How will the Iran war affect the global economy?

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With the war with Iran in its second week, the most immediate and tragic costs are measured in lives lost. Yet economists are obliged to consider another dimension: the economic consequences. These, too, could be significant – though their distribution across the world economy will be uneven. Some countries will bear substantial costs. For others, the impact may prove surprisingly modest.

The heaviest burden will inevitably fall on the region itself. History offers a guide. During the 12-day war last summer, Israel's economy contracted by around 1% in the second quarter. If the conflict is short-lived, a fall in output of a similar order of magnitude would seem plausible for both Israel and the Gulf economies. A more prolonged conflict would almost certainly inflict a deeper economic wound. Output would be disrupted, investment postponed and tourism curtailed. Iran's economy will be hit even harder. Based on the impact of wars elsewhere, GDP is likely to fall by more than 10% – although Iran itself last published official GDP data in 2024.

But what of the global economy? Directly, the Middle East matters less than is often assumed. The Gulf economies account for only around 2-3% of global GDP. Even a severe regional downturn would therefore have limited direct consequences for world output.

Chokepoints

Instead, the key risks surround the disruptions to the supply of goods that economies in the region send to the rest of the world. Crises such as this have a habit of revealing chokepoints that were previously hidden. For example, Qatar produces 40% of the world's helium, which is used in the production of semiconductors. The region is also a significant producer of ammonia and nitrogen, which are key ingredients in many synthetic fertiliser products. The real transmission channel, though, is energy.

Around a quarter of global seaborne oil passes through the Strait of Hormuz, along with roughly one-fifth of liquefied natural gas shipments. Any disruption to transit through this narrow chokepoint has immediate consequences for global energy markets. Unsurprisingly, oil and gas prices have jumped since the conflict's start as shipments through the Strait have collapsed.

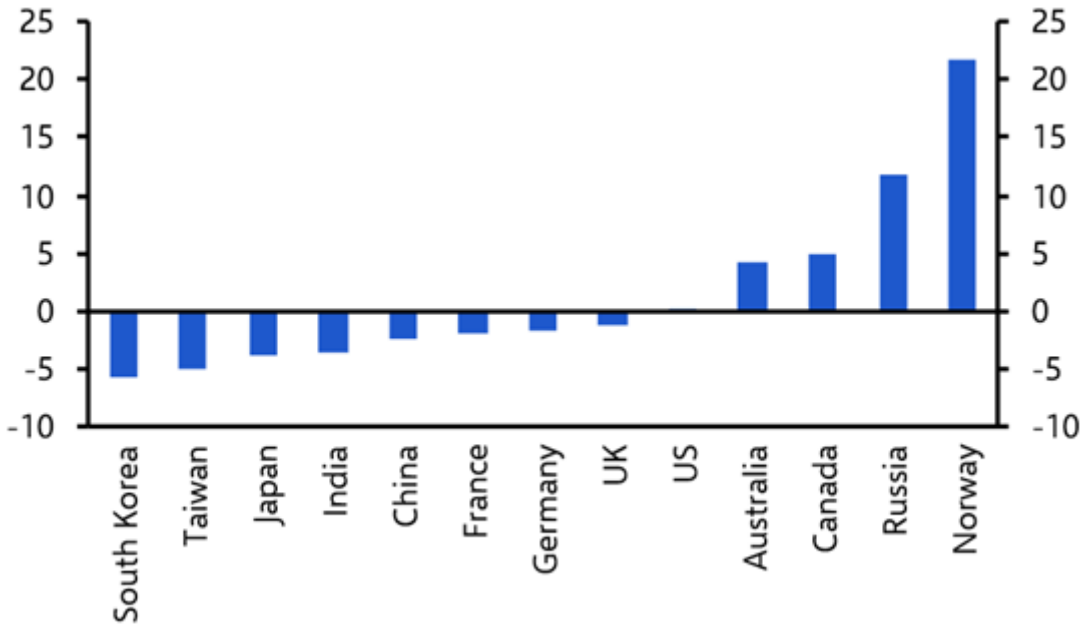
In economic terms, the mechanism through which such shocks operate is straightforward. Higher energy prices alter what economists call a country's terms of trade – the price of its exports relative to its imports. When energy prices rise, income is transferred from energy-importing countries to energy exporters.

