ECONOMIC VIEWPOINT

Economic Impact of the Invasion in Ukraine

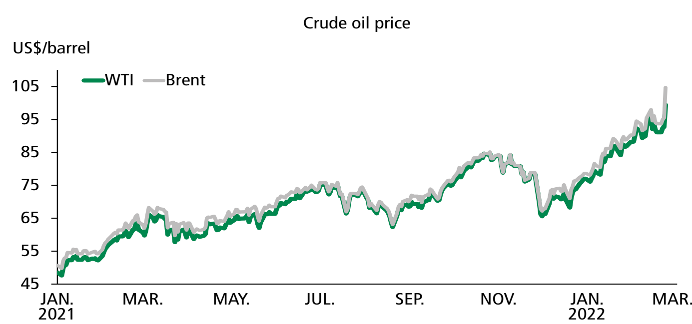
Diplomatic and military tensions between Russia and Ukraine that had been escalating for months, even years since the Russian annexation of Crimea in 2014, have now become a full-blown armed conflict. The situation has particularly escalated this week after Russia officially recognized the sovereignty of pro-Russian separatists in eastern Ukraine in the regions of Lugansk and Donetsk. Moving quickly from words to deeds, Russian President Vladimir Putin launched a major military offensive early Thursday morning in several regions of Ukraine, not just those at the origin of the conflict. Ukraine's European and American allies have already reacted this week with the imposition of diplomatic, financial and economic sanctions. However, in the wake of the Russian invasion, more severe sanctions appear likely, and there is a possibility of even more direct military support to Ukraine.

What Are the Immediate Effects?

Investors had already been on alert for a few weeks regarding the escalation of tensions and the risk of a more serious conflict. Several equity market indices had already posted several sessions in the red and the prices of several commodities, including oil and natural gas, were rising. At the time of writing, we were observing larger movements in the major equity market indices. The U.S. S&P 500 is now down 12% year-to-date, including about 5% this week alone. High commodity prices have been supportive to the Canadian stock market so far and the damage is limited to a year-to-date decline of about 3%, including nearly 1.5% this week. The U.S. benchmark crude oil price temporarily crossed the US$100/barrel mark this morning (graph 1). Natural gas prices are also up sharply, especially in European markets (graph 2). Other commodity prices, including some metals and food prices, are also showing significant increases.

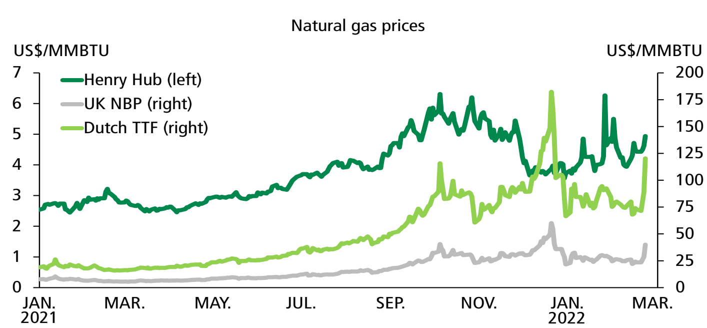
Low risk appetite favours the bond market where longer-term yields continued to fall this morning. U.S. and Canadian 10-year yields are hovering around 1.90%. The decline over two weeks in U.S. yields is a bit stronger relative to Canadian ones, narrowing the spreads. High commodity prices and lower yield differentials with the United States would normally benefit the Canadian dollar, but this has not been the case so far, as the loonie depreciated this morning to near US$0.78. In a situation of great uncertainty, investors will prefer the U.S. dollar to many other currencies. Gold has also been in demand, approaching the US$2,000/ounce mark (graph 3 on page 2).

GRAPH 1
Oil surges



WTI: West Texas Intermediate
Sources: Datastream, Bloomberg and Desjardins, Economic Studies

GRAPH 2
Stronger increases for European natural gas prices



MMBTU: Million British Thermal Units
Sources: Bloomberg and Desjardins, Economic Studies

