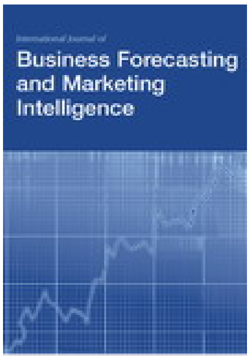

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Packiaraj Thangavel, Bibhas Chandra

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Impact of sanctions on Russia on global economy

Packiaraj Thangavel* and Bibhas Chandra

Department of Management Studies and Industrial Engineering,
Indian Institute of Technology (ISM) Dhanbad,
826004, India
Email: packiaraj7@gmail.com
Email: bibhaschandra@iitism.ac.in
*Corresponding author

Abstract: It has been well-established that countries make significant economic benefits when they participate in free trade with one another. The world has been becoming more and more integrated lately and frictionless flow of goods, capital and human resources have been happening across the boundary. When a country gets de-coupled from global trade by economic sanctions it crumbles, to name a few – Iraq, Iran, and North Korea. However, the sanctions are effective when they are imposed on the weak whose contribution to global GDP is insignificant, whereas when it is imposed on the one who has been offering key commodities, it is likely to backfire on imposing nations too. This article highlights various macroeconomic impact of Russian incursion into Ukraine territory and the resulted economic sanctions by Western allies. We do not discuss on the justification of the war or sanctions, but simply analyse the consequences of them on global economy.

Keywords: economic sanctions; invasion of Ukraine; global economy; inflation; supply chain disruption; globalisation; Russia; European Union.

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Biographical notes: Packiaraj Thangavel is a Doctoral student at Department of Management Studies and Industrial Engineering, Indian Institute of Technology (ISM), Dhanbad. He is a former Teaching Associate at Indian Institute of Management, Calcutta. His research interests are international business, generational studies and consumer behaviour.

Bibhas Chandra is an Associate Professor at Department of Management Studies and Industrial Engineering, Indian Institute of Technology (ISM), Dhanbad. He has authored and co-authored many research articles in journals of repute. His research interest includes consumer psychology, social media advertising and e-commerce.

"Nothing is more useless in developing a nation's economy than a gun, and nothing blocks the road to social development more than the financial burden of war. War is the arch enemy of national progress and the modern scourge of civilized men."

King Hussein I
Jordanian Statesman

1 Introduction

The beginning of 2022 appeared to be the starting of new era as the world has managed to live with COVID-19 and business houses began to operate after a long pause of two years. Foreign direct investments (FDIs) and growth trajectory began to show stable for a developing country like India. However, the Russian invasion of Ukraine has thrown all of those positive signs in disarray and made everyone to go in panic mode. The price of crude oil, gas, metals and food grains have gone through the roof, the ripple effect of it continues to push the global inflation in its upward trajectory. Though India does not have much merchandise trade with Russia apart from defence, oil and fertiliser import, it still stands to lose a lot economically owing to the cascading effect the western led sanctions likely to cause. It is to be noted that if the global growth weakens, it tends to spillover and sabotage India's export and inflow of FDIs (Victor et al., 2021). About 85% of India's fuel need is met through imports. The price of crude oil rose to 130 dollars a barrel from 90 dollars within few weeks into the conflict, which pushed up the prices of all other goods and services. It has been reported by Nomura Holdings (a financial services company) once that every 10% increase in crude oil price results in 0.4% increase in consumer inflation (Bloomberg, 2022). Further, it also dents rupee against dollar, which has been on a free fall lately.

