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Economic Development Winnipeg

WEEKLY ECONOMIC DIGEST

HOW THE WAR IN UKRAINE IS AFFECTING MANITOBA'S ECONOMY

DISRUPTIONS TO THE TRADE OF ENERGY, FERTILIZER, FOOD AND METALS

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Bottom Line

Russia invaded Ukraine on February 24, 2022, from Russian and Belarussian territory. This act of war brought down significant economic sanctions from the West on Russia, and **Belarus**. The European countries of Russia, Ukraine, and Belarus are enormous commodity exporters of energy, fertilizer, food, and metals. The war and sanctions have generated uncertainty, pushing up these commodities' prices. **So, while Canada does not have significant direct trade with any of these three countries, we are seeing a sharp increase in global prices for these commodities within Canada.**

Canadian producers of crude oil, and natural gas will benefit from this price increase, while consumers will face higher costs. There are similar issues with producers and consumers of iron and iron related products.

(continued).

Bottom Line (Continued)
Food commodity production is particularly sensitive to timing—spring planting season for crops in Ukraine and Russia is coming up soon, along with the harvest of winter crops. In Ukraine, having sufficient labour and inputs to plant and harvest is important for them to have crops to sell. In Russia, with sanctions in place, there may be challenges to financing crop planting. Buyers of Ukrainian and Russian wheat are concerned about rising wheat prices, with a **food crisis** already brewing in some countries.

Many world crop prices were already high, with tight world supply and demand balances due to crop production problems in 2021. Looking ahead to spring planting in 2022, Canadian farmers are looking favourably at higher crop prices, which they could lock-in by using various contracts or with futures and options. At the same time, farmers are facing higher fertilizer, diesel, engine oil and lubricant prices. Livestock producers are facing even higher feed prices, along with higher fuel costs.

Even before the invasion in Ukraine, the Bank of Canada had a need to raise policy interest rates to tame inflation. This extra source of inflation adds more pressure on select commodity prices faced by Canadians. **We are likely to see a 1.25 per cent overnight rate in January 2023, possibly with some Quantitative Tightening (QT).** With the added inflation from the Russian invasion of Ukraine, the probability of even higher rates is rising. Either way, the Bank must ensure inflation expectations remain well anchored, so we avoid even the spectre of stagflation.

For businesses and individuals, understanding the implication of interest rates rising from 0.25 per cent in January 2022 to 1.25 per cent or higher is something you should consider before launching new projects or taking on new debts.

ANALYSIS

A preliminary economic analysis of the 2022 Russian invasion of Ukraine
The easing of COVID-19's economic impact in Canada is very welcome news.**[1]** Unfortunately, the world was suddenly confronted by a new source of economic uncertainty through the Russian invasion of Ukraine, beginning on February 24, 2022. The launch of this offensive this year follows the seizure of Crimea in 2014 and other ongoing conflicts in Eastern Ukraine. See the map on the following page.**[2]**

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[1] See Chris Ferris (March 15, 2022) "Is COVID-19 Beginning to Fade as an Economic Influence in Canada?," **https://www.linkedin.com/pulse/covid-19-beginning-fade-economic-influence-canada-chris-ferris**.

[2] For Source for map, Washington Post, January 21, 2022. Updated February 26, 2022. **https://www.washingtonpost.com/world/2022/01/21/ukraine-russia-explain-maps/**.

ANALYSIS

Much of the world has responded in **favour** of Ukraine, with harsh **sanctions** being imposed on Russia and extended to **Belarus**. Numerous countries (particularly NATO countries) are also supplying Ukraine with arms and other supplies to aid their resistance to Russia's assault.**[3]**

The outcome of the war and the length of time it will take to resolve it are unclear. What we can do is consider some parameters of the Ukrainian, Belarussian, and Russian economies, then consider a few scenarios to understand the potential effects on the rest of the world.

Trade Exposure

Russia's trade in goods (Exports + Imports) as a share of GDP (Gross Domestic Product) is lower than that of Ukraine and Belarus. Russia's goods exports in 2019 were worth US$407 billion, approximately eight times more than Ukraine's exports.**[4]** We are showing Canada's exports as a point of comparison to Russia. See the following table.

