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PROJECTIONS UNDER ALTERNATIVE SCENARIOS OF THE MIDDLE EAST CONFLICT

BOX 2: PROJECTIONS UNDER ALTERNATIVE SCENARIOS OF THE MIDDLE EAST CONFLICT¹

Introduction

After hostilities began on 28 February 2026, the United States and Israel carried out coordinated air and missile strikes on military targets in Iran, substantially intensifying the conflict and heightening regional instability as neighbouring states to Iran were also subjected to military attacks. Fears over disruptions to global energy supplies rose as Iran restricted shipping through the Strait of Hormuz which serves as one of the world's most critical maritime chokepoints, with a fifth of global petroleum shipments passing through its narrow waters, making any closure, restriction, or highly risky to navigate such waters highly consequential for international trade and energy security.

The conflict led to higher market volatility and uncertainty whereby oil prices increased sharply, with global natural gas prices also increasing due to risks to Gulf LNG exports. As a result, the conflict has contributed to higher energy costs and increased uncertainty for the global economic outlook.

The Maltese economy is traditionally highly susceptible to disruptions in global energy markets, given its near-total dependence on imports for its energy needs. Nevertheless, the Government expressed clearly its intention to continue protecting households and businesses from the immediate and direct inflationary effects of an energy price shock. Consequently, as shown in Box 1, the primary impact domestically is on public finances, which are expected to absorb increases in wholesale electricity and fuel prices.

These energy disruptions also create a very significant negative supply shock on the global economy. As a highly open economy, Malta remains particularly exposed to economic performance of its main trading partners. As energy prices abroad increase, these would reduce demand from Malta's trading partners, which is reflected through weaker foreign demand. This would weigh on Malta's exports and thus on GDP.

At the same time, developments in foreign prices have a direct bearing on Malta's import prices and export competitiveness. In particular, higher production costs abroad are likely to contribute to imported inflation and raises cost pressures for domestic firms.

Given the high uncertainty surrounding the impact of the ongoing Middle East conflict on energy prices, and the propagation to the macroeconomy, this Box includes three scenarios to assess how the baseline economic activity, inflation, and fiscal projections could change in such scenarios.

Scenarios – Narrative, Assumptions and Key Transmission Channels

This box includes three scenarios; a milder, an adverse and a severe scenario. The scenarios differ with respect to the commodity price paths, the level of uncertainty and financial market volatility. Given the war's impact on the fertiliser market, we also incorporate upside

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risks to food prices into the adverse and severe scenarios. The scenarios in this box are in line with those published by the ECB in the June 2026 Eurosystem staff macroeconomic projections for the euro area.²

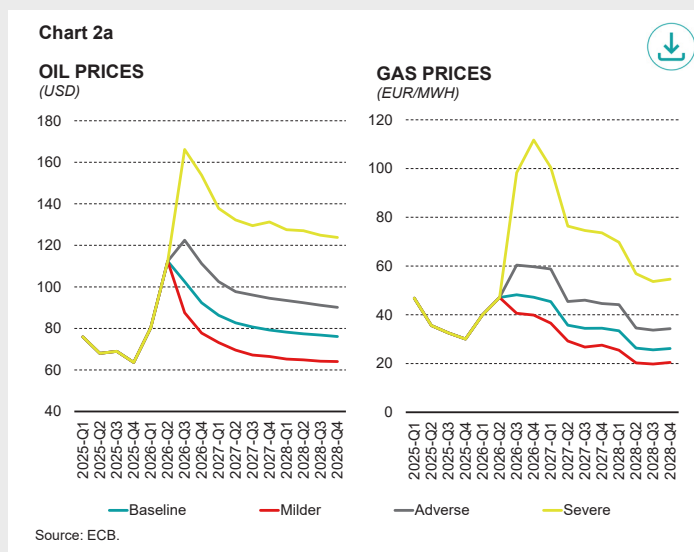
The milder scenario simulates a relatively faster resolution of the conflict such that commodity prices would be lower than assumed in the baseline projections (see

Charts 2a). In this scenario both oil and gas prices are assumed to follow the 25th percentile of the market implied probability distributions from the third quarter of 2026, implying that both prices are assumed to return to the pre-war levels by the end of 2026.

In the adverse and severe scenarios, both oil and gas prices follow the 75th and 95th percentiles of the probability distributions, respectively. In both scenarios commodity prices are assumed to peak in the third quarter of 2026, except for the price of gas in the severe scenario, which is assumed to peak in the following quarter. Oil prices are assumed to reach USD 122 and USD 166 per barrel in the adverse and severe scenarios, respectively. This is higher than the baseline peak price of USD 112 to be reached in the second quarter of 2026. Similarly, at the peak, the price of gas is assumed to stand at around €60 and €111 per MWH in the adverse and severe scenarios, respectively. The latter is significantly higher than the price of €48 per MWH assumed in the baseline projection. In addition to the above energy shock, in the adverse and severe scenarios we also include shocks to international food prices to account for the impact of fertiliser prices.

