Box A: The economic consequences of the Ukraine War for UK household incomes

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Introduction

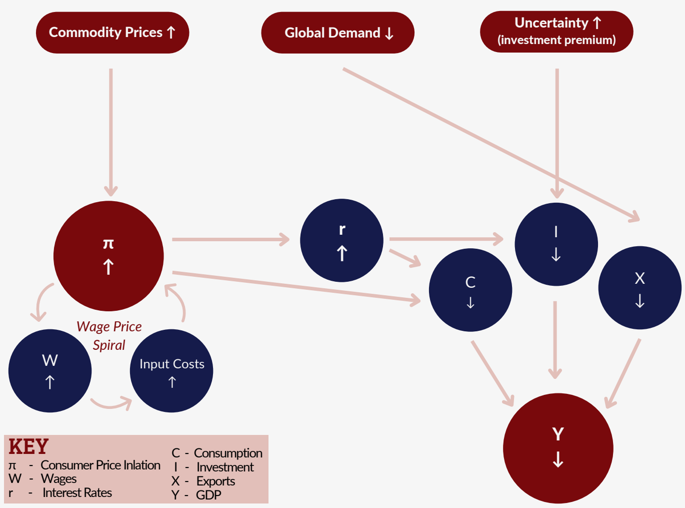
Russia's invasion of Ukraine on 24th February 2022, and the sanctions imposed in response by the UK and other countries, are likely to have a significant impact on the UK economy, despite this country having relatively few direct economic links to Russia. A quantitative analysis was produced by NIESR in early March (Liadze et al, 2022), which should be consulted for more details on the potential magnitudes of the shocks and their impacts.

Both the invasion itself and the sanctions imposed on exports of Russian energy have increased the prices of oil and gas, with oil prices above $100/barrel for the first time since 2014. In 2019, approximately 8 per cent of the UK's oil and 7 per cent of our gas was imported from Russia, compared to almost 60 per cent of gas from Norway. Electricity, gas and other fuels account for only 3.3 per cent of the UK consumer price index (CPI) basket, compared with 7.7 per cent of the US CPI basket. Nonetheless, with global GDP growth expected to slow down considerably this year, the significant negative supply shock which arises from elevated global commodity prices and a slowdown in global demand will have significant negative spillovers for UK GDP.

The prospect of further increases in energy prices heightens the dilemma facing members of the Bank of England's Monetary Policy Committee (MPC), who need to weigh the risk of higher global commodity prices becoming engrained in domestic inflation against the risk of amplifying the impact of the squeeze on incomes. In this box, we explore the channels through which the conflict are likely to impact the UK economy and real incomes in particular, using the channels through which NIESR's macroeconomic model, NiGEM, propagates the effects of the shock.

Analysis

Figure A1 Channels by which war-related shocks impact UK GDP and consumer inflation



Source: NIESR

Firstly, sanctions and supply disruptions have increased global commodity prices. This can be considered as a steepening of the Phillips Curve, so that a given level of demand is more inflationary. The shock has increased import inflation which feeds into higher consumer prices (see Figure A1). Higher domestic inflation directly reduces real disposable incomes, consumption and therefore GDP. If the shock is permanent, this

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represents a rapid transition to a new lower equilibrium growth path for the UK, meaning permanently lower real incomes for UK households.

This inflationary shock happened for businesses first and for households with the April rise in the energy price cap, with a large chance of another rise in the price cap in October. Low-income households will suffer the brunt of this worsening squeeze in real incomes, as they spend a larger share of their household budgets on food and energy. Fiscal transfers are also being eroded in real terms. Even before the invasion, NIESR forecast a 30 per cent rise in destitution, bringing the total number of destitute households to about 1 million (NIESR Winter 2022 UK Economic Outlook). As discussed in our UK Economic Outlook, the onus is on the government to provide greater fiscal support under these circumstances. In response to higher consumer prices (and in combination with a pre-existing tight labour market), workers may press for higher nominal wages, which in turn increases pressure on unit labour costs and may increase inflation further, if businesses respond by raising prices. If not contained, this potentially destabilising wage-price spiral may lead to inflation expectations becoming self-fulfilling, making it more difficult for the MPC to bring inflation back to target.

Higher domestic inflation is also likely to lead to tighter monetary policy than would have been the case otherwise, which further acts to reduce consumption and GDP. In addition to greater levels of uncertainty, higher interest rates increase the user cost of capital via long-term interest rates, which dampens investment and further reduces GDP. Finally, weaker global demand, particularly from Europe weighs on UK export volumes. The greater dependence of Europe on Russian energy compared with the UK means Europe faces much larger negative consequences, with negative spillover consequences for the UK.

Elsewhere, and with little impact on household incomes, the UK government is likely to increase temporarily spending on defence and refugee resettlement costs which may provide a small short-term boost to government consumption. More significantly for most households, the Spring Statement contained announcements intended to reduce the impact of rising energy bills, though this temporary rise in transfers and small cut in indirect taxation are likely to prove insufficient and may have to be increased or repeated later in 2022 (Millard et al, 2022). A small increase in the population via migration from Ukraine may also provide support to the economy in the long run. Nevertheless, the positive contributions to GDP and household incomes are small, and their effects will be significantly outweighed by negative GDP effects on consumption, from the erosion of real disposable incomes and higher interest rates, lower investment due to greater uncertainty and higher interest rates, and lower volumes of exports.

Conclusion

The war in Ukraine has further raised the prospects of stagflation and is likely to have a significant impact on the UK economy: in particular, worsening the squeeze on household incomes. Higher commodity prices and trade spillovers represent major channels through which the war will affect economic activity in the UK, and increased uncertainty weighing on confidence also has the potential to further reduce growth. Higher inflation, both directly as a result of higher commodity prices and indirectly through increased unit costs, will add to the squeeze on real household incomes. If rising inflation leads to significantly tighter monetary policy, there will be a further reduction in demand relative to our pre-war forecast, but if monetary policy is not tightened then inflation could be even higher and more persistent. There will need to be larger fiscal policy responses, as the only agent with the capacity to smooth the shock to national income without exacerbating it in the short-to-medium term is the government.

References

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