# Economic repercussions of a Middle East War

## Eurozone special

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## Summary

- First and foremost, the Israel-Hamas war is a major humanitarian disaster.
- Apart from for the parties involved, though, the economic impact so far has been very limited.
- An escalation of the Israel-Hamas war to a broader conflict in the Middle East, could have a serious impact on the European economy, however.
- We have drawn two escalation scenarios and calculated the impact thereof for the Eurozone.
- In a soft escalation scenario, tensions broaden to several neighbouring countries such as Egypt. Trade and energy flow disruptions through the Suez canal are the ones to watch here. Such disruptions could inflate energy prices, lifting inflation in the Eurozone. Interest rates and food prices would also increase a bit. It would prolong a period of stagflation throughout 2024, before growth gradually strengthens in 2025.
- In a hard escalation scenario, Iran and Saudi Arabia are being dragged in the war as well. Energy prices will skyrocket, while interest rates and food prices will rise further. It would prolong the recession in the Eurozone, pushing growth down to -0.1% in 2024, while the recovery will be very slow, with growth projected at just 0.5% in 2025.
- While our model results are certainly insightful, various aspects of a broadening of the conflict are difficult to account for in macro-econometric models.
- We argue that Europe's structural weaknesses make it ill-placed to deal with a broad war in the Middle East, and in fact with other forms of major geopolitical shifts and supply disruptions in future.

# Escalation risk

**The Israel-Hamas war is a major humanitarian disaster. The war has not yet escalated to a broader regional conflict, but the risk of escalation remains present. An escalation could have substantial economic ramifications for Europe as well.**

Shortly after the outbreak of the Israel-Hamas war, we argued that there is a significant risk of an escalation that could lead to an increasing number of parties getting involved. Since then, Israel has started ground operations in Gaza. Terrorist movements, including Hezbollah and Yemenite Houthis, have increased their military activity as well, though this hasn't required a significant step up of operations by either Israel or the US. That said, the US has brought considerable firepower to the region. Hezbollah leader Hassan Nasrallah recently alleviated immediate concerns that Hamas would significantly step up its game. Yet, this doesn't mean that medium-term risks have receded.

A broadening of the war to the wider region could have major implications for fiscal, monetary, and industrial policy, and from there to markets; with its severity depending on the scale of the conflict. Heuristically it means, volatile and higher commodity prices, higher inflation, higher interest rates, lower asset markets and a weaker euro.

In this publication we describe the economic impact of two escalation scenario's for the Eurozone, using the macro-econometric global trade model NiGEM. Admittedly, while model results are certainly insightful, they by no means include the impact of all moving parts an escalation would set in motion. Indeed, in a follow-up publication we will dive into Europe's structural weaknesses that make it ill-placed to deal with a broad war in the Middle East. In fact, Europe is ill-placed to deal with all kinds of major geopolitical shifts and supply disruptions in future. Besides pointing at weaknesses, we will ponder solutions in that forthcoming piece.

# Three scenario's

**As developments in the war are highly uncertain, we have drawn several scenarios for how the war could evolve. In turn we have analysed and calculated through what channels the Eurozone economy would be impacted in each of these scenario's.**

In short, (i) in our base case scenario we assume the war to stay mostly contained to Israel and Hamas, with incidental attacks between Israel and Hezbollah and Israel and Yemenite Houthi's. (ii) In our soft escalation scenario, Hezbollah significantly ups its attacks, the US gets more actively involved and also Egypt is dragged into the conflict. (iii) In our hard escalation scenario, the war expands to the broader region, dragging in Iran and Saudi Arabia as well. Please see the box below for a more detailed description of the two escalation scenarios.

## Two escalation scenario's

### Soft escalation scenario

In the soft escalation scenario, Hezbollah increases the number of attacks and Syria, Jordan and Egypt are getting actively involved. We assume that the latter will make it impossible or too dangerous for shipping companies to navigate through the Suez canal. We also factor in that oil flows through the SUMED pipeline next to the canal are interrupted. Consequently, cargos will need to reroute to around the Cape of Good Hope, which takes some two weeks longer and would clearly push up freight costs. With about 15% of world trade, 4.5% of crude oil, 9% of refined products and 8% of LNG tankers running through the canal, it can be considered an important chokepoint – the SUMED pipeline transports about 80% of oil going from the Middle East to Europe.

