Ukraine's "harvest of sorrow" with Russia's invasion

Conflict has brought tragedy once again to Eastern Europe with dramatic economic and political costs

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Russia's violent attack on Ukraine has dominated the headlines since 24th February. The tragic loss of Ukrainian lives, the desperate flight of women and children towards safety, and Russian President Vladimir Putin's declaration that nuclear forces are on 'high alert' has generated alarm around the world. This tragedy is another painful chapter in Ukraine's history with its larger Russian neighbour. The Ukrainian famine in the 1930s was a "harvest of sorrow" where many lives were also lost given the terror inflicted by another Russian dictator in Joseph Stalin.[1]

In the wake of this current tragedy, the global economy and financial markets have been shaken. Market prices for key commodities such as natural gas, oil and wheat have surged, given concern that Russian and Ukrainian supply will suddenly stop. Global share prices have slumped with the possibility that the war will spread west and engulf Europe. Investors and traders have also searched for 'safe havens' by bidding up the gold price and the US dollar.

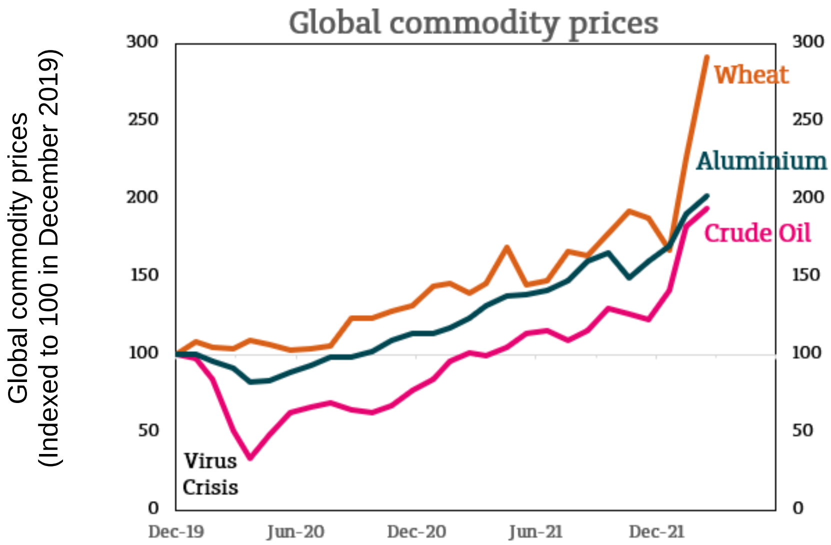
Russia and Ukraine are key producers of global commodities. Russia is a large producer of natural gas, oil, wheat, and metals such as aluminium.[2] To show how dependent Europe is on this commodity supply – Russia is estimated to account for circa 40% of European natural gas supply and 25% of oil supply.[3] Ukraine is also a major producer and exporter of wheat. Indeed, Russia and Ukraine combined produce almost 33% of global wheat exports.[4]

Russian production in 2020 as a percentage of global production

Natural gas	Oil	Wheat	Aluminium
16.6%	12.1%	11%	6.1%

Source: JP Morgan.

Commodity prices have extended their gains over the past two years by skyrocketing this year. For example, the Brent crude oil price has risen 42%, wheat prices are up 55% and aluminium prices are up 20% this year.[5] Commodity markets are now worrying that sanctions will be applied against Russian commodity exports, or alternatively that the Russian President Putin could decide to switch off exports of these commodities as a reprisal. The Biden Administration has just announced a ban on the US accepting Russian oil exports.



Sources: International Monetary Fund (IMF) Commodity Price Index data to November 2021, updated for price moves since then using respective Bloomberg data.

Given this Ukrainian crisis is likely to see more shocking twists and turns before the conflict ends, this is a dynamic situation where investors should keep an open mind. However, a clear risk scenario for investors is that the global economy has become more vulnerable to slipping into 'STAG-FLATION'. This occurs when global economic activity struggles as in 'STAG-nates' while also experiencing higher 'in-FLATION'. For those who remember the difficult times of the 1970s, this is a memory that one would prefer to be left in the history books. However, there are some insights from examining the experiences with commodity prices and inflation over the past five decades. The key lesson of the 1970s was that being 'patient' with low interest rate settings when inflation is rising means that the central banks' task becomes even harder.

Because of the 1970-1980s experience, central bankers have become more focused on managing inflation by raising and lowering interest rates when needed. Indeed, most central banks have implemented inflation targets of 2%-3% over the past 25 years such as the US Federal Reserve, European Central Bank and the Reserve Bank of Australia. The current dilemma is that cash interest rates have been set near zero per cent (0%) in Australia, Europe, and the US in response to the pandemic. Given continued supply disruptions as well as the threat from rising commodity prices, these low interest rates are now well below current consumer inflation (Australia 3.5%, Europe 5.8%, and the US at 7.9%).

However, the Ukrainian crisis now represents a potentially major negative force for global economic activity if businesses and consumers become more cautious about spending and investing. Hence the 'Stagflation' scenario of both high inflation and higher unemployment is set to trouble central bankers. Do central bankers delay raising interest rates as they did in the 1970s or do they become assertive to keep rising inflation in check?

There are some strategies that may mitigate this inflation and interest rate threat. Major oil producing countries such as Saudi Arabia, and Qatar for natural gas, could step up production to fill the potential supply gap left by Russia. Governments could lower transport costs by cutting fuel excise taxes (eg Australian consumers pay 44 cents per litre) as well as public transport fees. Over time, businesses and consumers can adapt to this higher commodity price environment through increasing their access to renewable energy (eg solar). Yet all this takes considerable time.

Realistically, there are no immediate solutions to this Ukrainian crisis apart from Russia abandoning this invasion. If President Putin does not change course, then the world will have been dramatically transformed when the Russian army invaded Ukraine on 24th February. While political risk has featured on investors' radar screens over recent years (eg Brexit and President Trump's election in 2016, Hong Kong protests in 2019-20), this conflict in Eastern Europe appears more dangerous and profound. Ukraine is a democratic and independent nation that has been attacked by an authoritarian and reckless Russian government. For all democracies – whether they be in Western Europe, Asia, Africa, or the Americas – this is a reminder that Abraham Lincoln's aspiration for "*government of the people, by the people, for the people"* is not guaranteed. A more recent US President highlighted that preserving liberty comes at a high cost but that is a price worth paying:

> *"Let every nation know, whether it wishes us well or ill, that we shall pay any price, bear any burden, meet any hardship, support any friend, oppose any foe, in order to assure the survival and the success of liberty."*
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> *President John F Kennedy, Inaugural Address, 20th January 1961.*

Sources:

1. 'The Harvest of Sorrow: Soviet Collectivization and the Terror-Famine' by Robert Conquest (first published 1986). This book documents the Ukrainian Famine in the 1930s. See also Britannica article on 'Holodomor: Ukrainian history' by Anne Applebaum at britannica.com/event/Holodomor.
2. JP Morgan, Global Data Watch, 25 February 2022.
3. 'EU plans to cut Russian gas imports by two-thirds in a year', Financial Times, 8 March 2022.
4. 'Food crisis looms as Ukrainian wheat shipments grind to halt', Financial Times, 6 March 2022.
5. IMF Commodity Price Index data to November 2021, updated for price moves since then using respective Bloomberg data.