HOW THE RUSSIAN INVASION OF UKRAINE WILL AFFECT EXPORTS TO THE UK AND THE EU

NEW ZEALAND FOREIGN AFFAIRS & TRADE
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Market Report

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Summary

In general, New Zealand exporters to the United Kingdom (UK) and European Union (EU) are not directly impacted by Russia's invasion of Ukraine, but are indirectly impacted by:

- highly changeable markets and trade patterns, including the magnified impact on inflation
- further disruptions in international transport and supply chains on top of existing, COVID-19 related supply chain disruption, and
- higher input costs (energy, fuel, animal feed and fertiliser).

The Europe network reiterates its recommendations that exporters to the UK and the EU:

- Closely monitor regulatory, policy and market developments, particularly with regard to subsidies and sanctions
- Anticipate rising transport and input costs
- Invest in long-term, trusted relationships with freight forwarding partners
- Build up greater inventory levels in market
- Future proof costs and consider long-term worse cases scenario contingency planning.

Report

We report on the current and anticipated impact of Russia's unjustified and illegal invasion of Ukraine on New Zealand's exports to the UK and EU. This builds upon recent Market Intelligence Reports on the impact of COVID on supply chains to the UK and the EU, the impact of the invasion on New Zealand's economy and the impact on the German economy.

UK and EU imports of fuel, grains, oils and fertilisers from Ukraine and Russia have been affected

- The top exports from Russia and Ukraine to the UK and the EU are fuel (crude oil, petrol, gas and coal), wheat, maize, canola oil, sunflower oil, and fertiliser.
- The supply of some of these essential inputs has suddenly stopped or decreased, which affects their overall price levels and leaves Europe and the UK's agricultural sectors in a precarious predicament (as has been much reported, these same cost increases will also affect inputs for New Zealand's agricultural sector). European and British producers and businesses are struggling, which in turn could have flow on consequences for general trade

in the region.

- The invasion comes during the vital spring planting season, and with this being hindered alongside sanctions, there is likely to be a further reduction in supply to the UK and the EU for these fuels, grains, vegetable oils and animal feeds in 2022, resulting in higher prices. In many cases this increase is already being felt due to panic buying.

- The trade volumes with Eastern and Central Europe, and therefore the risk of shortages and price increases, are higher than for Western Europe and the UK. A third of Europe's gas, and 13% of the UK's gas, is imported from Russia. On the whole, however, Russia accounts for just 1.5 percent of the UK's imports and 0.7% of UK exports.

Concerns about food security are resulting in subsidies, which could distort markets and affect the price competitiveness of New Zealand exports

- There are also real concerns about food security within the UK and the EU, within a wider context of an already high and rising cost of living.

- The European Commission has urged EU Member States to avoid imposing export restrictions on essential foodstuffs, following Hungary's decision in early March to ban all grain exports.

- The European Commission has also released a communication on support measures for EU farming to help offset rising input prices (fertiliser, animal feed, energy) and to help facilitate greater production of protein crops to partially offset reduced imports from Ukraine and Russia. The measures include €500 million (NZ$800 million) of emergency funding for farmers plus an extra €1.5 billion (NZ$2.4 billion) in co-financing.

- The impact of subsidies will be different in each market. In France, for example, the government has announced a €400 million (NZ$630 million) support package for livestock farmers to cope with the soaring cost of animal feed, initially for a four month transitional period, which may affect prices in the French market for beef, lamb, and dairy products.

- These agricultural subsidies are fairly limited compared to overall agricultural subsidies, the size of the sector and the additional cost the sector is facing. However, if the subsidy packages are expanded, they could affect the supply and demand, and subsequently prices, for dairy and meat within the EU and global markets, which could reduce the price competitiveness of New Zealand's exports.

Reduced supply of grains, fuel and oil will amplify inflation, and cautious household spending could decrease demand for New Zealand exports

- Aside from honey, which the EU imports from both Ukraine and New Zealand, there is little overlap between the key goods that the UK and EU import from Russia and Ukraine, and the key goods imported from New Zealand (meat, wine, dairy and fruit). Therefore the reduced supply of Russia and Ukraine's exports is unlikely to directly cause increased demand for New Zealand's exports.

- Instead, as many of the goods traditionally imported from Russia and Ukraine are essential foodstuffs, we anticipate that the higher prices will worsen inflation and the cost of living in the UK and the EU.

