Box 1
Russia's Invasion of Ukraine: Reflections on the International Economic Context

Russia's invasion of Ukraine is a conflict that has had repercussions on a global scale. Russia's attacks have created a humanitarian crisis in Ukraine as well as destruction of infrastructure and major disruptions in its economy. In response to the above, several of the world's major economies (the United States, the European Union, and the United Kingdom, etc.) have imposed severe economic sanctions on Russia. These have been centered on limiting transactions and freezing foreign assets of several banks and individuals, including the exclusion of specific banks from the Swift international payment system. In addition, access to a portion of the foreign reserves of the Russian central bank was restricted, transactions in the foreign debt market and access to the international capital market were affected, and foreign trade and investments in that country were also restricted. At the same time, the certification of the NS2 pipeline that would bring more gas from Russia to Europe was suspended and importing Russian crude oil into the United States and United Kingdom was banned in addition to other sanctions.[1] These measures have strongly impacted Russia's economy and its outlook.[2] The conflict in Ukraine is taking place in the midst of a global environment in which there is uncertainty with regard to the course of the pandemic and persistent disruptions in global supply chains, supply constraints, and strong inflationary pressure in a significant group of economies.

According to several international organizations and entities (IMF, 2022; ECB, 2022; OECD, 2022), this conflict could generate additional inflationary pressure and affect the international economic growth through several channels: 1) price increases and supply restrictions for various raw materials including crude oil, natural gas, coal, fertilizers, and various agricultural products due to Russia's role as a main exporter of these products and Ukraine's as an exporter of various food items and other raw materials; 2) increased global uncertainty, reduced investor confidence, and deterioration of international financial conditions; and 3) the effects on countries with which Russia and Ukraine have strong trade and financial ties. Furthermore, there may be a negative impact on trade and supply chains as well as a refugee crisis, etc. in the region where this conflict broke out (IMF, 2022). The Organization for Economic Cooperation and Development (OECD, 2022), in particular, notes that, compared to what was forecast before the invasion of the Ukraine, global growth could be 1.1 percentage points (pp)[3] lower and global inflation 2.5 pp higher over the twelve months starting with February 24, 2022. The impact would be different on regions and countries depending on their exposure to the conflict through the aforementioned channels. Likewise, there could be long-term consequences associated with the reconfiguration of international trade and supply chains, fragmentation of international payment systems, and rearrangement of foreign reserves, etc. (IMF, 2022; OECD, 2022). Note that these analyses are recent and great uncertainty remains with respect to the duration and escalation of this war (IIF, 2022b) as well as to the magnitude of its impact (ECB, 2022).[4] With the above in mind, this box describes the importance of Russia and Ukraine in terms of worldwide exports of raw materials and the recent fluctuation of international prices for some of these goods. It also describes Colombia's trade with these two countries. In addition, an analysis of the recent changes in the international financial markets and of some of the impact on capital flows to Colombia is given.

1. Foreign trade and prices of raw materials

Although Russia and Ukraine account for a relatively small share of the global GDP,[5] these countries are major players in the production and export of commodities to foreign markets. First of all, both are food exporters. Russia was a major exporter of wheat and barley in 2020 while Ukraine held a relevant share in the global foreign sales of sunflower oil, corn, barley, and wheat, etc. (Graph B1.1 and B1.2). Moreover, Russia is the world's leading supplier of some fertilizers. The country also plays a prominent role in the worldwide trade of mining and energy products, specifically petroleum and its derivatives, coal and natural gas, and others such as platinum, titanium, aluminum, and copper, which are some of the most notable. Ukraine, in turn, is a major exporter of iron products and oil derivatives. Thus, the impact of the invasion of Ukraine and the sanctions on Russia are likely to affect the production forecast of these raw materials. This has been reflected in rises in the international prices of these commodities. In fact, the average price between the start of January and 18 March 2022 for crude oil (Brent), coal, European natural gas, and

