels, consumer inflation is dampened, but the cost is transferred to the State Budget through subsidies and compensation (Harmono, 2022). This is consistent with the rise in compensation payments shown in Table 1 and Figure 1 (Ministry of Finance [Kementerian Keuangan], 2026). The inflation and fiscal channels are therefore linked by the government's pricing decisions.

Energy and fiscal space transmission channel

Energy prices affect the APBN mainly through subsidy and compensation spending. Harmono (2022) shows that reallocating fuel subsidies during a global crisis has implications for inflation and growth in Indonesia, which indicates that energy subsidies are a key fiscal instrument for cushioning domestic prices against external shocks. The Ministry of Finance reports that subsidy and compensation payments reached IDR 331.4 trillion by the end of August 2026 (Ministry of Finance [Kementerian Keuangan], 2026). The fiscal effect is not one directional, however. Higher oil prices also raise state revenue, including taxes paid by production sharing contractors, and windfall commodity revenues can be captured through fiscal instruments (Arifbillah et al., 2023). Because realized oil lifting remained below the budget assumption, the additional revenue is likely to have risen by less than the increase in prices alone would imply. Whether these pressures can be absorbed depends on the available fiscal space. Putri et al. (2022) find that limited fiscal space constrains the government's capacity to conduct countercyclical policy. Although their study does not focus on energy shocks, it suggests that higher energy-related spending may narrow the room for responding to later shocks.

Literature support and moderating factors

Table 4 summarizes the literature that most directly supports the core claim associated with each transmission channel.

Table 4. Literature and Official Data Supporting the Core Claims across the Transmission Channels

Core Claim in the Manuscript	Most Direct Literature Support
Geopolitical risk puts pressure on the rupiah through risk off behavior and safe haven flows.	Khaliq (2022) finds that geopolitical risk (GPR) encourages a shift from rupiah denominated assets toward U.S. dollar assets and represents a significant driver of the IDR to USD exchange rate.
The effects of GPR on the rupiah are not uniform and depend on the context.	Khaliq (2022) shows that the effects of global GPR are heterogeneous, whereas domestic geopolitical risk exhibits a more consistent relationship with rupiah volatility.
Exchange rate pass through (ERPT) exists in Indonesia but is incomplete.	A study of the founding ASEAN countries finds that exchange rate pass through to domestic prices is incomplete, with producer prices (PPI) responding more strongly and rapidly to exchange rate shocks than consumer prices (CPI) Anh et al. (2021).
Indonesia has historically exhibited relatively strong ERPT.	Ito & Sato (2008) report that CPI pass through was generally low across Asian economies following the Asian financial crisis, with Indonesia representing an exception.
Higher energy prices can increase APBN pressures through subsidies and compensation payments.	Ministry of Finance [Kementerian Keuangan] (2026) reports subsidy and compensation payments of IDR 331.4 trillion through August 2026, 52.1% higher than in the same period of 2025.
Higher oil prices do not necessarily improve the central government's fiscal position.	Ministry of Finance [Kementerian Keuangan] (2026) reports that higher oil prices raised revenue and partly offset subsidy spending, while oil lifting stayed below the budget assumption.

Table 5 summarizes the factors identified in the literature that amplify or mitigate the transmission of geopolitical risk

Table 5. Amplifying and Mitigating Factors in the Transmission of Geopolitical Risk

Factor	Role in Transmission	Implication
Energy and import structure	As a net oil importer, Indonesia experiences lower growth and a weaker rupiah when oil prices rise (Baek, 2021)	Energy diversification and efficiency can reduce sensitivity to external energy shocks.
Monetary policy credibility	Interest rate responses, foreign exchange intervention, and policy communication influence inflation expectations and investor behavior (Lutfiyah & Marseto, 2026)	Policy responses should be data dependent to avoid being either too weak or excessively aggressive.
External resilience	Foreign exchange reserves, debt structure, and investor composition determine the capacity to absorb external shocks (Beirne & Renzhi, 2026)	Foreign exchange reserves should be used to smooth excessive volatility rather than to maintain an exchange rate inconsistent with fundamentals.
Subsidy Design	Poorly targeted subsidies can absorb fiscal space without providing optimal protection to vulnerable groups (Jaylani et al., 2026)	Subsidy reforms should be supported by recipient level data, direct compensation mechanisms, and clear public communication.
Shock type and expectations	Forbes et al. (2018) show that the degree of exchange rate pass through depends on the type of shock driving the exchange rate.	Distinguish risk-off shocks from other sources of depreciation when assessing inflation risk.
Resource revenue structure	Commodity windfalls can increase government revenues through fiscal instruments (Arifbillah et al., 2023).	Windfall revenues should be managed and optimized sustainably.

2. Discussion

Integrated Interpretation of the Transmission Channels (RQ1)

In response to RQ1, the reviewed evidence indicates that escalation of conflict in the Middle East reaches Indonesia through three interlinked channels. Heightened risk aversion and higher risk premia can prompt capital outflows and depreciation pressure on the rupiah (Feng et al., 2023; Khaliq, 2022). Depreciation raises the cost of imported goods, inputs, and energy and, through pass through, feeds into producer and consumer prices (Anh et al., 2021; Maharani et al., 2022). Higher energy prices add cost-push pressure and, through subsidy and compensation mechanisms, raise government spending, which can narrow fiscal space (Harmono, 2022; Putri et al., 2022).