Economic sanctions have been known as a tool used to cripple enemy countries. It has been documented that – in the 17th and 18th century European countries resorted to economic sanctions by closing the port for ships from enemy countries and prohibition on trade of certain goods (Hufbauer et al., 1990). Sanctions have been an important tool against researching and developing nuclear warheads, military expansions and terrorism (Peksen, 2019). Following the invasion of Ukraine, the USA and its allies – the UK, Canada, Japan, Australia and the European Union have imposed devastating economic sanctions to punish Russia. Economic sanction has become particularly important for the world because almost all the international trade is carried out in dollars. Also, dollar is the reserve currency for the world (Salvatore, 2020). And the impossibility that comes in conducting cross-border trade without dollar gives requisite ammunition to USA and its allies to come harder on Russia or any other country which appears to be violating international peace and sovereignty. However, the sanctions are effective when they are imposed on the weak whose contribution to global gross domestic product (GDP) is insignificant, whereas when it is imposed on the one who has been offering key commodities (oil, gas, food grains, metals and defence), it is likely to backfire on the imposing nations too. Europe gets about 40% of its natural gas and 25% of oil from Russia, and it is very much likely that Europe will slip into recession due to the disruption in supply of these key commodities (THE WEEK, 2022). Russia is also one of the largest suppliers of wheat. Ukraine and Russia combined account for more than one fourth (~ 29%) of total global exports of wheat. And, about three fourth of Egypt's and Turkey's supply of wheat grains coming from Russia and Ukraine. Even the Middle East is dependent on Ukraine's wheat for their bread (Mottaleb et al., 2022). Russia may retaliate by deliberately creating supply shortage of key commodities to punish the European union or any other country who seems to be party to the sanctions. It demands for payments in Ruble from European Union for supply of oil and gas to strengthen its Ruble value against euro and dollar as it has fallen sharply right after the announcement of sanctions.

Over the last few decades, geopolitical conflicts have been the constant feature of global affair, yet the world economy and financial markets have continued to perform well though there were occasional downward swings. But this invasion of Ukraine and the subsequent economic sanctions is likely to break this pattern because the world is trying to isolate its 11th largest economy (Du and Wang, 2022). When we try and stop the contribution of one of the major contributors, it is obvious that every other country will get affected in the medium-to-long run. The immediate implication is the higher inflation for the globe and volatile financial markets. The long-term implications will be the formation of economic blocs created by China, Russia and their allies. The fabric of globalisation 'one should trade with everyone, not just with her allies' is questioned. Further, China is reported to be observing the sanctions on Russia closely and expected to form strategies to thwart if such situation arise for itself in the future. As such, not all of exports from Russia can be sanctioned without hurting the rest of the world economy.

This article highlights various macroeconomic impact of war and sanctions. We do not discuss on the justification of the war or sanctions, but simply analyse the consequences of them on global economy.

2 Impact of economic sanctions on Russia

The western led economic sanctions on Russia include expulsion of Russian banks from *SWIFT (The Society for Worldwide Interbank Financial Telecommunication* – an international financial transaction platform), restriction on export of critical technology, limiting FDIs and foreign credit which are critical for the growth of any country. As a consequence, the Russian Ruble tumbled by about 40% right after the announcement of sanctions. Multinational companies have abandoned their operation in scores from Russia as a protest against Russian invasion of Ukraine and to conform with the USA and its allies' sanctions (Li and Li, 2022). McDonald's has suspended its business by shutting over 800 stores, Nestlé has shrunk its operation by selling only the essentials such as milk and baby formulations. And, Starbucks has stopped operating over 130 stores. This will have substantial negative effect on Russia in terms of loss of job, inflation and decreased economic growth. Tens of thousands of Russian people working for foreign companies will lose their job. As more and more foreign businesses suspend their operation in Russia or with the companies associated with Russians, the country will get isolated from the world and the consumers will begin to bear the effect of sanctions by paying more for every product and service.

It is now obvious that Russia will go to Asian and Middle Eastern countries to tame the effect the western sanctions brought to its economy. But the Chinese are apprehensive about extending any credit as they have surplus trade with America and Europe and displeasing them will result in catastrophic to Chinese economy. The same is true for Middle Eastern countries too as they export half of their oil produce to the west (Kepel, 2020). However, Russia can threaten Middle East by asserting that it will pump out more oil to tame the price which will affect all the members of Organization of the Petroleum Exporting Countries (OPEC). Further, Russia is also axed from foreign credits which otherwise go toward investment and thus economic growth. Foreign investors tend to stay away from sanctioned country, otherwise it would jeopardise their reputation. Moreover, the growth of Russian economy has been stagnant for quite some time now and given the sanctions imposed, the investors see little upside for their money to grow if invested in Russia.

