



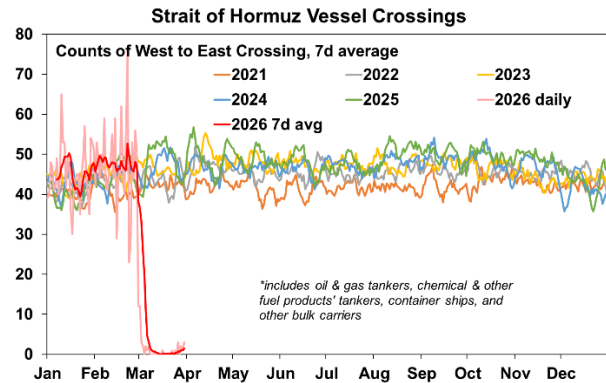
The Middle East War, oil prices, inflation and GDP

Key points

- ▶ Crude oil is a key commodity used around the world in transportation but also to produce other goods. The supply shock from the closure of the Strait of Hormuz is one of the largest hits to oil supply of all time.
- ▶ Oil prices have doubled from their pre-war levels and sharemarkets have had a modest drawdown. But, if there is no resolution to resuming oil supply, oil prices will surge further and have a significant downward hit to demand. The risk of a further 5-10% drawdown in markets is very high.
- ▶ But our base case for now is that US and Iranian negotiations are successful over coming weeks, as there are clear signs that President Trump is looking for an “off-ramp”. However, it may take a while for oil prices to normalise again. So higher inflation is likely for ~6 months. Consumer spending will slow and GDP growth will be lower than it would have been.
- ▶ The oil supply shock puts central banks in a difficult position. While usually central banks look through supply shocks as one-off increases to prices, the problem is higher inflation expectations which can increase wage demands and higher prices seeping into other parts of the supply chain, much as it did through COVID-19.
- ▶ The “PTSD” shock of COVID-19 will make central banks nervous to assume the current supply shock is transitory and will keep central banks hawkish. We see another increase to the RBA cash rate in May and the chance of another lift later in the year, but this means that there is a high chance of rate cuts in 2027 as GDP growth slows.

The oil supply shock

The biggest market impact (so far) from the war in the Middle East has been on oil prices. This is because the region in and around Iran has significant oil reserves, energy facilities and control global oil shipping routes. Iran effectively controls the “Strait of Hormuz”, a narrow waterway between the Persian Gulf and the Gulf of Oman where around 20% of global oil flows through as well as other commodities, mostly Liquefied Natural Gas (LNG), Liquefied Petroleum Gas (LPG), fertilisers, sulphur and helium. Iran borders the northern part of the Strait and has effectively shut the Strait through its military force of missiles, submarines, naval mines, drone surveillance and strikes, seizing ships or forcing hefty fines (one was reported to be around \$2million!) in retaliation for US and Israeli strikes. There have been reports of some ships of “friendly” countries (like India and China) allowed to pass through. Although the data shows very little passageway so far (see the chart below) and most of those allowed to pass have not been oil tankers.

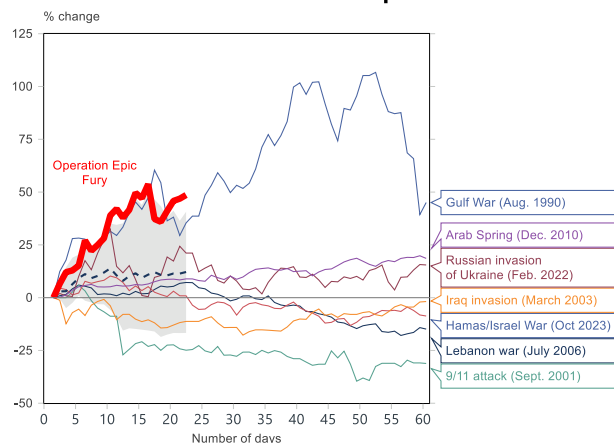


Source: Bloomberg, AMP

There are some offsets to the Strait including pipelines across the Arabian Peninsula to the Red Sea or Gulf of Oman (although these are now being threatened with Iran-backed Houthi attacks), the release of oil from strategic reserves, de-sanctioned floating oil from Russia and Iran, rationing and “lockdown-lite” measures in some countries to reduce fuel demand like new public-holiday days and encouragement to work from home. For now, it’s estimated that around 5% of global oil supply has been disrupted, which explains why the oil price has not surged by more. However, these offsets to the supply lost from the Strait will only last for so long. If the Strait remains closed for a month or longer, oil supply constraints will be impacted further and prices will shoot up.

