Much Hangs in the Balance of the Grain Deal

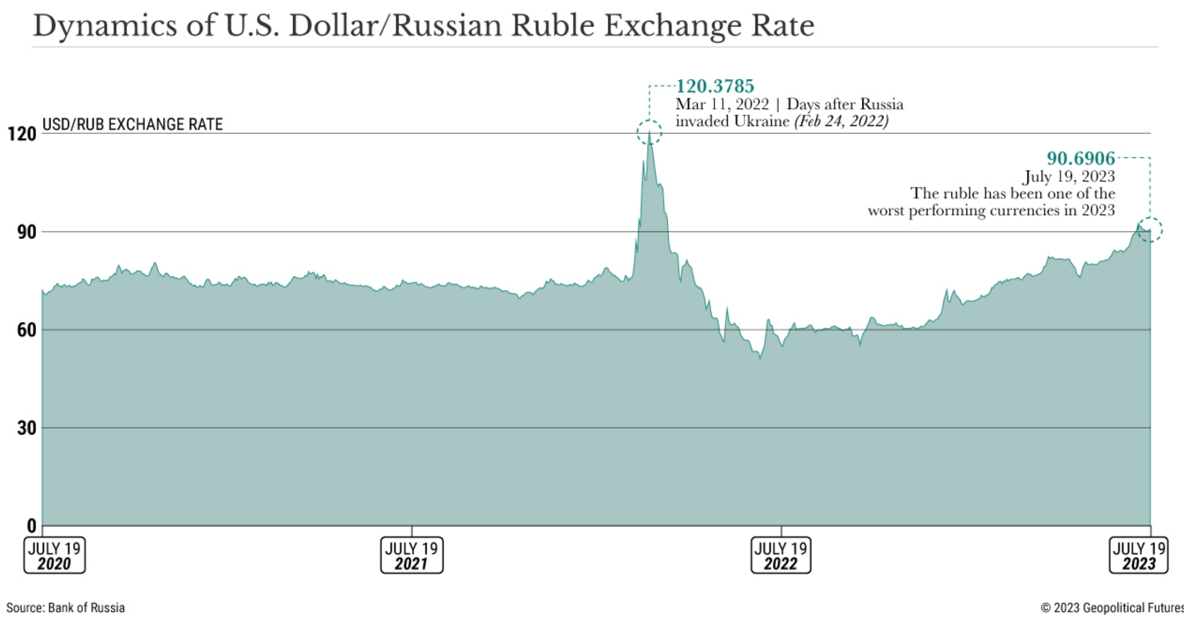
by Antonia Colibasanu - July 24, 2023

On July 21, Russia's central bank increased its key interest rate to 8.5 percent, citing inflationary risks from a tight labor market and strong consumer demand. This marks the first time the bank has lifted rates in over a year, and more may be in the offing. The move comes days after Russia withdrew from the U.N.-brokered Black Sea grain deal because, Moscow claims, it failed to live up to its promises, which included reconnecting a Russian bank to the international SWIFT system, the reopening of an ammonia pipeline and allowing Russian ships to dock in international ports.

The grain deal was established several months into the war in Ukraine to make sure Russia and Ukraine – two of the world's most important grain producers – could safely bring their products to market and thus help keep global food prices down. The Black Sea is vital in this regard, accounting for roughly 30 percent of global wheat exports and 20 percent of global corn exports. But Russia has begun to lose interest in the agreement. Most of its grain exports are bound for Asia and, increasingly, Latin America, and therefore don't need to pass through the Black Sea. (The recently inaugurated North-South corridor has become the first step in a global network of ports and routes that enables Russia to bypass the Black Sea entirely.) Meanwhile, Moscow has reason to curb exports. Doing so would protect domestic consumers, correct harvesting imbalances due to environmental factors and relieve pressure on the ruble.

