[Inflation after the Iran war]

CFM-DP2026-15

Ricardo Reis[1]

[1]London School of Economics and Political Science

As of the end of May 2026, the economic impact of the military conflict pitting Iran against Israel and the United States fits into the classic description of a supply shock. Since March, a few key commodities of which the Middle East is an important producer---oil, gas, fertilizers---could no longer reach the market. The contraction of supply raised their prices steeply, but was not so large as to cause shortages. A higher price raised the costs of production of many goods directly, and many more indirectly through the supply chain. In turn, this led global inflation to rise, and output to fall. While the impact on different economic areas will vary depending on whether they export or import these commodities, and on their place in global supply chains, as well as on how much military spending or uncertainty about defense rose, most major central banks faced similar challenges.

One of these challenges is whether to tighten monetary policy in order to bring down inflation, or to loosen it to boost output. Another is to evaluate whether the rise in inflation is large enough to offset using policy, and whether the fall in output causes an output gap as opposed to a change in potential output. And a third is whether the effects of the shock will persist long enough that monetary policy can do something about it if by the time its tools have an impact those effects will be gone. Common to these challenges is an underlying question: by how much will the initial supply shock transmit to inflation?

Not so long ago, there was another significant supply shock when Russia invaded Ukraine in 2022. This provided data to test and calibrate old models of the transmission of supply shocks, and to inspire the development of new ones. This paper uses these recent developments to provide a preliminary answer. I am writing it only three months after the conflict broke out, so the relevant economic data is often missing or is preliminary. Yet this will always be the case when relevant shocks hit the economy. Trying to apply economic insights in these circumstances is the ultimate test of their usefulness for policymakers.

This article uses some of the developments in the academic literature to assess whether the initial inflation shock from the Iran conflict will amplify and persist. Putting all the estimates together, the first-round impact of the energy shock on inflation via the gradual adjustment of sticky prices in section 2 amounts to a cumulative increase in inflation of 1.2--1.6pp over 2026 and 2027. The second-round impact on inflation through the expectations of household and firms in section 3 adds a further 0.3--0.4pp in 2027. The evidence for a further fiscal impulse in section 4 is inconclusive, and there is no evidence of a change in regime on the long-run credibility of the inflation anchor in section 5. Moreover, financial prices re consistent with a 2-year impact of the Iran conflict shock on inflation of 1.5--2.0pp, matching these estimates.

Should monetary policy look through the 2026 energy shock? One can argue that the size of the inflation increase and its persistence into 2027 justifies not entirely looking through the shock. At the same time, an aggressive tightening that would mirror 2022 seems unwarranted. Ultimately, the monetary policy decision must weigh the different risks and the balance of inflation against other goals.