

Russia and Ukraine conflict

Update from the Chief Economist's team

7 March 2022

Economic implications

The escalation of the conflict between Russia and Ukraine following the full-scale invasion by Russia at the end of February will cause inflation to rise while exacerbating supply chain pressures.

Despite the already strained relations between the West and Russia since the Russian invasion of Crimea in 2014, the new sanctions and the uncertainty around the supply of some key commodities will be felt particularly in Europe, where some of the strongest trade links with Russia remain.

Markets could see continued volatility as the crisis evolves, with investors opting for safe havens, and some transactions postponed. Geopolitical and economic uncertainty is likely to remain high while the military operations continue to take place.

We could see the ECB pursuing more accommodative monetary policy this year, with lift-off in interest rates postponed, despite the rising pressures on inflation. The Bank of England may, however, pursue an unchanged path of further two hikes in rates by the summer.

Supply chains under strain

Prior to the invasion, companies in the UK were reporting some easing in supply chain constraints, although they were still rising in the Eurozone. The latest developments are likely to reverse some of these gains.

UK trade with Russia fell sharply after 2013, although imports generally recovered while exports to Russia were still down by a third by 2020. During the first three quarters of 2021, UK imports of goods and services from Russia reached £8.3bn and exports £3.3bn, with main exports including cars, pharmaceuticals and specialised machinery while import goods were mainly oil, metal and gas products.

Russia and Ukraine produce a significant share of basic metals such as nickel, aluminium, and palladium. Delays in their procurement could hit industrial production and the wider supply chain. Other disruptions are likely due to shortage of components imported from the region, especially in sectors such as automotive manufacturing.

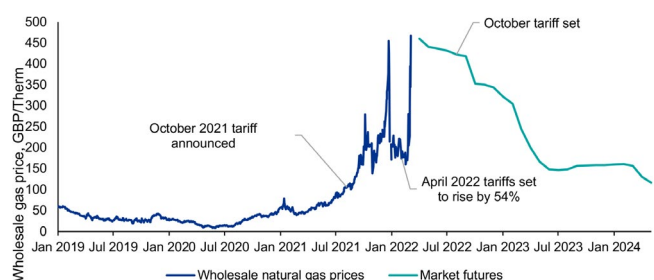
Food production could also be affected by the region's important global share of fertilisers production, impacting the global food supply chain.

Inflation to remain higher for longer

Prices of oil and gas, the most important Russian exports, have risen significantly. The price of gas more than doubled since the start of the conflict and oil prices rose above US\$125 per barrel.

If gas prices stay at current levels, the UK price cap could increase by around 50% again in October, following the scheduled 54% rise next month, with part of the October increase offset by the introduction of the Treasury-backed £200 discount on bills.

Chart 1: UK regulated gas prices could rise again in October



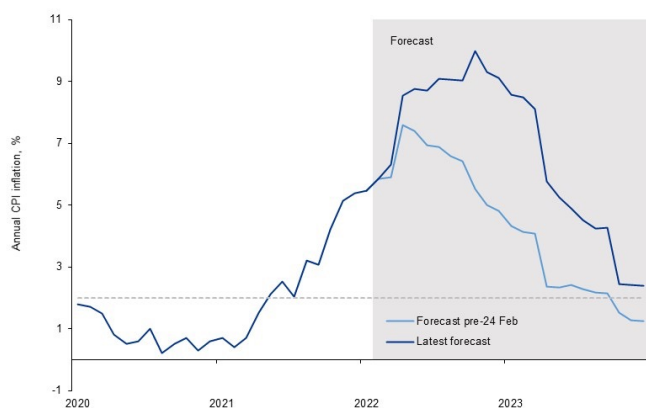
Source: Refinitiv Eikon, KPMG analysis, 7 March 2022.

The price of nickel has also gone up, as well as the prices of fertilisers and basic food staples such as wheat and vegetable oils, with overall food prices likely to be affected.

Russia and Ukraine make up 25-30% of global exports of wheat and a significant share of sunflower seeds. The higher price of wheat alone, up by more than 50% as of 7 March, could add more than one percentage point to UK inflation.

