25 February 2022

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Impact of Ukraine crisis on India

Background

Tension between Russia and Ukraine was simmering in the last few months. The bone of contention was Russia's objection to including Ukraine in NATO. However, in an unexpected turn of events, Russia invaded Ukraine yesterday and launched a full scale military offensive. Uncertainty over the crisis has roiled global markets.

Economic Sanctions are the global first response

Several developed countries including US, UK and European nations have imposed sanctions on Russia to deter further increase in hostilities by Russia. These have ranged from sanctions on banks as well as individuals and also export controls.

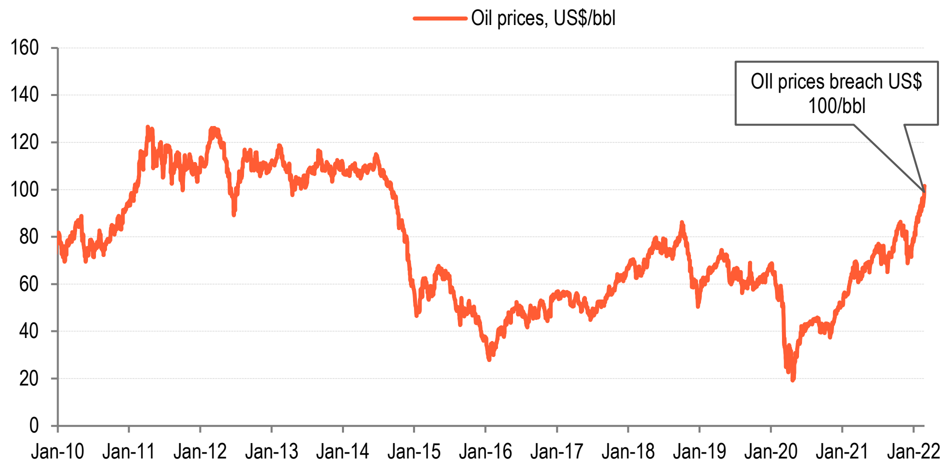
US has been the forefront and announced sanctions on Russian banks (Sberbank- holds nearly one-third of Russia's banking sector assets and VTB Bank- holds nearly one-fifth of Russia's banking sector assets), export control measures (which will more than halve Russia's high-tech imports) as well as sanctions on wealthy Russians and their families. Further, restrictions have also been placed on new debt and equity issue of 13 critical Russian financial entities. Also, sale of all US items and any item using US technology/software/equipment to Russian military and Ministry of defense has been prohibited.

Similar restrictions have been placed by the UK. This includes: Freezing the assets of Russian bank VTB (and 5 other banks) and arms manufacturer Rostec, sanctions on 5 more oligarchs (in addition to sanctions announced on 3 billionaire businessmen earlier), banning Aeroflot from British airspace, proposal of introducing legislation to prevent Russian state and entities from raising money in London, ban on export of "dual-use" equipment that can have military applications and legislation to limit on deposits by Russians in UK bank accounts (the ceiling has yet to be determined).

European Union has also announced sanctions against the 351 members of the Russian parliament who voted in favour of recognition of the two separatist states (Donetsk and Luhansk) and also against 27 individuals and entities. Travel ban applicable to the listed persons prevents these from entering or transiting through EU territory. Further, restrictions have been imposed on economic relations with these areas including restrictions on trade and investments and prohibition to supply tourism services; and export ban for certain goods and technologies. Sanctions have also been placed on Russia's access to EU's capital and financial markets and services, including freezing of Russian assets in the bloc. EU members also introduced export controls targeting Russia's energy and transport sectors, and plan to choke its trade and manufacturing. Further, Germany has stalled certification of Russian-owned Nord Stream 2 gas pipeline.

Apart from the humanitarian impact of war, economic impact is also estimated to be large. Global stock markets and currencies have fallen sharply. Demand for safe-havens such as gold has risen. Treasury yields across the world are also lower. Oil prices are at the highest level since Sep'14.

Fig:1 Oil prices have risen



Impact on India

Economic impact of the Russia-Ukraine crisis is likely to be through higher oil prices. Since India is a large consumer of oil much of which is imported, the impact of higher oil prices is likely to be visible not only on trade deficit and currency but will also impact inflation and fiscal situation. It must be noted that both the Union Budget and RBI's monetary policy announcement came much before this crisis and did not factor in the impact of the crude price shock. Both the Budget and RBI hence took a conservative estimate of crude prices ~US$ 75/bbl which is likely to be a challenge going forward.

1. **Trade deficit:** India imports more than 80% of its total oil requirement and is the world's third largest importer of crude oil. In FY21, India's oil imports totaled US$ 82.7bn. In FYTD22 (Apr'21-Jan'22), oil imports have risen to US$ 125.5bn driven in part by economic recovery as well as higher oil prices. However, with oil prices now hovering at an 8-year high, oil imports are likely to be higher. In FYTD22, we estimate oil imports at US$ 155.5bn.

