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When oil destabilises the world economy

It is not only the oil price that must be kept in focus, but the whole impact of a rise in oil on the global economy

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AGEFI LUXEMBOURG · APRIL 2026

> *A rise in oil is never only bad news for inflation: it is a complete macroeconomic shock. It revives inflation, weighs on growth, complicates the task of central banks, delays rate cuts and increases the nervousness of markets.*

A rise in oil constitutes one of the most destabilising macroeconomic shocks for the world economy. We all keep in memory the oil shock of 1973, which completely reorganised the balance of power between the old developed economies and the petro-monarchies of the Gulf, and durably modified world geopolitics.

The operation launched by the United States and its allies against Iran is at the origin of the first oil shock of the twenty-first century. The notes of IFPEN show indeed that oil markets have entered a phase of very strong tension: Brent has progressed strongly in weekly average, bullish scenarios now largely exceed the levels envisaged a few days earlier, and the blockage of the Strait of Hormuz raises fears of a genuine supply shock if the situation is prolonged. Today Brent costs 97 USD a barrel, whereas it cost only 70 USD before the crisis. With oil, the conflict in the Middle East has changed scale, and now plunges the entire world into instability.

The first channel: inflation

The first channel of transmission is naturally inflation. A rise in oil directly increases the cost of fuels, heating oil, certain transport costs and, in several regions, part of the cost of producing electricity or heat. We speak then of energy inflation. But contrary to what one may think, the most important element is not in the direct impact, but in the progressive diffusion to the whole of prices. When diesel, kerosene and refined products rise strongly, as is currently the case, the entire logistics chain becomes more costly.

Road transport, maritime freight, air transport, food distribution, construction and industry all see their costs rise. From there, companies must arbitrate between absorbing this increase in their margins or passing it on to their sale prices. In an economy already weakened by geopolitical tensions and by more fragmented value chains, the temptation to pass it on to prices is strong.

This logic of contagion to the whole of prices depends, however, on several parameters. First, on the initial level of inflation: if it was already above the target of the central banks, the oil shock is far more dangerous, because it can prevent any disinflation. Currently, in the euro zone, it would seem that we benefit from a very slight margin: the latest reports show an annualised inflation of between 1.7 and 1.9%, whereas the target of the ECB is set at 2%.

Next, expectations about the duration of the conflict: if households and companies begin to believe that energy will remain durably expensive, they rapidly adapt their consumption behaviour. Finally, it depends on the budgetary reaction of states: in certain European countries, governments can lessen the shock through tax reductions, energy cheques or targeted measures. The French government has for the moment evoked no measure of support, betting on a short conflict, pressed by the political context in the United States and by the unsustainability of the conflict from a strategic and economic point of view.

The second channel: growth

The second great channel of transmission is that of economic growth. A durable rise in oil acts in general as a brake on activity, above all in importing countries. For households, the effect is simple: a more important share of income is devoted to energy and transport, which reduces the income available for consumption. For companies, the rise in intermediate costs weighs on margins, on investment and therefore sometimes on employment.

The longer the shock lasts, the more painful the arbitrations become: a fall in consumption, the postponement of investments, a slowdown in the sectors dependent on transport or energy. This is particularly true in Europe, where energy dependence remains structurally important and where industry is more sensitive than in the United States to imports, above all in Germany.

It is necessary, however, to nuance. Not all countries react in the same manner. Oil producers benefit mechanically from an improvement in their terms of trade, from a surplus of external receipts and often from budgetary support. Conversely, the great importers such as the euro zone, Japan or several emerging economies suffer a negative shock. The United States occupies a more ambivalent position: it remains sensitive to the rise in petrol through household consumption, but its oil and para-oil industry benefits from a higher price.

The third channel: rates and monetary policy

The third channel is that of interest rates and monetary policy. It is here that oil becomes particularly complicated to manage for central banks. An oil shock often combines the worst of both worlds: more inflation, less growth. In other words, it creates a risk of stagflation. If the central bank reacts too aggressively by raising its rates to combat imported inflation, it accentuates the economic slowdown. If it does not react enough, it risks letting the shock diffuse into underlying inflation and into price expectations.

In practice, everything will depend on the duration of the shock. If the rise in oil is brief, central banks can look beyond the first effect and avoid a supplementary tightening. If, on the other hand, tensions in the Middle East settle in and Brent remains durably very high, oil becomes a major obstacle to monetary easing. In that case, markets push back the expected rate cuts, real bond yields can rise again, and financial conditions tighten.

The risk that matters

In total, today the principal risk is not so much the absolute level of Brent over a single session as the possibility of a durable supply shock in the Middle East. If this scenario is confirmed, oil could once again become, as in 2022, one of the central determinants of the trajectory of the world economy.

— Luxembourg For Family Office.

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