



Israel's strikes on Iran: assessing the macro impact

- **The overnight strikes by Israel on Iran mark a major escalation in the conflict in the region and, with the oil market tighter than it was a few months ago, the risks to oil prices look more balanced than we'd previously thought (rather than skewed to the downside). But barring a major escalation of the conflict that causes oil prices to spike much further, the macro implications for global inflation and growth should be limited.**
- Israel's military has reported that it has conducted a broad attack on at least 100 targets across Iran, including its nuclear facilities and a major military base housing Iran's ballistic missiles. Iranian state media has confirmed that the head of Iran's Revolutionary Guard Corps, Hossein Salami, and several other high profile military figures, as well as top nuclear scientists, have been killed in the attacks.
- Israel's attack suggests that it feels emboldened after its military successes against Iranian proxies, Hezbollah and Hamas – particularly in light of US opposition to the attacks. Oil prices jumped by 13% overnight, almost reaching \$80pb but some of that has since unwound and Brent crude is currently trading at ~\$73pb.
- **The key question now is what form Iran's response takes and how the conflict develops.** During tit-for-tat strikes last year, Iran's response appeared to be calibrated to avoid an escalation. So far, Iran has launched drones towards Israel (that are being intercepted) suggesting that its response this time is also being calculated. But comments from Iran's Supreme Leader suggest that a more aggressive response is a key risk.
- **Another key thing to watch is what happens with regard to talks around Iran's nuclear programme.** The US and Iran re-started negotiations over a new nuclear deal and were due to undertake a sixth round of talks in Oman on Sunday. The US appears to remain willing to continue to engage. It's notable that US Secretary of State Marco Rubio made clear in a statement that the strikes were "unilateral", perhaps an attempt to show to Tehran that the US does not condone Israel's action. That leaves the ball in Iran's court. Were Iran to show willingness to proceed with the talks, that may point to a lower likelihood of aggressive retaliation on Iran's part (and possible US pressure on Israel not to take further action).
- **One important point in all of this is that the risk that Iranian retaliation affects the Gulf economies – and their oil facilities – has diminished greatly over the past few years as relations have thawed.** Indeed, all Gulf governments have published statements strongly condemning Israel's attacks this morning and Saudi Arabia described Iran as "brotherly". So unlike in 2019, when Saudi Arabia's Abqaiq processing facility was targeted in strikes by Iranian proxies and over half of Saudi oil production was temporarily offline, there's very little risk that the Gulf's oil production facilities are directly affected.
- **Against that backdrop, from an energy market perspective, the jumps in oil and gas prices overnight reflect an increase in risk premia rather than a change in market fundamentals.** For what it's worth, there does not appear to have been any direct impact on oil production or export facilities in Iran. But the key risk for global energy markets is that Iran tries to block the Strait of Hormuz. Around 25% of seaborne global oil supplies and 20% of global LNG transit the Strait. Clearly, ongoing uncertainty and/or an escalation in hostilities could keep the risk premium in oil prices elevated or even see it rise further.
- **Crucially, one way in which this occasion differs from previous flare-ups between Israel and Iran is that the potential supply buffer provided by spare capacity within OPEC+, which has helped to insulate the oil market from bad news in recent years, is already in the process of being drawn down.** While we are

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only in the early stages of the increase in oil output, we forecast global oil output spare capacity to roughly halve, to below 3m bpd, by the middle of next year. This manifests itself in two opposing ways.

- **On the one hand, the fact that the focus in the market in recent months has largely been on prospects of a potential supply glut means that the latest oil price spike has taken place from a relatively low level.** Indeed, having fallen to a four-year low in May, even after the jump overnight the price of Brent crude is still around 12% lower than it was this time last year. **On the other hand, though, the fact that the outlook for the oil market balance has tightened following the change in tack from OPEC+ earlier this year means there is less margin in the global oil market and is a recipe for volatility.**
- All eyes in the energy market will be on how OPEC+ and Saudi Arabia react from here. If Iranian oil is taken offline, one could envisage a scenario in which the Gulf producers seek to utilise their spare capacity and recapture market share more quickly. That said, given the impact on Saudi's public finances from lower oil prices, barring a major shock to global supply, it may wish to stick to current plans and benefit from higher prices and the associated rise in revenues.
- **The main channel by which this escalation could impact the global economy would be through higher oil prices.** Even at current levels, oil prices are still considerably lower than they were a year ago, so will continue to have a disinflationary impact. **If Iran's oil production/export facilities were to be targeted, Brent crude could plausibly jump to around \$80-100pb, which would add about 0.5-1.0%-pts to DM inflation by the end of this year.** We suspect such a spike in prices would result in more OPEC+ production coming online though, thereby limiting the length of the inflation shock. But any rise in energy inflation would be another reason for central banks to proceed cautiously with cutting interest rates, and for the Fed to remain on the sidelines for now.
- **Meanwhile, any additional disruptions to shipping through the Strait of Hormuz could lead to higher shipping costs.** Shipping costs surged at the start of last year as conflict in the Middle East forced shipping companies to take longer journeys in order to avoid the Red Sea. But we doubt this would have a meaningful impact on global inflation. For one thing, many shipping firms are still opting to avoid the Red Sea. And even if shipping costs were to rise sharply, it would probably only have a modest impact on global inflation anyway, as was the case during the pandemic.
- **We'll continue to monitor the situation closely and will be discussing the news in a Drop-in at 11.00am BST – register [here](#).**



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