

## RESEARCH BRIEF No. 127

## Economic Impact of Russia-Ukraine Conflict: An Indian Perspective

Russia-Ukraine conflict takes its birth from the disintegration of the Soviet Union. Ukraine, a member of the erstwhile Soviet Union, became an independent country in 1991. The tussle between Ukraine and Russia began as an internal Ukrainian crisis in November 2013, when the then Ukrainian President rejected a deal for greater integration with the European Union and decided to join Russia-led Eurasian Economic Union, sparking mass protests across the country. The 'Euromaidan' protests toppled the government. In 2014, in an attempt to regain its lost influence in the Ukraine, Russia annexed Crimea, an important port region in Ukraine. Later, Russia and Ukraine had signed the Minsk peace Accord in 2014 to halt the armed conflict in east Ukraine.

The current crisis began in early January 2021, when Ukraine President urged the US to permit Ukraine to join the North Atlantic Treaty Organization (NATO). Ukraine and Russia are two countries that border each other in Eastern Europe, and any eastward expansion of the NATO is a direct threat to Russia's interest and border security. Subsequently, Russia demanded the West to give a legally binding guarantee that the NATO will not expand eastward or allow former Soviet States like Ukraine to join, and that the NATO will not hold any military activity in Eastern Europe. However, the US has ruled out changing NATO's 'open-door policy' which means, the NATO would continue to induct more members. Against no assurance from the US, on February 22, 2022, Russia recognised the independence of two separatist regions of Donetsk and Luhansk. The larger conflict materialized, on February 24, when Russia launched what it termed as a 'special military operation', which has invited a range of sanctions on Russia from across the world.

### SANCTIONS ON RUSSIA

The impact of financial sanctions imposed on Russia during 2014-2021 had been limited on Russian economy. However, their impact on specific firms and sectors had been more significant. According to the Congressional Research Service report of the US Government dated January 18, 2022, sanctioned firms lost on average about 25% of their operating revenues, equating to over 50% of their asset values, and about 33% of their employees relative to their non-sanctioned peers over a period from 2012-2016. Additionally, the limited design of the sectoral sanctions did not necessarily result in a rapid disruption in business operations, particularly as oil prices rose.

The current Russia-Ukraine conflict has resulted in several newly announced sanctions by the Office of Foreign Assets Control (OFAC), and several other countries since February 21, 2022, on major Russian financial institutions, Russian

firms, corporates, and family members of these businesses spread across various countries. The new sanctions imposed by the United States, the European Union (EU), the United Kingdom (UK), Canada, Australia, Japan, and others are unprecedented in terms of scope - both in terms of the type of sanctions and the entities targeted, coordination, and speed. These include asset freezing, blocking access to new funding, restrictions on certain types of transactions, and exclusion of Russian banks from the SWIFT payments system. In addition to financial sanctions, several trade sanctions have also been imposed, including suspension of export licenses for dual-use items which can be used for military purposes, banning exports of high-tech items and oil-refinery equipment, sale of aircraft and equipment to Russian airlines, etc.

### Impact of Sanctions on Russia

The freezing of the Bank of Russia's assets and prohibition of transactions with the Central Bank would significantly impair the central bank's ability to supply US dollar liquidity to the economy. The impact of the SWIFT related sanctions is likely to lead to destabilization of Russian financial system. This could profoundly impact banks' and corporates' ability to transfer money across borders. This would also affect their ability to receive and make payments for exports and imports of goods and services as well as debt repayments and foreign investments. Sanctions on the secondary local currency-denominated debt market would directly impact the fiscal health of the economy. These sanctions will lead to higher costs of funding to Russia and impact its fiscal policies which further will require either spending cuts or higher taxes. Sanctions on key Russian exports such as oil and natural gas would have a strong impact on Russia, both in terms of the country's external balance as well as the government's fiscal accounts. Revenues from oil and gas play a major role in Russia's budget. With significantly lower revenues from these sources, Russia would have to make meaningful adjustments to government spending to avoid large deficits. This would also pose serious challenges to countries that are reliant on Russia's hydrocarbon exports, especially the EU. Additionally, export controls have limited Russia's ability to import advanced technologies in Russian defence, aviation, and maritime sectors.

