NEW ZEALAND
FOREIGN AFFAIRS & TRADE
Manatū Aorere

14 February 2022

Minister of Foreign Affairs | For approval by | 16 February 2022

# Impacts of a Russia-Ukraine conflict on the New Zealand economy

BRIEFING Decision Submission

PURPOSE To provide an assessment of the potential impacts on the New Zealand economy of conflict between Russia and Ukraine and subsequent sanctions that may be imposed by the EU and US.

## Tukunga tūtohua – Recommended referrals

| | | |
|---|---|---|
| Prime Minister | For information by | 17 February 2022 |
| Minister of Finance | For information by | 17 February 2022 |
| Minister of Energy and Resources | For information by | 17 February 2022 |
| Minister Responsible for the NZSIS and GCSB | For information by | 17 February 2022 |
| Minister of Police | For information by | 17 February 2022 |
| Minister for Trade and Export Growth | For information by | 17 February 2022 |
| Minister of Agriculture | For information by | 17 February 2022 |
| Minister of Immigration | For information by | 17 February 2022 |
| Minister of Defence | For information by | 17 February 2022 |
| Minister of Transport | For information by | 17 February 2022 |
| Minister for National Security and Intelligence | For information by | 17 February 2022 |
| Minister of Customs | For information by | 17 February 2022 |
| Minister of Disarmament and Arms Control | For information by | 17 February 2022 |
| Associate Minister of Foreign Affairs | For information by | 17 February 2022 |

## Mā te Tari Minita e whakakī – Minister’s Office to complete

| | | |
|---|---|---|
| ☐ Approved | ☐ Noted | ☐ Referred |
| ☐ Needs amendment | ☐ Declined | ☐ Withdrawn |
| ☐ Overtaken by events | ☐ See Minister’s notes | |

**Comments**

# Impacts of a Russia-Ukraine conflict on the New Zealand economy

## Pito matua – Key points

- This submission summarises a report prepared by MFAT's Economic Division which provides a comprehensive analysis of the impacts of a potential Russia-Ukraine conflict on the New Zealand economy. That full report is attached in Appendix One in this Submission.

- Increasing tensions in Eastern Europe which threaten armed conflict and economic sanctions have the potential to cause significant global economic consequences.

- In March 2014 the annexation of Crimea by Russia caused significant volatility in international financial markets, with major negative impacts on the New Zealand dairy sector due to a collapse in global dairy prices following Russia's decision to ban European Union, Australian and United States of America agriculture exports.

- This is unlikely to occur this time around. Russia is now a smaller trading partner for New Zealand. Furthermore, global dairy markets are currently in a very different position compared to 2014, with global supply tight and demand proving resilient. EU dairy exports to Russia have collapsed following the previous round of sanctions, so the amount of diverted surplus dairy commodities likely to flow on to the market will not occur to the same extent this time around.

- While New Zealand has on a low exposure to the Russian economy in terms of bilateral trade. Nevertheless, there could be significant indirect flow on effects for New Zealand, driven by Russia's importance in key global commodity markets such as oil and wheat. This would translate through to the New Zealand economy occur through higher fuel and import commodity prices, instability of financial markets and the impact on global economic activity.

Vangelis Vitalis
For Secretary of Foreign Affairs and Trade

# Impacts of a Russia-Ukraine conflict on the New Zealand economy

## Tūtohu – Recommendations

It is recommended that you:

| | | |
|---|---|---|
| 1 | **Note** that low level of bilateral trade exposure between New Zealand and Russia and Ukraine will mean the direct impact of a conflict and any consequent economic sanctions will be limited; | **Yes / No** |
| 2 | **Note** that there could be significant indirect flow on effects for New Zealand, driven by Russia's importance in key global commodity markets such as oil and wheat. | **Yes / No** |
| 3 | **Note** that a separate submission is being prepared for Ministers recommending immediate measures New Zealand could take in response to a Russian invasion of Ukraine; outlining Russia's potential response; and identifying further measures we might take in the event our initial response needs to be ramped up; | **Yes / No** |
| 4 | **Refer** a copy of this submission to the Prime Minister, Minister for National Security and Intelligence, Minister of Immigration, Minister of Disarmament and Arms Control and Minister of Customs for their concurrence, and to the Minister Responsible for the NZSIS and GCSB, Minister of Finance, Minister of Defence, Minister of Agriculture, Minister for Trade and Export Growth, Minister of Transport, Minister for Energy and Resources, Minister of Police and Associate Minister of Foreign Affairs for their information. | **Yes / No** |

Hon Nanaia Mahuta
Minister of Foreign Affairs

Date: / /

# Impacts of a Russia-Ukraine conflict on the New Zealand economy

## Pūrongo – Report

*The Russia-Ukraine conflict threatens to have significant global economic consequences*

1. Increasing tensions in Eastern Europe over a potential armed conflict between Russia and Ukraine and proposed severe economic sanctions from the US and EU are raising the prospect of disruption to global financial and commodity markets.