Oil prices have doubled from early 2026 levels, rising from \$60/barrel to \$118/barrel today on Brent and \$101/barrel on the West Texas Intermediate. This is one of the largest increases to prices historically, against other geopolitical events (see the chart below). This is because the Strait of Hormuz has effectively never been closed before. President Trump has suggested the idea of US Naval escorts in the Strait, or getting allies to help him reopen the Strait, but this has not happened (yet).

Oil Prices and Geopolitics



Source: AMP, Macrobond

Oil is an integral part of the economy because of its broad-based use in many products, production processes and industries. Refined crude oil and its products are used for primarily used for petrol, Liquefied Petroleum Gas, diesel, jet fuel, plastics, sulphur and helium. Industries that are high users of oil include heavy manufacturing and transportation of goods, especially food. So, goods-related production and distribution are impacted significantly by the oil supply shock.

We looked at historic oil price shocks and the impact to the Australian economy in the table below.

Event	Start date	Crude oil price increase % (high-low or vice versa)	Change in RBA cash rate	Inflation at beginning of crisis (%)	Inflation at end of crisis (%)	GDP at beginning of crisis (%)	GDP at end of crisis (%)
Arab Oil Embargo	31-Oct-1973	130.7	+9ppt hike but not inflation targeting	N/A	N/A	4.9	1.4
Iranian Revolution	31-Aug-1978	169.2	+4ppt hike but not inflation targeting	N/A	N/A	0.8	2.9
Iran/Iraq War	31-Aug-1985	-59.2	-2ppt cut but not inflation targeting	6.4	9.2	5.3	0.5
Gulf War	30-Jun-1990	131.9	1 ppt cut to 14% but recession	6.7	6.6	3.5	-0.9
Commodities Super Cycle	31-May-2007	118.7	1 ppt increase	2.7	4.8	4.9	2.5
US Shale Shock	31-Jan-2014	-65.5	-50ppt cut	2.6	1.7	2.5	2.7

Source: Bloomberg, AMP

This table shows that historic oil shocks have had mixed impacts on the economy. Most of the time, the jump in oil prices led to higher inflation, rate hikes and lower GDP growth down the track. But it is hard to just isolate the impact of oil, as often there have been other macro demand shocks alongside the event. So basically, there is no “rulebook” that policy makers can follow. Every crisis is different and the starting point for the economy also differs. But what is likely to happen this time round?

Our base case

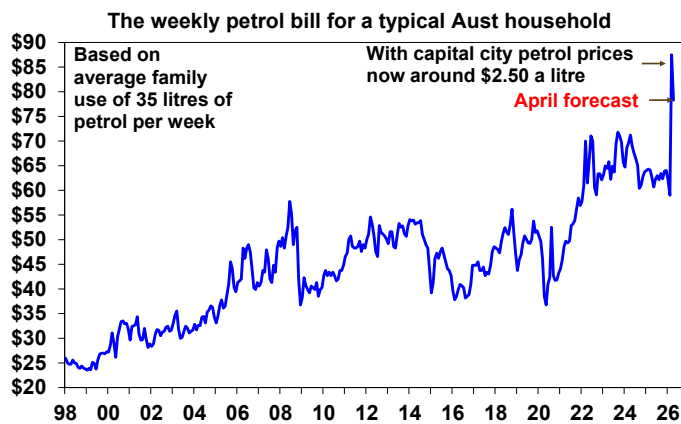
It’s very easy to get pessimistic right now about the outlook for Australia and the global economy. The good news is that oil intensity has fallen over time around the world, including in Australia because of energy efficiencies and the growth of the services sector, as our chief economist talks about [here](#). This means that the impact of the oil price surge today may be less than otherwise. There are also numerous constraints on the US, Iran and Israel to keep this war going for too long as we wrote about [here](#), including the US mid-terms in November, record low approval rates and pressure on Iran from China to end the conflict.