- Given many of New Zealand's food and beverage exports tend to be non-essential or higher value foodstuffs, we may see a decrease in demand, as people in the UK and the EU seek to balance their food budgets by foregoing premium products or substituting for lower value alternatives.

- Additionally, analysts anticipate that firms and households in the UK and the EU, fearful of the worst-case scenario, will delay investment and consumption decisions, holding back the wider pandemic recovery and potentially affecting other New Zealand exports outside of the food and beverage sector.

- However, these impacts could be softened by the weakening New Zealand dollar against the euro and the pound, which could increase the price competitiveness of New Zealand's exports; and moderated by the fact that higher income households (which are the primary consumers of New Zealand's exports) look to be less affected by the cost of living increases.

Supply chain and logistical challenges were already prominent for exporters to the UK and EU

- The illegal invasion occurs at a time of unprecedented supply chain disruption the UK and the EU due to COVID-19. Prior to the invasion, containers had become increasingly scarce, costly and delayed (particularly chilled storage containers such as those used by the meat industry), and freight companies had been finding it harder to employ truck drivers and port workers. MFAT has previously reported on the impact of COVID-19 on supply chains in Europe and the United Kingdom.

- Exporters have reported that many of the logistical issues they are experiencing in the wake of Russia's invasion of Ukraine are a continuation or worsening of the supply chain issues that they were already dealing with over the course of the COVID-19 pandemic, rather than necessarily something new.

- When asked about the impact of Ukraine on supply chains and logistics to Europe and the UK, members of the freight forwarding industry have told us that "the problem is seeing the wood for the trees. There are already significant issues facing exporters in terms of capacity and scheduling… it's hard to identify any Ukraine-specific issues."

Most New Zealand exports to the UK and the EU do not pass through the freight routes that have been most directly affected

- The invasion has affected commercial shipping through the Black Sea, the Sea of Azov and the Baltic Sea due to the closure of ports and redirection of ships. Air and train cargo between Europe and North Asia have also been disrupted due to sanctions and an aversion to travelling through Russian and Ukrainian airspace and territory, and sanctions on major Russian providers.

- New Zealand's exports to the UK and the EU do not generally go through any of these routes. New Zealand's exports via air cargo do not generally cross Russian or Ukrainian airspace. The China-Europe train route mostly serves e-commerce sales from platforms such as Amazon, Wish and Alibaba, so it is unlikely that many New Zealand exports would be affected by disruption to that route. Instead, New Zealand's exports primarily enter Europe through ports in Germany (Hamburg), Belgium (Antwerp) or the Netherlands (Rotterdam).

However, disruptions to these routes will have flow-on effects for exports to the UK and the EU

- Despite most New Zealand exports to the UK and the EU not passing directly through the most disrupted trade routes, disruptions to these routes have had flow-on effects to ports across Europe due to the interconnected nature of global and regional freight. The New Zealand Embassy in Berlin has reported that shipping schedules at ports such as Hamburg have experienced flow-on disruptions (although the Port of Hamburg has reported that the invasion and sanctions have not impaired business activity significantly). Reduced train cargo capacity from North Asia to Europe will put pressure on the capacity of shipping from North Asia to Europe, which is linked to some of New Zealand's export supply chains.

- Industry associations have identified a risk that containers get stuck in Russia or the Ukraine, facing regulatory, safety or economic impediments to leaving, and thereby reducing the global availability of containers. So far, we are only aware of one such case: a Cosco ship in Odessa. Many shipping companies, Mainfreight included, have withdrawn from Russia and Ukraine.

The enforcement of sanctions against Russia are causing disruption at some ports

- The UK and the EU have both imposed steep import tariffs on luxury goods from Russia, and banned the export of luxury goods, iron and steel to Russia. They have also imposed sanctions against a range of companies whose products are used by the Russian military but could also be used in supply chains, including those in the aviation, shipbuilding and machine building sectors.

- New Zealand has announced trade sanctions with effect from 25 April, including 35% tariffs to all imports from Russia, and extension of existing export prohibitions to industrial products closely connected to strategic Russian industries. This is New Zealand's most significant economic response to the Russian invasion to date

- EU customs authorities (especially in the Netherlands, but also Belgium and Germany) have dedicated significant resources to inspecting freight to determine whether it is in breach of sanctions, including both freight that was shipped before the sanctions were imposed, and freight deliberately in breach of sanctions and attempting to avoid detection. When sanctions first came into effect in the Netherlands, over 6000 containers needed to be pulled out and inspected. These inspections cause delays not only to the containers being inspected, but to the wider port as the movement of the inspected containers disrupts other container movements. We anticipate the same disruptions may be occurring for air freight, though so far we have no evidence of this affecting New Zealand exports.

