

Global Economics Quarterly - Tightening tensions | Insights

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Given the escalation in the Middle East and renewed rise in energy prices, many central banks are now tightening monetary policy but, despite the persistent rise in public debt and rise in long-term interest rates, we have yet to see many governments make the difficult political choices needed to tighten fiscal policy.

Markets may ultimately force them to do so. The public finances in many advanced economies are on an unsustainable path and even a future AI-driven productivity surge may not save the day, given the high reliance on labour-related taxes in current government revenues in most economies.

Yet global growth has been remarkably resilient so far this year. The temporary fall in oil prices following the US-Iran memorandum of understanding in June lifted confidence, while an even bigger impact has come from the ongoing AI investment and export boom and widespread fiscal support. What comes next?

We still forecast some moderation in global growth to the end of the year, with higher inflation and higher interest rates weighing on consumer spending. We have raised our annual average global GDP forecasts for 2026 from 2.5% to 2.7%, but this is largely because of the upside surprises in Asian and European growth in the first half of the year. Our 2027 forecast is unchanged at 2.7%.

When it comes to inflation, most of the rise since the start of the war has been driven by energy, and current oil prices mean headline figures are set to rise again imminently. Very few signs of the potential price shocks from El Niño and other food production costs have materialised yet; this will likely be a story for 2027. We have revised up our 2027 global inflation projection from 3.1% to 3.3%.

When so much of the rise in inflation so far has been driven by externally induced supply shocks, there is a limit to what monetary policy can achieve. For central banks, it is now mostly about maintaining enough credibility to keep expectations anchored and limit the scope for second-round effects on inflation, without making policy so restrictive that it slows the economy too sharply.

Under our central forecasts we are looking for modest tightening from here, with just one more 25bp rate rise from the US Federal Reserve and the Bank of Japan, and two more from the European Central Bank by early 2027. Unless energy prices fall back sharply from here we expect the Bank of England to deliver 25bp hikes in November and February, taking Bank Rate to 4.25%, followed by a reversal from August 2027 onwards.

We have also made our first stab at forecasts two years ahead, which is challenging when we cannot be confident about the levels of traffic through the Strait of Hormuz even a month from now. We pencil in a forecast of 2.7% GDP growth for 2028 but see plenty of upside and downside risks, including those arising from AI and numerous elections worldwide. We also note that neither the ECB, nor the 18 members of the Fed's Federal Open Market Committee who submit forecasts, is projecting that inflation will be back down at 2% by 2028.

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