Geo-economic Implications of the Conflict in Ukraine

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An unusual, multi-dimensional conflict is underway in Europe. One dimension of this conflict is that Ukraine and Russia are engaged in seemingly endless conventional military battles on the ground in Ukraine. The other dimension is that United States (US) led North Atlantic Treaty Organization (NATO) alliance is arming and funding Ukraine for these battles. The alliance is also pursuing an all-out economic war against Russia through trade and financial sanctions against Russia, and Russians.

There are differing perceptions of rights and wrongs of the conflict. The possible military and diplomatic outcome is not clear yet. However, some things are a given.

First, there is a cost to war, which is immense, and will take a long time to overcome. There has already been a lot of death and destruction. There is much more to come. Second, regardless of the actual outcome of the fighting, the conflict will have significant geo-economic implications, early indications of which are already visible.

In the near term, the conflict has a direct impact, which is already being felt. The supply disruptions due to the fighting coupled with the sweeping trade and transportation embargoes are impacting commodity

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and currency markets all over the world. Markets for oil and gas, food, commodities, fertilisers and base metals are in turmoil and are affecting prices and availability of these essentials in importing countries.

The Western Sanctions Regime

There are also signs of wider geo-economic trends and implications, arising primarily out of the sweeping sanctions regime put in place by the Western world. Some of the prominent sanctions are outlined next.

Russian foreign exchange reserves denominated in US dollars have been frozen. It is estimated that about US$ 300 billion of Russia's foreign exchange reserves of about US$ 630 billion have been so impounded.[1]

SWIFT (Society for Worldwide Interbank Financial Telecommunications is a cross-country financial messaging protocol that enables secure and quick worldwide money transfers to happen. Over time, it has become the de facto industry standard, with over 11,000 financial institutions in 200 countries using it.[2] It is almost essential for enabling international money transactions.

Following a joint US–EU decision,[3] the 'independent' SWIFT overnight cut off Russian banks from their network, severing their banking links with the rest of the world. As a result, today SWIFT is no longer 'worldwide' in scope. Notably, such steps were not taken even at the height of the Cold War.

Also, for the first time, private sector enterprises based in US/EU jurisdictions doing business in Russia have had to close down their operations and exit the country at their own expense. Tech giants like Apple and Tesla, energy multinationals like Shell and Exxon, IT companies like IBM and Apple, credit card majors like Visa and MasterCard and consumer brands like McDonalds and Coca-Cola have had to hastily pull out of Russia.

The transportation embargo has disrupted movement of essential commodities through shipping, particularly in the Black Sea. Transit through European airspace is blocked for Russian airlines, and transit through Russian airspace is blocked for Western airlines. This means longer routes, and higher costs of East–West air movement.

Sanctions are targeting not just the State, but also individual Russians. The US-led alliance is treating it as a whole-of-society war. Assets of 'oligarchs', i.e., rich businessmen of Russian origin have been summarily seized, including assets like private yachts found docked in

European ports! Prominent Russian personalities like sportsmen, artistes are being denied participation in international events.

Global Geo-economic Implications

Financial sanctions against Russia have hit its economy, however it has shown surprising resilience. Russian gas exports are continuing at higher prices. By stipulating rouble payment for such exports, the exchange value of the rouble has stabilised. Alternative markets for oil have been found in Asia. Against the initial thinking that current year Gross Domestic Product (GDP) may contract by a third in 2022, Russia now estimates the actual contraction to be less than 3 per cent.[4]

At the same time, there is simultaneously going to be a strong blowback to the sanctions regime. This is because the economic sanctions do not just hurt the Russian economy, they strike at the very heart of the international capitalist order. The current order based on trust in open global trade and business, and sanctity of ownership of private property across borders is in peril.

For example, most countries hold foreign exchange reserves that represent the earnings of a country from the goods and services exported by it to other countries. Most reserves are held in dollars, since the dollar is regarded as the universally acceptable currency. However, now, if the dollar issuing country so desires, such reserves belonging to a country can be just taken away.

This is surely a cause of concern to any non-Western country with relatively large foreign exchange reserves (e.g., China, India, Saudi Arabia, Brazil) who may at some point of time be on the wrong side of the US. It would lessen the confidence in the dollar as a reserve currency and eventually lead to weakening of the historically dominant status of the US dollar in the world economy.

A few signs are already visible on the horizon. One major force reinforcing the dollar as the world's reserve currency has been the petrodollar. By signing an agreement with the US,[5] Saudi Arabia agreed to sell its oil only in exchange for dollars. Later, all members of the Organization of the Petroleum Exporting Countries followed suit. This arrangement also meant that oil-importing countries also had to stock dollar reserves to pay for its oil.

Today, the US has reduced its dependence on Saudi oil, while China constitutes about 25 per cent of the market. Saudi Arabia is reportedly[6] seriously considering accepting yuan in addition to the dollar as payment for oil. If this happens, it may be the beginning of the unraveling of unquestioned dollar supremacy. Other efforts are on to bypass the dollar like the alternative rupee–rouble payment settlement mechanism being worked out by India and Russia for bilateral oil trade.