### Hard escalation scenario

In the hard escalation scenario, the war evolves into a broader regional conflict, dragging in Iran and (its rival) Saudi Arabia. If Iran gets openly involved, the US will likely better enforce international sanctions on oil export from Iran, triggering retaliation by Iran through harassing and/or trying to stop oil and LNG cargos shipping through the Strait of Hormuz. Iran could also chose to hit Saudi oil infrastructure with drones or get involved through its proxies in Yemen – earlier Saudi Arabia has already intercepted a missile fired by Iran-backed Houthi fighters in Yemen. When attacked by Iranian drones, clearly, Saudi Arabia is unlikely to stand by idle.

To put things into perspective, note that about 3% of global oil is produced in Iran – of which half goes to China. On top of that, about 17% of global oil flows through the Strait of Hormuz, as well as Qatari LNG (home to over a quarter of global LNG production).

# 'First order' economic impact of an escalation

Before moving on to the economic implications of both escalation scenario's, it's important to keep in mind that, from several perspectives, the cyclical starting point for the economy is worse than at the time of the 2021-22 Russian gas crisis shock (see also the box at the end of the publication). Dwindling pandemic buffers, structural government deficits, a fall in corporate margins plus a higher base for inflation, imply that a new energy shock could pull the economy into a deeper recession with possibly more damage to the labour market and thus to demand.

That being said, higher deficits and interest costs are unlikely to prevent governments from lending a hand if a new energy price shock hits. Indeed, if anything, recent policy announcements show that governments are set to continue to support firms and households to cope with the permanently higher energy prices and the cost of living shock, well into next year and even beyond. Yes, some measures introduced during the energy crisis are being withdrawn, but others are extended and even new ones are introduced – such as the energy subsidies to German industry.

## (i) Baseline scenario

Israel exploits two natural gas fields, of which part is exported to the Mediterranean through Egypt. Israel has temporary shut one of its gas fields (Tamar), but is restarting operations. Given that Israel only produces 0.5% of global natural gas, this has had just a minor impact on global energy prices in any case.

Apart from gas, the war could have an impact on global potash and phosphate fertilizer trade. With 6% to 8% of global exports, Israel is an important player in these markets. Overall, the war could lead to a marginal increase in energy and fertilizer prices, impacting farmers around the globe. At the same time, lower import demand from Israel for grains and oil seeds, lead to lower global market prices for these products. All in all, we have seen only limited impact on global commodity prices and financial markets. In our baseline scenario, we don't expect this to change.

## (ii) Soft escalation scenario

### Commodity prices

As a result of a blockade of the Suez canal, Brent oil would go up to USD100 per barrel and the TTF gas price would rise to between EUR80 per MWh in summer and EUR100 per MWh in winter (see Figures 1 and 2). Furthermore, in the short term, the global food price index would rise by 3 to 5 percent, before reversing in de medium term. Given the difficulty in quantifying the impact of supply chain disruptions and higher freight costs on goods – other than food and energy commodities –, the results below should be seen as a conservative estimate.

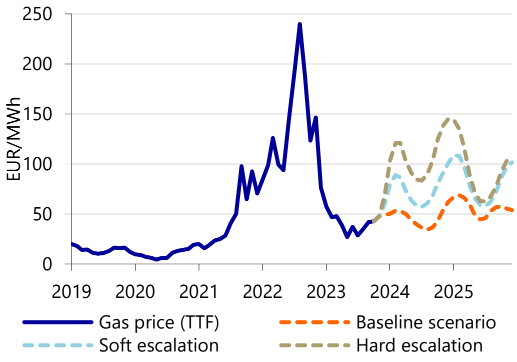
### Financial markets

In the 26 October ECB press conference, President Lagarde did not explicitly outline the ECB's reaction function in case of another energy price shock, suggesting it may look at both the inflation and *economic* impact as we are facing *"a completely different economy today"*. Still, interest rates will increase somewhat in the soft escalation scenario. We plot risk premia to rise in line with developments seen just prior to the Second Gulf War in 2002 and an extra rate hike by the ECB to stem upward inflation pressure. This means that the policy rate will be some 25 basis points higher in 2024 than in the baseline scenario. Finally, we project the euro to depreciate by some 5% against the US dollar up to 2025.