Though the sanctions appear to be crippling Russia, one has to recognise that Russia stands on its oil, gas, metals (nickel, aluminium and palladium) and defence exports to defend itself from the sanctions. It also has the foreign reserve of 630 billion in US dollars to tide over a time something like this. This asset has been frozen as a part of sanctions imposed and yet to be known how Russia intends to get it back, of course it must have a devised strategy in place after all they have kept this money aside for a time like this. Further, Russia demands for payments in Ruble from Europe for its export of oil and gas. The spokesman of Russian parliament *Vyacheslav Volodin* announced that Russia is ready to accept if Europe does not want to take its energy and other key commodities, it will redirect its supply to Asian markets. It has also reached out with discounted oil and gas to its long-term allies – India and China. Russia has also threatened the European Union by announcing that it will stop supplying of natural gas as Europe gets about 40% of its gas supply from Russia. The inflation in Europe has been steadily increasing in the last few years, this supply disruption may simply push up the inflation further and the bloc will slip into recession (McWilliams at al., 2022). Owing to this, not all European Union member countries are aligned with the sanctions imposed on Russian commodities.

3 Impact on the USA and European Union

The sanctions likely to affect the growth of the USA economy by 0.25% to 0.50% in the next 4 to 6 quarters, whereas the European economy will get affected by about 0.50% to 1% as it has larger trade tie-up with Russia than USA or Canada do (Constable, 2022). However, the investments that are pulled out from Russia likely to be infused into the USA and Europe. But that is unlikely to make a difference in the growth prospects of European union as it is so mammoth in size (18 trillion) compared to the miniscule Russian economy that is of 1.4 trillion GDP. Further, the USA has been reeling under rising prices for quite some time now and the Federal Reserve announced the much-awaited increase of interest rates in March 2022. When developed markets become difficult for corporations to operate, they will shift their focus towards developing markets like India and Indonesia. Further, this geopolitical conflict likely to cause countries to increase their defense spending. The Europe and those who depend largely on Russian oil and gas will look for ways to reduce their dependence on Russia and seek out self-reliance or sourcing from alternatives. Also, the investments to pick up in clean energy. The war also raises question over globalisation and relying on other countries for resources (Thangavel et al., 2021). Further, though trade between Russia and the USA is insignificant, the continued impact of sanctions in Europe likely to spill over to the USA in the long run. Russia and Ukraine are large suppliers of battery cells and semiconductors, the war and the following sanctions from the west will hinder the export of these commodities. Hence, the USA automobile industry likely to get affected in near future. Further, about 300 thousand companies in Europe and the USA have suppliers in Russia and Ukraine, sanctions are going to disrupt their supply (Mbah and Wasum, 2022). That is how the world is connected now, trying to axe the 11th largest economy will hurt every other nations.

Further, Russians have been big spenders on holiday vacation in Europe's exotic locations. This geo-political tension likely to slow down the tourism economy across Europe which is already weakened by COVID-19 (Silvestrova et al., 2022). Also, European countries have been put in a soup recently by Russian demand for payments in Rubles for supply of oil and gas which had been taking place priorly in Euro or dollar. Since Europe has stopped all their export to Russia, how will they get Ruble? Either they have to resume the normal trade with Russia, or they have to simply buy Ruble from Russian banks to meet the demand. But most of the Russian banks are excluded from *SWIFT*, so they have to transact with *SPFS* (*The Financial Messaging System of the Bank of Russia* – a sort of Russian alternative to *SWIFT*) which is a cross violation of economic sanctions. An estimate shows that it would take about 10 years for Europe to completely move away from Russian energy. Given the Europe's dependence on Russian oil and the rising inflation there, if it makes any hurried move to stop buying oil from Russia, it will end up hurting itself.

4 Impact on Asian economies

While forecasting is complicated, it gets even more complex when there is a raging geopolitical war. The effect of war and sanctions will be uneven, while it would be advantageous to some countries, others might end up losers and there would be few who are hardly affected. Companies and institutions that are closely associated with Russia will bear the brunt. However, the spillover effect likely to occur, as discussed above the rising prices of oil, gas, food commodities and metals will have cascading effect on all other products and services and thus the overall global economy will be under pressure for the next 12 to 18 months period (Orhan, 2022). The developing countries like Bangladesh, Pakistan and to some extent India, and Indonesia in Asia are highly concerned about shortages of certain commodities due to supply disruptions and rising oil prices. Further, these countries are worried about the out-flow of FDIs to safe havens in developed economies. There is a news report that about 1 trillion US dollar was pulled out from Indian market from the onset of invasion of Ukraine by Russia. The countries which are neutral, or a go-between Russia and the rest of the world will get benefited from the sanctions. In other words, if a product that is manufactured in Russia required in some other country, the country that is not part of the sanctions can buy the product from Russia and exporting it to the country where it is needed by taking a nice commission.

