ECOINSIGHT

Issue 15
6 March 2026

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WAR IN THE MIDDLE EAST: FIRST ASSESSMENT OF THE MACROECONOMIC DAMAGE

The conflict in Iran is already having a significant impact on energy prices, particularly oil and gas. Inflation should therefore rise in March. Beyond that, the outlook will depend on the evolution of the conflict, but the situation remains highly uncertain. Three types of scenarios are plausible: 1) a return to the status quo ante on the hydrocarbon market after a few weeks; 2) a prolonged period of political uncertainty in Iran leading to a relatively modest, but sustained, rise in oil and gas prices; 3) acute and sustained tensions over oil and gas supplies. The latter two scenarios would constitute a stagflationary shock, i.e. one that slows growth and increases inflation. Fortunately, growth was generally robust on the eve of the shock. In addition, inflation was on track to be brought under control, or even better, allowing central banks not to rush to react. Consequently, even in adverse scenarios, growth would slow significantly but remain positive, and major central banks would be forced to tighten their current stance only in the hypothesis of the most severe scenario. Nevertheless, given the latent fragilities in financial markets, which were already apparent in the weeks leading up to this major geopolitical shock, the utmost caution is warranted. This EcoInsight analyses the impact of the various scenarios, first on energy prices and then on inflation, growth, central bank policies and exchange rates, for the main advanced and emerging economies.

AN ENERGY SHOCK LIKELY TO BE LESS SEVERE THAN IN 2022

The reaction of oil and gas prices following the outbreak of war in Iran has, so far, been significantly more moderate than in 2022: at their peak, Brent oil prices rose by USD 15/barrel (+20%) to USD 85/barrel, and European gas prices (TTF) rose by EUR 21 (+65%) from EUR 32 to EUR 53/MWh (compared to USD 123 and EUR 240 in 2022). This reflects, on the one hand, the fact that, unlike the global supply shortage that prevailed in 2022 (when the global economy was in full post-COVID recovery mode), on the eve of the conflict in Iran, the oil and gas markets were in a phase of supply growth exceeding demand, and therefore of structural downward pressure on prices. On the other hand, the market seems to view the current shock as less structural. In fact, as Iran was already subject to heavy sanctions on the eve of the conflict, there is no parallel with the European Union's decision in 2022 to wean itself off Russian supplies, on which it was heavily dependent at the time. Nevertheless, the outcome of the conflict in the Middle East is highly uncertain.

In most scenarios, there would be at least a temporary impact. There is still a possibility of a rapid de-escalation that would bring us back to the baseline scenario within a few weeks, but it is rapidly diminishing. On the other hand, the likelihood of a more adverse scenario is increasing[1].

Scenario 1: De-escalation

The conflict subsides and maritime traffic returns to normal, allowing oil and gas prices to quickly return to their initial levels. However, the TTF would peak at around EUR 50/MWh in Q2 2026 due to the halt in production in Qatar. Oil prices would then stabilise at around USD 60-65/barrel and gas at around EUR 25-30/MWh.

Scenario 2: Prolonged uncertainty

Oil prices would initially remain around current levels, then gradually fall by the summer. They would remain higher than in the de-escalation scenario (around USD 70/barrel) for a sustained period. The TTF would peak at around EUR 50/MWh in Q2, as in our de-escalation scenario. Stronger supply constraints would also materialise due to a decline in production in Iran linked to instability in the country.