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[3] I briefly touched on some of the impacts of Russia's invasion in an economic outlook presentation to the Brandon Chamber of Commerce on **March 8, 2022**. The presentation was covered in a Brandon Sun article by Colin Slark. **https://www.brandonsun.com/local/outlook-positive-for-manitobas-economy-576273492.html**.

[4] Source: * World Bank, World Development Indicators, February 15, 2022. **https://databank.worldbank.org/reports.aspx?source=2&series=NE.TRD.GNFS.ZS&country=#**, and ** The Observatory of Economic Complexity (OEC), **https://oec.world/en/resources/about**.

TRADE ANALYSIS

Description	Russia	Ukraine	Belarus	Canada
Trade (share of GDP): Ten-year average [2011 – 2020] *	48%	99%	131%	64%
2019 Goods exports (US$ Billions) **	$407	$49.5	$31.8	$431.0
2019 Goods imports (US$ Billions) **	$238	$55.4	$35.9	$443.0
2019 Net exports (US$ Billions) **	+$169	-$5.9	-$4.1	-$12.0

Selected Trade Details (B = Billions)

In this section we show a few details about the exports by product and destination for Russia, Ukraine and Belarus. We show Canada for comparison purposes.

Russian Federation exports in US$

- According to trade data from the Observatory of Economic Complexity (OEC), Russia's chief product exports in 2019 were: **crude petroleum** ($123 B), **refined petroleum** ($66.2 B), **petroleum gas** ($26.3 B), **coal briquettes** ($17.6 B), and **wheat** ($8.14 B).
- Its chief export markets were **China** ($58.1 B), **Netherlands** ($41.7 B), **Belarus** ($20.58 B), **Germany** ($18.9 B), and **Italy** ($16.7 B).
- In 2019, Russia was the world's largest exporter of **wheat** ($8.14 B), **semi-finished iron** ($6.99 B), **coal tar oil** ($4.49 B), **raw nickel** ($4.03 B), and **nitrogenous fertilizers** ($3.05 B).

Ukrainian exports in US$

- Ukraine's 2019 chief exports were: **corn** ($4.77 B), **seed oils** ($3.75 B), **iron ore** ($3.36 B), **wheat** ($3.11 B), and **semi-finished iron** ($2.55 B).
- Its chief export markets were **Russia** ($4.69 B), **China** ($3.94 B), **Germany** ($3.08 B), **Poland** ($2.75 B), and **Italy** ($2.57 B).
- In 2019, Ukraine was the world's biggest exporter of **seed oils** ($3.75 B).

Belarussian exports in US$

- Belarus' 2019 chief exports were: **refined petroleum** ($5.24 B), **potassic fertilizers** ($2.78 B), **cheese** ($996 M), **delivery trucks** ($958 M), and **crude petroleum** ($727 M).
- Its chief export markets were **Russia** ($13.4 B), **Ukraine** ($4.14 B), **United Kingdom** ($2.3 B), **Germany** ($1.32 B), and **Poland** ($1.31 B).

Canadian exports in US$

- Canada's chief product exports in 2019 were **crude petroleum** ($67.8 B), **cars** ($40.9 B), **gold** ($14.6 B), **refined petroleum** ($12.3 B), and **vehicle parts** ($10.8 B).
- Its chief export markets were the **United States** ($314 B), **China** ($18.5 B), **Japan** ($9.92 B), and **Mexico** ($6.18B).
- In 2019, Canada was the world's largest exporter of **sawn wood** ($6.35 B), **raw aluminum** ($5.45 B), **potassic fertilizers** ($5.27 B), **rapeseed AKA canola** ($3.23 B), **rapeseed oil AKA canola oil** ($2.6 B).

TRADE ANALYSIS (CONTINUED)

Exports by select product codes: Harmonized System (HS) at HS4 level

For 2019 exports, Russia had a large share of the following commodities:

- Crude petroleum exports (approximately 13 per cent),
- Refined petroleum (approximately 10 per cent),
- Nitrogenous fertilizer (approximately 13 per cent),**[5]**
- For 2019 exports of potassic fertilizers:
    - Between Russia and Belarus, they represented approximately 32 per cent,
    - Canada was approximately 33 per cent.

