Global Economic Fallout of a Regional War in the Middle East

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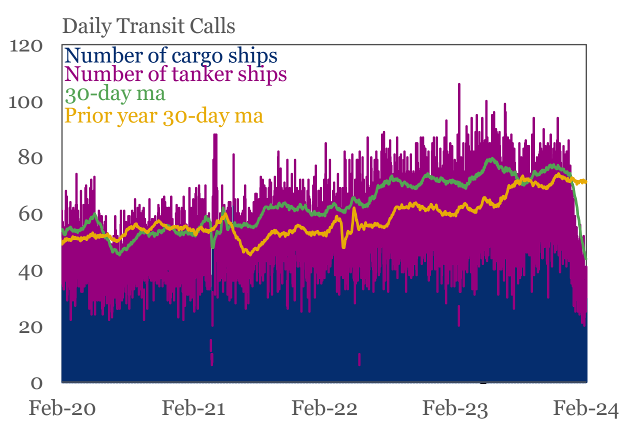
- In this report we highlight the potential fallout to the global economy of a wider, prolonged, war in the Middle East.
- Focusing on two scenarios to see how they affect commodity prices, trade disruption, and global inflation and growth.
- The Israel-Hamas war has brought the Middle East, which accounts for 35% of the world's oil and 13% of natural gas exports, to the edge of a wider conflict with the potential for higher commodity prices and lower trade volume.
- Attacks on ships in the Red Sea, which helps transport 12% of global trade, have already disrupted the flows of goods and have more than doubled freight rates since end-2023.
- While an energy supply disruption has not yet occurred, the risks are rising, and could lead to a surge in energy prices.
- In our pessimistic scenario, with 30% probability, we assume that the conflict escalates into a full-blown war with Hezbollah, and to a lesser extent with Iran, that could lead to a disruption of oil and gas shipping in the Strait of Hormuz.
- In such a scenario, energy prices surge, leading to higher inflationary pressures and weaker global growth.
- We use annual panel data from 1960-2023 to quantify the relationship between inflation, real GDP growth, and geopolitical risks, as measured by Caldara and Iacoviello.
- Our panel regression results show that higher geopolitical risks raise inflation and lower economic activity.

This note presents our views on the global and regional economic fallout from the recent escalation in hostilities in the Middle East. Such a fallout could be manifested through higher global commodity prices, higher inflation, a delay in monetary easing in advanced economies, and, ultimately, lower global growth. Back in October, we outlined what we saw as the three most likely scenarios stemming from the war in Gaza: 1) a quick and precise response by the Israeli Defense Forces (IDF), which would focus on retrieving hostages while targeting Hamas' leadership and military infrastructure; 2) a large scale operation that could lead to a larger regional conflict; and 3) a quick cease fire leading to the release of hostages and some sort of peace treaty. The conflict has largely followed our second scenario, though it had, until recently, remained constrained to the Gaza Strip. Repeated strikes from Iran's "Axis of Resistance" against US military targets, as well as against ships crossing the Bab-el-Mandeb strait, and the Western response to those actions, have considerably escalated the situation.

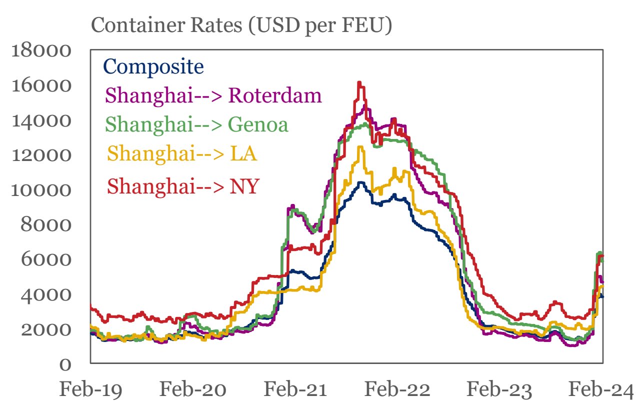
The attacks on cargo ships in the Red Sea are particularly alarming for the global economy. Repeated attacks by the Houthis have reduced crossings in the Suez Canal and raised global transportation costs (Exhibits 1 and 2). The Red Sea trade route accounts for 12% of global trade and is the primary shipping lane connecting Asia to Europe. The number of ships passing through the Suez Canal fell drastically, from 75 per day in November 2023 to around 45 per day in January 2024. In addition to the shipment of containerized goods, this route is also important for shipments of oil and liquified natural gas (LNG). According