### GLOBAL IMPACT OF RUSSIA-UKRAINE CONFLICT

The current conflict is affecting global economies through following channels:

#### a) Commodity Price Channel

**Rising Price of Crude Oil and Natural Gas:** Since Russia is one of the biggest oil exporters in the world, the conflict

has caused an instantaneous global supply shock. The conflict has resulted in crude oil and natural gas prices shooting up on expectations that sanctions against Russia would cripple energy exports. International natural gas prices have also been rising amid increased uncertainty in European natural gas markets. The conflict would disrupt supplies from the Nord Stream pipelines to the EU, leading to further energy shortages and inflation. The concerns over tightening supplies and further sanction on oil and gas supplies have added to the uncertainty in the market.

**Rising Prices of Food:** Russia and Ukraine are among the important producers of agricultural commodities in the world. The disruptions caused by sanctions and the related uncertainty would directly impact the availability of food in the global market. Reduced availability of food and critical agriculture-related goods have bid up the prices, thus leading to higher food costs. This would contribute to the rise in the global inflation level.

**Edible Oil:** With Ukraine and Russia being the largest exporters of edible oil, essentially sunflower oil, the ongoing conflict between the two nations have further created a supply crunch in the market, thus leading to higher prices.

**Metals:** Russia and Ukraine are major producers of metals and steel. Uncertainty over the supply of metals and sanctions on Russia have led to sharp rise in the prices of these products.

**Chip Shortage Widens:** Russia and Ukraine control a significant share of global palladium and neon supplies. These are the key raw materials that go into making of semiconductors. The global chip shortage is likely to worsen if the conflict continues. It is through this shortage of semiconductors that industries such as automobile, mobile phones, and consumer electronics industry are impacted, which are directly dependent on these chips for their production.

### **b) Financial Market Channels**

Sanctions have proved to be disruptive to businesses as it impinged on the profits of companies in Russia and raised questions on capability and willingness of Russia to repay its debts. It has also resulted in severe depreciation of Russia's currency and raising key interest rates to 20% from 9.5% by Russian Central Bank. The global credit rating agencies withdrew ratings for Russia's sovereign and Russian entities.

### **c) Trade and Supply Chain Channels**

With Russia and Ukraine being major suppliers of several commodities, there would be supply chain disruptions in these sectors in the global commodity market. The conflict has disrupted shipping and air logistics networks, causing freight rates rising across the board. The disruptions in the Black Sea are already impacting the prices of several agricultural products using Black Sea trade routes for transit. Russian airlines, specifically, have been banned from the EU airspace - including Aeroflot and AirBridgeCargo. Since the latter is a top-20 global provider, with 18 widebody freighters, its

ban is further reducing the already tight capacity on Asia-Europe lanes.

### **d) Confidence Channel**

The uncertainties surrounding the current conflict is eroding the global market/business confidence, leading to increased volatility, higher investor uncertainty and risk premia in global financial markets. Further disruptions in financial sector would affect various asset categories severely, which in turn would further depress risky asset prices, tighten financial conditions and increase volatility. The conflict has already resulted in general increase in risk premia, leading to higher external financing costs for companies and weighing on investment.

## **INDIA'S TRADE WITH RUSSIA AND UKRAINE**

**Russia:** India enjoys a privileged strategic partnership with Russia. India's exports to Russia increased from US\$ 1.8 billion in 2011-12 to US\$ 3.3 billion in 2021-22, recording an average annual growth rate (AAGR) of 7.7%. During the same time, the imports have recorded an AAGR of 12%, growing from US\$ 4.8 billion in 2011-12 to US\$ 9.9 billion in 2021-22. India has been maintaining a trade deficit with respect to Russia, with the deficit widening from US\$ 3 billion in 2011-12 to US\$ 6.6 billion in 2021-22. Trade with Russia in terms of both exports and imports recorded the highest levels in 2021-22.

**Exports:** As part of the Eurasian Economic Union (EAEU), Russia provides GSP benefits to exports from India. With respect to commodities traded, around 16% of India's exports to Russia during 2021-22 were electrical machinery and equipment. This was followed by pharmaceutical products (14.7%), machinery and mechanical appliances (9.3%), iron and steel (7.4%), and organic chemicals (7.1%).

**Imports:** With respect to India's imports from Russia, over 53% of India's imports were mineral fuels and oils, followed by pearls, precious and semi-precious and stones (12.7%), fertilizers (7.8%), project goods (5.3%), animal or vegetable fats and oils (5%), and paper and paperboard (1.5%) during 2021-22.