1 See IIF (2022a), Goldman Sachs (2022), Nolsoe, E. and Pop, V. (2022) and the White House (2022).

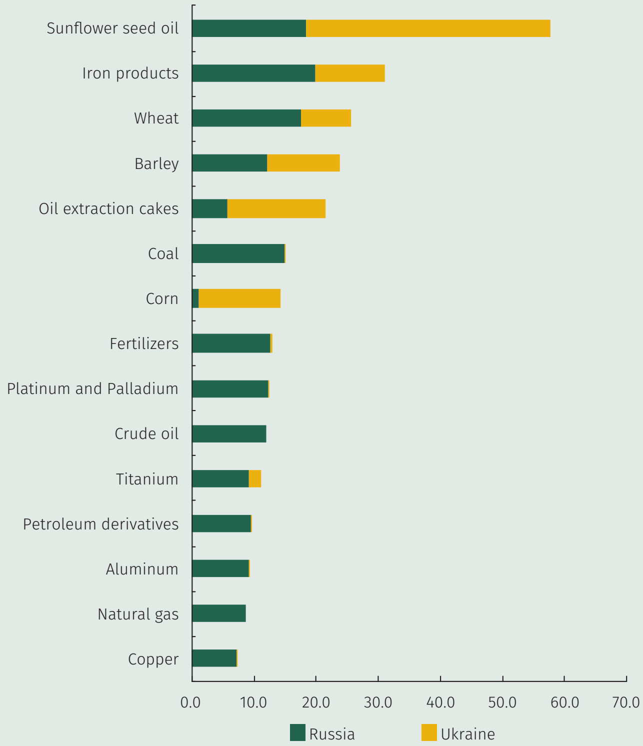
2 In Russia, the currency was significantly devalued, the risk measures increased, the credit rating was downgraded, the stock market plunged and was closed, and the financial markets remain under high stress. In addition, the OECD (2022) forecasts a sharp contraction in GDP and significant increases in inflation in that country.

3 Based on OECD simulations, the economic growth will probably be 1.4 pp lower for the Euro area, 0.9 pp for the United States, and 1 pp for the OECD country average.

4 The European Central Bank reduced the growth forecast for 2022 in the Euro zone from 4.2% to 3.7% in its March publication on macroeconomic projections. However, they point out that a scenario of greater disruptions in energy prices, trade, and confidence associated with the war could reduce the growth to 2.3%.

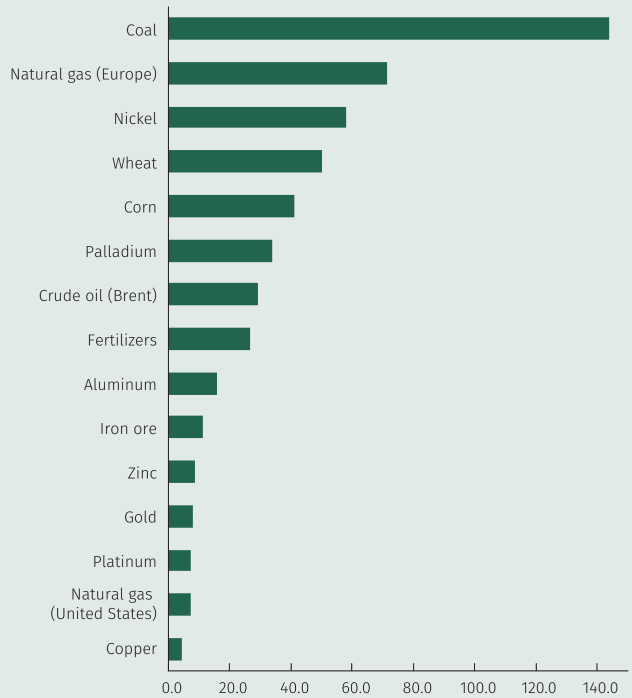
5 According to OECD (2022), these two countries together account for about 2.0% of the global GDP at current market prices.

Graph B1.1
Commodity Exports from Russia and Ukraine [a/]
(percentage of world exports, 2020)



a/ Aggregate data based on 4-digit HTS. Fertilizers correspond to the world total.
Source: TradeMap with Comtrade information.

Graph B1.2
Raw Material Prices[a/]
(percentage, difference between average price in January and the one through March 2022)



a/ The percentage change between the average price for January and the one for the period from March 1 to March 18 is shown. For fertilizers, the North American fertilizer price index from Green Markets is used.
Source: Bloomberg.

the international metals index rose 29.4%, 144.1%, 71.4%, and 13.1% respectively. During this same period, corn and wheat prices rose 41.3% and 50.2% respectively.

Despite the fact that Russia and Ukraine are important players in the global export of raw materials, Colombia's direct trade links with these countries are of low significance. In fact, Colombian exports to Russia and Ukraine in 2021 accounted for only 0.4% of the country's total sales abroad while imports from those countries reached 1.2% of the value imported by Colombia. However, the Russian market is relevant in the case of some products. For example, Russia buys 25% of the total value of meat exports[6] and 17% of dairy products. Likewise, Colombia's fertilizer imports mostly (22%) come from Russia when compared to purchases from the United States (16%) and China (12%).