Given the high uncertainty surrounding the impact of the ongoing Middle East conflict on energy prices, and the propagation to the macroeconomy, apart from the above shocks we also take into account some uncertainty impacts. The assumed uncertainty path is broadly consistent with historical episodes of comparable tensions, including during the war between Russia and Ukraine.

Since the Government is committed to keeping energy prices fixed for both local consumers and businesses, the direct impact of the increase in oil and gas prices will be absorbed by public finances. Hence, the impact of the war on international oil and gas prices is reflected through Malta's GDP and HICP only indirectly through the foreign demand and foreign price channels.



² See [Eurosystem staff macroeconomic projections for the euro area, June 2026](#).

The calibrations of the scenarios through the foreign demand and foreign price channels are derived from ECB model-based results of the impact of the war. Changes in the demand for Maltese exports from the euro area are based on the estimated fall in the euro area real GDP, while the drop in foreign demand from the rest of the world is proxied by the fall in foreign demand faced by the euro area. Changes in the euro area consumer prices are taken from the expected impacts of the war on the euro area HICP while the price increases in the rest of the world are proxied by the projected increases in the euro area competitors' export prices.

Beyond the effects on foreign demand and import prices, additional shocks are judgmentally incorporated to capture potential non-linear outcomes. These have been calibrated using a BVAR and a two-country DSGE models.

Fiscal impact of support measures

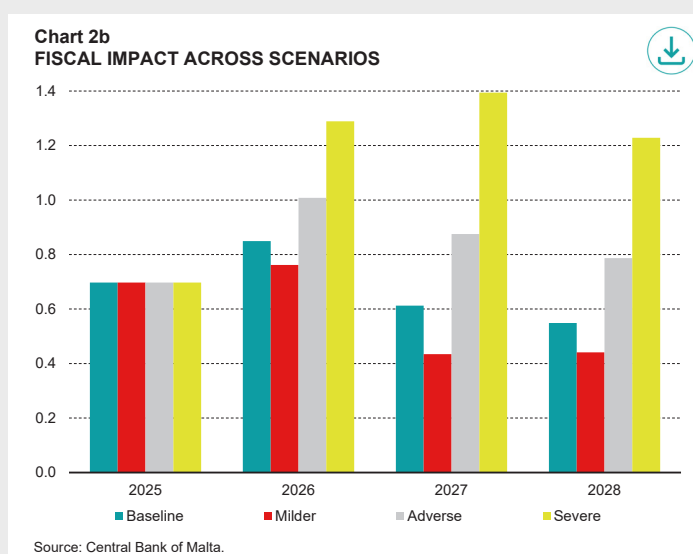
Chart 2b shows the estimated fiscal cost of energy support measures across scenarios. These measures consist of subsidies aimed at maintaining fixed retail electricity, fuel pump and LNG gas prices. While such measures were in place before the start of the conflict, their impact is expected to vary in each scenario, in line with the projected level of oil and gas prices.

Under the baseline projections, support measures are forecast to amount to 0.8% of GDP in 2026, up from 0.7% on 2025. Outlays are then expected to decline gradually to 0.6% of GDP in 2027 and 0.5% in 2028 (see Box 1).

In the milder scenario, the fiscal cost of support measures in 2026 is projected to be somewhat lower than under the baseline scenario, with outlays declining more rapidly thereafter. By 2028 outlays are set to amount to 0.4% of GDP.

Outlays are expected to remain higher than in 2025 throughout the projection horizon in the adverse scenario. In 2026 spending is set to amount to 1.0% of GDP, which is 0.2 percentage points higher than in the baseline. While the share of outlays in GDP is set to gradually decline in 2027 and 2028, it remains around 0.3 percentage points higher than the baseline.

The fiscal impact in the severe scenario is significantly higher compared with the other scenarios.