**Ukraine:** Total trade between India and Ukraine increased from US\$ 3 billion in 2011-12 to US\$ 3.4 billion in 2021-22. India's exports to the country remain relatively stable throughout the last decade. During 2021-22, India's exports to Ukraine was US\$ 472.7 million, lower than US\$ 491.2 million recorded in 2011-12. On the other hand, India's imports from Ukraine witnessed an increase from US\$ 2.5 billion in 2011-12 to US\$ 2.9 billion in 2021-22, increasing by an AAGR of 4.2%. As is the case with Russia, India has been recording a trade deficit with the country which stood at US\$ 2.4 billion in 2021-22, increasing from US\$ 2 billion recorded in 2011-12.

**Exports:** Pharmaceutical products remain the major exported commodities from India to Ukraine, accounting for over 30% of India's exports to the country during 2021-22. It was followed by plastics and articles (5.5%), machinery and appliances

(5.3%), iron and steel (5.1%), miscellaneous chemical products (4.9%), and electrical machinery and equipment (4.2%).

**Imports:** Animal or vegetable fats and oils (sunflower seed oil in particular) accounted for almost 3/4<sup>th</sup> of India's imports from Ukraine in 2021-22. This was followed by fertilizers (12.7% of imports), inorganic chemicals (7.6%), project goods (1.2%), and wood and articles (1.1%).

## IMPACT OF RUSSIA-UKRAINE CONFLICT ON THE INDIAN ECONOMY

Russia - Ukraine conflict and the set of punitive sanctions imposed on Russia by the US and its allies, especially European Union countries, have the potential to impact India through multiple channels.

### *Surge in Input Costs and Impact on Macroeconomic Variables*

An expected resultant commodity price surge could lead to a severe increase in input costs, leading to increase in the product prices for exports and goods for domestic consumption. The impact of higher crude oil prices for a prolonged period on India's macroeconomic fundamentals could be severe, affecting through various channels such as GDP growth, inflation, savings, exchange rate of rupee, interest rates, trade, current account and finally on India's fiscal deficit.

**Exchange Rate:** High oil prices and volatility prevailing in global markets have resulted in rupee coming under significant pressure. Higher oil prices would result in higher trade deficits and leading to sharp rupee depreciation. Exchange rate is likely to remain volatile due to the uncertainties related to the conflict, risk aversion tendencies, the spike in Brent crude oil prices and policy tightening by the Federal Reserve.

**Inflation:** A rise in global crude prices and heightened uncertainties would increase the domestic price of crude products and increase domestic inflation. The continuous hardening in crude oil prices exacerbated by the Russia-Ukraine conflict, other geo-political concerns, and its impact on the Indian Rupee pose the biggest risk to the WPI as well as the CPI inflation. The impact of rising crude oil prices on WPI and CPI inflation would be influenced by the extent of pass through to domestic retail prices of fuels.

**Financial Services:** Flight to safety has resulted in capital outflows from emerging economies, including India. Foreign Portfolio Investment (FPI) flows are expected to remain volatile in the coming months due to Russia-Ukraine conflict and its fallout in the form of sanctions, high inflation and expected increase in interest rate by the Federal Reserve. Continuous FPI outflows and heavy selling in domestic equities could weigh on the equity markets and India's market valuations. Indian companies having exposure to Russia, Ukraine and other European companies would come under the scanner, with chances of stress in their financial conditions.

**Public Services:** The impact of higher oil prices could affect India's expenditure budget, leading to fiscal targets going awry. Impact of high crude oil prices on Government finances could lead to Government of India cutting back on capital outlays.

### *Trade Channel and Impact on Current Account*

Since pharmaceutical products, being necessary goods, are currently exempted from sanctions, India's pharmaceutical exports which are the largest exports from India to both Russia and Ukraine are expected to witness only a marginal impact. Russia and Ukraine are also major destinations of Indian tea exports, and the crisis is expected to create an over-supply of tea in the domestic market, leading to falling tea prices. At the same, a depreciating Indian rupee is expected to benefit India's export-oriented sectors by making exports competitive. Disruptions in supply chains, along with rise in export insurance costs and shipping freights are also expected to raise the trading costs of Indian exporters. As regards imports, India's import costs would rise owing to higher prices of crude, fertilizers, metals, and edible oil. India's external sector remains highly vulnerable to global crude oil price movements and is expected to continue to remain so in the near future.

On the other hand, rise in commodity prices may prove favourable in case of sectors such as steel and aluminium, leading to higher realisations for domestic primary steel makers and aluminum smelters. However, it would have negative impact on the construction, real estate, and automobile sectors which are the end users of these products.