Further, the ongoing crisis in Sri Lanka is a testament to what will happen to the developing countries if there is a shortage of fertiliser. Sri Lanka is one of the major exporters of tea to the world, few years ago the country decided to go 100% organic to earn more from every kilogram of tea it exports. However, this decision resulted in significant reduction of farm yields (FINSHOTS, 2022). In a country where more than three fourth of population engaged in farming for their livelihood, employing a new approach in farming en masse results in unprecedented economic crisis. Drawing lesson from Sri Lankan crisis, we need to understand that over 75% of Potash (key ingredient of fertiliser) coming from Russia and Belarus. Any attempt to restrict the export of Russian Potash will result in supply crunch of fertiliser which will lead to reduced farm yields. Reduction in farm yields will lead to food inflation, economic crisis and unrest in Africa and in few developing nations like the one we are witnessing in Sri Lanka currently. Further, India and other developing countries have to reduce the income inequality and build large consumer-oriented economy like the USA, European Union and China. But the war is likely to detract the decade long foundation India has put in place to level the income inequality. The vulnerable section of the society is expected to hit harder by the sanctions as they are the one who spend substantial amount of their income in food and other basic necessities (Gutmann et al., 2021).

5 Supply chain disruption

The other important risk to the global economy is the one that arises from supply chain disruption. The UK has announced the ban of all Russian ships from its ports. European union has restricted the Russian flights from its airspace and Russia has countered by banning all European aircrafts from its territory. The result is that the flights between Europe and Asia must take longer routes which means higher cost for everyone involved. This longer route also means that some of the cargo shipment will no longer be cost efficient. Moreover, some of the container shipment companies began avoiding shipment to and from Russia to condemn Russian invasion of Ukraine and to save their reputation. The cost of booking oil tankers has increased sharply expecting that war will disturb the pipelines between Europe and Russia/Ukraine and thus the oil has to be shipped from Middle Eastern countries through tankers. Moreover, global supply chain is yet to emerge from the disruptions caused by the COVID-19 pandemic (Queiroz et al., 2022).

Further, the zero-COVID policy by China has put some of its port cities again under lockdown. Thus, supply chain disruption caused by COVID-19 is expected to get worse further due to this conflict between Russia and Ukraine. Companies that have not diversified supplier source are prone to serious damages, they need to act fast and create Tier-II and Tier-III supplier base with a blend of indigenous and foreign partners. Continuous real-time monitoring of them is also warranted as perceptual disruption is going to be the new normal.

6 Conclusions

Given the uncertainty with how the invasion will turn out to be, economic sanctions and the retaliation by Russia, the financial markets responded sharply by tanking about 30% and the oil and gas prices rose sharply. The prices of food commodities such as corn, maise and wheat which are largely exported by Ukraine and Russia also rose in tandem. Reduction in export of Russian oil, gas and metals will result in higher inflation across the world and thus weak global economy. If history is of any indication, economic sanctions often give rise to unintended consequences by making the targeted country offended resulting in failure of negotiation (Hackenbroich and Chugh, 2022). It also costs heftily for the sanctioning countries, as well as for third parties who get affected indirectly. After decade-long war in Iraq, Syria and Afghanistan and spending few billion dollars, the USA does not want to put its force in Ukraine and that is understandable. In addition to loss of human beings, war brings in serious economic cost in the form of destruction of infrastructure, uncertain future, higher inflation, low to no new investments and shortages of basic commodities as hoarding of them will be on the rise.

It is important to remember how things have changed in a span of just three months into the conflict, based on how negotiation and invasion progresses things will change even more for the better or worse. What we see here is that an attempt to ostracise an important member from trading with rest of the global members, which will push up the cost of living in every nation. Though economic sanctions likely to cause pain to Russians initially, the country will find other markets for its key commodities (oil, gas and defence) by offering them at cheaper rate. It is the European Union which is likely to lose as it is already reeling with stagflation and this attempt aiming at avoiding Russian oil and gas will result in increased inflation and muted growth in the medium to long run. Further, the direct and indirect negative impacts of sanctions on target country dissipates over a period of time through import substitution by domestic production and export substitution by domestic consumption or routing it to alternative markets. It is also to be noted here that it is too early to predict or quantify the impact of war and economic sanctions on global economy, only time will tell how things unfold.

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