This last point is critical. Propping up the ruble is the reason Russia needs to keep the grain deal going and why connecting the government-controlled agricultural bank Rosselkhozbank to the SWIFT system is the key Russian demand. Increasingly, Russia relies on the Chinese yuan rather than on Western currencies. According to the central bank's latest financial stability review, the share of the yuan in the exchange market rose to roughly 40 percent, and in foreign trade operations reached 25 percent for exports and 31 percent for imports in May 2023. Along with the increase in the share of the yuan, the share of the ruble in foreign trade also continued to grow, reaching 39 percent of exports and more than 30 percent of imports.

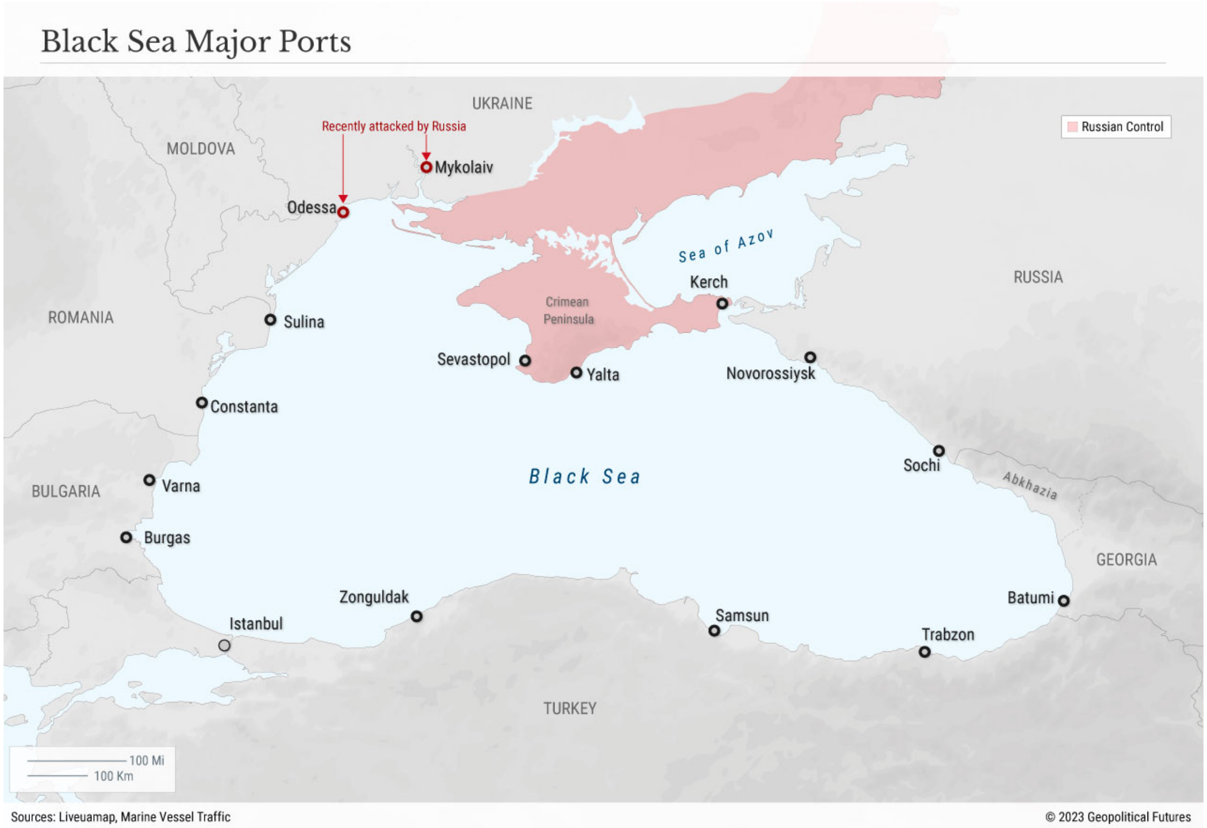
This has complicated things with traditional Russian allies. Russia's prolific use of the yuan, a currency that's not freely convertible, has essentially made its monetary policy dependent on Beijing while contributing to domestic inflation. Meanwhile, recent news reports suggest a weak ruble has caused problems in Central Asia, where Russia has an imperative to help keep populations safe and stable.