2. Having all but ruled out engaging militarily with Russia (directly at least), the main policy options for the US and Europe being openly discussed are economic. Both the US and European countries have threatened to impose severe sanctions on Russia if it goes ahead. These measures are expected to form part of a broader package of sanctions focused on finance, energy, and technology.

3. New Zealand cannot follow these countries in applying its own sanctions on Russia. New Zealand law only allows sanctions to be placed in line with the United Nations and any proposed UN sanction against Russia is certain to be vetoed by the country itself. MFAT is providing separate advice to Ministers on the measures that New Zealand could take in response to further Russian aggression against Ukraine.

*The economic impact was significant last time for key New Zealand export sectors*

4. In March 2014 the annexation of Crimea by Russia caused significant volatility in international financial markets, with major negative impacts on the New Zealand Dairy sector. Dairy prices fell by more than 40 percent over the course of the year following Russia's decision to ban EU agriculture exports. This then filtered through to New Zealand farmers with the farm-gate pay-out collapsing over the course of the following two-seasons, causing financial strain across the sector that took years to recover from.

*New Zealand is less directly exposed this time*

5. Despite obvious similarities between the situation then and now, we do not expect to see a repeat of the financial impacts of 2014 on New Zealand's largest export industry. Global dairy markets are currently in a very different position with global supply tight and demand proving resilient. Most importantly EU dairy exports to Russia have collapsed following the previous round of sanctions, so the amount of diverted surplus dairy commodities likely to flow on to the market will not occur to the same extent this time around.

6. Nevertheless there will be some impacts should New Zealand's dairy trade need to divert to other markets. Total dairy exports to Russia were $168.9 million for the year ending June 2021. Of this total, butter represented $147.9 million, comprising 5.5 percent of New Zealand's total for this commodity.

7. Looking beyond dairy markets, any sanctions on Russia itself are unlikely to have a major impact on New Zealand's other big export sectors either. Russia was New Zealand's 27th

largest export trading partner in the year ending June 2021, with goods exports totalling $293 million (0.5 percent of New Zealand's total). Beyond dairy, the only export commodities of any significance were apples ($26.7 million), seafood ($22.4 million), wine ($15.2 million) and medical equipment ($15.2 million).

8. Prior to 2021, almost all imports from Russia were crude oil. However, the planned closure of the Marsden Point oil refinery in April has meant New Zealand will now be switching to refined petroleum products from alternative markets, with the last significant crude oil shipment from Russia occurring in January 2021.

9. Trade with Ukraine is negligible, with exports totalling $17.0 million (mainly seafood and dairy) and imports of $25.4 million (mainly sunflower seed oil and tobacco).

10. MFAT has an ongoing engagement process underway with exporters to determine the firm level impacts of any disruption of trade flows with Russia and Ukraine.

11. s9(2)(b)(ii), s6(e)(vi)

12. s9(2)(b)(ii), s6(e)(vi)

13. s9(2)(b)(ii), s6(e)(vi)

*Nevertheless there could be significant indirect flow on effects for New Zealand*

14. Although the low level of bilateral trade exposure means the direct impacts will be quite limited, this won't completely shelter New Zealand from the global market and economic pressures likely to emerge from any conflict. The potential for disruption stems from Russia's importance in key global commodity markets. In the event that an invasion of Ukraine by Russia is followed by tough sanctions, this would raise the price of a wide range of globally-traded commodities, particularly oil and wheat. The flow on financial effects could impact the value of the New Zealand dollar and place additional pressure on domestic

inflation and the cost of living. It is these factors which could have the most significant flow on effects to the New Zealand economy.

15. Russia's influence on the oil market is significant. It is the world's second-largest exporter of crude oil after Saudi Arabia, producing around 10 percent of global supply and is a key member of the OPEC+ alliance. It is also the world's largest exporter of natural gas. Oil and gas markets could be significantly affected by western sanctions, disruptions due the potential conflict itself, or counter sanctions imposed by Russia itself. The pivotal role of energy in the global economy will also mean that price rises will spill over to other markets too, further increasing global freight costs and the price of many other imported goods for New Zealand.