Scenario 3: An escalation with a sustained de facto blockade of the Strait of Hormuz

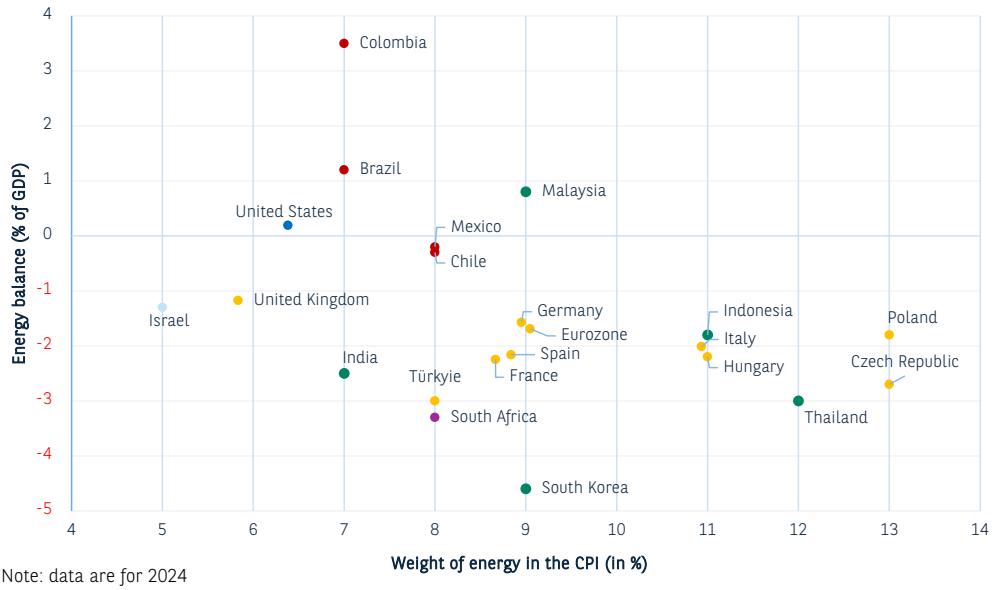
An escalation with a sustained de facto blockade of the Strait of Hormuz. In Q2, Brent would average USD 100/barrel (peaking at USD 130/b) and the European TTF would average EUR 100/MWh, then converge towards Scenario 2 after 3 to 6 months.

A NEGATIVE MACROECONOMIC IMPACT, BUT OF VARYING MAGNITUDE ACROSS COUNTRIES

Countries' exposure to energy shocks depends mainly on two factors: the weight of energy in price indices and the energy balance (Chart 1). The rise in energy prices impacts inflation and interest rates, and through this channel, consumption and investment. External accounts are also impacted. On this basis, Europe and Asia appear as the two most vulnerable regions. However, their macroeconomic fundamentals are sufficiently strong to absorb the anticipated rise in energy prices. Latin American countries appear, a priori, the least vulnerable to the energy price shock. However, their macroeconomic fundamentals and position in the cycle are weaker than in the other regions.

1 For the Eurozone, the risk associated with LNG is greater than that associated with oil. Even without significant destruction of LNG facilities, the market would be structurally tighter due to limited global stocks (particularly in Asia, where Qatar is a major supplier) and very low stocks in Europe. Furthermore, unlike oil, there is no alternative to Qatari LNG (around 20% of global production) in the short term, as other LNG exporters are already operating at almost full capacity. In the event of a prolonged closure of the Strait of Hormuz, the Asian market would compete with the European market for available LNG. Furthermore, even if the conflict were relatively short-lived, the spring-autumn period is when stocks are replenished in Europe, which would maintain some pressure on prices in Europe. Finally, Europe is the importing region that is most dependent on the spot market for its LNG supply, i.e. the gap between demand and supply negotiated through contracts with producers is greatest there.

