



# THE ECONOMIC IMPACT OF WAR IN UKRAINE

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**Russia's invasion of Ukraine on February 24<sup>th</sup> has materially altered the near-term outlook for the UK and global economies and increased uncertainty over the path ahead. The note below summarises early analysis on the impact on the UK economy via four main channels: energy (and other commodities), trade, financial links and confidence. It concludes with a brief discussion of the possible implications for UK inflation, growth and the outlook for interest rates.**

## Summary

- At a macro level, higher energy prices are by far the greatest concern for the UK economy which, all else equal, will result in further upward pressure on inflation and a modest hit to GDP growth over the next two years. However, Europe's high dependency on Russia for its energy supplies means even small disruptions to supply could have a significant impact on economic activity, resulting in a more severe shock than is widely considered likely at present.
- Higher prices for non-energy commodities, together with the potential for supply disruption, could exacerbate supply chain pressures in some sectors. Sectors at particular risk include automotive, technology and food & drink, given the prominent role of Russia and Ukraine in exports of key inputs/components.
- Generally, however, the UK has much less direct exposure to Russia and Ukraine than the EU: the UK is far less reliant on Russian gas and trades less with both countries. In turn, the US is more insulated than Europe.
- Depending on how the UK's sanctions regime evolves, individual companies with links to or operations in Russia may also be affected either directly (eg, energy, financial, technology firms) and indirectly (eg, airlines paying fly over fees).
- The prospect of further increases in energy prices sharpens the dilemma facing the Bank of England's Monetary Policy Committee. The MPC must weigh up the near-term impact of higher energy prices on domestic inflation against corresponding hits to demand (via the impact on real household incomes and firms' earnings).
- While heightened uncertainty might normally encourage the Bank to adopt a "wait-and-see" approach, given existing concerns around near-term inflation expectations and wage-price dynamics, higher energy and commodity prices are likely to reinforce expectations that the Bank will raise interest rates further in the coming months.

## The four main impact channels:

### Commodities

The most significant risk to the outlook stems from the possible disruption to European energy supplies which, though considered by analysts as unlikely, is already resulting in a supply shock as the prices for oil, gas and other commodities move higher.

## Energy

Russia is the biggest provider of gas to mainland Europe and a major exporter of crude oil and refined products. European oil and gas prices rose sharply following Russia's invasion of Ukraine, reflecting the potential for physical interruptions to supply, particularly for gas where the risks are higher than for oil.

- Russia supplies around 5% of the UK's total natural gas imports, but around 40% of the EU's gas imports, including over half of Germany's gas imports and 100% of imports for some smaller central and eastern European countries.
- So far, energy has been spared in the initial wave of sanctions announced by the UK, EU, US and others. The 2014 precedent suggests sanctions to limit on Russian energy exports would be unlikely, as Russia's ability to redirect oil flows limits their effectiveness and Europe's dependence on gas precludes actions that would result in gas shortages.
- Against this backdrop, analysts present a range of scenarios for supply disruption. At the milder end, there could be a modest hit to activity from a short-lived loss of gas flows from Ukraine to Europe due to operational constraints. However, Russia has already reduced the volume of gas flowing through Ukraine this year and any disruption could be mitigated by Gazprom's ability to redirect gas flows through the Yamal pipeline, which doesn't cross Ukraine.
- A more extreme scenario could see Russia seek to retaliate to escalating sanctions by the West by curtailing gas flows to Europe, exacerbating an already tight European gas market and hitting production by major energy users, with a knock-on effect on GDP across Europe.

Russia's invasion and the mere threat of disruption to energy supplies sent oil and wholesale gas prices sharply higher. Although energy prices retreated as details of sanctions emerged, a prolonged period of heightened tensions/conflict is likely to keep prices elevated for longer. Coupled with this, Germany's announcement that it would suspend approval of the NordStream2 pipeline means that Gazprom is likely to continue with its strategy of limiting gas sales to Europe through the coming summer, which would mean European gas markets will remain tight, and prices high, heading into next winter.

- Dutch gas futures, a European benchmark, climbed by 50% overnight following Russia's invasion, before retreating, ending Friday up 30% in a week and over 400% higher than in February 2021.
- Similarly, UK gas futures rose by 50% overnight, back above £3 per therm, before retreating to end the week 24% up over the previous seven days, and 370% up over the year.
- Brent crude oil prices breached the \$100 per barrel mark following Russia's invasion, rising to \$104 p/b in intra-day trading, before dipping just below \$100 p/b on Friday—levels not seen since 2014 and up by more than 10% in a month.
- The near-term direction of prices will be influenced not only by the response to developments in Ukraine, but also by the outcome of ongoing negotiations over Iran's nuclear programme (with a deal likely to release more Iranian oil onto the market) and by the willingness/ability of OPEC+ and the US to respond by bringing additional oil to the market in order to limit price increases.
- Oil price forecasts have moved higher in recent days, with baseline forecasts seeing prices in the region of \$110 p/b through to the summer. Some market analysts predict that a failure to reach a deal with Iran and a lack of a response from OPEC+ could see oil prices approach \$125 p/b in the coming months.

## Non-energy commodities

Russia and Ukraine are both major exporters of non-energy commodities, particularly industrial metals and foodstuffs, as well as fertilisers. There are reports that the closure of Ukrainian ports and rail is disrupting exports of agriculture and metals (with 90% of Ukrainian grain exports transported by sea, for example). Higher prices will ripple through to end users, adding to existing cost pressures for firms in a range of sectors, particularly automotive, aerospace and technology industries, as well as the construction sector.