It’s always hard to make assumptions and predictions about war and conflict as negotiations can and do fail but we are paid to make assumptions as economists, so we need to have a working “base case”, with probabilities on either side. For now, we are assuming that the negotiations and non-energy specific strikes continue until mid-April. This fits in with Trump setting April 6th as the “deadline” for Iran to reopen the Strait of Hormuz. Up until this point, global oil supply can manage on the “offsets” I explained beforehand up to this point. But the situation becomes much more challenging the longer that supply is constrained, which is likely to be sometime in mid to late April.

So, what will be the impact this time on Australian inflation and economic growth?

The impact on consumers

The direct impact on consumers from higher oil prices is via petrol prices which is worth around 3% of consumer spending. Petrol prices in March increased by around 45% from their February levels. This week the Australian government announced a halving in the fuel excise from 52.6cents per litre to 26.3 cents per litre from April for a period of 3 months. On our estimates, for a petrol-driving household using 35L of petrol per week average spending on petrol would have been ~\$60/week before March and in March priced to \$88/week and will decline a little to \$78/week from April (assuming no further rise to oil prices). For those with diesel engines (around 20% of the market), prices have risen by more like 80% in March but lower use of fuel means that weekly fuel bills are in a similar ballpark. Around 5% of households in Australia have electric vehicles but sales are rising significantly and make up more like 10% of the market now.

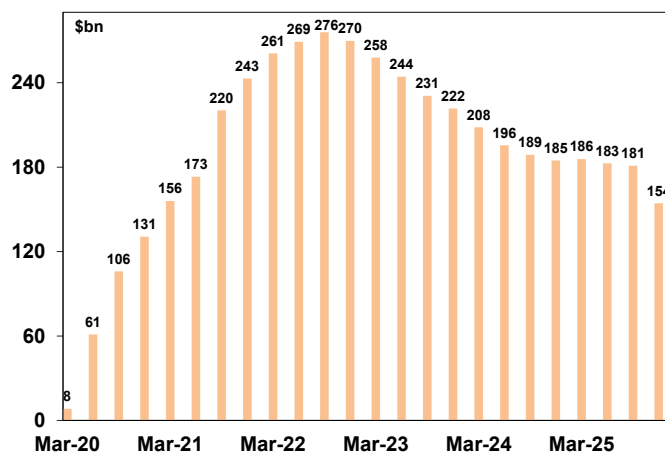


Source: MotorMouth, AMP

The other big hit to consumers is the lift in interest rates, over February and March, which has taken the cash rate to 4.1%. A 0.25% lift to rates is worth an additional \$120 per month on the average new mortgage size of \$740,000. This is similar to the impact of the higher fuel price. Of course, the average mortgage size across [all loans](#) in Australia is smaller, so the petrol price hit is probably worth more than 1 interest rate increase.

During the period of rising interest rates over 2022-23, one of the factors that helped consumers with debt was built-up savings and buffers that remained high after the pandemic. These excess savings are still elevated (see the chart below) but are around half of what they were during the pandemic. We also know that there are large distributional issues in these savings (i.e. that most seem to be with older households). The bottom line is that accumulated savings may not provide as much of a support for households as they did a few years ago.