16. The indirect impact of an invasion on global grain prices could be even more significant. Russia is the world's largest exporter of wheat, with Ukraine the fourth biggest. Ukraine is also the world's third largest exporter of corn. Together they export 28.6 percent of the world's wheat and 19.6 percent of corn, with a significant proportion of Ukrainian cultivation taking place in its eastern regions, which would potentially be the most exposed to any conflict.

17. The threat of war has also seen a big fall in risk appetite in international financial markets. A conflict would likely further impact market confidence, with investors likely to respond by continuing a retreat to more "safe-haven assets" such as the US dollar. A consequent weakening New Zealand dollar will boost the competitiveness of New Zealand's exports. However it will also increase the price of imported goods, pressuring profit margins for domestic businesses, and further fuelling domestic inflation.

*<u>Proposed sanctions for an extended period would weigh on global growth</u>*

18. As a small export-focused nation, he biggest medium term impact to New Zealand's economy may come from any consequent dampening in economic growth across the world economy.

19. s6(b)(i)

20. Cutting off Russia would hurt many European countries. Russia is the EU's fifth largest trading partner with exports of USD 89.6 billion in the year ended December 2020 and imports of USD 98.6 billion.

21. In particular the pivotal role of energy in the global economy means any inevitable price rises will spill over to other markets and act as a drag on global economic growth.

# Impacts of a Russia-Ukraine conflict on the New Zealand economy

Global inflation, which was expected to peak and decline later this year, will be further pressured by these higher energy prices. In the context of tight household purchasing power, that could lower global recovery prospects, including that of many (if not all) of New Zealand's key trading partners.

# Impacts of a Russia-Ukraine conflict on the New Zealand economy

Appendix One:

# Impacts of a Russia-Ukraine conflict on the New Zealand economy

## Taipitopito whakapā – Contact details

| NAME | ROLE | DIVISION | WORK PHONE |
|---|---|---|---|
| Geoff King | Senior Economist / Head of Research | Economic Division | s9(2)(a) |
| Stuart Horne | Divisional Manager | Economic Division | |

NEW ZEALAND
FOREIGN AFFAIRS & TRADE
Manatū Aorere

# Potential impacts of a Russia-Ukraine conflict on the New Zealand economy

February 2022

*Prepared by the Economic Division in Wellington*

## Summary


***Limited bilateral trade but exposure to indirect economic fallout likely***

- Increasing tensions in Eastern Europe over a potential armed conflict between Russia and Ukraine and proposed severe economic sanctions from the US and EU are raising the prospect of disruption to global financial and commodity markets.

- s6(a)

- New Zealand's distance from the potential military action between Russia and Ukraine combined with limited bilateral trading relationships (our 27th largest export partner) will help insulate it from the direct economic effects of the conflict. In particular, the global conditions and supporting factors that led to major falls in dairy commodity markets during the last round of tensions in 2014, are not currently present. Exports were only $293 million in the year to June 2021 (half of which was butter) and most could be diverted elsewhere, though this would be difficult for some smaller-scale export products. New Zealand imports from Russia, which are mostly crude oil, have dropped to close to zero in recent months.

- The most significant impacts on New Zealand of any conflict would be indirect, primarily through higher fuel and commodity prices, financial market volatility and the potential drag on global economic activity. The looming potential Russian action towards Ukraine is already creating significant anxiety and testing global financial and commodity markets. In the event an invasion of Ukraine by Russia is followed by tough economic sanctions, this would raise the price of a wide range of globally-traded commodities, particularly oil and wheat. The flow on financial effects could impact the value of the New Zealand dollar and raise the cost of some imported goods (particularly fuel), placing additional pressure on domestic inflation and the cost of living of New Zealand consumers.

- For many of our key trading partners, particularly in Europe, the impact would be far more significant. To the extent that an extended conflict weighs on global economic growth, this could potentially affect the medium term prospects for New Zealand's export sector.

# Report

*The Russia-Ukraine conflict threatens to have significant global economic consequences*

Over the past few weeks, tensions have flared in Eastern Europe where Russia has amassed tens of thousands of troops along the Ukraine border. This has led to concerns that Russia could launch a full-blown military action, plunging the region into war at a time when the global economy is already reeling from the impacts of COVID-19.

