



By: *Gene Frieda*

How will the regime in the Strait of Hormuz affect fiscal and monetary policy?



The Gulf ceasefire lasted barely three weeks. After Iranian attacks on three commercial ships in the Strait of Hormuz, the United States struck **more than 80 targets**, revoked Iran's oil-sanctions waiver, and declared the memorandum of understanding "over."

Yet the market response was telling: Brent crude rose to around \$79 per barrel—a meaningful jump, but far below April's \$120 peak, when the strait was closed outright.

That gap between renewed war and restrained prices confronts policymakers with a key question: Is this the road back to blockade, or a violent renegotiation of the terms of passage?

Five months into the war, the severity of the underlying shock is not in doubt. This is not 2022, when Russia's invasion of Ukraine rerouted supply, and the world absorbed a costly but manageable adjustment.

Today's shock is destroying supply rather than rerouting it, with lost oil output **already exceeding** that of the 1973–74 OPEC embargo.

Once liquefied natural gas, fertilizer inputs, and freight are included, the global energy bill is at least **twice the crude price** quoted on trading screens.

There are two starkly different readings of Iran's intentions. According to the first, Iran is seeking full control of the strait. That path leads to a larger conflict, another blockade, and a return to the price dynamics of March, when oil prices spiked.

Alternatively, Iran is behaving less like a blockader than a toll collector, maximizing the revenue it can extract from traffic through the strait.

Sporadic attacks on shipping then keep the risk premium alive without choking off the flow; oil prices remain elevated and choppy rather than soaring.

The evidence so far points, tentatively, to the second reading. American strikes have

deliberately avoided Iran's energy infrastructure; Iran's attacks on shipping have been demonstrative rather than systematic; its parliament has debated tolls on "hostile" shipping; and the MOU itself envisaged Iran's help managing strait traffic.

None of this precludes escalation—miscalculation is the Gulf's default risk—but for now both sides appear to be contesting the price of passage rather than passage itself.

Why markets react so sharply to every headline

For **central banks**, the two paths lead to very different destinations. If Iran is collecting tolls, elevated but broadly capped energy prices act like a chronic tax: painful, but not a reason to restart aggressive monetary-policy tightening.

Interest-rate expectations would settle roughly where they stood two weeks ago, with attention shifting to second-round effects—whether higher fuel, freight, and food costs fuel wage pressure.

Interest rates are unusually sensitive to oil

If Iran is reaching for the strait itself, central banks will be compelled to act forcefully to prevent a temporary shock from becoming embedded inflation.

That is why markets react so sharply to every headline. Investors are not refining a single forecast; they are toggling between two regimes, and each jump in oil poses the same question: Is this a move from toll collection to blockade?

As a result, interest rates are unusually sensitive to oil. Positioning, at least, is healthier than in the spring: in March, many investors had effectively sold insurance against large swings in interest rates, and when oil spiked they were forced to buy it

back at any price, amplifying every move.

That exposure has largely been cleared out, so the same headline still moves markets, but without the forced unwinding of March.

Treacherous economic terrain

Neither scenario, however, resolves the underlying policy bind. With inflation above central-bank targets, and public finances under strain worldwide, none of the standard responses works.

Aggressive monetary tightening—unavoidable in the blockade scenario—impedes growth and undermines debt sustainability.

Expansive fiscal support fuels inflation and drives up borrowing costs, now that foreign central banks no longer buy government debt at any price.

And doing nothing invites a procyclical adjustment, with financing costs rising even as the economy slows.

Fiscal and monetary policy must reinforce rather than offset one another

To navigate this treacherous economic terrain, fiscal and monetary policy must reinforce rather than offset one another.

That means targeting support at the most exposed households and sectors, rather than conducting broad cash transfers, and issuing debt that resists the lure of cheaper short-term paper, which merely concentrates refinancing risk when the next shock hits.

It is in the blockade scenario that this logic reaches its unorthodox conclusion.

With central banks tightening even as the shock deepens, rising government borrowing costs would crowd out the targeted fiscal support most needed—unless central banks

cap increases in short- and medium-term interest rates.

With such intervention remaining firmly under central-bank control, and with a clear exit strategy, this would not compromise central banks' independence, and the alternative—leaving them to bear the burden of adjustment alone—is worse.

Recognizing the trade-off now, while the toll collector still holds sway, is preferable to confronting it in the middle of a blockade.

The US has the most room to maneuver

That option is not available to every country: success depends on fiscal starting points, institutional credibility, and investors' confidence that intervention will be temporary.

The US has the most room to maneuver, thanks to deep global demand for Treasuries, even as the dollar's privilege gradually erodes.

The Federal Reserve has held interest rates steady, and markets that began the year expecting cuts now flirt with hikes—the direction hinging on which Gulf scenario prevails.



In either scenario for the strait, the United Kingdom has the narrowest path

The eurozone faces a more complicated trade-off. Its fragmented sovereign-debt markets mean that any conditional intervention

immediately raises the question of which government is being supported, and why.

The European Central Bank's recent **25-basis-point rate increase** underscored the dilemma: the ECB has little choice but to tighten, yet helping the governments most in need of fiscal support would revive the fragmentation fears its 2022 **Transmission Protection Instrument** was designed to contain.

Japan is in a stronger position: its large foreign-exchange reserves let policymakers resist yen depreciation before energy costs feed into domestic inflation.

In either scenario for the strait, the United Kingdom has the narrowest path: a limited fiscal cushion, a persistent external deficit, and inflation running above the Bank of England's projections point to a wider gap between UK and German government bond yields and a weaker pound.

Even the more benign scenario offers little comfort as winter approaches.

European gas storage is at its lowest level for this time of year since 2011, while Qatar would require two months to **restore LNG** exports even after a durable reopening of the strait.

Regardless of how the latest escalation is resolved, Europe's energy bill will not fall materially before winter.

That is why sequencing matters. The economies most likely to need this toolkit lack the institutional credibility to use it, whereas those with the greatest credibility are least likely to require it.

And the path will not announce itself in advance: by the time markets know which one they are on, the room for a measured response will have narrowed—and ordinary borrowers and savers in the most exposed economies will bear the cost of the delay.

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