Exhibit 1: Attacks by the Houthis have drastically reduced the number of cargo ship crossings in the Suez Canal…



Source: IMF PortWatch and IIF

Exhibit 2: …leading to a noticeable uptick in shipping costs, though far off from the peaks seen in 2021/22.



Source: Bloomberg and Drewry World Container Index to the International Energy Agency (IEA), in 2023, about 10% of global seaborne oil and 8% of (LNG) trade transited the Red Sea. A prolonged rerouting of ships around Africa's Cape of Good Hope, which adds about two weeks to the voyage time, increases the risks of supply chain bottlenecks, leading to higher freight costs and renewed inflationary pressures.

TWO POSSIBLE SCENARIOS

In this context, *we seek to quantify the potential effects of this new phase of the conflict, both on the region and for the global economy*. We focus on two scenarios:

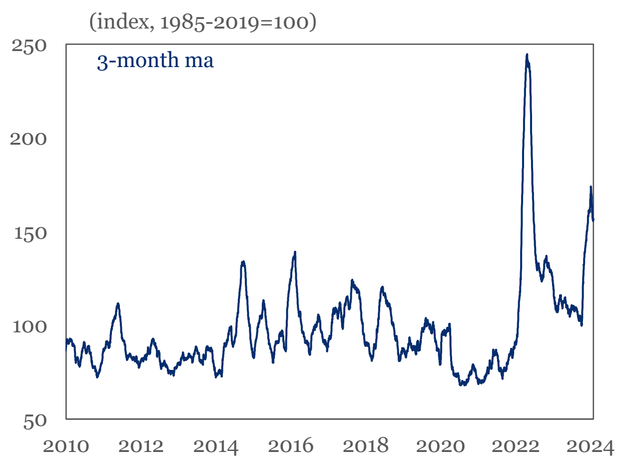
- In our *baseline scenario (which we give a probability of 70%),* we assume a containment of the conflict. In this scenario, Western strikes succeed in sufficiently degrading the Houthi's military capabilities or, at the very least, sufficiently raise the costs for the Houthis. This would allow for the resumption of trade across the Red Sea in the next couple of months. We also assume a continuation of limited clashes between Israel and Hezbollah. Finally, ongoing efforts by the international community, led by the USA, will help prevent further escalation in the conflict.
- In our *pessimistic scenario (with less than 30% probability)* the US and the UK are not able to degrade the capacity of the Houthis and their attacks on shipping in the Red Sea continues or intensifies. The conflcit between Israel and Hezbollah escalates to a full blown war, including the launching of rockets and missiles into Israeli cities and strategic targets and Israeli heavy bombardment of major cities in Lebanon. The Houthis may also target oil tankers and carriers which transport raw materials, such as iron ore and grain, heavily impacting commodity prices. While Iranian officals have repeatedly indicated that Iran would like to avoid a wider regional war, the evolution of the war in Gaza and Lebanon could drag Iran into direct confrontation with Israel and/or the USA. This may then lead to a disruption of shipping in the Strait of Hormuz, which would choke oil supply.

In the following sections we explain how each of these scenarios affect both the global economy and Middle Eastern economies.