The United States and much of the West, including Australia, are poised to take immediate action. EU foreign ministers have issued warnings that they would impose "massive consequences" against Russia if it invades Ukraine. However, at this stage at least, it appears unlikely that the United States and NATO countries will directly enter armed conflict with Russia, should an invasion of Ukraine take place.

Therefore, having all but ruled out engaging militarily with Russia (directly at least), the main policy options being openly discussed are economic. Both the US and Europe have threatened to impose severe sanctions on Russia if it goes ahead. These measures are expected to form part of a broader package of sanctions focused on finance, energy, and technology.

The main financial sanction that has reportedly been canvassed by the US is preventing Russia from participating in the SWIFT interbank payment system used to make cross-border transfers. This would make any bilateral trade with Russia highly challenging.

Restrictions on the secondary trading of Russian sovereign debt are also being considered, as are cutting selected Russian nationals and companies off from the global financial system by freezing their western based assets.

In energy, potential sanctions are also being considered, targeting not just current production, but investment as well.

Restrictions could also be placed on financing and equipment going to Russia's upstream oil sector in New York and London. Both Europe and America have threatened to prevent the opening of Nord Stream 2, a pipeline that would send Russian gas to Europe.

However, technology is arguably the most powerful lever that could be deployed. Potential sanctions include blocking exports of high-tech equipment to restrict Russia's access not only to items used by its defence sector, but also to parts used in many phones and appliances, inconveniencing Russian consumers as much as its weapons-makers.

Nord Stream 1 and proposed Nord Stream 2 gas pipelines


Source: The Economist

New Zealand cannot follow these countries in applying its own sanctions on Russia. New Zealand law only allows sanctions to be placed in line with the United Nations and any proposed UN sanction against Russia is certain to be vetoed by the country itself.

MFAT (EUR) are separately providing further advice to MFA on the measures that New Zealand could take in response to further Russian aggression against Ukraine, in particular any action that represents a clear violation of Ukraine's sovereignty or territorial integrity such as an invasion or military incursion.

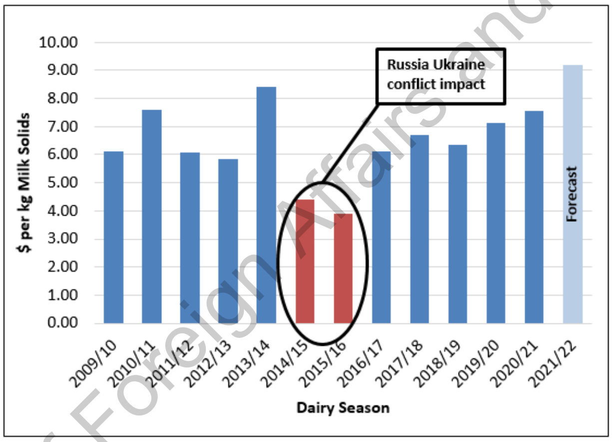
*The economic impact was significant last time for key New Zealand export sectors*

In March 2014 the annexation of Crimea by Russia caused significant volatility in international financial markets, with major negative impacts for key sectors of the New Zealand economy.

Dairy prices fell by more than 40% over the course of the year following Russia's decision to ban EU agriculture exports. The EU was (and remains) the world's largest dairy exporter, and at the time Russia was its largest market destination. This saw global dairy markets flooded with unsold product that contributed to a supply glut.

The consequent collapse in dairy commodity prices then filtered through to New Zealand farmers with the farm-gate pay-out collapsing over the course of the following two-seasons, causing financial strain across the sector that took years to recover from.

Fonterra Milk Price Payout




Source: Interest.co.nz

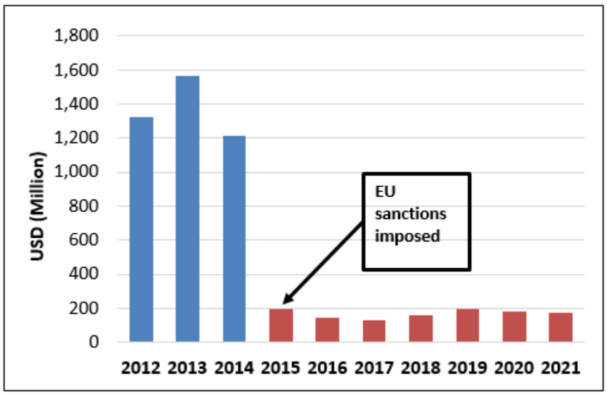
*New Zealand is less directly exposed this time*

Despite obvious similarities between the situation then and now, we do not expect to see a repeat of the financial impacts of 2014 on New Zealand's largest export industry in the coming months.