(click to enlarge)

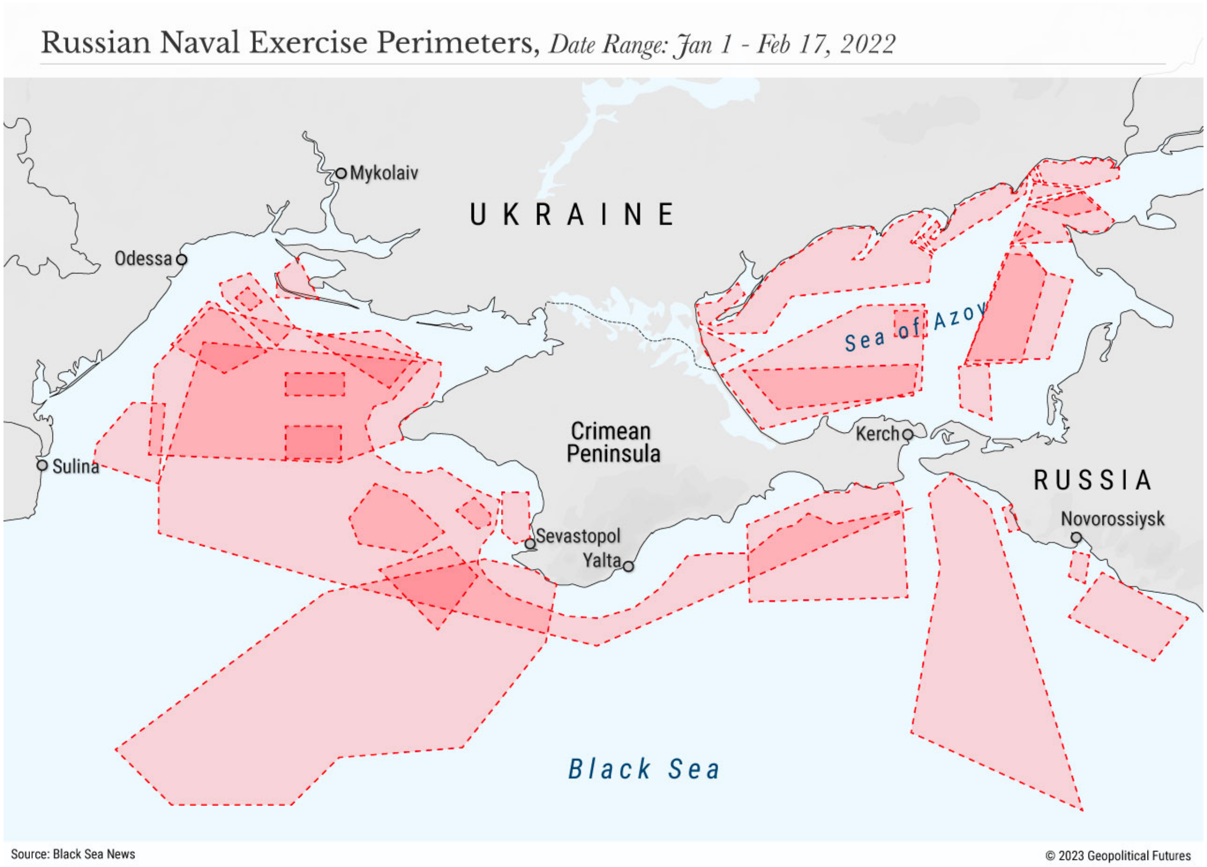
All of this makes Moscow want to control the flow of dollars and euros – both of which are convertible currencies. While there are private Western banks working in Russia, and though there are a few Russian banks that are still connected to SWIFT, they are not controlled by the Russian government. Motivated by profit, these banks will keep the flow coming in and make use of it for their own purposes. Increasing the interest rate is pretty much all Moscow can do to address inflation. Hence why it wants to reconnect its public banks to SWIFT via the grain deal.