IMPACT ON THE GLOBAL ECONOMY

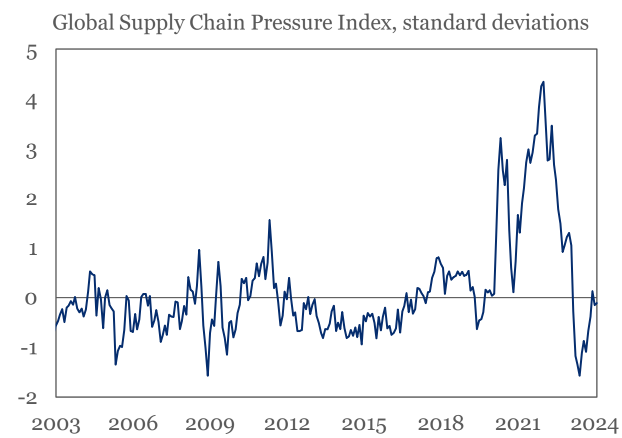
Under our baseline scenario, the current unrest in the region remains a short-lived development without major consequence for the outlook of the global economy. While the escalation in the conflict has raised shipping costs, a steady supply of container ships coming into the market and weaker demand for goods (especially in the US and China) should keep supply pressures at a minimum. Indeed, a high frequency indicator developed by the New York Fed shows that current supply chain pressures, as of January 2024, are at their historical average (Exhibit 4). Though the index is trending upward, we expect it to moderate in the coming months if shipments across the Red Sea resume. This is further supported by commodity prices, which have largely remained steady over the past few months (Exhibits 5 and 6).

Exhibit 3: While geopolitical risks have increased, they remain lower than in early 2022 when Russia invaded Ukraine.



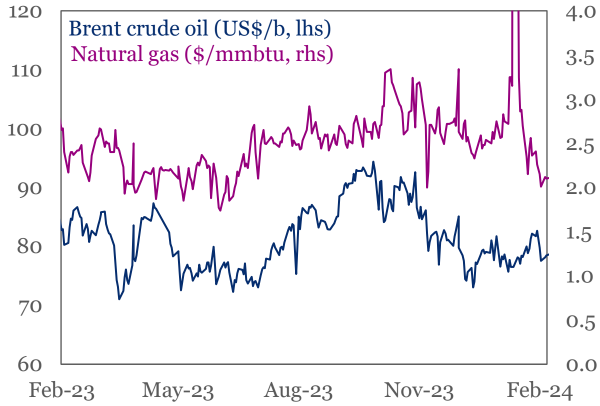
Source: Caldara and Iacoviello, Haver, and IIF

Exhibit 4: Despite the recent uptick in supply chain pressures, they remain around their historical average.



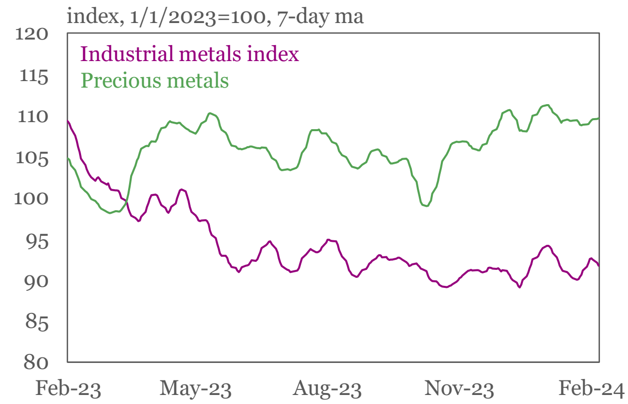
Source: Federal Reserve Bank of New York and Bloomberg.
Note: The index is normalized such that zero is the mean, with positive (negative) values representing how many standard deviations the index is above (below) the average. Latest data point: January 2024.

Exhibit 5: Oil and gas prices remain close to the levels seen a year ago.



Source: Haver and IIF

Exhibit 6: Nonfuel commodities prices have also remained stable.



Source: Haver and IIF

Under our baseline scenario *we expect global growth to moderate from 3.1% in 2023 to 2.8% in 2024*, with high real interest rates and slightly tighter fiscal policies in most advanced economies restraining economic activity. Growth in the USA will slow from 2.5% in 2023 to 2% in 2024. Slower growth will likely be viewed as a positive by the Fed. The Euro Area is expected to flirt with a mild recession, as higher borrowing costs squeeze demand for loans. We also expect China's growth to slow, as tepid consumer sentiment and continued downturn in the property sector weigh on demand and activity.