Global dairy markets are currently in a very different position compared to 2014. EU dairy exports to Russia have collapsed following the previous round of sanctions, so the amount of diverted surplus dairy commodities on to the market will not occur to the same extent this time around.

Critically, the 2014 conflict took place at a time when global dairy production was ramping up following good weather and when European production caps were being lifted. It also occurred at a time when demand out of China was slowing. The combination of these two factors was what drove dairy commodity prices dramatically lower.

EU Dairy Export Trade to Russia




Source: Global Trade Atlas

However the current dynamics of supply and demand for global dairy markets is very different. Global dairy supply is currently very tight. Poor weather in New Zealand has weakened production, with the season now 3.2% below the previous year. Similarly a combination of bad weather, high feed, and other key input costs such as fertiliser and fuel is constraining production in other key exporting countries such as the EU and US.

This is occurring at a time when demand, particularly out of China, is proving highly resilient (even in the face of exceptionally high dairy prices). Prices on the Global Dairy Trade Auction are currently 28% higher than a year ago, nearly 38% higher than their five year average, and at their highest level since 2014.

Nevertheless there will be some impacts should New Zealand's dairy trade need to divert to other markets. Total dairy exports to Russia were $168.9 million for the year ending June 2021. Of this total, butter represented $147.9 million, comprising 5.5% of New Zealand's total for this commodity - Russia was New Zealand's 4th largest butter destination in 2021. s6(a)

Looking beyond dairy markets, any sanctions on Russia itself are unlikely to have a major impact on New Zealand's other big export sectors either. New Zealand's exports to Russia have recovered since their crash in the aftermath of the tensions back in 2014, but it remains relatively insignificant as an NZ export partner.

Russia was New Zealand's 27th largest export trading partner in the year ending June 2021, with goods exports totalling $293 million (0.5% of New Zealand's total). Beyond dairy, the only export commodities of any significance were apples ($26.7 million), seafood ($22.4 million), wine ($15.2 million) and medical equipment ($15.2 million).

Prior to 2021, almost all imports from Russia were crude oil (well over 90%) and Russia was a moderately important source of crude oil imports (16% of New Zealand's crude imports in 2020). The planned closure of the Marsden Point oil refinery in April will mean that New Zealand will be switching to refined petroleum products from alternative markets anyway, of which currently Korea and Singapore are currently our largest. The last significant crude oil shipment from Russia was in January 2021.

Trade with Ukraine is negligible, with exports totalling $17.0m (mainly seafood and dairy) and imports of $25.4m (mainly sunflower seed oil and tobacco).

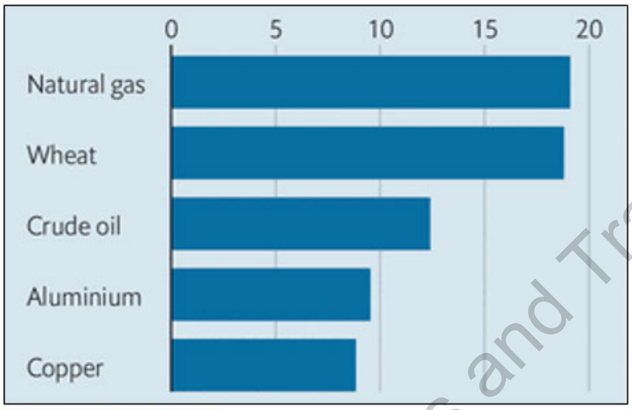
s6(a)

*<u>Nevertheless there could be significant indirect flow on effects for New Zealand</u>*

Although the low level of bilateral trade exposure means the direct impacts will be quite limited, this won't completely shelter New Zealand from the global market and economic pressures likely to emerge from any conflict. While the extent of both military conflict and sanctions are mostly unknowns for now, if they are severe (as indicated by the US and European leaders), they could have a serious impact on the world economy.

The potential for disruption stems from Russia's importance in key global commodity markets. Russia is the world's largest exporter of natural gas, and the second-largest exporter of oil. It supplies nearly a tenth of the world's aluminum and copper, and produces a range of other metals, including 43% of the world's palladium, a component of catalytic converters. It is also the world's largest exporter of wheat.