However, Moscow could not persuade the West to accept its terms, and it has given the West a three-month ultimatum to do so. To show that it still has some leverage in the talks, Moscow has upped its attacks on the Ukrainian ports of Odesa, Mykolaiv and Chornomorsk. (Most recently, according to the Ukrainian media, the ports of Ismail and Reni, both on the Danube, were also hit – marking a first attack on ports inside the country.) It announced that it would treat all ships going to Ukrainian ports across the Black Sea as carriers of military cargoes, called for new military drills and has declared that it has the right to block the exclusive economic zones of Black Sea region states – even those in NATO.



(click to enlarge)

So far, Moscow has blocked the Ukrainian coast and, according to local sources, part of the Bulgarian economic zone – all under the pretext of holding naval exercises. By claiming it suspects all cargo going toward Ukrainian ports of carrying military cargo in support of Kyiv, Russia says it has the right to inspect ships passing through the Black Sea. This is likely why Russia blocked the perimeter within the Bulgarian economic zone: so its warships could stop commercial ships for inspection, considering the perimeter is nearby the Western coast of the Black Sea, where naval commercial traffic is still working from and into the Bosporus. It is unclear what Russia would do should a commercial ship not stop for inspection.



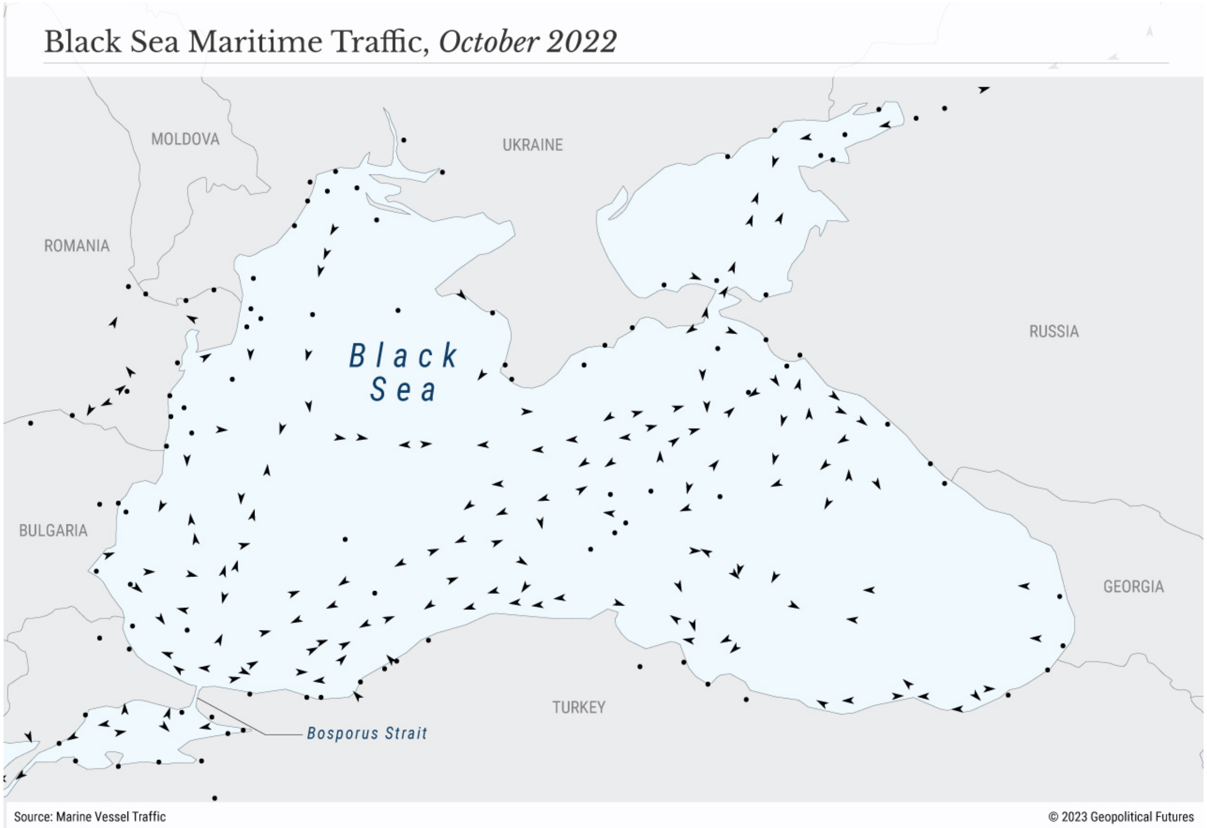
(click to enlarge)

