# Russia and Ukraine conflict: Economic implications

## Update from KPMG's Chief Economist in the UK

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 both the European Central Bank and, to some degree, the US Federal Reserve pursuing a more accommodative monetary policy this year, with a slightly more gradual lift-off in interest rates, 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, the US and China 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.

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 a shortage of components imported from the region, especially in sectors such as automotive manufacturing. Several German car makers have already curtailed production due to the shortage of wiring systems supplied from Ukraine.

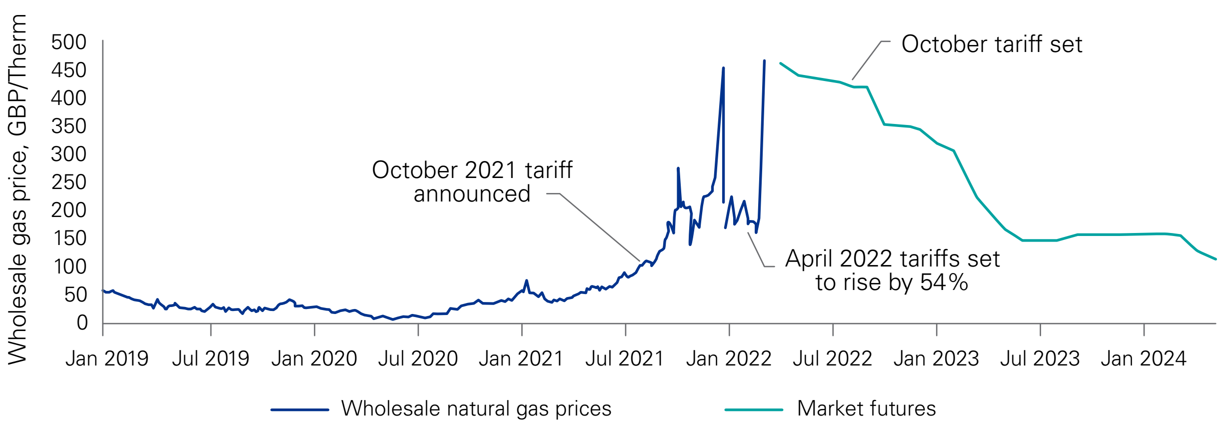
Food production could also be affected by the region's important global share of fertilizers production, impacting the global food supply chain.

### 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.

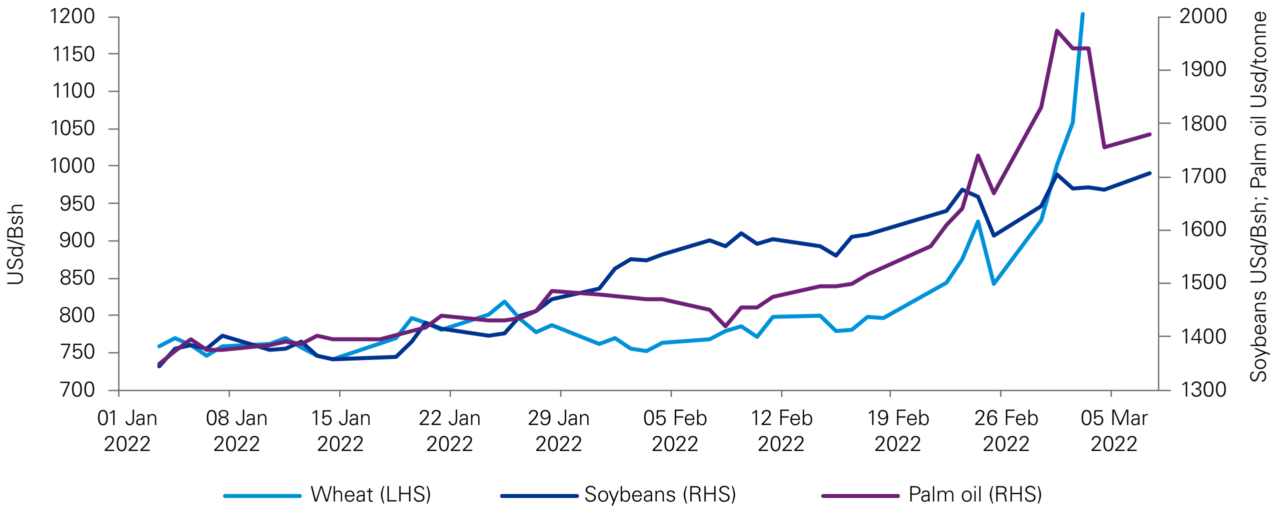
If gas prices stay at current levels, energy bills are likely to rise in the near future, exacerbating the squeeze on consumer incomes. In the UK, the cap on households' gas prices could increase by around 50% again in October, following the scheduled 54% rise next month, with part of the October increase 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.

## Chart 2: Prices of some food staples are on the rise




Source: Refinitiv Eikon, 7 March 2022.

The price of nickel has also gone up, as well as the prices of fertilizers 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.

The need to lower the dependency on Russian energy will mean that energy costs are likely to remain high for much longer. All European economies are likely to see some impact, which could translate into a stronger pace of inflation over the next few years.