- Together, Ukraine and Russia account for more than half the world's exports of pig iron, and double-digit shares of semi-finish iron/steel products. Russia supplies one fifth of the world's nickel exports (used in the production of lithium-ion batteries, for example). It accounts almost one tenth of the world's aluminium (with uses ranging from car bodies to aircraft to household appliances) and copper (widely used in construction and electronics). Russia also produces a range of other metals, including 43% of the world's palladium (a component of catalytic converters).

- Ukraine is also a major exporter of mineral products, such as ceramics and clays. Other supply chains risks cited by analysts include key inputs used in the production of semi-conductors, such as neon, 90% of which comes from Ukraine and Russia.
- The conflict is likely to push up foodstuff prices, which were already at multi-year highs. Russia and Ukraine are the world's largest and third largest exporters of wheat, respectively, together supplying more than one-quarter of the world's wheat exports (8% from Ukraine). Ukraine supplies 12% of barley exports, almost 13% of corn exports and 40% of sunflower oil exports. Cereals prices have jumped by as much as 10% following Russia's invasion. Russia is also the world's largest exporter of fertilisers.
- Major commodity markets are already tight owing to the supply disruptions inflicted by Covid, so prices are highly responsive to even the smallest shocks. In a worst-case scenario, Russian exports could be curtailed if the payments infrastructure needed to facilitate them are hit by Western sanctions, which send prices higher.

## Trade and investment

Overall, Russia and Ukraine represent relatively **small export markets** for the UK—around 1% for Russia, even less for Ukraine. However, any escalation of sanctions against Russia that resulted in disruption to international payments would take a toll on international trade for individual businesses.

- UK exports to Russia are worth around £4.3bn per year, dominated by business services (£450m), cars (£386m), telecoms & computer services (£277m), pharmaceuticals (£272m), financial services (£269m), and a range of capital equipment.
- UK imports from Russia are worth around £11.6bn per year, mainly consisting of energy and other commodities.
- UK firms have direct investments in Russia worth £11bn, while Russian direct investment in the UK is worth £680m.
- UK exports to Ukraine are worth around £750m per year, with imports worth £1bn, dominated by foodstuffs and steel.
- The indirect impact of any disruption to trade via trade linkages should be limited, with the euro zone's exports to Russia and Ukraine also small (about 1% of GDP). Germany is slightly more exposed than Italy or France.

## Financial conditions

Financial links between Russia and the rest of the world are relatively limited. Reflecting this, global financial conditions tightened only slightly following Russia's invasion, with stockmarkets dipping by a couple of percentage points, and bond prices rising only slightly. According to J.P.Morgan, the total exposure of foreign banks to Russian corporates and banks (based on BIS locational banking statistics) is relatively small at \$89bn. Of this, UK banks have a total exposure of \$13.7bn, of which \$4.9bn is lent to Russian banks.

## Sentiment

There is a possibility of an impact through broader **sentiment** channels. Previous episodes of conflict in the region (such as the annexation of Crimea in March 2014) did not have clear or lasting impacts on business surveys in Europe. However, the scale and broader geo-political significance of Russia's actions this time, coupled with the extreme tail-risks for commodity supplies and prices, mean a more noticeable impact of business sentiment across Europe remains a possibility, with knock-on impacts on consumer spending and business investment.

## Impact on inflation, growth and the policy response

The jump in commodity prices will add to inflationary pressures in the UK. In the short-term, the impact of higher energy costs on CPI inflation and household incomes will be limited by Ofgem's price cap, which is fixed until October (assuming no changes before this). However, businesses may feel the effects on their energy bills more quickly, while transport companies and motorists will face higher fuel costs. Initial estimates from economic forecasters suggest CPI inflation could now peak above 8% in April and fall more slowly than previously expected.

Higher inflation will, in turn, add to the squeeze on real household incomes, weighing on spending on other goods and services. And for businesses, given that wages tend to be sticky in the short-term, higher costs

for energy and other inputs will put further pressure on profitability, potentially leading some firms to scale back employment or investment plans. Academic research suggests that, as a rule of thumb, a 10% increase in the oil price would tend to lower the level UK GDP by 0.4%, with around half of the impact being felt within the first year, and remainder felt over the following 2-3 years.

On the assumption that the risks to the global economy outlined above don't materialise—notably interruptions to the physical supply of energy and other commodities—the hit to the UK economy from Russia's invasion of Ukraine should remain fairly modest. Our expectations for a solid recovery this year remain broadly unchanged, with GDP growth now expected to be in the region of 4.5% (somewhat lower than our December forecast of 5.1%, considering recent developments, as well as Ofgem's decision to raise its energy price cap in April).

Nonetheless, the prospect of upward pressure on commodity prices sharpens the dilemma for the Bank of England, which must weigh the upside inflation risk and downside growth risk against each other when deciding the appropriate level of interest rates in the coming months. Historically, central banks have sometimes preferred to delay major policy decisions until uncertainty surrounding geopolitical risks has diminished. However, in the current climate, with concerns that a tight labour market is already stoking wage pressures, further increases in commodity prices might be more of a concern for the Bank of England. On balance, therefore, developments in recent days are likely to reinforce expectations that the Bank's Monetary Policy Committee will raise interest rates further in the coming months, although it is likely to proceed cautiously, with three to four increases of 25bps over the next two years likely to be sufficient to bring inflation back down to target.

**For information on UK government sanctions and support, please visit the CBI website:  
[www.cbi.org.uk](http://www.cbi.org.uk)**

**We would also welcome your feedback and thoughts on the economic impact of the Ukraine crisis.  
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