### Result

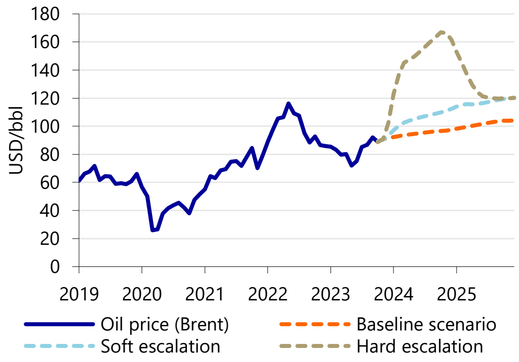
As a result, in the soft escalation scenario, we project euro area inflation to be some 0.6pp and 0.2pp higher in 2024 and 2025, respectively, than in our baseline scenario (Table 1). Weaker purchasing power, higher interest rates and somewhat higher uncertainty lower demand. The blow to GDP is somewhat softened, however, by falling imports due to the terms of trade shock. All in all, economic growth would be slightly lower in both 2024 and 2025. This would essentially lengthen the stagflation outlook – with high inflation and low growth, yet low unemployment – with growth coming in at just 0.4% in 2024 and 1.2% in 2025.

**Figure 1: TTF Gas price scenario's**




Source: ICE, RaboResearch

**Figure 2: Oil price scenario's**




Source: ICE, RaboResearch

## (iii) Hard escalation scenario

### Energy prices

If Iran, and per default Saudi Arabia, get actively involved, the oil price will rapidly increase and temporarily reach over USD150 per barrel. The gas price would shoot up to EUR120 per MWh in the short-term and to EUR135 per MWh in the winter of 2024 – although gas price developments clearly also depend upon the winter of 2023/ 2024 and how European gas stocks come out of this winter.

### Food prices

Shipment of wheat and fertilizers will also be significantly hampered, given that the Middle East and North Africa are important players in these markets. Furthermore, the major increase in energy prices will feed into food prices. We assume the global food price index will increase by 10 percent in the short term, which will be reversed in the medium term.

### Financial markets

Interest rates will rise much more than in the soft escalation scenario, as risk premia double and central banks will hike more: we pencil in three hikes of 25bp by the ECB in 2024. Finally, we project the euro to depreciate against the US dollar by up to 25% in 2025.

### Government spending

Especially in the hard escalation scenario, we are likely to see rising pressures from both within European borders and the US for Europe to increase military spending. Indeed, the US would have to devote means and time to the Middle East War, requiring Europe to take more care of itself when it comes to defence. The call for financial public support will likely be larger than in the soft escalation scenario and also second-round effects are expected to be bigger. Yes demand is likely to suffer more, but given the higher input price increase, firms are still expected to raise consumer prices more than in the soft escalation scenario to make ends meets. Moreover, energy intensive production in Europe will be scaled back and less production means higher prices and/ or higher transportation costs to obtain products from elsewhere.

### Result

As such, in the hard scenario, we project euro area inflation to rise a lot more than in the soft escalation scenario. It is estimated to reach 5.5% in 2024 and 3.5% in 2025, respectively some 2.3pp and 1pp higher than in our baseline scenario. Weaker purchasing power, higher interest rates, higher uncertainty and lower production have a large impact on demand. While a major fall in imports due to the terms of trade shock supports the headline GDP figure, the Eurozone economy will suffer substantially. Economic growth would come in some 0.7pp and 0.9pp lower in 2024 and 2025, respectively, implying GDP would contract by 0.1% in 2024 and grow by just 0.5% in 2025.

**Table 1: Scenario analysis key economic variables**

| | *Baseline scenario* | | *Soft escalation* | | *Hard escalation* | |
|---|---|---|---|---|---|---|
| | 2024 | 2025 | 2024 | 2025 | 2024 | 2025 |
| GDP (% y/y) | 0.6 | 1.4 | 0.4 | 1.2 | -0.1 | 0.5 |
| Inflation (% y/y) | 3.2 | 2.5 | 3.8 | 2.7 | 5.5 | 3.5 |

Source: RaboResearch, NiGEM

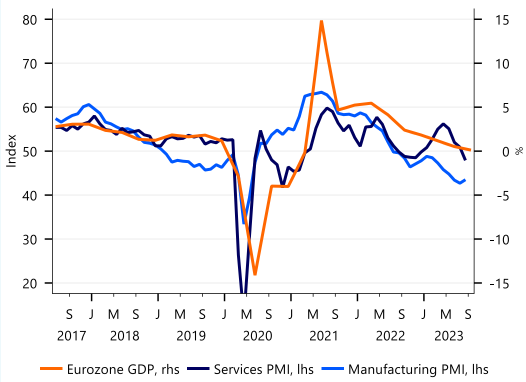
## A weak(er) starting point

When the previous energy price shock (which was largely the result of a cut in the Russian gas supply) hit the Eurozone back in 2021-22, its economy was still recovering from the pandemic. Several economies continued to 'benefit' significantly from post-Covid pent-up demand, backlogs and the need to replenish inventories. Secondly, pandemic savings acted as a buffer during the height of the energy crisis. Thirdly, governments took measures in 2022 and early 2023 to alleviate the impact of energy prices on households and businesses.

