

# FOREWORD

The global outlook has abruptly darkened following the outbreak of war in the Middle East on February 28, 2026. The closure of the Strait of Hormuz and serious damage to critical production facilities in a region central to global hydrocarbon supply could cause an energy crisis on an unprecedented scale.

The war interrupted what had been a steady growth trajectory. Prior to the war, we were poised to upgrade our global growth forecast, reflecting continued momentum in the global economy supported by a tech investment boom, some moderation in trade policy tensions, fiscal support in some countries, and accommodating financial conditions. War in the Middle East will overwhelm these underlying forces.

## **The War's Impact on the Global Economy**

The duration and scale of the conflict and the time it will take for energy production and transit to normalize after the end of hostilities will determine the ultimate size of the shock to the global economy.

The overall impact of the shock depends on three channels. First, the direct effect of commodity price increases represents a textbook negative supply shock, raising the cost of all energy-intensive goods and services—including fertilizers, chemicals, food, transportation, and heating—disrupting supply chains, feeding into headline inflation, and reducing purchasing power. This direct shock can be amplified via second-round effects as workers and firms try to recoup expected income losses through higher wages and prices. The risk of such wage and price spirals will be higher for countries where inflation expectations are already poorly anchored, requiring a more forceful tightening of monetary policy, at greater cost to the economy. The reaction of financial markets is the third channel. A classic risk-off episode triggered by the prospects of macroeconomic instability could ensue, impairing asset valuations, increasing risk premiums, causing capital flight and the dollar to appreciate with a flight to safety, and dampening aggregate demand.

As in past commodity price surges, energy importers are highly exposed, with low-income developing countries—particularly those with preexisting macroeconomic vulnerabilities and limited buffers—likely to be hit hardest. Gulf region energy exporters are also likely to suffer, reflecting conflict-related damage and production closures, export constraints, and weaker tourism and business activity, while countries supplying migrant workers may face remittance losses. Reduced fiscal resources amid higher spending needs may force many of these countries to lower net savings, possibly through drawdowns of their substantial external wealth, pushing up global real interest rates and further tightening global financial conditions.

As the environment remains very fluid, this report presents a reference forecast based on a bottom-up assessment assuming a relatively short-lived conflict, as reflected initially by financial markets in early March, together with two complementary model-based scenarios that assume a longer-lasting or even expanding conflict. As always, the hard work, dedication, and agility of the staff in the IMF research and area departments are what made all of this possible.

Our reference forecast, assuming a short-lived conflict, projects global growth of 3.1 percent for this year, a downward revision of 0.2 percentage point from our January projections, while headline inflation is expected to rise from 4.1 percent in 2025 to 4.4 percent in 2026. However, more attacks on critical energy facilities and the prospect of a longer shutdown of the Strait of Hormuz are raising the specter of a more significant and persistent conflagration for the global economy. Under an adverse scenario, broadly anchored to market conditions prevailing toward the end of March, global output would be expected to decline to 2.5 percent, with inflation rising to 5.4 percent. Under our severe scenario—assuming dislocations in energy markets that extend to next year, together with a de-anchoring of inflation expectations and a tightening of financial conditions, the global economy would come close to experiencing a recession, with growth around 2 percent this year and next and global headline inflation near 6 percent. Clearly, the downside risks are tremendous.

### Lessons from the 2022 Energy Crisis

It is instructive to compare today's shock with the 2022 commodity-price surge in the wake of Russia's invasion of Ukraine. Then, global inflation rose to levels not seen since the 1970s, triggering a broad and synchronized monetary policy tightening. The subsequent disinflation without a recession is widely viewed as a major policy success.

Should we expect a similar scenario this time? There are reasons to doubt it, both good and bad. On the positive side, inflation pressures in 2022 predated the energy shock from the war in Ukraine, driven by postpandemic supply-demand imbalances, tight labor markets, and abundant household and corporate liquidity. Today, labor markets are significantly softer, private sector balance sheets have normalized, and pre-shock inflation pressures are more subdued—though still above target in some countries, including notably the United States. As long as the shock itself remains modest, this suggests a possibly more subdued inflation impact, consistent with our reference scenario.

But the previous episode left scars. With price levels permanently higher, cost-of-living concerns remain fresh in people's minds, heightening the sensitivity of inflation expectations to price developments, especially where central bank credibility is seen as having eroded. The 2022 inflation episode was also the result of an unusually steep aggregate supply curve as a result of supply bottlenecks. For central banks trying to contain inflation, a steep supply curve means it is possible to bring price inflation down significantly without a large slowdown. Unfortunately, the supply curve now appears much flatter: The disinflation this time around could prove more costly.