   For the next year, oil imports are likely to be higher due to improvement in economic activity. We estimate a modest 5% increase in oil demand. Ceteris paribus, we assume trade deficit to increase to US$ 165bn. Further, a sustained increase in oil prices will push imports higher. We estimate that for every 10% increase in oil prices on a permanent basis, oil imports are likely to inch up by US$ 15bn or 0.4% of GDP. This will get reflected in higher current account deficit. On the positive side, India also exports some refinery products and is likely to benefit from higher oil prices. This will likely offset some of the negative impact on imports.

2. **USD/INR:** Rupee has come under pressure due to higher oil prices. Higher oil prices lead to burgeoning trade deficit and hence adversely impact the external stability. This lead to currency depreciation. On 24 Feb 2022, when the news of Russia's offensive against Ukraine broke, oil prices inched up by 2.3%. Concomitantly, INR depreciated by 1.4% registering its steepest single-day decline since Apr'21. With uncertainty around the future course of the war, INR is likely to remain volatile. Hence, RBI may announce more USD/INR buy/sell swap auction to manage volatility in the forex market. We expect INR to remain under pressure given the elevated level of crude prices and trade in the range of 75-77/$ in the near-term.

3. **Inflation:** Crude oil related products carry a weight of 7.3% in the WPI basket. Hence the direct impact of a 10% increase in oil prices is estimated be around ~0.7% on WPI. Adding the indirect impact, the overall effect can be around 1% increase in WPI inflation.

   The impact on CPI inflation will be both direct and indirect. First is the direct impact. Petrol and related products have a weight of 2.4% in the CPI basket. However, retail prices of petrol and diesel at pumps also include excise, VAT etc. which will remain unchanged. Even if the base rate of petrol/diesel goes by 5%, the actual impact on the retail prices is estimated to be ~5%. Hence, we estimate that the direct impact of a 10% increase in oil prices is only ~0.15%. Higher oil prices will also feed into supply chains and push prices of other commodities and services upwards. The indirect impact of this pass-through is likely to be higher at about 0.25%-0.35%.

4. **Bilateral trade with Russia:** Russia is not a major trade partner for India. In FY21, India's exports to Russia were US$ 2.7bn or 0.9% of India's total exports. These are mainly pharmaceuticals and electrical machinery. India's imports from Russia were US$ 5.5bn or 1.4% of total imports. Petroleum products form half India's imports from Russia and can be easily replaced with other markets. Hence impact on India's bilateral trade with Russia is not likely to be significant.

5. **Fiscal impact:** The fiscal response to the crude oil price needs to be monitored closely. As stated earlier, government has assumed oil prices at US$ 75/bbl in the Budget. Notably, government lowered its subsidy bill for FY22 and FY23 significantly. This included cutting subsidies on petroleum products as well. Further, it must be noted that the government had cut excise duty on petrol and diesel by Rs 5/litre and Rs 10/litre respectively in Nov'21. With the government walking on the narrow road of fiscal consolidation and already elevated borrowing programme, the fiscal space for increase in subsidies or excise duty is limited.

6. **RBI policy:** RBI has remained fairly dovish in its Feb'22 policy statement and maintained its accommodative stance. While noting that rise in inflation remains supply-driven, MPC members gave priority to growth. RBI's last policy meet which was held before the flare-up of geo-political tensions between Russia and Ukraine, did not account for the impact of higher oil prices on inflation. RBI's estimates for inflation for FY23 at 4.5% looked too optimistic. Oil prices have inched up by 11.2% since 10 Feb 2022 (RBI policy meet) which is likely to push the inflation trajectory upwards. Hence, RBI might drop its accommodative stance in Apr'22. Further, the first policy of FY23 may also mark the start of policy normalisation by RBI through a change in reverse repo rate.

7. **Implications:** India's 10Y G-sec yield closed 2bps higher at 6.76% yesterday and is currently trading at the same level today. We expect 10Y yield to remain elevated in the near-term amidst higher oil prices and uncertainty over the crisis. In any case, the lower ceiling of 10Y yield is likely to be 6.7% in the near-future. A lot will depend on the duration and the trajectory of the crisis.

Conclusion: While there will be no direct impact of the Russia-Ukraine crisis on India in terms of bilateral trade, however surge in oil prices as a result of the crisis pose considerable risks to the Indian economy. Higher oil prices pose risks to external stability and currency movement. Further, apart from the direct impact of higher prices on inflation, pass-through effect on other sectors may not be transitory as expected by the RBI. Further, government may have to calibrate its fiscal stance given the rising yields.

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