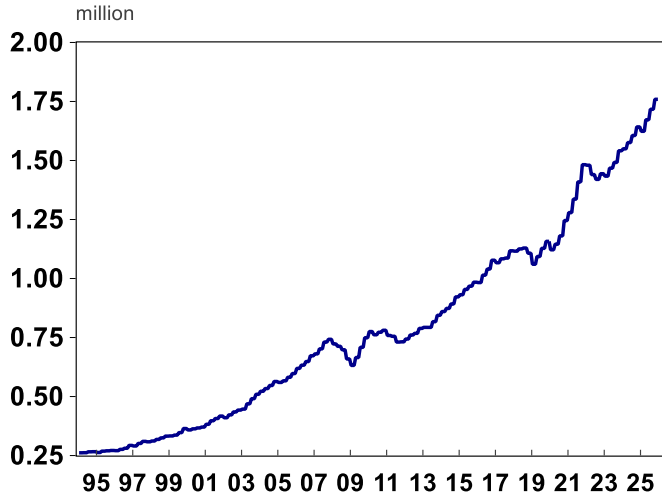
Australia Accumulated Household Savings



Source: ABS, AMP

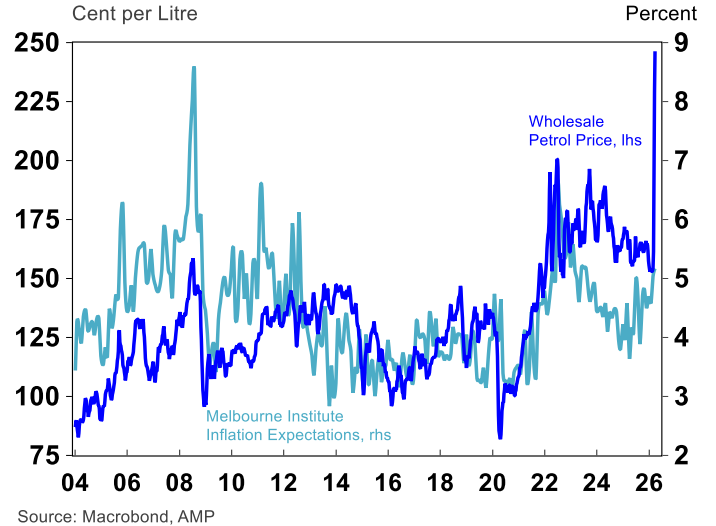
Elevated household wealth has been another driver of consumer spending in recent years. On our estimate, the average household is worth \$1.8mn, a nearly 10% increase on last year and a 60% increase since Covid. This is thanks to the booming housing market (capital city home prices are up nearly 50% since 2020) and solid sharemarket and superannuation returns. While you can’t necessarily touch accumulated your wealth in many ways, it does provide a psychological boost and higher wealth growth tends to suppress savings and increase spending. The outlook for wealth from here is slower growth – we expect national home prices to have sub 5% returns this year and for investment markets to also run at a softer pace. So, any boost to spending from higher wealth growth could be a bit slower going ahead.

Australia Net Wealth Per Household



Consumer income growth will slow over the coming quarters from higher mortgage repayments and higher prices, consumer spending on essentials will rise due to higher fuel prices and limit discretionary spending. As well, accumulated savings and household wealth may provide less of an offset to these pressures which is likely to see lower consumer spending growth in the next few quarters, after a turnaround in the second half of 2025.

Inflation Expectations and Petrol Prices

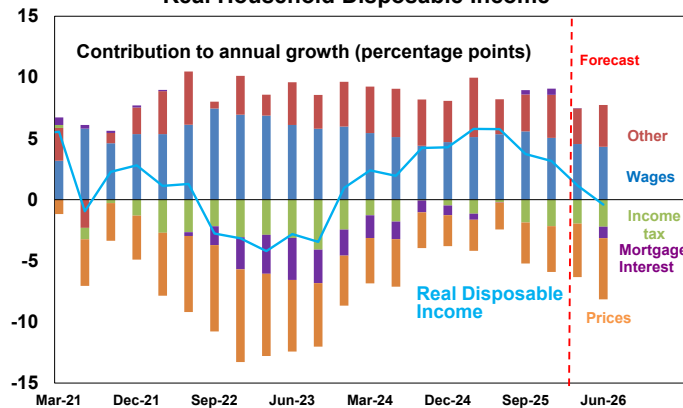


Are we headed into a recession?

The longer-term impact from higher oil prices is lower spending growth in the economy. We have revised down our GDP growth forecasts to 1.6% by December, which is basically just in line with population growth. But we are not forecasting an Australian or global recession (yet).

A recession or stagflation (high inflation low growth) scenario is possible as a worst-case outcome. A further rise in oil prices to \$150/barrel or above will cause panic. There will be large cutbacks to spending from consumers and businesses. Global trade will halt. And inflation will surge. This would put the central banks in a very difficult position as they will not want to cut interest rates while inflation is high but will want to support the economy. We have not reached this panic situation yet. Global supply pressures are not yet as bad as they were during Covid when supply was severely constrained (see the chart below) and inflation surged.