COUNTRIES' EXPOSURE TO AN ENERGY SHOCK



Note: data are for 2024

CHART 1

SOURCE: UNCOMTRADE, NATIONAL STATS OFFICES

INFLATION TO ACCELERATE QUICKLY, BUT LESS THAN IN 2022

In the Eurozone, fuel prices are already on the rise. However, the impact of higher energy prices on headline inflation depends on whether the shock is permanent or transitory, and on how it transmits to core inflation (which itself depends on the economic context: whether the economy is overheating or has some slack, whether or not inflation expectations are well anchored to the target, whether there are other concurrent factors pushing inflation up or down, etc. Energy prices would rise in two stages: instantly for fuel, while gas and electricity prices would rise more gradually (and at different rates and to varying degrees across the various countries in the area, because of fixed-price contracts with variable revision dates and sometimes state regulations). Furthermore, the experience of 2022 shows that governments could intervene, either through taxation or subsidies, to counteract the rise in energy prices. Overall, in scenarios 1 and 2, the impact on prices would be significant but limited (around 0.5 percentage points at most). In addition, given an initial inflation level below the target and reasonably anchored expectations, it would not be necessary for the ECB to raise its interest rates. In contrast, in scenario 3, our estimates indicate that a barrel price peaking at $130 would generate an additional inflationary burden of 0.9pp on average in 2026 and 0.4pp in 2027 (the same estimate as the ECB's (December 2023). Under those circumstances, the ECB would probably deem it necessary to tighten policy in order to avoid second round effects act.

In the United States, the impact on inflation is expected to come mainly through higher fuel prices. Scenario 2 is associated with an increase in inflation of +0.3pp in 2026 and +0.15pp in 2027 (versus +0.6pp in 2026 and +0.5pp in 2027 in scenario 3). These estimates line up with those of Presno and Prestipino (FEDS Notes, 2024), who calculate that a 10% increase in the real price of oil leads to a +0.15pp rise in the headline CPI and a +0.06pp rise in core inflation in the first year. Consequently, the impact would be more modest than in the euro area, regardless of the scenario. The US economy benefits structurally from its position as a net exporter of hydrocarbons and from its independence in gas supplies, whose prices are not set at the global level like that of oil. In addition, the interaction with the tariff shock is a key point of attention, especially regarding firms' ability to avoid passing the entire price increases. Nevertheless, the level and trend of inflation on the eve of the shock were significantly less favourable than in the Eurozone (above target and deviating from it).

For emerging economies as a whole, if the oil shock does not spread to agricultural and food prices, its impact on inflation could also be limited. Most economies are in an intermediate phase of their business cycle – neither at the bottom nor at the top (output gaps are either moderately positive or moderately negative). The inflationary impacts should therefore not be amplified. In addition, exchange rate depreciations remain modest (around 1% on average and median against the USD since Friday 27 February 2026). The countries that would be most affected are, those already experiencing high inflation and/or those where the weight of energy in the CPI is highest (see Chart 1).

In the Europe-Africa region, this is the case, for example, for Türkiye, which also has one of the largest energy deficits. Its central bank estimates that a permanent 10% increase in oil prices would lead to an inflation surplus of around 1pp after a year, with half of that effect already materialising in the first quarter. For Poland, a more representative country among emerging net oil importers, an equivalent (+10%) increase would add 0.3pp to inflation. The same price rise would generate an additional 0.5 pp inflation increase in South Africa, whose currency has weakened by 3.7% against the US dollar since the conflict has begun.

In emerging Asia, part of the inflationary shock stemming from higher energy prices should be absorbed by government fuel subsidies, without however fragilizing public finances[1]. Thailand and Indonesia appear to be the two most vulnerable countries, given the weight of energy in their respective consumption baskets. However, in Thailand the ongoing disinflation process should dampen the expected inflationary impact. This will not be the case for Indonesia, where price rises have accelerated significantly since the beginning of the year (+4.8% y/y in February, above the Central Bank's target of 2.5% +/-1%). The Indonesian Central Bank could therefore raise its key rate if oil prices remain sustainably close to USD 80/barrel. By contrast, inflationary pressures resulting from a depreciation of local currencies should be very limited, as Asian currencies have held up fairly well since the start of the conflict.

