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Russia decides to invade Ukraine

As we approach a week since Russia moved towards full-scale military escalation in Ukraine, global financial markets have been responding rapidly to the news. As expected, major energy commodity prices such as Oil and LNG have increased. This brief note provides a summary of what the impact has been on global markets in the first 7 days of this escalation, and discussed the **transmission effects** that this escalation ***may*** have on the PNG economy in the short to medium term, particularly ***imported inflation pressures***.

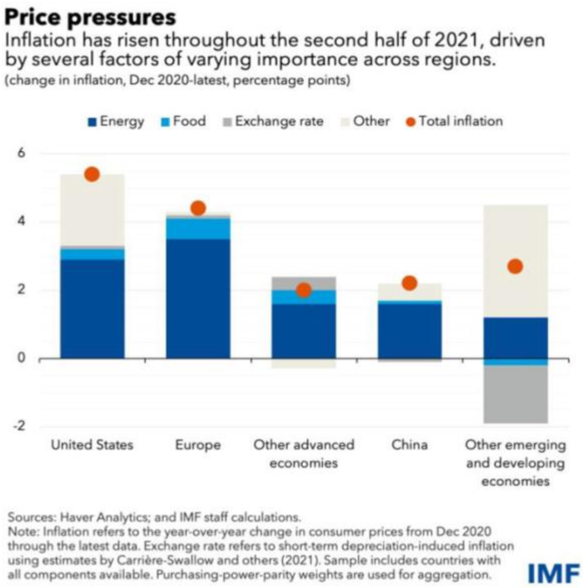
Natural Resources and Commodities

Both Russia and Ukraine are major producers of **energy, precious metals, fertilisers** and **agriculture** products. Their respective share of global production for these ***key production inputs*** will cause **global inflationary pressures**

- Russia is responsible for **11% of global** oil production
- Russia makes up **16% of natural gas production** globally
- Russia is a major global supplier of **Precious Metals**, including Palladium (35%) and **Platinum (9%)**, which are used to produce catalytic converters for cars
- **Ukraine** produces a quarter of the world's **neon gas**, which together with metal palladium is used to manufacture semiconductors
- Russia makes up 6% of the world's **aluminium** and **7% of global nickel mine supplies**
- Both Russia and Ukraine provide a **third of the global wheat exports, 20% of corn trade** and almost **80% of sunflower oil production**

Global inflation

Global inflation has been very stubborn over the past 12 months, recovering from the aftermath of the impact of COVID-19 in 2020. According to the IMF, continuing **supply chain disruptions, clogged ports, logistics strains** and **pent-up demand** mean inflation is more 'persistent' and 'broad-based' than was initially expected. Prior to the Russian invasion, price gains this year were forecast to average **3.9% in advanced economies** and **5.9% in emerging market and developing economies**, according to the IMF January World Economic Outlook update.



What could this mean for PNG?

PNG is a global price-taker for its major exports, particularly for both Oil and LNG. The global supply-shock has meant that global prices for these commodities have sharply risen. **LNG** is projected to account for 37% of total PNG exports in 2022, with a forecasted price of **US$9.8 per MMBTU.** This price assumption is linked to the Asian LNG market price benchmark given PNG's primary export market for LNG is Asia, using the Japanese Customs-cleared Crude (JSS) price, which is linked to the price of Crude Oil.

The 2022 budget forecasted crude oil at **US$64 per barrel**. Following last week Thursday's announcement by President Putin to escalate military activity, crude had already peaked at US$105 per barrel, closing the week at **US$99 per barrel**, while the LNG JCC was up 51% in the week, trading at US$37 per MMBTU to close last week.

Outlook

Stronger Government Revenues

- Stronger global prices for Oil and LNG, will mean more revenues for Government
- Greater revenues can also support the Government's fiscal plans, which have been hampered in previous years due to lower revenue earnings
- This could theoretically mean that the Government will not rely too heavily on **domestic borrowing**, if the revenues can help with the budget deficit

Inflation

- The higher global commodity prices also means higher cost of goods being imported. **Import inflation** was a planned risk this year – now the risk factor has grown substantially in light of global events and the likelihood of global inflation transmitting into the domestic economy
- Treasury had initially forecasted a **5.6% rate of inflation in 2022**. However, with the revised pricing in major commodity exports and production input costs, we anticipate that inflation may be higher than originally planned

Global Markets

- Many analysts had penned 2022 to be an year for correction following the recovery in 2021. However, inflationary pressures and the added sensitivity of geopolitical risks mean the short-term will need careful navigation, with trepidation as global markets and investors understand the full extent of the crisis and its impact, particularly on energy commodities
- Given the risk in commodities and the U.S Fed's stance on inflation, we anticipate that the proposed plan to hike US interest rates will continue to drive market sentiment in the near term

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Sources: 2022 National Budget; Bloomberg; International Monetary Fund (IMF) World Economic Outlook; Reuters

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