Although Colombia's direct trade links with Russia and Ukraine are not very strong, the global impact of this conflict on the prices of various raw materials could have an impact on the foreign performance of the Colombian economy. For one thing, the higher prices registered and expected for oil and its derivatives, coal, gold, and nickel are likely to favor the value of Colombian exports of these goods in dollars. These goods together accounted for about 55% of the total foreign sales in 2021. This positive effect on the balance of trade and the terms of trade is likely to be limited because the country also makes purchases abroad of raw materials and is a net importer of agricultural products such as corn, wheat, and barley, and agricultural supplies such as fertilizers and some animal food items. Therefore, the aforementioned increase in the prices of these goods would make imports necessary for domestic production more expensive and threaten to increase inflationary pressure in the country.

2. International Financial Markets

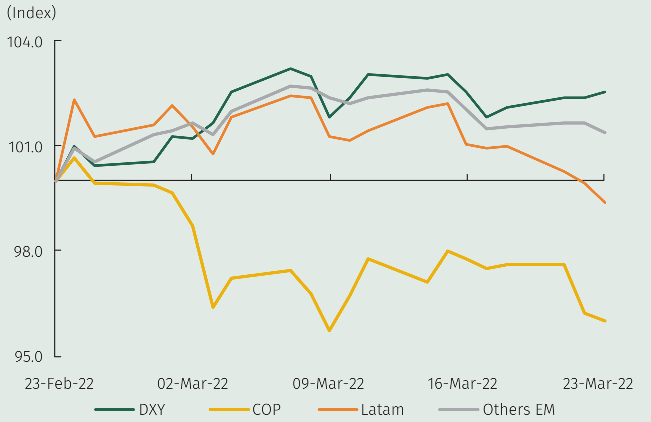
After the beginning of the war between Russia and Ukraine (February 24th), the indicators of the international perception of risk rose significantly as a result of the high uncertainty related to the duration of the conflict and its economic consequences.[7] In this context, the U.S. dollar strengthened against most of the currencies in developed and emerging economies while the stock market indices showed a sharp deterioration in these countries (Graph B1.3). Interest rates in advanced economies, in turn, initially corrected downward as a result of the increased demand for safe-haven assets and fears of an economic slowdown thus leading to a moderation in expectations of a less expansionary monetary policy path.[8] In contrast, in the

6 These exports correspond to deboned beef that is either fresh, refrigerated or frozen.

7 The Vix (implied volatility of three-month S&P 500 options) rose to a level not seen since January 2021. The Vstoxx (implied volatility of three-month options on the Euro Stoxx 50), in turn, reached a level not seen since the beginning of the Covid-19 pandemic.

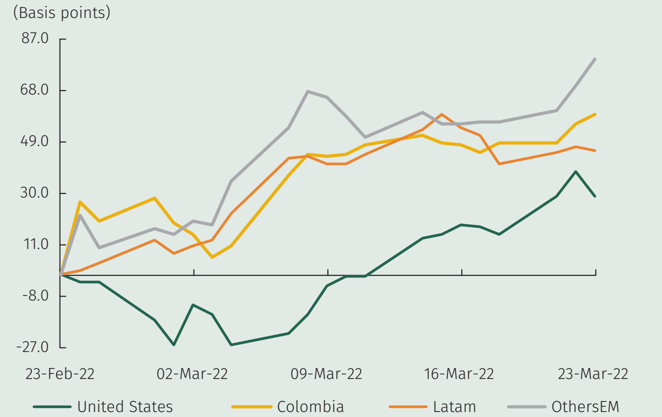
8 While, on 23 February 2022, the futures market was pricing in more than six rate hikes (of 25 bp each) by the Federal Reserve during 2022, the market expectation had declined by 01 March to just a little more than four increases. Likewise, in the case of the European Central Bank, the expectation that interest rates would rise in 2022 as implied by the futures market went from 60 bp to 30 bp between 23 February and 01 March.

Graph B1.3
Exchange Rate Performance after Beginning of Russia-Ukraine War[a/]



Note: Latam corresponds to the average performance of the exchange rates of Brazil, Mexico, Chile, and Peru.
a/ Base 100 = February 23, 2022. An increase indicates a depreciation against the dollar. The DXY is composed of a basket of six currencies of developed countries.
Source: Bloomberg.

Graph B1.4
Performance of 10-year Sovereign Bond Rates After the Beginning of Russia and Ukraine War[a/]



Note: Latam corresponds to the average performance of the 10-year sovereign bond rates of Brazil, Mexico, Chile, and Peru.
a/ Changes (bp) in rates since February 23, 2022 are presented.
Source: Bloomberg.

case of emerging economies, the interest rates rose due to greater risk aversion[9] (Graph B1.4).

