

2 The International Economy

2.1 Global Macroeconomic Developments

The global economy faces a major supply shock

Geopolitical developments in the Middle East have severely undermined the erstwhile benign global macroeconomic outlook at the January *Review*. The disruptions to shipping at the Strait of Hormuz and damage to energy infrastructure in the Middle East constitute a major shock to the global economy.

The attendant macroeconomic effects are propagating through multiple, interrelated channels. Constraints to oil and gas flows from the Middle East represent an immediate supply chain shock, reducing output in energy-dependent sectors. At the same time, the higher energy prices are a negative terms-of-trade shock for net energy-importing economies, eroding real incomes and corporate profitability. Financial conditions are also tightening as markets price in more restrictive monetary policy amid higher inflation and rising fiscal sustainability concerns. These factors will weigh on final demand.

2.2 Outlook

Global inflation is expected to rise in the near term

Relative to past energy crises, the current shock is likely to be more systemic and sustained. The International Energy Agency has warned that more than 40 energy assets across the Middle East have been severely damaged, materially impairing productive capacity and prolonging the effects of supply disruptions. As the damage to infrastructure will take years to repair, oil prices may not revert to pre-war levels even after the conflict abates.

The energy shock is set to lift inflationary pressures globally, though the impact will vary with each economy's energy exposure and degree of pass-through. Currency depreciation will further compound these dynamics in several emerging markets amid external stability and fiscal risk concerns. Among advanced economies, the Eurozone may be more vulnerable, as restoring gas reserves after last winter's drawdown will be costly amid heightened demand in the gas market. In the US, price pressures from the energy shock are accelerating and likely to keep inflation above target.

Accordingly, global headline inflation is expected to average 2.7% in 2026, rising sharply from 1.8% last year. It is then expected to moderate to 2.0% in 2027 as weaker aggregate demand exerts downward pressure on prices.

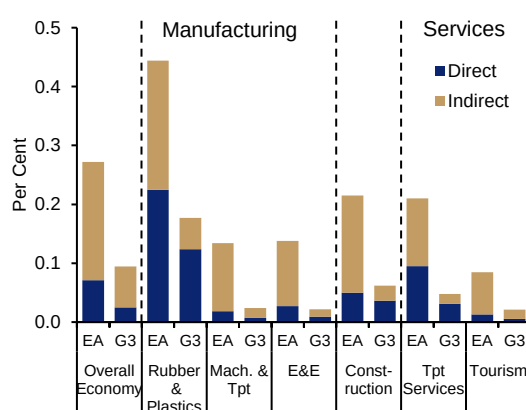
Global growth will initially be dragged down by supply chain disruptions, before higher energy costs further weigh on aggregate demand

The Middle East shock will exert a drag on global growth, initially operating through supply chain disruptions before broader and more pervasive negative terms-of-trade effects take hold. The former reflects constraints on production from material shortages and elevated business costs, while the latter stems from reduced real incomes and profits. The terms-of-trade channel could be the main driver of the slowdown, reflecting the increased cost of energy inputs that are critical to a broad swathe of economic activity. Nevertheless, the impact will emerge with a lag as households and corporates mitigate the initial impact with existing balance sheet buffers.

The growth impact will differ across countries and reflect the distinct industrial production structures, energy mixes, and extent of reliance on imports from the Middle East. Economies with oil- or gas-intensive energy systems and heavy reliance on energy imports from the Middle East are likely to face larger growth drags, while net energy exporters with substantial domestic production should be more resilient. The extent of vulnerabilities will also depend on the sectoral composition of activity: economies with large exposure to industries directly affected by the current energy supply disruption, such as rubber & plastics manufacturing and transport services, could see more severe impact (Chart 2.1). Indirect spillovers are also likely to be material in economies with large downstream sectors that are significant users of energy, such as construction, hotels and restaurants. Moreover, there will be some economies which are adversely affected by declining remittances from the Middle East.

Against this backdrop, global GDP growth is expected to slow to 3.0% in 2026 and 2027, down from 3.5% last year. The Middle East shock is estimated to reduce the global growth forecast by 0.4% point for 2026 relative to the pre-war prognosis (Chart 2.2). That said, several factors should continue to provide support, including pre-committed multi-year investment plans as well as the ongoing electronics upcycle that is bolstered by AI-related spending.

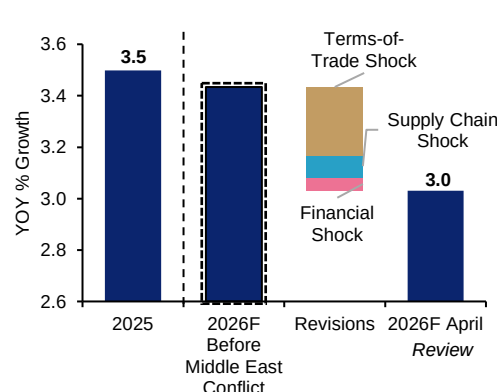
Chart 2.1: Elasticity of Selected Sectoral Output to Energy Supply Shock



Source: EPG, MAS estimates, based on ADB's MRIO National Input-Output Tables

Note: EA denotes ASEAN-5, NEA-2, India and China. The chart shows the elasticity to a 1% change in supply from the mining, oil refining and chemicals sectors.

Chart 2.2: Decomposition of 2026 Global Growth Forecast



Source: Oxford Economics and EPG, MAS estimates

Note: The 2026 growth forecast prior to the Middle East conflict had been lifted to 3.4%, higher than the 3.1% projection in the January Review. This reflected stronger-than-expected growth momentum into 2026 and a reduction in overall effective US tariffs following legal rulings in February 2026, which resulted in a rollback of fentanyl-related tariffs and reciprocal tariffs imposed last year.

A more severe energy shock could trigger broader financial stress in an adverse scenario

There remain risks of a prolonged interruption to the normal supply of energy and related products. In such a scenario, oil prices would rise more sharply and remain elevated for longer.

Against this backdrop, the tightening in financial conditions would be even more pronounced and could induce disorderly corrections in asset prices, with supply chain and terms-of-trade shocks intensifying. Countries with lower energy, fiscal and external reserve buffers would likely be the most vulnerable. Contagion would also take hold if the retrenchment in risk-taking behaviour were to trigger broader negative sentiment and amplify risk-off dynamics across financial markets.

At the same time, the AI-led growth momentum could be disrupted should the energy supply shock constrain investment in energy-intensive infrastructure that underpins AI deployment. Sustained power shortages, energy rationing, and elevated electricity costs may delay data centre expansion, disrupt advanced semiconductor production, and increase operating costs across high-performance computing activities. Together with tighter financial conditions and heightened uncertainty, these constraints could slow investment in, and the deployment of, AI capacity.

In such an adverse scenario, global growth is expected to drop sharply even as inflation stays high in 2026. The ensuing demand destruction from a combined energy and financial shock will be more severe, weighing heavily on growth in the global economy and subsequently generating disinflationary pressures into 2027.