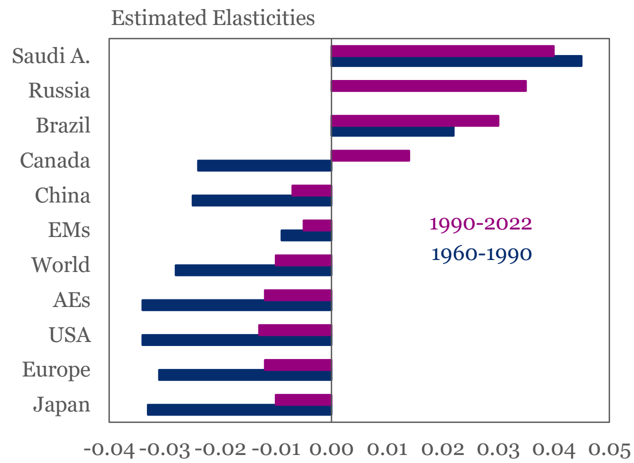
Oil and natural gas prices are forecasted to remain at around current levels through the end of this year, due to lower global demand, an increase in the supply of oil and gas by non-OPEC+ countries, and a significant increase in the inventory levels of natural gas in the Euro Area. Likewise, lower demand from China will keep most commodity prices stable. Lastly, under our baseline scenario, inflation in advanced and emerging economies would continue to decline towards their target rates by end-2024, thus conditions would be conducive to start lowering policy rates in advanced economies by mid-year, in line with current market expectations.

In our pessimistic scenario, we expect global growth to be 0.4 percentage points of GDP lower than in our baseline scenario, that is, global growth will fall to 2.4% in 2024 (Exhibit 9). This additional fall in global growth is primarily attributed to a greater disruption of shipments through the Suez Canal and the Strait of Hormuz (which lies between Oman and Iran). This is particularly true if Iran or one of its proxy forces begin militarizing oil by disrupting shipments through the Strait of Hormuz. About 30% of global oil consumption passes through this strait, with a large portion of the oil exports from Saudi Arabia, Iraq, Iran, the UAE, Kuwait, and Qatar's LNG passing through it as well. This makes the strait an important chokepoint in the global oil and gas market. The potential impact of a disruption of supply on energy prices depends on the duration and severity of the disruption. While it is difficult to predict by how much and for how long energy prices would rise, we assume that oil and natural gas prices surge by 40% in 2024. Along with the increase in oil and natural gas, freight and insurance costs would increase considerably, creating inflationary pressures at a time when inflation remains above target. Furthermore, *we forecast that growth in global trade volume decelerates to 0.8%* (as compared to 1.6% in the baseline scenario) due to continued attacks on cargo ships, which would also feed into inflation.

The main risk for advanced economies under such a scenario is the potential of keeping interest rates higher for longer, for fear that geopolitical tensions could lead to supply constraints which in turn would lead to a resumption of inflationary pressures. Indeed, the literature supports this. Caldara, Conlisk, Iacoviello, and Penn (Federal Reserve Board, July 17, 2023), using a monthly VAR model for advanced and emerging economies, find that global geopolitical risks (as measured by the Caldera and Iacoviello geopolitical risk index), increase inflation, with the inflationary effect of higher commodity prices and currency depreciation more than offsetting the deflationary effects of lower consumer sentiment and tighter financial conditions. Glick and Taylor (2010) likewise show that lower trade can be inflationary, as counties experience limited access to external markets and capital. Therefore, under this scenario it is likely that central banks in advanced economies, which are at the end of their aggressive tightening cycles, would postpone policy easing and keep policy rates on hold until the end of the year. Restrictive monetary policy would feed into the economy, inhibiting consumption and demand, therefore reducing growth.