This points to a growing danger to essential Black Sea trade routes, which raises the prospect of global market instability for everything from oil to foodstuffs to fertilizers. Wheat prices have been on an upward trend for nearly a week, and the shipping and insurance industries are trying to remove the uncertainty in the market. The Lloyd's of London insurance market has already placed the Black Sea region on its high-risk list. However, on July 18, Lloyd's insurer Ascot said the insurance facility is on pause, leaving open the possibility that Russia could re-enter the grain deal. It's unclear what the insurer thinks after days of heavy attacks on grain facilities in Odesa and the other ports, but it is obvious that war risk premiums are increasing by the day for all shipping corridors in the Black Sea. Russia's decision has effectively reinstalled the blockade and turned the Black Sea into a heightened-risk war zone.

For Ukraine, this has forced a massive amount of grain to be transported by river, road and rail – all of which are difficult and expensive. Right now, the primary alternative route for the grain corridor from Odesa to the Bosporus is the Romanian port of Constanta, which, like the rest of Romanian infrastructure, has grown only more important since the outset of the war. Ukrainian grains are shipped to the mouth of the Danube and, from Sulina, the load is transported further into Constanta (through the Danube and its channels) and then taken either by sea, rail or road into the market. Despite the fact that Romania modernized its infrastructure over the past year – about 2.5 million metric tons of Ukrainian grain now transit through the country, from 300,000 metric tons in March 2022 – logistical problems abound due to limited shipping and storage capacity.

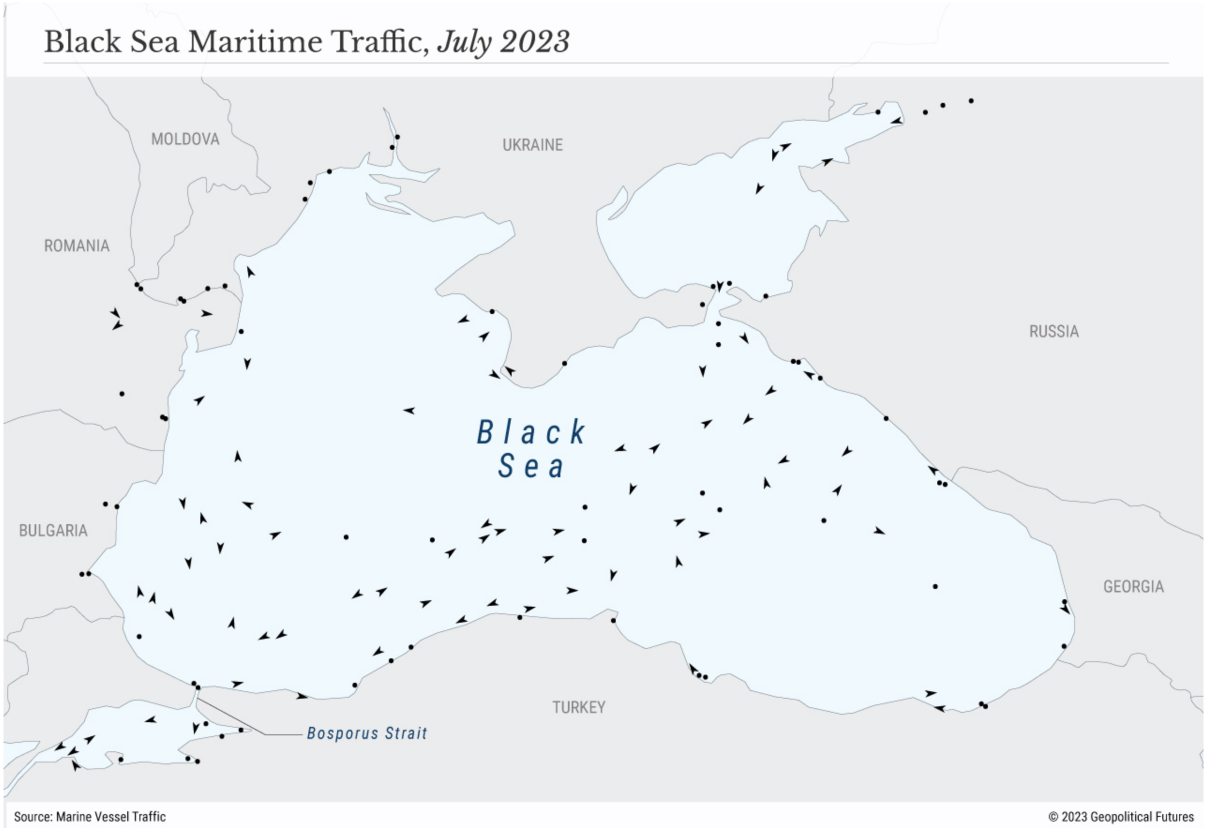
While limited, Romania could still implement several enhancements to expand the flow from Ukraine and partially compensate for the collapse of the grain deal. At the moment, because of the risk posed by undersea mines and the lack of night signals on Sulina Danube Channel, ships are sailing only during the day. Furthermore, the average weight for vessels passing through Sulina is around 5,600 metric tons. By introducing night sailing, increasing vessel capacity to 15,000 metric tons, increasing use of the railway network and increasing use of the Galati port facilities on the Danube, Romania could handle up to 3.5 million metric tons more of Ukrainian grain on average each month. However, because offload capacity will largely remain the same, the result may only be greater congestion. Furthermore, with the annual crop just entering harvesting season, challenges will increase.