**Russia's Major Exports, 2020 (share of world total)**




Source: The Economist

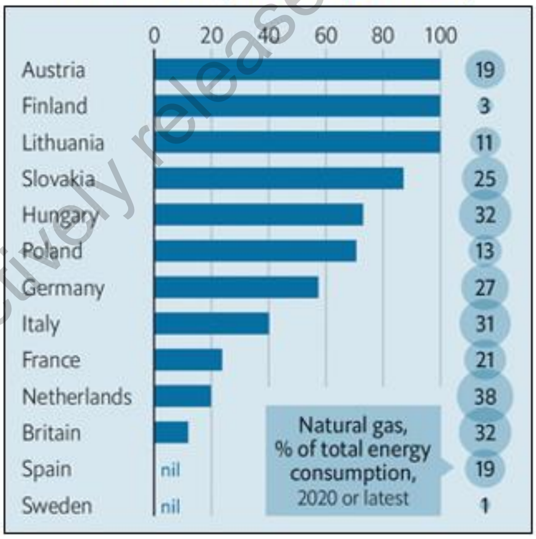
The worst-case scenario is that flows of these vital raw materials are disrupted as tensions escalate, or the payments infrastructure needed to facilitate them is hit by Western sanctions. Alternatively, Russia could itself decide to halt some exports (most likely gas flows to Europe) as a potential counter measure to Western sanctions.

The largest impact on New Zealand of any conflict would therefore be mainly indirect, through higher import fuel and commodity prices, instability of financial markets and the impact on global economic activity. The potential Russian action towards Ukraine is already creating significant anxiety which is testing global financial and commodity markets. In the event that an invasion of Ukraine by Russia is followed by tough sanctions, this would raise the price of a wide range of globally-traded commodities, particularly oil and wheat. The flow on financial effects could impact the value of the New Zealand dollar and place additional pressure on domestic inflation and the cost of living. It is these factors which could have the most significant flow on effects to the New Zealand economy.

*__Energy prices could rise, particularly for oil__*

With energy markets likely to be hit if tensions turn into conflict, the biggest effect on New Zealand is the likely significant movement in global oil prices. Oil and gas markets could be significantly affected by western sanctions, disruptions due the potential conflict itself or counter sanctions imposed by Russia itself.

**Selected European country gas imports from Russia (Percentage of total)**




Source: The Economist

**Primary Russian Oil and gas Pipelines to Europe**

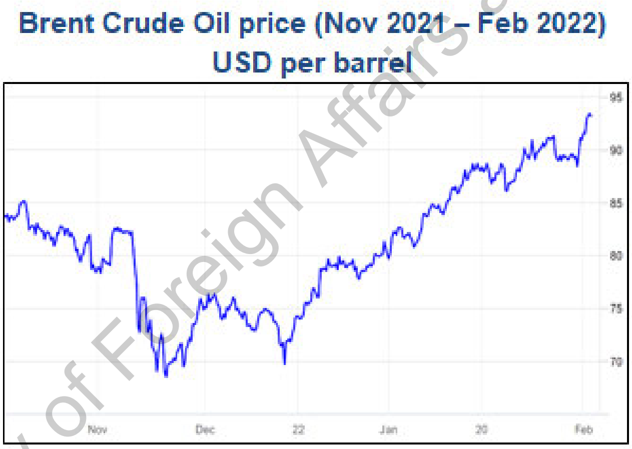

Source: Wikipedia

Russia's influence on the oil market is significant. It is the world's second-largest exporter of crude oil after Saudi Arabia, producing around 10% of global supply and is a key member of the OPEC+ alliance.

Ukraine moves Russian oil (11.9 million tonnes in 2021) to Slovakia, Hungary and the Czech Republic. In addition, about 35% of the EU's natural-gas imports come from Russia. These mostly come through pipelines which cross Belarus and Poland to Germany. Nord Stream 1 goes directly to Germany via the Baltic Sea, while others pass through Ukraine itself.

Any disruption to Russian gas flows would lead to higher natural gas prices, and would ultimately increase demand for heating oil in Europe. With spare capacity so low, the oil market is currently highly vulnerable to supply disruptions in the short term.

All this is occurring at a time when many members of OPEC and its allies (which include Russia) are struggling to meet their quotas for increased production, due to under investment and COVID-related complications. As a result, the fear of disruptions is a contributing factor toward rising prices. Brent crude oil has risen 8.8% since the beginning of December and at USD 93.35 per barrel is sitting at a seven-year high.



Source: Trading Economics

The impact of these higher energy prices are already flowing through to fuel costs for New Zealand consumers and businesses and could increase further.

