



MACROECONOMIC *view*

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A few things we know about oil shocks and their consequences



KEY HIGHLIGHTS

- With the Gulf War, oil price have surged by nearly 60% in 3 weeks.
- Donald Trump has a lot to lose politically and economically if the war drags on.
- This type of shock is doubly problematic: it fuels inflation and weighs on economic activity.
- This creates a dilemma for monetary policy: tightening or easing?
- This shock comes at a time when inflation in the eurozone was low and there was no wage pressure.
- Unlike in 2022, the ECB is not forced to aggressively raise interest rates



In early January, Donald Trump threatened to annex Greenland, a vast territory stretching 2,600 km from north to south but whose influence on the state of the world is close to absolute zero. In late February, the U.S. president sparked a new war in the Persian Gulf, a region that has repeatedly disrupted global economic conditions throughout history. All eyes are on the Strait of Hormuz, which, at its narrowest point, is only 55 km wide.

Under normal circumstances, it is the transit point for one-fifth to one-quarter of the oil and liquefied natural gas consumed worldwide, as well as for a large quantity of derivatives needed to manufacture fertilizers or cool batteries. For the past three weeks, the Strait of Hormuz has been almost completely closed to trade. Furthermore, while both the United States and Iran had taken care at the start of the conflict not to target energy production facilities, that line has now been crossed. In short, this is a major oil shock. A barrel of Brent crude was worth \$72 on February 27. As of today (March 23), it exceeds \$113—a rise of nearly 60% in three weeks.

There is no doubt about the direction of such a shock: more uncertainty, more market volatility, more inflation, less investment, fewer jobs, less economic activity. As for the intensity of the shock,

the key factor is its duration. Everyone is reduced to making assumptions and thus playing out scenarios.

ECB experts have just analyzed three scenarios covering a broad spectrum of possibilities. Assuming that tensions in the Persian Gulf subside fairly quickly, their baseline scenario is a modest slowdown in eurozone growth in 2026 (-0.3 percentage points) and a temporary spike in inflation to around 3%. That is the best-case scenario. In an “adverse” scenario where the energy shock intensifies further throughout the spring and does not ease until 2027, we would be on the brink of recession and inflation would exceed 4%. In a “severe” scenario where energy prices would rise even further (oil toward \$150) and sustainably, economic activity would plunge, and inflation would quickly exceed 6%.

The difficulty lies in assigning probabilities of occurrence to each of these scenarios. The statements from Commander-in-Chief Donald Trump fluctuate so much from one day to the next that they do not help define the war’s objectives or assess how far we still have to go. Let’s not waste our time trying to guess what he has in mind.



It is more useful to examine the pain threshold for the belligerents. Here, there is a glaring asymmetry. Military dictatorships—and Iran is certainly one—are less sensitive to the plight of their people than democracies. Nevertheless, even in Iran, this conflict is costly. With the Strait of Hormuz closed, Iranian leaders are seeing their oil and gas revenues dwindle—a source of funding used to buy the support of one segment of the population while the other is subjected to the harshest repression.

On the U.S. side, public pressure will intensify. Midterm elections will take place in a few months. The ruling party always suffers some setbacks in these elections. Now, the risk is a debacle for the Republicans that would cause them to lose control of the House and the Senate. Filling up with gas in the United States now costs 35% more on average than before the war began. According to polls, most Americans are opposed to this conflict. In short, a rational analysis should encourage de-escalation. If that is indeed the case, the economic consequences will be manageable, and investors could regain their appetite for risk. Many hope Trump will back down, but this TACO effect (Trump Always Chickens Out) is easier to pull off when it comes to announcing tariffs than to ending a war.

One final factor to consider is the initial conditions at the time of the shock. In the collective memory, the most recent energy shock occurred four years ago following the invasion of Ukraine. Overnight, people wondered how Europe—and especially Germany—would manage to meet its energy needs without Russia. Inflation, which was already high at nearly 6%, spiraled out of control. The ECB responded by tightening its monetary policy at a breakneck pace.

The current situation differs from the 2022 shock in many ways. At the time, during the post-COVID rebound, the European economy was experiencing a boom in demand, and companies did not hesitate to raise their prices. The labor market was under pressure, a situation conducive to wage inflation. Nothing of the sort exists today. In 2022, the oil and gas shock had a very rapid and amplified impact on electricity prices. That is not the case today. The impact on energy bills for industries and households is expected to be much smaller. Finally, in 2022, the ECB's key interest rates were ultra-low, even negative. The central bank was forced to correct this atypical situation. Today, at 2%, the ECB's rates are considered roughly normal. The ECB can afford the luxury of keeping a cool head and not overreacting to a shock where so many factors remain so uncertain. Raising rates immediately would risk undermining an economic recovery that is still faltering. In our view, the cure would be worse than the disease.

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