Jimmy Jean, Vice-President, Chief Economist and Strategist • Royce Mendes, Managing Director and Head of Macro Strategy
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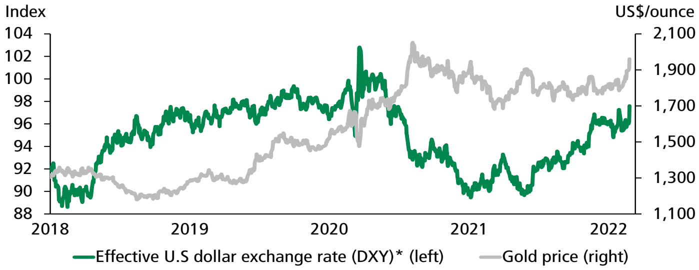
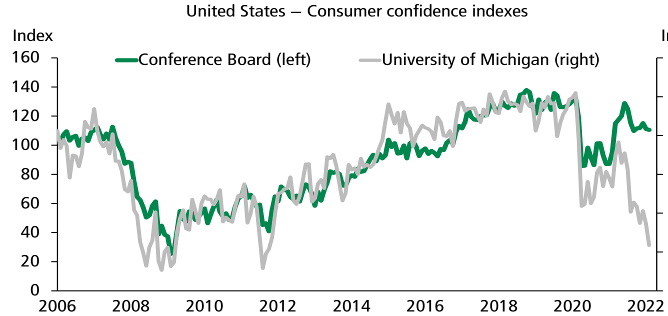
GRAPH 3
The U.S. dollar and gold are bought as safe havens



* Based on a basket of currencies including the Canadian dollar, the euro, the pound, the yen, the Swiss franc and the Swedish crown.
Sources: Datastream and Desjardins, Economic Studies

GRAPH 4
Already fragile, U.S. consumer confidence could deteriorate further in the coming months



Sources: Conference Board, University of Michigan and Desjardins, Economic Studies

What Economic Consequences Can We Expect?

As far as the economy is concerned, the consequences could be important for Europe. Obviously, the Ukrainian economy (0.4% of world GDP according to purchasing power parity) could suffer for a long time from the conflict within its territory. The neighbouring countries of Eastern Europe are also likely to suffer serious consequences. Their governments, their populations and the investors who operate there will will look with apprehension at the Russian ambitions on the former member nations of the USSR and its satellite countries. The Russian economy (3.2% of the world's GDP according to purchasing power parity) will obviously suffer the consequences of sanctions as well as a decline in attractiveness to investors.

Even Western Europe, including the eurozone, is likely to suffer negative economic consequences. It has already been dealing with a sharp rise in energy prices for some time now, fueling inflation and complicating the situation of companies already struggling with supply problems resulting from the pandemic. Western Europe remains highly dependent on Russian natural gas. For example, German natural gas imports come from Russia at a rate of nearly 70% according to Eurostat and Oxford Economics. The situation will differ from country to country, depending on the importance of their trade relationship (including energy) with Russia. In this sense, Europe could also suffer the effects of the sanctions imposed on Russia, either the current ones or those that will follow.

In the wake of multiple pandemic waves, the European economy is still fragile. Further escalation in energy prices (from already extremely high levels), in addition to a surge in uncertainty and a deterioration in household, business and investor confidence, could easily cause more economic setbacks. If the Ukrainian conflict worsens, a further contraction of the European economy can be anticipated.

In the United States and Canada, one of the first direct effects that should be felt by the majority of the population should be a further increase in gasoline and energy prices. In the coming months, if the conflict drags on, we could see negative effects on consumption due to market volatility, additional inflationary pressures, and weaker consumer confidence (graph 4).

Inflation is expected to be higher, at least in the short term, due to higher prices for gasoline prices and many production inputs. Prolonged disruptions in supply chains may also delay the expected cooldown in inflation.

A prolonged armed conflict on Europe's doorstep involving several countries would have potentially more severe consequences for the global economy. The degree of risk to the economy and markets will therefore depend primarily on the military situation in Ukraine and the extent to which European and American allies respond.

What Are the Implications for Monetary Policy?

Monetary policymakers around the world will be weighing the upside lift to inflation from higher commodity prices against the prospect of the conflict derailing the economic recovery. With inflation already higher than it's been in decades in many parts of the world, a further tailwind to prices puts central bankers in a particularly difficult position. The typical response for monetary policymakers would be to look through such inflationary pressures, but that's much more difficult in a world where inflation expectations are already on shaky ground.

North American economies have fewer direct ties to Russia, meaning harsh sanctions will take less of a bite out of overall economic activity in the United States and Canada. As a result, the escalation shouldn't alter plans for both the Federal Reserve and the Bank of Canada to raise rates 25 basis points in March, but markets are rightly paring back bets for a 50-basis point move.

It's a different story in Europe. Both the lift to prices and the damage to the economy will be more acute. With the euro zone having dealt with persistently low inflation for such a long period before the pandemic, the European Central Bank will likely want to err on the side of caution regarding the economy. Such a tactic could keep the institution from both setting a firm timetable for ending its asset purchase program and from signalling, with any more certainty than it already has, that rates could rise this year. While the Bank of England will likely to continue to raise rates in March, there will be more caution evident in their communications surrounding the recovery. Overall, the impact of the Russian invasion is going hurt more now than it would have if central banks didn't already have their backs against the wall with inflation.