This time around, these 'favourable' conditions no longer apply. Inventories have been rebuilt, backlogs declined and global demand has cooled. Pandemic savings have been largely eroded by the bout of inflation that followed and government support measures have been partially unwound now. Note also that the EU budget rules have been suspended since 2020 but are slated to be re-activated, albeit in an adjusted form, from 2024.

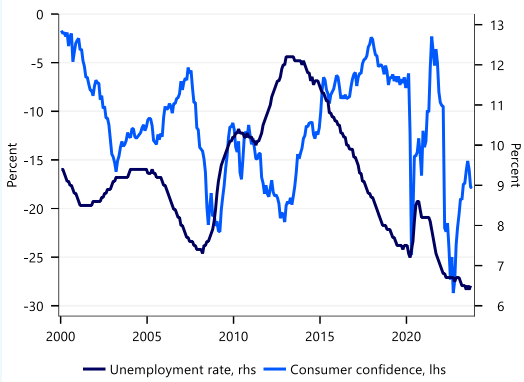
Meanwhile, economic activity has gradually slowed over the course of this year, with GDP declining by 0.1% q/q in the third quarter. If GDP declines in Q4 as well – which we believe is actually quite likely going by the recent short-term indicators – this would already make H2 a technical recession (Figure 3). Higher interest rates will continue to weigh on growth and uncertainty and may also affect investment spending, even without an escalation of the war. Forward-looking indicators, such as the purchasing managers indices, indicate that European firms cut employment in September, the first drop in headcount since the early 2021 lockdowns.

**Figure 3: Even without escalation of the war, the economy is now in a mild recession scenario**




Source: Macrobond, RaboResearch

**Figure 4: Even with record-low unemployment, consumer confidence hit cyclical lows in 2022**




Source: Macrobond, RaboResearch

In a recent piece we argued – assuming no escalation of the Middle East war – that any recession is likely to be mild as long as the labour market remains tight, as firms hoard labour to avoid future hiring costs.

Yet in case of a significant escalation, firms may no longer feel comfortable doing so. In such a scenario we could therefore see a more significant impact on unemployment and hence consumption, especially considering that consumers can't rely anymore on a glut of pandemic savings and businesses are now in a weaker position to handle a new energy price shock. Just for illustration: so far, consumer confidence has been mainly bogged down by concerns over inflation rather than 'jobs', but if another inflationary shock hits and jobs are added to those concerns, consumer confidence could plummet to fresh historical lows (figure 4).

## To conclude

Using a macro-econometric global trade model, we have simulated the economic impact of two escalation scenarios. In short, in the soft escalation scenario, Europe's open economy is likely to be mainly impacted by elevated energy prices and somewhat higher interest rates. In the hard escalation scenario, energy prices will rise even more, while also food prices and interest rates will rise significantly. In the soft escalation scenario we see a prolonged period of weak growth, while in the hard escalation scenario growth will actually turn negative for the year 2024 and only recover minorly in the year thereafter.

The model outcome is insightful as it helps to grasp the economic impact of different scenario's in the short term. That being said, models also very much depend upon the assumptions you feed into them and they are by no means perfect to project the impact of an inherently complex set of events. Indeed, apart from the fact that the war need not precisely follow either one of our scenarios, Europe has to cope with various strategic weaknesses that could amplify or broaden the ramifications of an escalation. Yet these weaknesses are difficult to account for in the model.

In a follow-up publication we discuss how and why i) relatively weak military capabilities to defend or project power, ii) a high dependence on non-EU countries and lack of strategic raw materials, iii) a rising risk of social and political instability, and iv) high government debt and the latent risk of fragmentation, could amplify any fall-out from a deterioration in the global security order. Apart from pointing out weaknesses, we also contemplate in which directions we would have to look for 'solutions' in trying to square an increasingly complex puzzle.

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