An important caveat for the energy markets Russia serves is that a significant amount of it flows through pipelines. **As of this writing, flows of crude oil, natural gas and its products have not been as significantly disrupted as initially thought. [6]**

Thus, crude prices have backed off from its initial surge. In the medium to longer term, Russia's invasion seems to have accelerated a move away from their crude and natural gas in Europe and encouraged NATO members to boost their defense spending. **[7]**

Semi-Finished Iron (HS4 7207):
Between Russia and Ukraine, the countries' exports approximately 37 per cent of the world's semi-finished iron in 2019. This is likely to put pressure on related prices, with upstream price increases likely.

Geography	Value (USD Billions)	Share	Cumulative share
Russia	$6.99	27%	27.09%
Ukraine	$2.55	10%	36.98%
Brazil	$3.20	12%	49.38%
Japan	$1.40	5%	54.81%
India	$1.26	5%	59.69%
R.o.W.	$10.40	40%	100.00%
World	$25.80	100%	

[5] The key feedstock for making nitrogenous fertilizers is natural gas.

[6] See International Energy Agency (IEA): **https://www.iea.org/reports/russian-supplies-to-global-energy-markets/oil-market-and-russian-supply-2**. China's current lockdowns are thought to reduce demand for crude oil and natural gas so this also pressuring prices lower. The war is likely to result in further short-term and medium term changes to energy markets.

[7] See Germany's announcement on February 27, 2022, of boosting defense spending to 2 per cent of GDP and building of Two Liquified Natural Gas (LNG) ports. **https://www.politico.eu/article/germany-to-ramp-up-defense-spending-in-response-to-russias-war-on-ukraine/**.

TRADE ANALYSIS (CONTINUED)

Geography	Value (USD Billions)	Share	Cumulative Share
Russia	$8.14	18.5%	18.5%
Ukraine	$3.11	7.1%	25.5%
USA	$6.94	15.7%	41.2%
Canada	$5.97	13.5%	54.8%
France	$4.54	10.3%	65.1%
R.o.W.	$15.40	34.9%	100.0%
World	$44.10	100%	

Wheat (HS4 1001)

Between the two countries, Russia and Ukraine represented approximately 25 per cent of world trade in wheat.**[8]** Their wheat typically is some of the cheapest in the world on a US$/MT F.O.B. (Free on Board), Black-Sea-ports basis. Thus, their wheat is often the winner of tenders by large buyers like Egypt that run subsidized bread programs. If their winter wheat does not get harvested and spring wheat does not get planted and harvested, this may set off a round of food riots in North Africa and other markets the two countries dominate. A **food crisis** is already a serious concern in parts of North Africa and the Middle East, and matters may worsen if the war in Ukraine lasts longer.

The core wheat producing areas of Ukraine and Russia are relatively close to the shoreline of the Black Sea and Sea of Azov.**[9]** The most pressing issue is planting barley, corn, rice, soybeans and sunflowers since the planting windows for these crops are coming up soon.**[10]** Russia has significant offshore participation in farming and grain handling along the Black Sea, which is its core winter wheat growing area. If offshore firms end up pulling out of the area, then financing, producing, and shipping crops from the area may be disrupted as well.

Cargo Vessel Traffic Disruption

Ukrainian ports are closed due to the ongoing conflict, so cargo vessels are avoiding Ukraine's shoreline along the Black Sea and Sea of Azov.**[11]** The closures are cutting off export shipments of grains and oilseeds out of Ukrainian ports. Vessels are calling on other ports in the Black Sea and Sea of Azov. Some grains and oilseeds are **reportedly** being shipped by rail to neighboring countries including Romania, Hungary, Slovakia and Poland, but it is not clear how much if any is being shipped. Having alternative export channels will become important if the war drags on, since its key exports are crops.

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[8] See OEC **https://oec.world/en/profile/hs92/wheat?redirect=true**.
[9] Source: USDA Foreign Agricultural Service. **https://ipad.fas.usda.gov/rssiws/al/global_cropprod.aspx**.
[10] See planting and harvesting time for Ukraine in: **https://www.linkedin.com/posts/higby-barrett-llc_the-ability-to-harvest-the-wheat-and-export-activity-6909504594238676992-_O0w?utm_source=linkedin_share&utm_medium=member_desktop_web**.
[11] See Marine Traffic **https://www.marinetraffic.com/en/ais/home/centerx:32.9/centery:45.5/zoom:7** Cargo ships will often avoid war zones since their marine insurance typically does not cover acts of war that result in them being sunk or captured. In this case Ukraine has closed the ports due to the war.