The action on SWIFT will have equally significant implications. The exclusion of Russia from this interbank financial messaging system has opened up room for parallel systems to fill the gap. Russia and China have similar systems, the Financial Message Transfer System of the Bank of Russia (SPFS) and Cross-Border Interbank Payment System (CIPS) respectively, however these have limited reach. Russia is pushing the use of SPFS to bypass sanctions. However, wider acceptability of a Russian or Chinese system will be a problem.

India has the technical capabilities, having put in place far more complex domestic messaging and transfer systems like Real Time Gross Settlement (RTGS)/National Electronic Financial Transfer (NEFT) and the Unified Payments Interface (UPI), and can also potentially set up an alternative. The Reserve Bank of India (RBI) has indicated[7] the possibility of floating an international payment settlement system based on the UPI platform. It is possible, and worth attempting.[8] While SWIFT has the first mover advantage and is not going away anytime soon, its self-limiting decision makes it likely that sooner or later alternatives with acceptability in the non-Western world may emerge.

Another unique feature of the sanctions has been the trashing of hitherto sacrosanct commercial contracts, regardless of international law! Foreign investors have complied. Time-honoured rules of the game have been given the go-by, just by an American diktat. Faith in the reliability of Western investors will be shaken, to their disadvantage.

The sanctions and de facto economic blockade (with a few exceptions) have cut off or restricted communication linkages across a large part of the globe. The hard line being adopted by the countries of the NATO alliance leads to the strong possibility of the increasing segmentation of world trade, transport, communications and the Internet continuing even after the crisis is over.

Major Regional Implications

The regional impact of the conflict on the parties to the conflict is not going to be uniform, even for regions on the same side. Some region-specific trends are emerging, which are discussed next.

Russia and Ukraine

The economies of both the combatants on the ground are going to be hard hit as they bear the direct impact of war, though estimates of the costs vary widely depending on the point of view. With prospects of the war continuing, and sanctions perhaps outlasting the cessation of hostilities, there is near term economic pain ahead for Russia. The availability of high technology inputs for key industries as well as consumer goods will be squeezed, there will be shortages, and things will cost more.

Nevertheless, being a large country with immense natural resources, Russia may be able to tighten its belt and tide through the sanctions regime, albeit at a reduced level of living. In the medium term, the importance of being a commodity-producing country in the new world economic environment is only going to grow. Because Russia is endowed with vast oil, gas and key mineral deposits that are needed for the modern world to function, excluding Russia from the Western economic order may lead to more painful adjustments for the West than anticipated. The forces of demand and supply will ensure that commodities and resources find their way to where there is a requirement, irrespective of whether sanctions are imposed or not.

Being the theatre of war, Ukraine and Ukrainians will suffer the maximum damage. As per the Ukrainian estimates, the total cost of the war in terms of infrastructure destroyed and economic losses has already reached about US$ 1 trillion, and is increasing further. Ukrainian President Zelensky is reported[9] to have stated that the government needs US$ 7 billion every month in foreign assistance just to stay afloat. Ukraine's GDP may contract by up to 30–35 per cent in the current year, according to estimates. A study by the World Bank suggests that Ukraine will need over US$ 350 billion[10] for reconstruction. The human cost is incalculable. The generosity of donors may not match the requirements.

European Union and the UK

For the European countries, the early signs are ominous. Mainland Europe had built up deep economic linkages with Russia after the collapse of the Soviet Union, to its economic advantage. Pipelines from Russia had made gas cheaper and more plentiful in Europe. Russian gas had been meeting up to 40 per cent of Europe's demand. Now the sanctions and the sabotage of both the Nord Stream pipelines has ensured that gas supply from Russia will be drastically curtailed.

Energy shortages are likely, and the resources available will cost more. Recessionary conditions are likely to develop. For example, the competitive edge of the globally competitive manufacturing industry in Europe's economic powerhouse Germany will erode. It is a sort of economic hara-kiri for Germany to be deliberately cutting off the links that served it well and made good economic sense. It is the common man who will suffer in the form of layoffs and rising prices.

It looks like it is going to be a cold winter in Europe. Oil, gas, food and fertiliser shortages will lead to higher cost imports, rationing, price rises and create economy-wise inflationary pressures that will be hard to control. Budgets will be difficult to balance. The EU's trade balance for the first eight months of the year has swung from a surplus of 92 billion euros in 2021 to an estimated deficit of 310 billion euros in 2022![11]

Further, there is now sharp escalation in threat perception from Russia, which implies that European countries will spend a lot more on arms. For instance, even normally pacifist Germany declared that it would spend an additional US$ 100 billion on armaments. It goes without saying that this would be at the expense of spending on development and welfare. Similarly, other EU countries are also upping their military spending, with similar trade-offs.

Europeans also have to bear the burden of the refugee influx (about 7.6 million at last count)[12] caused by the displacement of populations due to the conflict. At the end of the war, European governments will be expected to contribute substantially to the reconstruction of Ukraine.