As mentioned above, prices for raw materials showed rapid and significant rises starting on 02 March, and this led to a rise in expectations regarding global inflation. This, in turn, resulted in expectations of a less expansionary monetary policy path, in contrast to what was seen during the first days of the war. In this scenario, interest rates resumed their upward trend in developed countries and reached levels above those registered prior to the beginning of the conflict. In the case of emerging countries, the rates continued to rise. The Federal Reserve raised the federal funds rate 25 bp on 16 March in line with market expectations, but below the 50 bp priced in by some market participants prior to the start of the war.[10]

In Latin America, even though interest rates have followed the global trends, most stock market indices have shown a relatively positive performance throughout the entire period in contrast to what has taken place in other emerging markets. Likewise, some currencies in the region have appreciated against the dollar and, those that have depreciated, have done so to a lesser extent than in other emerging countries.[11] This could be the result, in part, of higher raw materials prices and the region's commercial remoteness from the war area which has induced the rebalancing of portfolios towards Latin America.[12]

Since the invasion of Ukraine began, the Colombian peso has appreciated 4.0% (as of 23 March). Aside from the increases in crude oil prices, the behavior of the currency has been sustained by the expectation of inflows of dollars resulting from the announcement of new takeover bids for Grupo Sura and Nutresa and the offer of dollars in the derivatives market by foreign investors.

In view of the geopolitical conflict between Ukraine and Russia, the Colombian public debt and stock market performance has been similar to those of the region. It is noteworthy, in particular, that investors whose portfolios follow investment indices in emerging markets' fixed income securities and stock market shares realized that Russia could lose its share in these investments given the current conditions of the Russian market and the deteriorated accessibility to it. This situation led to the sale of Russian securities, and this generated strong devaluations and the significant reduction of their share in these indices. In the case of the JP Morgan's GBI-EM Global Diversified Index, which has the largest amount of assets under management[13] (USD 221 billion) within its emerging bonds indices denominated in local currency, Russia's share went

9 Between 23 February and 03 March, ten-year rates declined 15 bp on average in the United States, Germany, the United Kingdom, and Japan, and rose 12 bp in Latin America and 19 bp in other emerging economies. Russia, in turn, showed an increase of 300 bp.

10 Although the war had an impact on monetary policy expectations - which declined after the beginning of the conflict and did not return to previous levels as of the March meeting - there has been a rapid recovery in monetary policy expectations for the next meetings. These have even surpassed the levels predicted by the market prior to the beginning of the conflict. For example, on 23 February, the Fed was expected to raise rates more than six times during 2022 while as of 23 March, more than eight hikes (by 25 bp each) were expected.

11 Between 23 February and 23 March, the Colombian peso appreciated 4.0%, followed by the Brazilian real (3.6%) and the Mexican peso (0.1%). The Peruvian sol, in turn, depreciated 0.9% and the Chilean peso depreciated 0.4% while the MSCI EM index showed a depreciation of 1.4% in its basket of emerging currencies.

12 Five-year CDS declined 27 bp in Colombia, 10 bp in Peru, 9 bp in Brazil, and 7 bp in Mexico and Chile between 23 February and 23 March. In contrast, the CDS of a sample of 18 emerging economies rose an average of 30 bp.

13 Followed by GBI-EM Diversified (USD 14 billion).

from 6.84% to 1.84%[14] while Colombia's went from 4.05% to 4.26%[15] between 31 January and 28 February 2022.

JP Morgan announced on February 28th the effective exclusion of Russian securities from its bond indices denominated in local currency starting on 31 March 2022. With this news as well as Russia's remaining 1.84% participation in this index, it is only to be expected that this percentage will be distributed among the other countries that make up the index[16] where Colombia could reach a weighting of 4.38%. As a result of Russia's exclusion from the index beginning in March, this rearrangement could represent approximately USD 276.2 m in inflows into the TES market. However, this value will depend on the investors' decisions, and they can adjust their portfolios following their own investment policies. MSCI, S&P Dow Jones, and FTSE Russell, in turn, also announced the removal of Russia from their equity indices for emerging markets.[17] Colombia also has a share in these indices. Nonetheless, it is not clear what the impact of Russia's exclusion is likely to be on the share held by other countries.

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14 This reduction is the result of the devaluation of local currency securities and the depreciation of the exchange rate in Russia. JP Morgan adjusts its weightings based on the market value in U.S. dollars and the total value of government debt issued by each country in the index.

15 Colombian sovereign bonds participate in the *Emerging Market Bond Index* (EMBI), *Government Bond Index-Emerging Markets* (GBI-EM) and *JP Morgan ESG Index* (JESG EM). The EMBI index takes only securities issued in dollars into account while the GBI-EM and JESG EM indices consider sovereign bonds issued in local currency.

16 The distribution is proportionally based and the rule that a maximum of 10% weighting per country is maintained.

17 Russia was weighted at 1.7% in the *Dow Jones Emerging Markets Index*, 1.6% in the *MSCI Emerging Markets Index*, and 1.7% in the *FTSE Emerging Index* as of 28 February 2022.