Marine Traffic in the Black Sea and Sea of Azov (Approximately March 15, 2022)

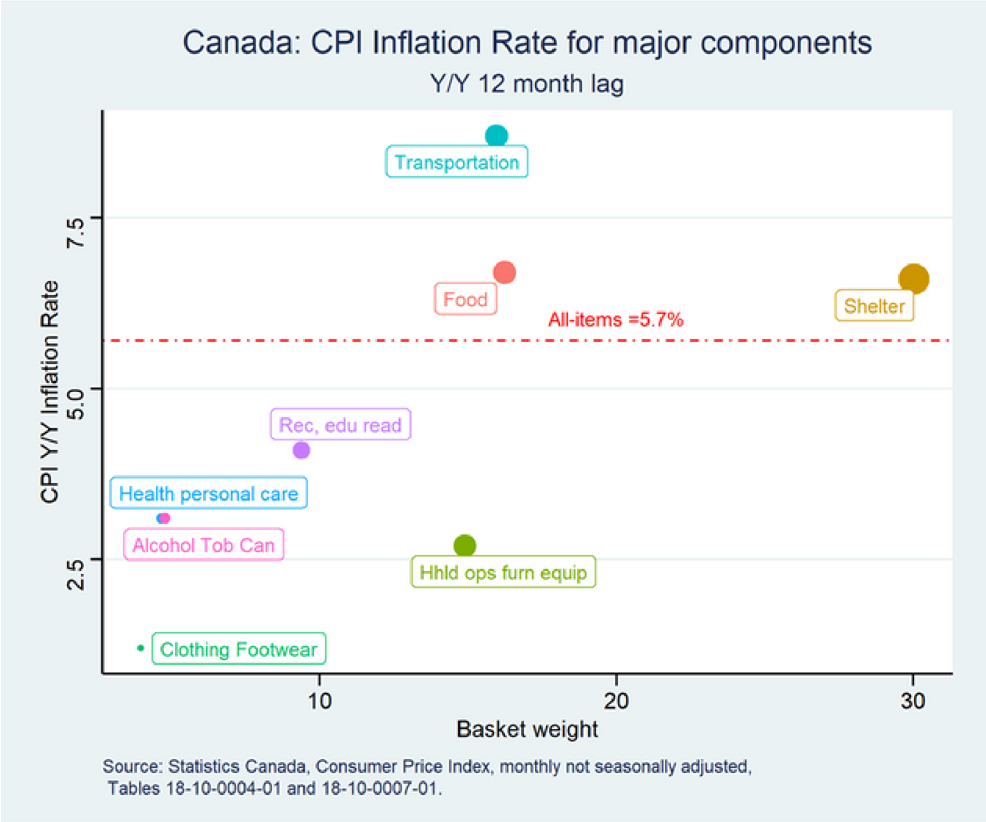
Possible Scenarios and Outcomes

If the war were to end within the next two weeks to – at most - a month, Ukraine and Russia's spring planting could occur, and the harvest of spring and winter crops would not be as significantly disrupted. In this scenario, crop prices should ease somewhat, along with related input prices, but expect disruptions to continue to reverberate.

If the war disrupts planting and harvesting in Ukraine and Russia throughout 2022 either directly or through sanctions, expect higher crops and input prices to continue. This will encourage farmers in other countries to attempt to make up for the lack of production coming from Ukraine and Russia. Given the Russia and Ukraine's share of these crops though, a fair bit of the work may have to be done by rationing demand and pushing some consumers to substitute goods.