### Policies

How should policymakers react? The first—and obvious—observation is that an early and orderly end to the war is the best way to limit the damage to the global economy. Beyond that, the standard policy response to a surge in energy prices is for central banks to look through, *as long as inflation expectations remain well anchored*. The logic is sound: There is no trade-off for central banks since the supply shock is already reducing activity while increasing price pressures. Moreover, there is little any central bank can do in isolation about the price of energy. The argument breaks down, however, as soon as inflation expectations start drifting up. With an unchanged policy rate, monetary policy would become overly stimulative as higher inflation expectations lower the real interest rate. In this case, central banks need to take firm action to reanchor expectations, and this must take precedence over near-term growth concerns. This suggests a graduated and state-contingent monetary policy response: Look through if and as long as inflation expectations remain stable while communicating clearly and forcefully that any sign of de-anchoring will be met with a strong policy response. Exchange rate flexibility plays an important role, not only as a buffer but by allowing monetary policy to concentrate on price stability. If the energy shock proves more permanent, a coordinated tightening across countries to curb global demand can also help reduce energy prices.

What should we avoid? First and foremost, wasteful fiscal measures, especially as fiscal buffers are now much thinner. Energy price surges are often accompanied by a host of untargeted fiscal measures, such as energy caps or subsidies, designed to protect households and firms. This time is no exception. While such measures are popular, evidence suggests they are often both poorly designed and very costly for the public purse. Instead, it is critical that fiscal support be well targeted, temporary, with clear sunset clauses, and consistent with medium-term fiscal plans. Moreover, avoiding fiscal stimulus at a time of rising inflation is another critical component so as not to complicate the task of central banks.

Preserving price signals is key, as they transmit a critical market signal of scarcity and of the need to reduce demand and expand supply. Price controls or export restrictions simply cannot change that fact. Worse, they may simply push up the price of energy ex-subsidy—or create rationing in the case of price caps—providing limited relief for households and firms and generating negative spillovers to other countries, since protecting energy demand in one part of the world implies less net energy supply elsewhere. In many cases, the same amount of fiscal support could have been deployed more effectively through other channels, such as direct and targeted transfers focusing on the most vulnerable. Too often, these lessons were not heeded in the 2022 episode. Countries should strive to do better this time around.

Finally, should financial conditions deteriorate markedly, with an associated weakening of global demand, monetary and fiscal policies will need to pivot toward supporting the economy and the financial system, together with appropriate financial and liquidity policies.

### **Fragmentation and Multipolarity**

The latest war illustrates how the international order remains under siege. Old alliances continue to fray, new conflicts are emerging, national security concerns take precedence in policymaking. Our analytical chapters explore the consequences of defense buildups on aggregate economic activity and the specific challenges and policy advice for economies experiencing conflict or facing reconstruction needs. The analysis is sobering. War, beyond its human toll, imposes extremely high and persistent economic costs and creates acute trade-offs.

Beyond outright conflicts, long-standing geopolitical tensions have already made the global economic environment more complex, with signs that we are transitioning to a more multipolar world. Countries are looking for alternative trading partners, deviating from well-established geopolitical alignments, as illustrated by the recent rise in new regional trade agreements. One major concern is that these geopolitical trends will further encourage countries to turn toward more inward-looking policies. Few areas manifest such tensions more clearly than the market for critical minerals. Extraction and refining activities of critical minerals are geographically highly concentrated, while they are indispensable for the green and digital transition. Our report conducts a deep-dive analysis into the economics of rare earths and implications of licensing requirements. Output losses associated with the supply disruption of rare earths are sizable, while the case for multilateral coordination, rather than unilateral industrial policy, is self-evident.

### **Medium Term**

The war and its direct implications are capturing everyone's immediate attention, but we should not lose sight of the need to invest in durable sources of growth. Recent developments in artificial intelligence, most recently with the arrival of agentic AI, raise the prospect of very meaningful productivity gains—the ultimate driver of standards of living. Yet the transition could be challenging. Financial markets' enthusiasm for these technologies may well have run ahead of fundamentals, raising concerns about potential price correction. Moreover, a rapid technological transformation could render many jobs obsolete, potentially slowing aggregate demand. Policymakers should adopt policies that encourage diffusion and adoption of these new technologies while ensuring adequate investments in skills to help facilitate a smoother labor market transition. Faster adoption of renewable energy can strengthen resilience to energy shocks, improve energy security, and support the climate transition.

The world economy faces yet another difficult challenge. And while it may well become more multipolar, it need not become more fragmented. Beyond actions that countries can take on their own, we should continue to seek ways to improve global cooperation. With the right policies, including a swift cessation of hostilities and the reopening of the Strait of Hormuz, the damage could remain limited. International financial organizations such as the IMF were born out of a vision, forged in the aftermath of war and great destruction, to promote economic and financial cooperation and integration, to the benefit of all. More than ever, these principles are needed to preserve global prosperity.

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