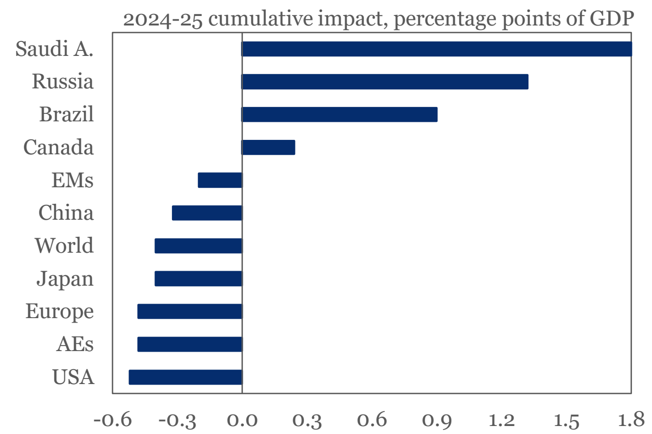
Expanding on the literature, in a panel regression covering advanced and emerging markets, in which we regress growth and inflation on a set of independent variables including the geopolitical risk (as measure by Caldara and Iacoviello), *we also find that geopolitical risk negatively affects global growth and positively affects inflation*. Furthermore, as to the impact of higher oil prices on growth, our previous research suggests the following: (1) the elasticity of global output with respect to real oil prices has declined from -0.028 in 1960-1990 to -0.010 in 1991-2022; (2) the adverse growth effect on emerging economies (EMs) is much smaller than in advanced economies (AEs); and (3) for most AEs the main impact will be felt in 2025, while in EMs it will be in 2024. Consequently, while the inflationary effects of higher oil prices are less than in the past, they will still have a considerable impact on global growth.

Exhibit 7: The elasticities of output with respect to oil prices have declined significantly in recent decades.



Source: IIF estimates

Exhibit 8: A hypothetical 40% increase in oil and gas prices in 2024 will reduce the level of global output by 0.4 percentage points below the baseline.



Source: IIF estimates. The support to growth in Saudi Arabia, Russia, and Brazil are based on no change in oil and gas production.

Exhibit 9: Global Growth, Inflation, Trade, and Oil Prices (Hypothetical Two Scenarios for 2024)

	Average 2012-2021	2022	2023	Baseline 2024	Pessimistic 2024
Real GDP Growth, %					
World (PPP weights)	3.1	3.5	3.1	2.8	2.4
Advanced Economies	1.8	2.6	1.6	1.4	1.0
United States	2.1	1.9	2.5	2.0	1.7
Euro Area	1.4	3.4	0.6	0.8	0.4
Japan	0.6	1.0	1.9	0.9	0.6
EMDEs*	4.1	4.1	4.1	4.0	3.6
Latin America	1.2	4.2	2.5	2.1	2.0
Emerging Europe	2.4	1.2	2.7	2.5	2.0
Asia/Pacific	5.8	4.5	5.3	4.7	4.4
Middle East	2.3	5.8	2.0	1.6	-0.6
Average Consumer Prices, %					
Advanced Economies	1.5	7.3	4.6	2.7	3.0
EMDEs*	5.1	9.8	8.4	7.8	8.1
World Trade Vol. % change	3.0	5.5	0.3	1.6	0.8
Real Oil Prices USD/barrel**	88.4	99.8	82.1	80.0	120.0

Source: IMF through 2023; IIF projections for 2024.
** Emerging Markets and Developing Economies. **Real Oil prices in 2022 USD*