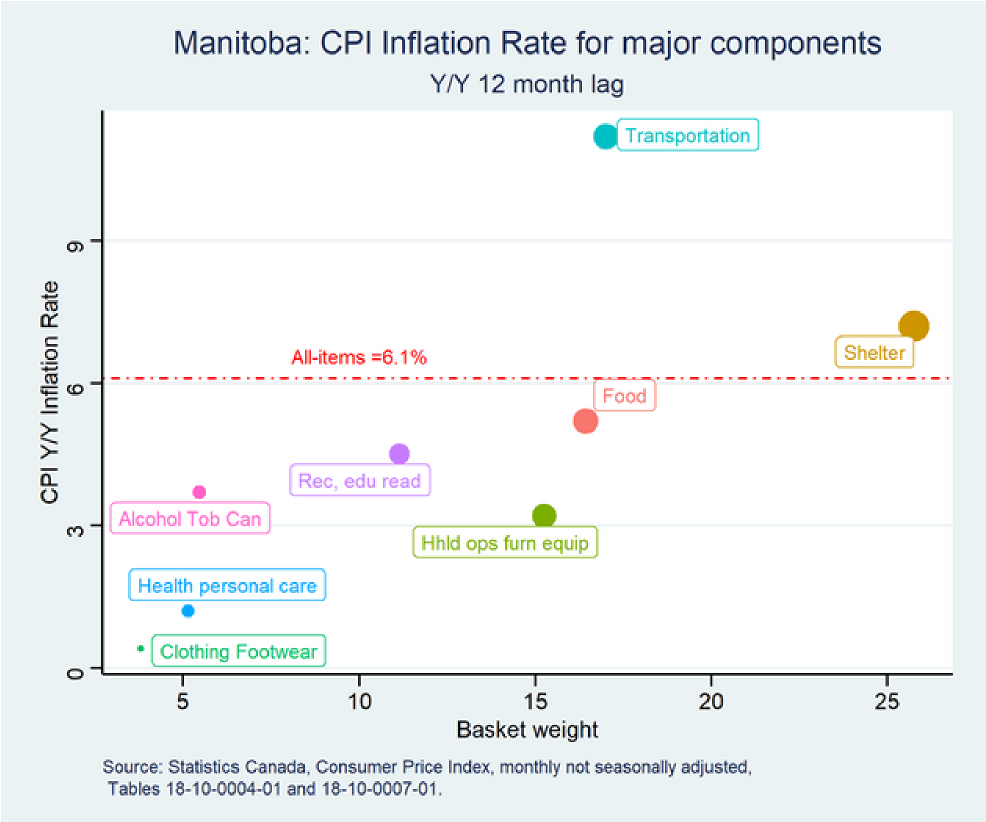
If higher natural gas and crude oil prices are sustained, it could dampen economic activity around the world. Major central banks are reversing extraordinary supports that were put in place due to the COVID-19 pandemic. Some commentators are concerned that **stagflationary** effects could arise. The effect would be muted compared to the 1970s energy crisis, since the West uses much less crude oil per dollar of GDP.

CANADIAN INFLATION



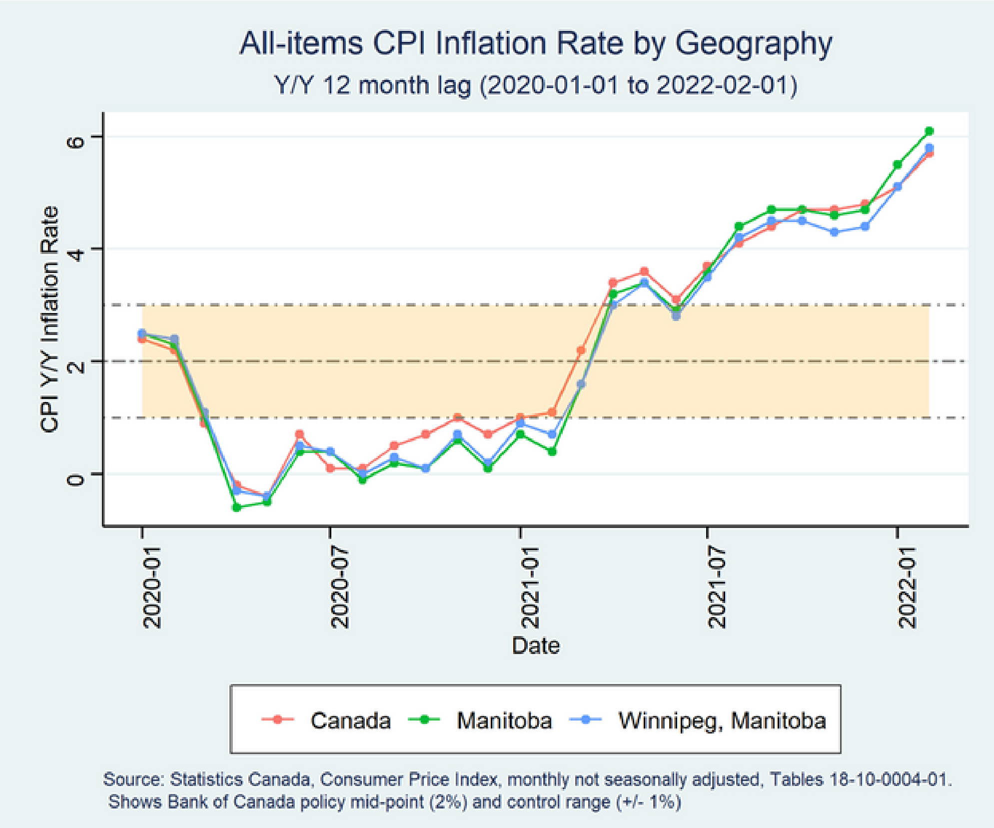
Canada's inflation, and policy interest rates