With Russia and Ukraine producing around 75% of the neon gas (Ukraine alone about 70%) used to manufacture semiconductors, disruptions are expected in the automobile sector which is already undergoing disruptions from the semiconductor shortages. Russian sanctions are expected to further curtail semiconductor production. With Russia being one of the largest producers and suppliers of palladium globally, there has been a significant increase in the price of palladium amidst uncertainties surrounding Russian sanctions.

Thus, an expected increase in import bills due to elevated food, fuel, and fertilizer prices; moderation in domestic demand in major trading partners and growing uncertainty surrounding capital inflows may further widen India's current account deficit and thus impacting reserves in the short term.

### *Heightened Defence Spending*

India's present military arsenal is heavily stocked with Russian-made or Russian-designed equipment, purchased mostly under government-to-government contract. Due to Russia-Ukraine conflict, India's reliance on Russia for arms imports are expected to come down. However, this would lead to India diversifying its import sources, leading to increased defence spending for the country. On the other hand, increased efforts by the Government of India to increase the domestic production of defence equipment

under 'Make in India' would reduce India's dependency on Russian based defence products and divert part of its huge defence budget to meeting development needs and other priority sectors.

### ***Exposure of Indian Banks in Russia***

Except for the Commercial Indo Bank LLC (JV of SBI and Canara Bank), Indian banks do not have any subsidiaries, branches or representative offices in Russia, and trade finance businesses for Indian banks are relatively less because of the limited trade size between India and Russia. State Bank of India, the largest Indian commercial Bank's exposure in Russia is reported to be less than US\$ 10 million. However, according to reports, due to the worsening geopolitical situation, Indian banks have decided not to process any transactions involving Russian entities due to global sanctions. Indian banks are currently exploring ways to circumnavigate the sanctions placed on Russian trade. Thus, implications of the current conflict on Indian banks are expected to be limited.

### ***India as an Alternative Supplier of Products***

A positive possible benefit of the ongoing crisis is that India could emerge as an alternative supplier of several of products which were being supplied by Russia and are currently facing supply disruptions. Indian exporters of these commodities could perhaps benefit from increased global demand for these commodities, emerging as an alternative import source.

### ***Towards Greener Energy and Increased Investment in Renewables***

Using unconventional energy in the place of crude, along with increased use of electric vehicles (EVs) could help India to reduce its heavy dependence on imported fuel, while cushioning the country from similar oil price shocks. The present scenario is perhaps ideal for India to invest more on renewables and alternative fuels and increase renewable energy consumption in the coming years, paving way for greener energy in the country.

## **SANCTIONS AND PAYMENT RELATED ISSUES**

The sanction has led to several problems on India's export front, which is largely related to payment issues due to the sanctions in the banking system, along with leading shipping lines suspending deliveries to and from Russia, resulting in sending fresh consignments difficult.

### ***Alternative Payment Mechanism - Settlement of Payments in National Currencies***

As a solution, an alternative payment mechanism could be established for engaging in economic and commercial relations with Russia.

Rupee-rouble payment mechanism is one solution. These transactions could be facilitated through selected banks, which is already in place for several of India's defence transactions with Russia. Under the "rupee-rouble" exchange scheme which existed prior to 1991, prices and payments of goods were designated in roubles and rupees according to a mutually agreed rate of exchange, but accounts were settled in goods. The goods traded were, however, specified and restricted, and purchases and transactions were conducted under the supervision of the Reserve Bank of India.

India and Russia could work on promoting mutual settlements of payments in national currencies as an initiative for significantly increasing volume of bilateral trade in the context of current sanctions. Central Banks of both countries could work out the modalities, especially pegging the rupee - rouble exchange rate for bilateral trade in consultation with both governments.

Finding an alternative to bank transactions such as SWIFT would also support a move away from dollar-based trade. For instance, Structured Financial Messaging System (SFMS), a secure messaging standard developed by the IDBFT (Institute for Development and Research in Banking Technology) Hyderabad to serve as a platform for intra-bank and inter-bank applications may be promoted globally and use for cross-border transactions. The SFMS is built on the lines of SWIFT, with several advantages and additional utilities.

There are also possibilities of countertrade mechanism where Russian banks and companies opening accounts with a few public sector banks in India, which are having limited foreign exposure, for trade settlement. This would also require public sector banks in both countries opening branches in the other country. Funds in such accounts could act as a guarantee of payment for trade exchanged between two countries, while the parties' barter commodities from each other to offset the sum.

The contents of the publication are based on information available with India Exim Bank. Due care has been taken to ensure that the information provided in the publication is correct. However, India Exim Bank accepts no responsibility for the authenticity, accuracy or completeness of such information.

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