- Customs authorities in the UK and the EU may also begin to pay more attention to addressing exporters' efforts to circumvent the sanctions by trading with Russia via China and India. This could mean that authorities more closely inspect containers travelling to and from these countries. New Zealand exporters may want to pay attention to the routing of vessels they are using, especially if they are trans-shipping through China (Guangzhou).

Higher fuel prices, labour shortages, the increased Suez Canal tariff and shortages of transport industry inputs will combine to push up shipping and freight costs

- New Zealand exporters are preparing for higher shipping costs as a result of limited capacity and inflation of fuel prices. Contacts are not expecting the shortage in shipping capacity (and therefore cost) to be rectified any time soon, not least because even while new vessels are being constructed, older ones are being retired out of service. Freight forwarders have told us that the cost of airfreight from Europe is increasing steeply and that they expect Bunker Adjustment Factors (BAFs, a surcharge levied on ship operators to compensate for fluctuations in fuel prices) to "skyrocket" shortly.

- Mainfreight has called attention to a shortage of drivers looming in the road transport sector across Europe, which will result in reduced capacity in the transport industry in the coming weeks. Many companies in Central and Eastern Europe employ Ukrainian drivers who are currently being called up for military operation; and an estimated 12,000 drivers are unable to leave Ukraine. Reservists are also being called up in the countries on the EU's eastern border.

- Egypt has announced an increase on tariffs on ships transiting the Suez Canal by up to 10%, commencing 1 May 2022, which will further increase shipping costs.

- Analysts have identified that further disruption could occur due to global dependence on Russian production of goods essential to supply chains. For example, in 2020 Russia produced 43 percent of the world's palladium, an essential component of catalytic converters in cars. Disruption in the trade of this and other metals could lead to price rises in the aerospace and automotive industries, further exacerbating supply chain problems.

- Given the disruptions, rising costs and ongoing uncertainty, re-shoring (shortening supply chains and bringing parts of the supply chain process back to nearer markets) may become more attractive for some markets. This could have implications for export opportunities for New Zealand businesses.

Export industry representatives are particularly concerned about higher input costs to produce their exports

- New Zealand's agricultural exporters have expressed particular concern over higher input costs for farmers due to the shortage of fertiliser and animal feed. Prior to the Russian invasion of Ukraine fertiliser prices were already very high. Exporters reported that Russia is a major source of finished fertilisers and fertiliser raw materials, so the conflict will put more pressure on supply and prices, particularly as China (which is another large fertiliser exporter) started limiting its fertiliser exports in late 2021.

- Russia and Ukraine are also two of the major global exporters of wheat, and are also large exporters of corn (Ukraine), rapeseed (Ukraine) and sunflower seeds (Ukraine and Russia), so the conflict will likely increase global feed prices. While the sheep and beef sector are primarily grass-fed, the dairy sector is a larger user of grain feed. Although New Zealand only imports small amounts of grains and cereals from Russia and Ukraine, there has already been a significant increase in global feed and grain prices which will have an impact on New Zealand's dairy sector.

Implications for New Zealand exporters going forward

- In this context, we provide the following recommendations for exporters to the UK and the EU to best position themselves in the current environment, reiterating previous conclusions:

    - Closely monitor regulatory, policy and market developments

- Anticipate higher transport and other input costs for the foreseeable future. Exporters with a ‘lower-value’ business model are going to experience more challenges trading into the UK and the EU, and the long distances will continue to be a significant factor.

- Invest in longer-term, trusted relationships with freight forwarding partners, be aware of their capabilities, and diversify relationships where possible, instead of focusing solely on comparative cost. Where appropriate, exporters should engage with their supply chain partners on developments in order to proactively identify and address issues across the chain.

- Together with their importers/customers, consider building up and holding greater inventory levels in market to accommodate challenges with shipping scheduling.

- Exporters and freight forward partners should undertake to do due diligence which provides assurance that they are not exporting, either directly or indirectly (through intermediaries) prohibited goods or to prohibited entities.

- Our analysis throughout this report is based upon the current state of play. Labelled by some as a “black swan event”, the final consequences of Russia’s aggression towards Ukraine is not yet clear. Some analysts consider that if the UK, EU or Russia decide to completely stop energy flows, parts of the EU will face a recession potentially worse than that of 2020, and large parts of European industry will come to a standstill.

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