## Weaker economic growth

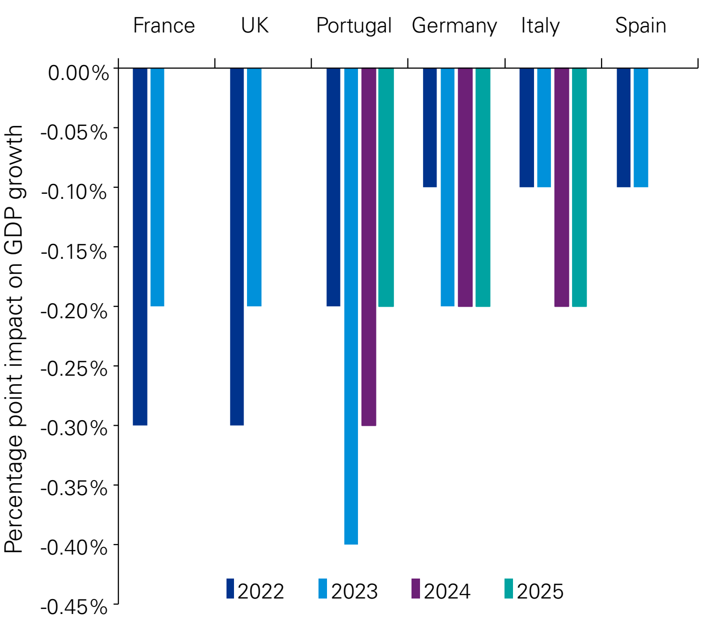
The most exposed country to trade frictions arising from the conflict could be Lithuania, whose exports to Russia make up 6 percent of its GDP. Analysis by the Kiel Institute found that Lithuania could see a reduction in GDP of around 2.5% in the long-run as a result of trade restrictions with Russia, with Latvia and Estonia potentially experiencing a reduction of 2% in the size of their economies in the long-run.

The larger European economies of Germany, Italy, and France have a much smaller exposure, with exports to Russia accounting for between 1 and 2 percent of their total exports, and the long-term impact from trade restrictions on their economies was estimated as a reduction of around 0.4% to 0.16% in GDP, while Poland could see a slightly higher reduction of 0.78%, according to analysis by the Kiel Institute.

Higher inflation will put downward pressure on demand, in addition to the headwinds from disruptions to trade. Our simulation analysis found that a 10% rise in the price of oil together with a 50% rise in the price of gas could see around a 0.5% reduction in the GDP of some of the larger European economies. As of early March, market data suggest this simulation captures around half of the impact on GDP growth given the rise in energy prices.

The impact on economies outside Europe will be felt through rising prices and spillover effects from trade frictions. IMF's estimates suggest that a 10% rise in oil prices that is entirely supply-driven would decrease world GDP by between 0.1% and 0.2%. If sustained, we would expect this to result in a redistribution of income from oil-consuming to oil-producing countries, which tend to have a lower propensity to spend. That could also negatively affect investment in oil-importing countries through a fall in profitability. Meanwhile, as trade with Russia is diverted away from the West and towards other destinations, some countries could see their exports benefit in the short-term.

## 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)



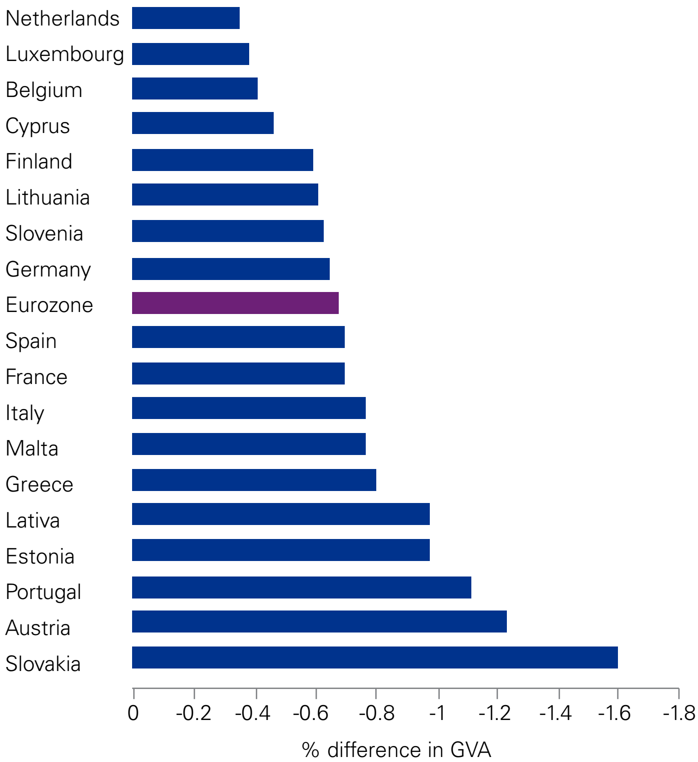

Source: National Institute Global Econometric Model, KPMG analysis, 3 March 2022.

## 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 gas 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%.

That would also represent a significant indirect shock to economies such as the UK, which import only 5% of its gas supply from Russia, through a decline in demand for exports and further disruptions to supply chains.

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




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

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