Importantly, Russia has reasons to escalate attacks in southern Ukraine independent of the grain deal. Moscow would prefer to reconnect with SWIFT, of course, but flexing its military muscles at a time of perceived weakness is politically valuable too. It shows the Russian people that the military is still capable despite its setbacks, and it shows the West that there are consequences if Moscow doesn’t get its way.



(click to enlarge)

For its part, the West doesn't have many viable responses. Romania and Bulgaria have improved coastal anti-ship missile capabilities, but they are still behind the curve. Delays in U.S. defense deliveries have put more pressure on coastal states in the immediate proximity of Ukraine. Turkey has an advanced naval capability, and in theory it could partner with Romania and Bulgaria (all NATO member states) to provide an armed escort for commercial ships in the Black Sea. Romania and Bulgaria are coordinating on minesweeping along the coastline, and NATO could also provide shore support. However, NATO is a military organization with a political component, much of it driven by the United States. Black Sea countries have advocated that the U.S. adopt a Black Sea strategy in the hope that NATO might follow suit. These kinds of strategies take time to develop.



(click to enlarge)

Russia will use that time to its advantage. Hitting Black Sea shorelines and Ukrainian port infrastructure serves the long-term strategic goal of Russia: to destroy the most productive sector Ukraine has left, agriculture, which makes up about 40 percent of Ukraine's GDP. There are about 18 million metric tons of grain stored in the Ukrainian silos from last year –more than half of annual production – because it couldn't get them out. The grain deal helped, of course, as did the creation of new routes through Romania and Poland, but it hasn't been enough.

The blockade and the Russian attacks on port infrastructure make it unlikely that Ukraine will be able to move its production to the market soon either. The end result that Russia is looking to achieve is that Ukraine doesn't participate in the international grain market this year or in the foreseeable future. Its inability to move surplus grain to the market has already killed much of the Ukrainian grain business this year.

With no industry to rely on (most was located in eastern areas now occupied by Russia) and no functioning agriculture, there isn't much of a Ukrainian economy left. Even if the West promises to help Ukraine rebuild it, there is nothing easy in the process of socio-economic reconstruction. For

Russia, making things hard in the long term is a safe way to bring Kyiv under its influence. Russia is likely to have problems of its own, so its pressure on Kyiv might be less aggressive than it would like, but its current actions are designed to be able to pressure Kyiv later, even if it loses the kinetic war.

Author: Antonia Colibasanu

Read more from this author on geopoliticalfutures.com