The channels also reinforce one another. Because pass through may be nonlinear and sensitive to uncertainty (Forbes et al., 2018), a given depreciation can produce stronger inflation under heightened geopolitical risk, which in turn raises the need for stabilization spending and affects market expectations and financing needs. Offsetting forces exist, however. Higher export commodity prices can raise foreign exchange

earnings and government revenue (Khan et al., 2024), and the 2026 budget data are consistent with this two-sided picture: higher oil prices raised revenue, but lifting below the budget assumption limited the gain while subsidy and compensation spending rose sharply. The net effect therefore cannot be determined from the literature alone and is ultimately an empirical question.

Amplifying and Mitigating Factors (RQ2)

In response to RQ2, the factors in Table 5 can work in either direction depending on their strength. Import dependence shapes how oil price shocks are felt: when Indonesia was a net oil exporter, higher oil prices supported growth and the rupiah, whereas in the net-importer era they reduced growth and depreciated the exchange rate (Baek, 2021). Energy diversification and efficiency can reduce this sensitivity. A weak monetary policy anchor is associated with stronger pass through, as in Indonesia's post crisis experience (Ito & Sato, 2008), whereas credible policy and well anchored expectations help contain it. Adequate reserves, a resilient debt structure, and a stable investor base strengthen external buffers, while poorly targeted subsidies consume fiscal space without protecting vulnerable groups effectively. The way commodity windfalls are captured and managed determines whether higher export prices translate into fiscal strength. The same structural feature can therefore amplify or mitigate transmission, and the direction depends on how well it is managed.

Policy implications (RQ3)

In response to RQ3, the policy implications fall into two horizons. In the short term, policymakers face trade-offs. Raising administered energy prices eases fiscal pressure but increases inflation, while absorbing the cost through subsidies protects consumers but narrows fiscal space. Interest rate increases can support the rupiah but may slow growth, and foreign exchange intervention can smooth volatility but depletes reserves. The study therefore recommends integrated monitoring of oil prices, shipping costs, exchange rates, capital flows, and inflation expectations; targeted stabilization measures for vulnerable groups and systemically important sectors; coordination among fiscal, monetary, and energy policy; APBN stress testing; and clear communication regarding the duration, targeting, and financing sources of policy interventions.

Over the medium to long term, the policy agenda should include energy diversification (see Baek (2021), on Indonesia's sensitivity to oil prices as a net importer), strengthening of domestic industries, improved logistics efficiency, deepening of the rupiah financial market, reduced dependence on strategic imported inputs, a contingent expenditure framework, sustainable management of commodity windfall revenue, and an early warning system for geopolitical risks.

Limitations and Directions for Future Research

Beyond the limitations noted in Section B.6, the 2026 figures in Table 1 and Figure 1 are descriptive and compare realization through August with annual budget

assumptions, so they illustrate pressure rather than test it. Future research can test the framework empirically using VAR, SVAR, TVP-VAR, or other nonlinear and time varying models with Indonesian data, jointly incorporate indicators of geopolitical conflict and energy prices, and evaluate the effectiveness of subsidies, social assistance, and foreign exchange market intervention in mitigating external shocks.

The descriptive data in this study cover budget assumptions and subsidy and compensation payments only. Data on consumer price inflation, the policy rate, and government bond yields are not examined, so the inflation and financing-cost channels are discussed conceptually rather than with 2026 data.

D. Conclusions

The escalation of conflicts in the Middle East has the potential to constitute a source of macroeconomic shocks for Indonesia through heightened geopolitical risk, changes in energy prices, trade disruptions, and shifts in capital flows. These risks are transmitted primarily through the exchange rate, inflation, and the fiscal space of the State Budget (APBN), as summarized in the conceptual framework presented in Figure 2. Rupiah depreciation can increase import prices and the domestic currency burden of foreign currency liabilities, while higher energy prices can intensify cost push inflationary pressures. At the same time, stabilization policies may increase the need for subsidies, compensation payments, and social protection measures. The overall impact is not unidirectional, as Indonesia may also benefit from higher export commodity prices. Whether these gains offset higher imported energy costs, financing costs, and stabilization expenditures cannot be determined from this review and should be tested empirically, although the 2026 budget data suggest that spending pressure has been substantial. The intensity of these transmission mechanisms depends on the structure of the energy sector, policy credibility, external resilience, subsidy design, and prevailing fiscal conditions. The main policy implication is the need for closer coordination between monetary and fiscal policies, stronger external buffers, better targeted subsidy reforms, energy diversification, APBN stress testing, and the development of an early warning system for geopolitical risks. Since this study adopts a conceptual approach, further empirical research is required to quantify the magnitude and direction of the effects associated with each transmission channel in the Indonesian context.

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F. Author Contributions

Lulu Nabian contributed to the design concept and implementation of the research, analysis of the results, and writing of the final manuscript. Sri Sundari and Djamarel Hermanto were involved in planning and supervising the work, processed the data, performed the analysis, drafted the manuscript, and designed the figures. Sri Sundari developed the theory Djamarel Hermanto verified this analytical method. Djamarel Hermanto investigates and supervises the findings of this study. All authors discussed the results and contributed to the final manuscript.

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H. Data availability

All data generated or analysed during this study are included in this published article.

I. Declarations

Ethics approval and consent to participate

The study was approved by the Ethics Committee of the Universitas Pertahanan, West Java, Indonesia. No participants in this study.

J. Competing Interests

The authors declare no competing interests

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