The pivotal role of energy in the global economy will also mean that price rises will spill over to other markets too, further increasing global freight costs and the price of many other imported goods for New Zealand. For example, expensive power has already caused some aluminum smelters to close in Europe with the potential that increases in gas prices could cause further reductions in supply. As a result, Aluminum prices (of which Russia is a major player in the global market) have risen 15.6% since the beginning of December.

In addition, increasing gas prices could also hit fertiliser production on the European continent—for which gas is used as both raw material and fuel.

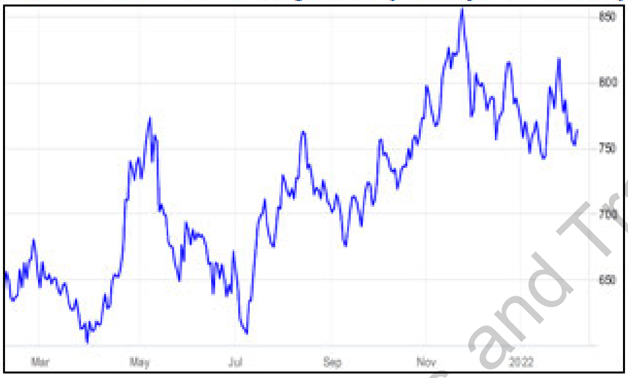
*Disruption to global wheat and grain markets could be significant*

The indirect impact of an invasion on global grain prices could be even more significant. Russia is the world's largest exporter of wheat, with Ukraine the fourth biggest. Ukraine is also the world's third largest exporter of corn. Together they export 28.6% of the world's wheat and 19.6% of corn, with a significant proportion of Ukrainian cultivation taking place in its eastern regions, which would potentially be the most exposed to any conflict.

The nearby Black Sea also serves as a major conduit for international grain shipments. If there is damage to port infrastructure or disruption to shipments then this could have long-lasting impacts that could stretch into future crop seasons. Any interruption to the flow of grain out of Russia and Ukraine is likely to have a major impact on prices because the demand for wheat is so inelastic.

This is occurring at a time when falling grain stocks in America and Europe and bad weather in South America is already placing upward pressure on prices. As a result, Chicago wheat futures are trading 19.0% higher than they were a year ago. In addition to gas, Russia is a big producer of urea and potash, important ingredients for fertilisers used in the production of these crops.

**Chicago Board of Trade Wheat Futures March 2021 – February 2022 (USD per Bushel)**




Source: Trading Economics

Any disruption or export sanctions on these commodities would put further upward pressure on global grain and cereal prices, although the impact may be difficult to predict and will depend on the timing and nature of any conflict. However when Russia annexed Crimea in 2014, concerns about the disruption of supplies from the Black Sea drove wheat prices up around 25% in two months.

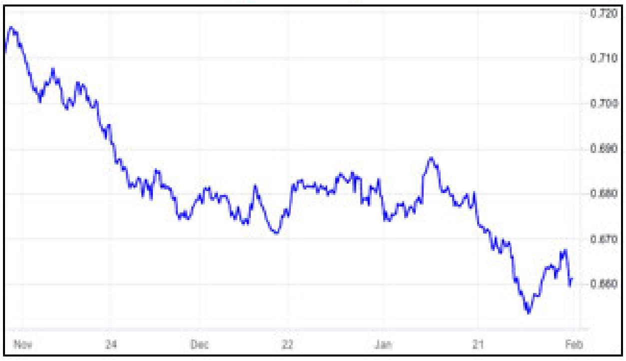
This has implications for New Zealand as a net importer of grains and cereals. New Zealand imported $328 million of cereals in the year ended June 2021, of which the majority was wheat and maize. Although a relatively small import commodity, rising imported grain prices would indirectly raise the price of farm feed for New Zealand farmers. While New Zealand sources its farm feed from other nations (mainly Australia and South East Asia), any pressure on prices in the global market would also up prices from these suppliers as well. New Zealand's largely pasture based dairy and meat production system will help New Zealand farmers fare better than our overseas grain-fed competitors.

As a staple food product in many developing countries, rising wheat prices could exacerbate food insecurity in many regions, with potential implications for stability in those countries.

*__The New Zealand dollar may weaken as investors move to safe haven currencies__*

The threat of war has already spilled over into developed markets, seeing a big fall in risk appetite in international financial markets. A conflict would likely further impact market confidence, with investors likely to respond by continuing a retreat to more "safe-haven assets" such as the US dollar, the Swiss franc, and the Japanese yen.

**NZD / USD Exchange Rate (Nov 2021 – Feb 2022**




Source: Trading Economics

These safe haven currencies have outperformed in recent weeks, with the New Zealand Dollar weakening against the US Dollar. Although much of that will have been driven by signals for monetary policy tightening by the US Federal Reserve.