The economic consequences of that transfer depend on three factors: whether a country is a net importer or exporter of energy; how large and persistent the price rise proves to be; and how

governments, households and businesses respond to the shift in income.

The obvious winners are large net energy exporters outside the Gulf whose ability to sell abroad is unaffected. Countries such as Norway, Russia and Canada stand to benefit the most from higher energy prices. (See Chart 1.)

Chart 1: Balance of Trade in Energy (as of % of own GDP)



Sources: LSEG Data & Analytics, Intracen

At the other end of the spectrum sit economies where energy imports account for a large share of GDP. This group includes countries such as South Korea, Taiwan, Japan, India and China, as well as most European economies including France, Germany and the UK.

The United States sits somewhere in the middle. Thanks to the shale revolution, the country has shifted from being one of the world's largest energy importers to a modest net exporter. In aggregate, that means the US economy as whole now benefits slightly from higher global energy prices – although the gains will be unevenly distributed.

Duration is key

The scale and persistence of the energy shock will ultimately determine the macroeconomic impact. For energy-importing economies, the main transmission channel is likely to be via inflation. Higher oil and gas prices raise the import bill faced by households and firms, squeezing real incomes and eroding purchasing power.

Recent signals provide some hope that the conflict may not last long. If so, and provided there is no lasting damage to energy production facilities, the recent spike in oil prices to above $100 per barrel would likely prove temporary, allowing most advanced economies to absorb the shock without significant disruption. As oil prices fall back, inflation in Europe and Asia in 2026 would likely be only around 0.5 percentage points higher than pre-conflict forecasts. Under this scenario, central bank

strategies would remain largely unchanged, and the impact on real GDP growth would be minimal. (Our core scenarios around this conflict can be viewed here.)

A more severe scenario in which the conflict persists for several months could see oil prices rise to around $130 per barrel before declining in the second half of the year. At a global level, the hit to growth would be modest, though the impact would be felt unevenly across regions. The euro-zone economy would probably contract in Q2 and then flatline over the second half of the year. The US economy would fare better but would nonetheless experience a slowdown in growth. Despite the weaker growth outlook, the accompanying rise in inflation would likely force central banks to shift policy. The Federal Reserve could abandon rate cuts while the European Central Bank could move to raise interest rates.

Even so, the scale of this shock would be smaller than that which followed Russia's full-scale invasion of Ukraine, when Europe faced an abrupt and dramatic disruption to its energy supplies. The current conflict, unless it escalates dramatically, is unlikely to provoke large-scale fiscal rescue packages from governments.

In several emerging markets, the impact of higher energy prices is softened by government subsidies. In such cases, it would be the state rather than households and businesses that would bear the initial increase in costs. That will cushion the blow to growth in the short term but come at the expense of weaker public finances.

For most emerging economies this will be manageable: fiscal positions are generally stronger than they were a couple of decades ago. But in countries where energy subsidies remain extensive and government finances are already shaky, higher energy prices could unsettle bond markets. Economies such as Egypt and Tunisia appear particularly vulnerable. A surge in global energy prices could also destabilise Pakistan’s fragile economy.

America is more insulated

One final consequence of the conflict is that it is likely to reinforce a broader pattern in the world economy: the relative strength of the United States. Having moved from a large net importer of energy to a modest exporter, the US is now less exposed to global energy shocks than many of its peers. While American households will still face higher fuel prices, energy producers – and their investors – stand to benefit.

The movements in energy prices seen so far are unlikely to transform the US economic outlook for this year. But they may complicate the task of the Federal Reserve. A renewed rise in fuel inflation would give policymakers another reason to proceed cautiously when considering interest rate cuts.

None of this diminishes the human cost of conflict. But from an economic perspective, the effects – while real – are likely to be uneven and, in most scenarios, manageable. Indeed, if the surge in energy prices proves fleeting, the world economy may absorb the shock with less disruption than many fear.

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