A SIGNIFICANT IMPACT ON GROWTH, BUT MANAGEABLE WITHOUT A RECESSION

The Eurozone, a net energy importer, would be more affected than the United States and, within it, the most industrialised economies (Germany, Italy) and those where household confidence appears particularly sensitive to a resurgence of inflation (France). In our scenario 2 (prolonged uncertainty), we anticipate a negative impact on growth of around 0.2pp in 2026 and 2027 (each) compared to our baseline scenario. In scenario 3 (escalation of tensions), we anticipate a larger effect, with a decline of 0.5pp in 2026 and 0.7pp in 2027. Nevertheless, the growth levers expected in the Eurozone (such as the European rearmament plans and investment programmes in Germany) should soften part of the shock, albeit with a lower multiplier than initially factored in. The literature (**ECB, December 2023**) highlights that a Brent price of USD 130/bbl would reduce growth by 0.7pp in the first year and 0.3pp in the following year. The main transmission channel would be uncertainty and a decline in purchasing power. It would directly affect investment (a 1% increase in energy prices due to oil shocks leads to a 4.1% decline in investment spending, according to the **ECB, 2024**) and household consumption (especially of durable goods, as during the 2022 energy crisis, according to the **ECB, 2022**). At the sectoral level, manufacturing would be hardest hit because of its cyclical sensitivity and heavy dependence on energy inputs. As in 2022, the impact on household confidence should be immediate. Their saving rate would fall in the short term (inflation cutting real household income), then rise as a precautionary response. Consequently, the expected rebound in consumption could be delayed, and the saving rate remain persistently high.

INFLATION SCENARIO IN THE EUROZONE

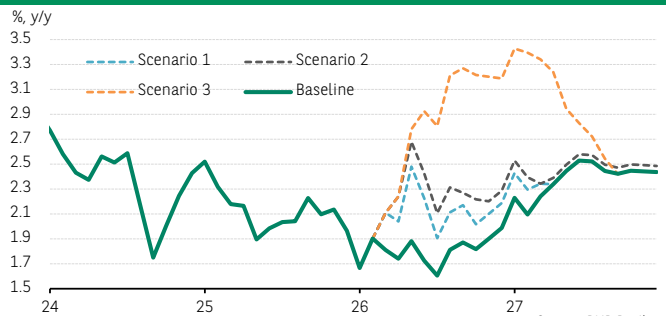


CHART 2 SOURCE: BNP PARIBAS

In the United States, the impact on growth would be slightly lower than in the Eurozone. The importance of domestic energy production acts as a dual buffer. It tempers the transmission of higher market prices and allows a pickup in investment in energy production to offset in part a decline in demand from consumers and non-energy sector corporates. Blanchard and Gali (2008) point out that oil prices now affect growth less than in the past because of a more credible monetary policy and the declining weight of oil in aggregate consumption. Furthermore, the energy shock occurs in a context where the productivity boost associated to artificial intelligence (AI) could be an offsetting factor. Nevertheless, household consumption is likely to slow sharply and immediately under the price increases, while the additional investment would take longer to support the economy.

The impact of the conflict in the Middle East on oil and gas will affect India more than China. In terms of oil, the energy shock is not expected to impact China in the short term given the level of its strategic reserves (1.2 billion barrels). China can absorb the loss of 1.5 million barrels of Iranian crude oil per day without weakening its reserves (Iran accounts for 11% of China's crude oil imports). India has sufficient oil reserves to cover 45 days (only 6 days of crude oil), which is still modest in terms of ensuring its energy security. Following the agreement with the US administration, the Indian government began to turn to Russia with two tankers carrying a total of 1.4 million barrels of Ural crude. In terms of gas, Qatar is one of the world's largest producers of LNG (around 20% of global production) and a key supplier to Asian countries. Qatari LNG accounts for half of India's LNG imports and around 30% of China's. However, Qatar has no alternative but to use the Strait of Hormuz for its exports. A prolonged closure of this strait therefore directly threatens India's energy security. For China, the short-term consequences are less significant as it has other sources of gas supply (via pipelines and domestic production).