A weakening New Zealand dollar will boost the competitiveness of New Zealand's exports. However it will also increase the price of imported goods, pressuring profit margins for domestic businesses, and further fuelling domestic inflation.

*Proposed sanctions for an extended period would weigh on global growth*

As a small export-focused nation, perhaps the biggest medium term impact to New Zealand's economy may come from any consequent dampening in economic growth across the world economy.

The sanctions proposed by Western leaders could hit the Russian economy hard. However this effect alone will have little impact on global growth. The size of the country's economy is negligible, accounting for about 1.7% of the world's gross domestic product. For sanctions to be effective and reach the level of severity on the Russian economy indicated by the US and European allies, they will need to demonstrate unity and be willing to shoulder some self-inflicted economic pain themselves.

This could happen if the two main tools mentioned by Western governments so far are used: boycott of Russian gas flowing to Europe, with the Nord Stream 2 pipeline being postponed indefinitely; and removing Russia from the SWIFT messaging network used by banks for international money transfers. However, the use of these two economic weapons is not currently supported unanimously by Western governments, and for now, government officials have refrained from indicating that they will go ahead.

Cutting off Russia would hurt many European countries, particularly Germany, which has significant trade with Moscow. Russia is the EU's fifth largest trading partner with exports of USD 89.6 billion in the year ended December 2020 and imports of USD 98.6 billion.

In particular the pivotal role of energy in the global economy means any inevitable price rises will spill over to other markets and act as a drag on global economic growth. Global inflation which was expected to peak and decline later this year will be further pressured by these higher energy prices. In the context of tight household purchasing power, that could lower global recovery prospects, including that of many (if not all) of New Zealand's key trading partners.

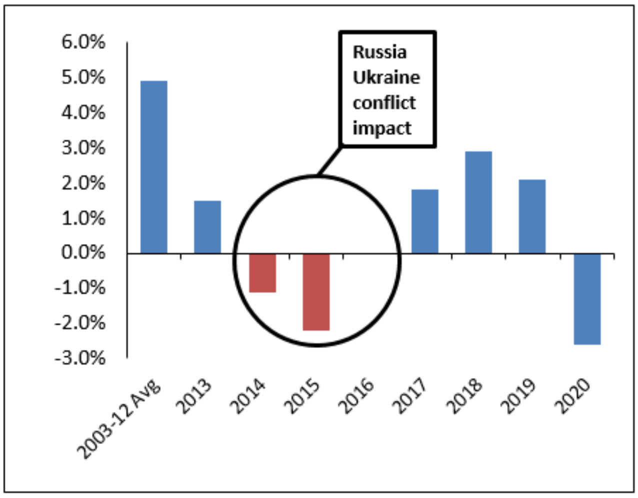
*The Russian economy may be better placed to withstand sanctions this time around*

The impact that the conflict and any sanctions have on global markets will also be dependent on the period of time over which Russia has the ability to withstand the economic cost.

Sanctions imposed after the annexation of Crimea and the beginning of the Ukrainian conflict in 2014 acted as a significant drag on Russia's economic growth in subsequent years. However, the Russian economy is now in a significantly better shape than it was in 2014.

In 2014, Russia had little foreign currency reserves and a big foreign debt. Since then Russia has built a significant cushion of reserves and has cut down its exposure to foreign creditors. Therefore, although insulating its economy fully will be impossible, the economic consequences of war may be survivable for Russia, at least in the short term. At 19.3% of GDP, Russia now has very low levels of Government debt by international standards,

**Russia real GDP (annual percentage change)**




Source: International Monetary Fund

with the share in dollars falling steadily in recent years, currently sitting at 16%. In addition, only a fifth of Russia's sovereign bonds are held by foreigners. Critically, according to the Russian central bank, its foreign cash reserves are currently USD 634.1 billion, representing a USD44.1 billion increase over the past year.

Expelling Russia from the SWIFT system could be potentially damaging however, particularly in the short term, as it would restrict its ability to execute its international financial transactions. For the nation, this could potentially trigger currency volatility and possibly cause large capital outflows. In recent years, Russia has developed a financial messaging system of its own to try to emulate SWIFT which could mitigate some of these effects. However it is highly unlikely to insulate the financial system effectively, as it is still a marginal system mostly used only by Russian banks.



View full list of market reports from MFAT at www.mfat.govt.nz/market-reports