These burdens are likely to engender public dissatisfaction in European countries, with consequent political turmoil. In all, the European continent is headed for a downward economic spiral.

The United States

The United States is the leader of the NATO alliance and actively driving the hard line economic and societal sanctions against Russia. The US is a gainer from the conflict in the short term. It has created a huge additional demand for the output of its weapons industry. The US Government has already provided military assistance worth US$ 27.5 billion to Ukraine.[13] This is a bonanza for the US arms manufacturers, who include the biggest names in US industry like Boeing, Raytheon, Lockheed Martin and General Electric. Sales are brisk, without any country risk, as their own government is directly underwriting the orders.

In addition, the US-led Ukraine war sanctions have at one stroke successfully scuttled the growing Europe–Russia trade relationship, and strengthened American economic links with European markets. By disrupting the supplier–consumer relationship between Russia and Europe, the US has created a market for export of its gas. Expensive liquefied natural gas (LNG) from the US is being imported by Europe to partially fill the gap in supplies from Russia.

No wonder that the US would like Ukraine to continue fighting 'to the last Ukrainian'.

However, the long-term geo-economic fallout may prove to be less rosy for the US.

Already, the war-induced price pressures in energy and food have led to record inflation levels around 8 per cent. Steps taken like raising interest rates may not be able to check rising prices. Analysts are forecasting probability of a looming recession.

The weaponisation of private sector entities may eventually threaten the trans-national credibility of these entities. The arbitrary seizure of another country's dollar reserves will erode the international trust in the dollar as the ultimate reserve currency. The petrodollar arrangement may unravel sooner rather than later. These may pose a challenge to the universal acceptability of the dollar.

Formally, the US national security strategy[14] 'recognizes that the PRC presents America's most consequential geopolitical challenge'. In reviving Cold War hostilities with Russia on an unprecedented scale, the US has opened a front that could have been avoided. It may have taken its eyes off the ball, and given its main geopolitical challenger valuable breathing space. This is likely to cost US in the years to come, in ways yet to be seen.

The World Beyond the West

China stands to benefit from the new US focus on Russia as enemy number one. With its sizable domestic economy, manufacturing capabilities, close relationship to Russia, and potential weakening of the US-dominated global financial order, China is well placed to emerge stronger once the conflict is over.

India too is prudently staying on the sidelines of the conflict, and seeking to derive national economic advantage out of a tricky situation. Its historical relationship with Russia, and present strategic utility to the US may enable it to ride out the storm relatively unscathed.

Rather, it is now increasingly possible that there may be enduring gains for India. To take a few examples, energy security may be enhanced by the diversification of sources of oil imports, and the possible picking up of stakes in Russian oilfields. The development of the multi-modal International North–South Transport Corridor (INSTC) from Russia to India may help build stronger economic links with Eurasian and Central Asian countries.[15] The push for greater acceptability of rupee-based international financial messaging and transaction systems could have great potential.

Barring the oil-producing countries, for the rest of the developing world in Africa, Asia and South America, there will be hard times. Declining economic growth in rich countries, instability in the global economic order and Western prioritisation of a Euro-centric conflict will mean less trade and financial flows to needy regions. They will also have to put up with shortages of food, essential commodities and tackle domestic inflation. The spectre of economic distress may stare some vulnerable countries in the face.

The Kenyan proverb 'When two elephants fight, it is the grass that gets trampled', more or less reflects the state of the world today!

Conclusion

The present global economic order based on more open trade and commerce and greater economic integration has been in place since World War II. The rich Western countries that created the architecture dominate this economic order. However, so far this order has been generally accepted even by leading non-Western countries that have different domestic political systems, e.g., China, Russia and Saudi Arabia.

Clarity in the rules of the game brought about a long period of relative stability. The fallout of the current set of economic sanctions will have the effect of many countries questioning the rules of the game, and seeking alternatives to the existing international financial system. International law will have less force, and trans-national commercial contracts may no longer be seen as binding.

It is very likely that the geo-economic ripples resulting from the Ukraine-centred events will keep expanding for many years into the future. Continued exclusion by the leading powers of a major player from the world economy, increased segmentation of commerce, communications and the internet, financial turmoil, shifts in relative economic power are all in the offing. All these will lead to a splintering of the current global economic order. Ironically, the fallout of such a splintering would first and foremost hit the economic self-interest of the Western world that has played a major role in setting these ripples in motion!

We are seeing the beginning of a period of major churning of the world economy, the end outcome of which cannot be predicted. All that can be hazarded at this stage is that global trade and economic growth will falter. The era of West-led globalisation seems to be winding down.

Economic strength determines the ability of a country to project comprehensive national power. The differential economic impact of the war will thus inevitably result in strategic power shifts. Indications are that these power shifts will be away from the Western world. Non-Western countries with sound economies not involved in the conflict will gain. Who gains more, who gains less, is to be seen as the geo-economic forces let loose by the dogs of war play themselves out.

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