In the rest of emerging Asia, growth should remain robust thanks to government support policies. Three countries stand out for providing direct subsidies: Indonesia and Malaysia for petrol (and gas for Indonesia), and India (for gas). In recent years, their governments have significantly reduced their subsidies (which were raised at the start of the conflict in Ukraine in 2022). An increase in subsidies could be decided if oil prices stay persistently high.

1 In Malaysia, the rise in petrol prices could raise public spending by 0.6%-0.8% of GDP (depending on the scenario chosen). However, the cost would be entirely offset by the increase in dividends received from the state-owned oil company PETRONAS. In Indonesia, the government had used a conservative assumption of USD 70/barrel in its 2026 budget. The oil price increase could lead to an additional expenditure of about 0.1% of GDP. In India, gas subsidies for the 2026/2027 fiscal year are estimated at 0.04% of GDP. Therefore, the price increase does not pose a fiscal risk for the country.

CENTRAL BANKS CAN STAY THE COURSE UNLESS A SEVERE SCENARIO UNFOLDS

The ECB is likely to adopt a wait and see stance. Before the outbreak of the war in Iran, the inflationary backdrop in the Eurozone was favourable, and our initial baseline scenario predicted inflation remaining below the 2% target in 2026. Inflation will now probably exceed that level, but the acceleration in core inflation should stay modest, prompting the ECB to observe the developments before taking action. In any case, this shock tests the new **monetary policy strategy** that the **ECB** unveiled in June 2025, which is expressly designed to tolerate modest, temporary deviations - both upward and downward - from the 2% target. The ECB will have to strike the right balance between (i) not overreacting (the energy shock will initially affect imported inflation, over which the ECB has little control) – which would amplify the negative effects on economic activity and household purchasing power; (ii) ensuring that key interest rates are high enough to limit second-round effects (wages pressures, inflation expectations) if the shock persists. At this stage, our scenario still envisages a status quo in 2026, followed by two rate hikes in the second half of 2027.

The Fed is expected to raise rates if market inflation expectations become unanchored. A rise in fuel prices constitutes a negative supply shock that monetary policy cannot directly address (**J. Powell, 2022**). Furthermore, aggregate demand is not as strong as it was in 2022 and the supporting factors that were present then (post-pandemic reopening, excess savings, labour market tensions) are now absent. In addition, the Fed Funds starting point is relatively high, around+3.5% - +3.75%, about 60bp above the FOMC's long-term estimate, whereas it was the zero lower bound four years ago. The reaction function would therefore shift further toward price stability.

The Bank of Japan's goal appears to be the same: not to deviate from its path of reducing the degree of accommodation. A stagflationary shock would not materially change the terms of the equation for the BoJ, which must, on the one hand, arbitrate between inflation, the risk of being "behind the curve" and the level of the JPY (rate hike) and, on the other hand, the adverse consequences for economic activity – even ameliorated by fiscal policy – the competitiveness of the export sector and financial conditions (stability).

FX: A MODEST COMEBACK FOR THE DOLLAR

While the dollar had been on a downward trend for a year, the situation is creating a renewed appetite for it. In the case of EUR/GBP and from a strictly macro/FX interaction perspective, a growth differential that favours the United States and the disappearance of the probability of Fed rate cuts are factors that would support the US dollar. In addition, a positive correlation between the USD (in terms of real effective exchange rate) and the price of Brent crude as existed since the United States became a net exporter of hydrocarbons (2020). In fact, the currencies of other oil-producing countries (such as the Canadian dollar) have also been supported since the surge in oil prices. The magnitude of the USD, however, is for now limited and is likely to remain so in the absence of more durable disruptions (as envisaged in scenario 3).

Article completed on 6 March 2026 by the Advanced Economies team and the Emerging Economies team of the Economic Research.

With the help of Clara Ngo Ba Do (intern)

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Published by BNP PARIBAS Economic Research
Head office: 16 boulevard des Italiens – 75009 Paris France / Phone : +33 (0) 1.42.98.12.34
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