The increase in raw materials and energy prices will gradually translate into higher inflation figures. We currently expect UK CPI inflation to reach around 8.8% in May this year, but then to remain elevated for longer, potentially peaking at 10% in October 2022.

Chart 2: UK inflation could hit double digits this year



Source: ONS, KPMG forecasts, 7 March 2022.

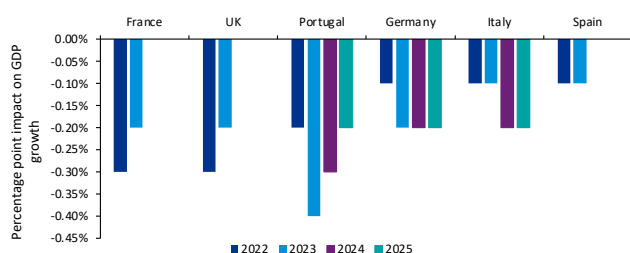
Inflation in the UK is now expected to average 8.3% in 2022 and 5.1% in 2023.

The need to lower the dependency on Russian energy could see energy costs remaining high for much longer. Our expectations are that inflation will go back to the Bank of England's 2% target in 2024, but there will be less downward pressure on prices after that than was originally expected.

Weaker economic growth

Higher inflation will put downward pressure on demand. Our analysis shows that a 10% rise in the oil price together with a 50% rise in the price of gas could see a 0.5% reduction in UK GDP and a similar fall in other European economies.

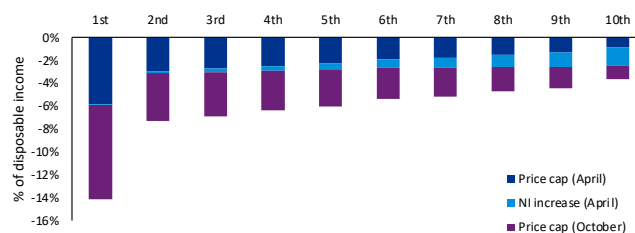
Chart 3: The impact of a 10% rise in oil prices and a 50% rise in gas prices on selected European countries (percentage points change in GDP growth)



Source: NiGEM, KPMG analysis, 3 March 2022.

Higher energy prices will particularly hit hard lower income households, which are already disproportionately affected by the rise in utility prices this April. Absent further support from the government, the two expected increases in the gas price cap this year could see disposable income of the lowest income households fall by nearly 14% in the UK. Higher income households are likely to be less severely affected thanks to spending relatively less of their income on energy, although more proportionally affected by the rise in National Insurance contributions.

Chart 3: UK households are facing a squeeze on income



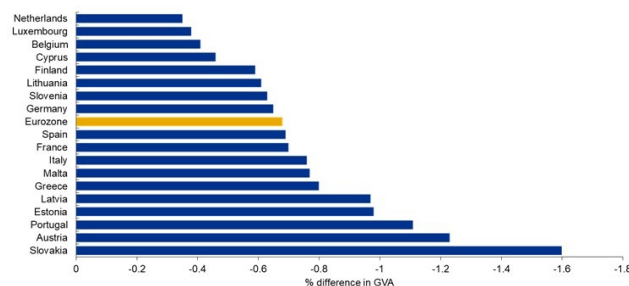
Source: ONS, University of Essex, KPMG analysis, 7 March 2022.

Further headwinds for the UK economy are likely to arise from the elevated levels of uncertainty, tighter financial conditions, and disruptions to trade, potentially reducing GDP growth to 3.3% this year and to 0.8% next year.

Risks from further escalation

One scenario which could exacerbate the impact of the crisis on many European economies is a potential reduction in the availability of gas, in addition to the rise in prices. The region is particularly vulnerable to a cut in gas supply, given that it gets 30-40% of its gas supply from Russia. While this is not our central scenario, in the event Eurozone no longer had access to Russian gas, its GDP could fall by around 2%.

Chart 4: Impact of a 10% cut in the gas supply on Eurozone GDP



Source: ECB (2022), 'Natural gas dependence and risks to euro area activity', ECB Economic Bulletin, Issue 1/2022.

While the UK only imports around 5% of its gas supply from Russia, such a scenario would represent a significant indirect shock to its economy, through a decline in the demand for its exports and further disruptions to supply chains.

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