Statistics Canada released its **February 2022** Consumer Price Index data on March 16, 2022. Canada's overall CPI (Consumer Price Index) inflation was 5.7 per cent in February, pulled higher by transportation, food, and shelter.



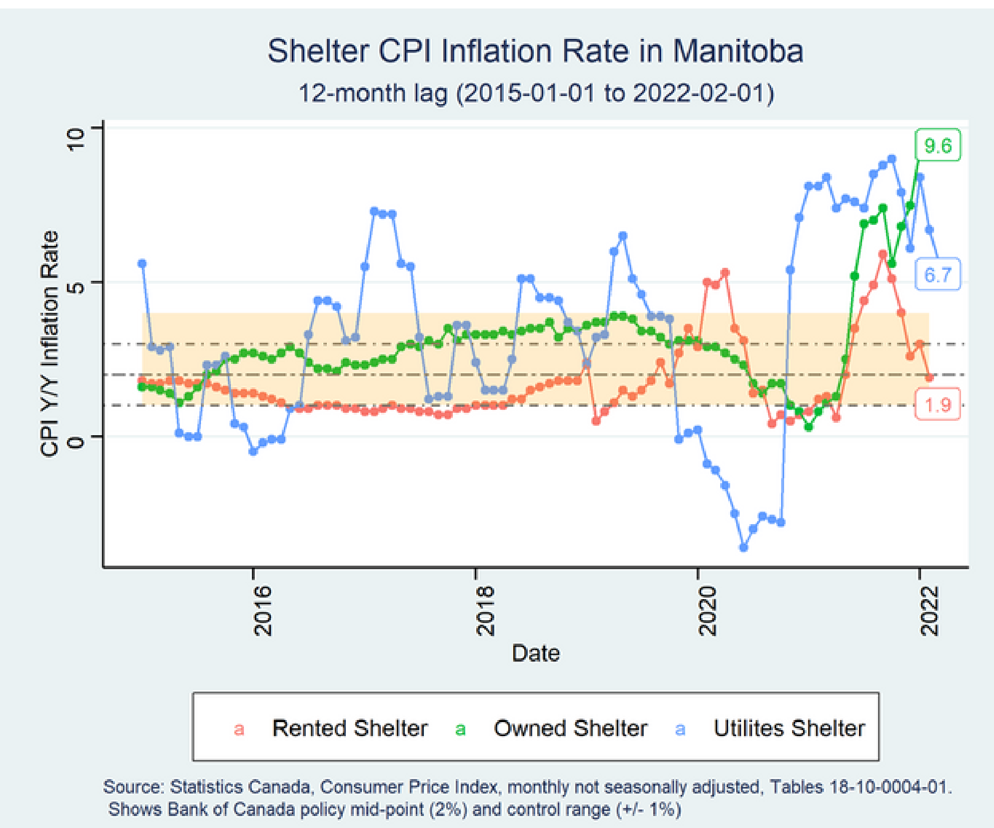
Manitoba's overall inflation rate was 6.1 per cent, pulled higher by transportation and shelter costs.