Real Household Disposable Income

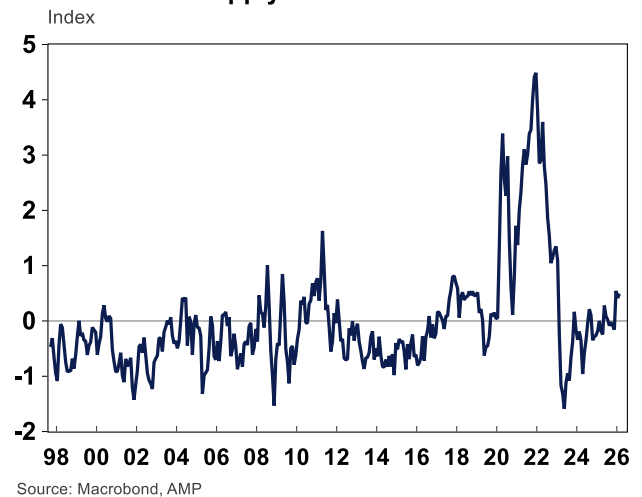


Source: ABS, AMP

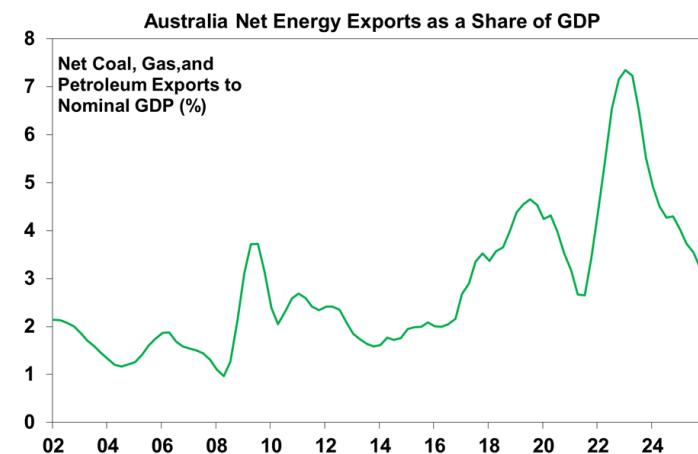
The impact on inflation

The first-round impact to inflation is the increase to fuel prices which will add 1.2 percentage points to March monthly headline inflation and 0.7 percentage points to the June quarter. There will be little flow through to trimmed mean (or underlying inflation) in the March quarter. But second-round impacts will be felt in the June quarter from other products that use oil and its byproducts including gas, plastics, semiconductors and industries that produce and move goods like manufacturing, agriculture and transport (especially air and road). Even service industries are adding a "fuel surcharge" for increased costs to travel. Consumers may demand higher compensation via wages. The first evidence of this is the government recommending an above inflation increase to the minimum wage decision which is due in June. Consumer inflation expectations have already moved along with higher petrol prices (see the chart below). We expect headline annual inflation of 4.3% in the March quarter, 5% in June and 4.3% by December. For the trimmed mean we expect annual growth of 4% in June and 3.5% in December – both well above the RBA's target band. The lift to inflation expectations will also make the RBA nervous.

Global Supply Chain Pressure Index



Australia is a net energy exporter (we export more energy than we import - see the chart below) so in the short-term we may actually benefit from higher prices, at least until trade volumes suffer if global growth takes a hit.



Source: ABS, AMP

Implications for investors

The fundamentals for major economies and company profits looked positive before the conflict erupted. Better news on tariffs and expected US Federal Reserve rate cuts was supporting US sharemarkets. Australian profit growth was positive for the first time in 3 years. Those fundamentals are mostly still intact, provided that the conflict doesn't drag out much beyond the next few weeks. However, in the interim, bad news on negotiations, or more missile strikes are possible which will send oil prices higher and that could see another 5-10% hit on sharemarkets. So far, US shares are down 6% from their highs, Australia is down by 8% and Europe has fallen by 10%.

However, the conflict does mean that inflation stays higher for longer as prices take time to normalise from the shock but also because there has been some permanent damage to energy facilities in Qatar for example which will limit LNG supply significantly for a number of years. For the US Fed, this may not matter too much if Trump's appointed Kevin Warsh cuts interest rates a few times. However, for Australia it means more interest rate increases, as Australian inflation was already too high before the conflict started. We are expecting another rise in May, taking the cash rate to 4.35% and erasing all the rate cuts we had last year and the risk of another hike in the second half of the year. But this could be met with interest rate *cuts* sometime next year, as demand takes a hit from restrictive interest rates.

Diana Mousina
Deputy Chief Economist, AMP