IMPACT ON MIDDLE EASTERN ECONOMIES

In our baseline scenario, the economic impact will be limited and will be mainly confined to the countries most affected by the current war in Gaza, namely Israel, Egypt and Lebanon (Exhibit 10). Nonetheless, geopolitical uncertainty will still have an adverse impact on many of the countries in the region, through lower private consumption and investment, lower tourism, higher import costs, and a rising risk premia that is increasing borrowing costs. In this baseline scenario, we expect overall growth in the Middle East, including Israel, to be 1.6%, with countries like Lebanon and Israel registering a small contraction in output. Growth in Egypt could moderate to 2.8% and the current account deficit is forecasted to widen to around 3.5% of GDP, negatively affected by falling transportation and tourism receipts. The negative impact on the six GCC countries will be limited, but could be seen through a modest increase inflation, falling tourism, and weaker private investment. Non-oil real GDP growth could remain strong at around 4% in Saudi Arabia and the UAE. However, oil production cuts may extend beyond March of this year, in the context of the next OPEC+ agreement, dragging overall growth to 2% in Saudi Arabia and 3% in the UAE. Finally, the normalization of relations between Israel and other countries in the region, most notably Saudi Arabia, will be postponed indefinitely. With Saudi authorities recently stating that no normalization will occur until a two-state solution is found.

Under our pessimistic scenario, the consequences for the Middle East region would be dire. The major factors that would weigh on regional economic activity include (1) the extent and duration of the wider war; (2) additional cuts in oil production due to attacks on oil tankers under the assumption of tighter sanctions on Iran; and (3) prolonged tight monetary policy in the six GCC countries (due to their peg to the USD). A wider regional war involving Hezbollah could destroy whatever is left of the Lebanese economy; while heavily damaging Israel's infrastructure, leading to a contraction in output of at least 20% in Lebanon and 4.5% in Isarel (Exhibit 10). A wider war could also aggravate the precarious economic situation in Egypt. Cargo passings through the Suez Canal dropped by more than 40% in January of this year, compared to a year earlier. Suez Canal receipts are a major source of hard currency for Egypt. The Iranian economy could contract by around 5% in fiscal year 2024, inflation would accelerate to over 100% (driven by a sharp depreciation of the parallel exchange rate), and Iran's limited readily available FX reserves (which exclude frozen reserves) would be depleted by March 2025. Other Middle Eastern countries could also be significantly impacted, including Iraq, Syria, and Yemen, especially if Western strikes intensify or begin to target more critical infrastructure. While the GCC countries are unlikely to be involved in the war, their economies could suffer if oil and/or LNG shipments are disrupted for a prolonged period (either via the Suez Canal or through the Strait of Hormuz). The expected large loss in the volume of hydrocarbon exports in Saudi Arabia and other oil exporters in the region would more than offset gains from higher energy prices, leading to lower overall growth, wider fiscal deficits, and deteriorating their current account balances. Finally, an intensification of the conflict would heavily affect tourism, particularly in Saudi Arabia, the UAE, Oman, Bahrain, Egypt, and Jordan.

Exhibit 10: Selected Middle Eastern Economies that Could be Impacted by the War

		Real GDP Growth, percent						
	2022 GDP US$ bn	2019	2020	2021	2022	2023 Est.	2024 Baseline	2024 Pessimistic
Middle East	3,407	1.7	-2.2	5.2	6.8	1.9	1.6	-0.6
Saudi Arabia	1,109	0.8	-4.3	4.3	8.7	0.5	2.0	1.5
Israel	525	3.8	-1.5	9.3	6.5	2.2	-0.9	-4.5
UAE	510	1.1	-5.0	4.5	7.8	3.5	3.1	1.5
Iran	458	-2.9	4.1	4.4	3.0	2.8	1.8	-5.0
Egypt	475	5.5	3.5	3.3	6.6	3.6	2.8	2.0
Iraq	236	6.4	-11.2	7.6	5.5	-1.1	-0.8	-1.8
Jordan	47	1.8	-1.6	2.2	2.5	2.8	2.5	1.3
Yemen	24	2.1	-8.5	-1.0	1.5	-1.2	-2.5	-8.0
Lebanon	24	-6.9	-25.9	-9.6	1.6	-0.6	-1.2	-20.0
		Non-oil Real GDP Growth, percent						
Saudi Arabia		2.7	-2.6	4.8	5.6	4.3	4.1	3.1
UAE		2.7	-5.4	6.0	7.0	5.4	4.3	2.8

Source: IIF