CANADIAN INFLATION (CONTINUED)



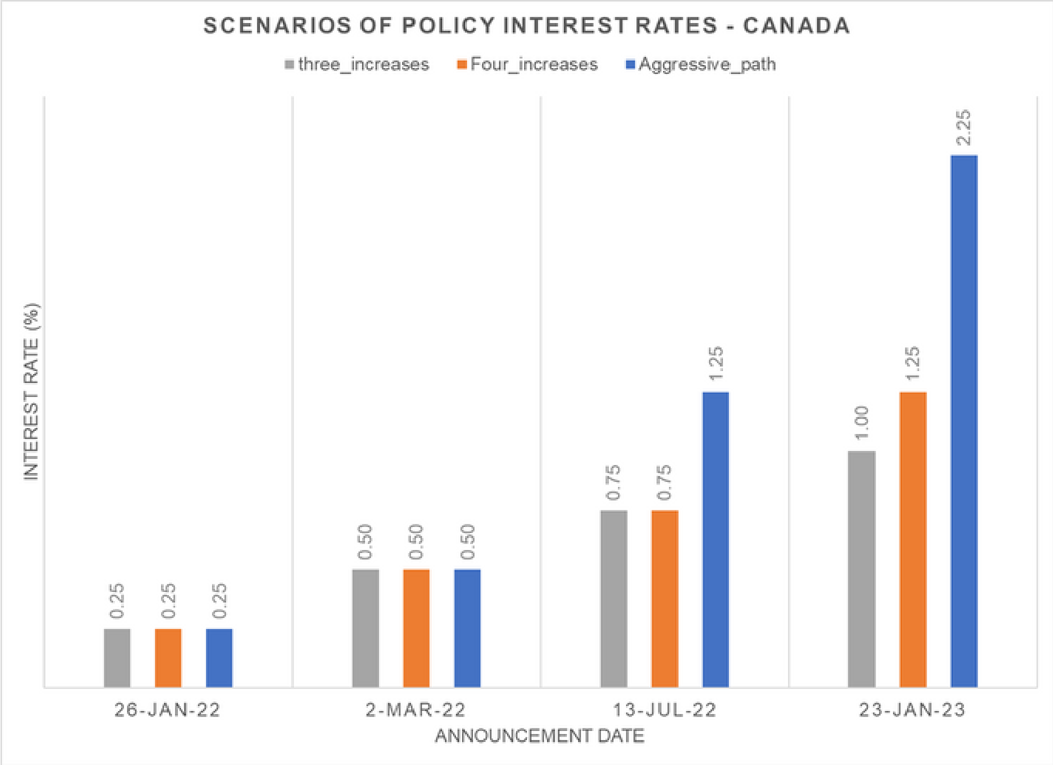
The low base-year effect on CPI during 2020 and 2021 will begin to ease with the March 2022 numbers and cease being relevant as of May 2022.

It will be key to watch housing, transportation, and food costs over the coming months since they are driving overall inflation.



Rising interest rates and the opening of the economy should start taking the froth out of the housing market over the coming year (which is being driven by the owned shelter subindex of the shelter index).

CANADIAN MONETARY POLICY



Canadian Monetary Policy

After the **March second** rate hike to 50 basis points, the Bank of Canada needs to continue to raise policy interest rates to help tame inflation. The Bank will be increasing rates, and at some point, will begin reducing the debt holding on its balance sheet or quantitative tightening (QT).

We are likely to see a 1.25 per cent overnight rate in January 2023, possibly with some QT. With the added inflation from the Russian invasion of Ukraine, the probability of even higher rates is rising. Either way, the Bank must ensure inflation expectations remain well anchored and we avoid even the spectre of stagflation.

Looking Forward: What does this mean for individuals and businesses?
Businesses and individuals need to consider the implications of rising interest rates. The overnight rate could easily be 1.25 per cent by January 23, 2023. The central bank could raises rates more aggressively, but we are unlikely to see overnight rates exceed 2.25 per cent by January 2023.

For individuals, this calls for stress testing your ability to comfortably carry debt in the case of an interest rate increase of at least 1 to 2 per cent.

For businesses, if borrowing to implement projects, stress test an increase in the interest rate of at least 1 to 2 per cent to ensure your Return on Investment (ROI) will not be compromised by rising interest rates.

Talk to your financial advisors and lenders to review your situation and adjust before it becomes a problem.

INQUIRIES AND CONTACTS

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