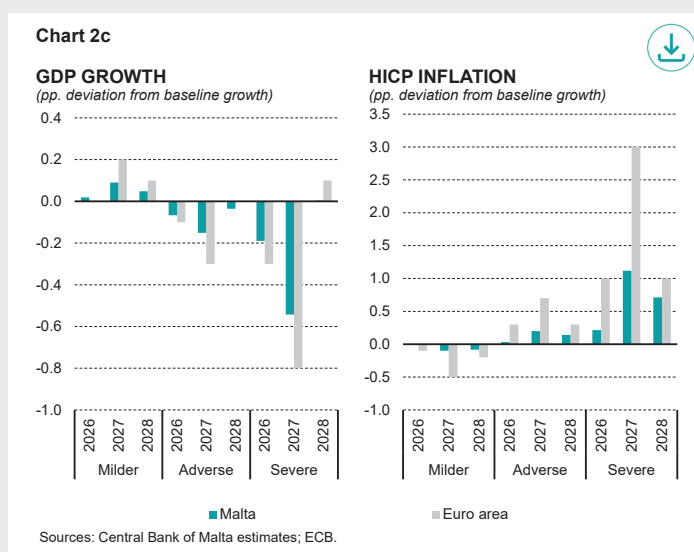
Outlays are set to amount to 1.3% of GDP in 2026, and to peak at 1.4% of GDP in 2027, equivalent to 0.4 percentage points and 0.8 percentage points above the baseline scenario, respectively. Although expenditure is expected to moderate slightly in 2028, it would still amount to 1.2% of GDP, remaining 0.7 percentage points above the baseline projection.

Macroeconomic impact

Given the nature of the milder scenario, that of a faster resolution than the baseline, results imply minor upside risks to economic growth and downside risks to inflation and the fiscal impact, especially for 2027. Simulation results suggest that GDP growth would be 0.1 percentage points higher than the baseline projections in 2027 and largely unaffected in 2026 and 2028 (see Chart 2c). As the conflict resolves rapidly and energy prices normalize quickly, the indirect effects on the prices of Maltese goods arising from higher foreign prices in 2026 are therefore limited and simulation results point to a 0.1 percentage point lower inflation in 2027 and 2028.

In the adverse scenario, the impact on GDP growth and inflation is somewhat limited. The main effect on economic activity stems from weaker external demand, which would reduce GDP growth by 0.1 percentage points in 2026 and 0.2 percentage points in 2027. This mainly reflects lower export growth. The impact on GDP growth is nil by 2028. At the same time, HICP inflation is estimated to be 0.2 percentage points higher in 2027 and 0.1 percentage points in 2028, as lagged indirect spillovers from higher international inflation feed through to higher prices for imported goods and food in Malta. These effects offset the weaker domestic price pressures associated with the slowdown in economic activity driven by lower foreign demand.

In the severe scenario, impacts would be relatively larger and longer lasting. Similar to the adverse scenario, the main effect on economic growth stems from weaker external demand, which is estimated to reduce GDP growth by 0.2 and 0.5 percentage points in 2026 and 2027, respectively. The impact on GDP growth is estimated to be nil by 2028. At the same time, HICP inflation is estimated to be 0.2 percentage points higher in 2026, and 1.1 and 0.5 percentage points higher in 2027 and 2028. These largely reflect the indirect spillovers from higher international inflation, which could feed through to higher prices for imported goods and food in Malta.



Comparing the simulation results for Malta with the June 2026 Eurosystem projections for the euro area, we note that the impact of the war on economic growth and inflation in Malta is much smaller. This is due to the cushioning of energy prices by the Government of Malta as well as a lower share of energy intensive industries in the economy.

In the milder scenario, GDP growth would stand at 3.7% in both 2026 and 2027, increasing to 3.8% in the outer year (see Table 2a). With regards to the adverse scenario, GDP growth would be expected to stand lower than the baseline in the first two years at 3.6% and 3.4% and unchanged in the outer year at 3.8%. Similarly, in the severe scenario GDP growth is expected to stand at 3.5% in 2026, 3.1% in 2027 and recovers to 3.8% in 2028.

With regards to inflation, in the milder scenario, overall HICP inflation is estimated to stand at 2.5% in 2026, unchanged from the baseline, and at 2.4% and 2.1% in the following two years. Inflation in the adverse scenario is also equivalent to the baseline in 2026 but is then estimated at 2.6% and 2.3% in 2027 and 2028, respectively, marginally higher than the 2.5% and 2.2% projected in the baseline. As for the, severe scenario, HICP inflation is estimated at 2.6% in 2026, 3.4% in 2027 and 2.7% in 2028, which implies that in such a scenario inflation would be substantially higher and more persistent when compared with the baseline.

Table 2a
KEY MACROECONOMIC VARIABLES UNDER THE BASELINE AND ALTERNATIVE SCENARIOS

	Baseline			Milder			Adverse			Severe		
	2026	2027	2028	2026	2027	2028	2026	2027	2028	2026	2027	2028
GDP Growth	3.7	3.6	3.8	3.7	3.7	3.8	3.6	3.4	3.8	3.5	3.1	3.8
HICP inflation	2.5	2.5	2.2	2.5	2.4	2.1	2.5	2.6	2.3	2.6	3.4	2.7

Source: Central Bank of Malta.