

# IMF warns of major downturn in global growth

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The International Monetary Fund (IMF) has warned that the global economy could face its most serious downturn since the onset of the COVID pandemic in 2020, amid elevated risks of financial instability if the Iran war continues.

The foreword to its *World Economic Outlook* (WEO) report released yesterday set out the overall situation.

“The global outlook has abruptly darkened following the outbreak of war in the Middle East... The closure of the Strait of Hormuz and the serious damage to critical production facilities in a region central to global hydrocarbon supply could cause an energy crisis on an unprecedented scale.”

Prior to the outbreak of the war, the IMF said it was poised to upgrade its growth predictions on the back of some easing of trade tensions, a tech investment boom and more accommodative financial conditions. “War in the Middle East will overwhelm these underlying forces.”

Due to the uncertainty generated by the war, the IMF abandoned its usual practice of issuing a “baseline scenario” replacing it with a “reference scenario,” which assumed that the war would end shortly and oil prices would quickly return to their previous levels. But even under these conditions, it said global growth would fall to 3.1 percent this year down from 3.5 percent in 2025 and inflation would rise to 4.4 percent from 4.1 percent last year.

Under what it called an “adverse scenario,” the global economy would grow by only 2.5 percent this year—the lowest since 2020 and the start of the pandemic—and inflation would rise to 5.4 percent.

Speaking to the *Financial Times*, IMF chief economist Pierre-Olivier Gourinchas said that developments at the weekend—the collapse of talks in Islamabad and the imposition of a US blockade on the

Strait of Hormuz—had triggered a rise in oil prices “that would bring us closer to the adverse scenario.”

In blog post, he said that if a “severe scenario” developed, where inflation expectations were less anchored and financial conditions tightened sharply, “global growth would decline to 2 percent this year and next, while inflation would exceed 6 percent.”

As the foreword to the report spelled out: “Under our severe scenario—assuming dislocations in energy markets that extend to next year, together with a de-anchoring of inflation expectations and a tightening of financial conditions, the global economy would come close to experiencing a recession... Clearly, the downside risks are tremendous.”

In its policy prescriptions, the IMF made clear that the burden of the developing crisis must be borne by the working class.

Gourinchas wrote that for now central banks could generally “look through” the energy price surge and not immediately raise interest rates “*but only as long inflation expectations remain well-anchored.*” [Italics in original]

But if inflation expectations “drift up as prices and wages pick up, restoring price stability must take precedence over near-term growth.”

In other words, if workers respond to the price hikes with wages struggle, central banks must lift interest rates, pushing their economies into recession if that is considered necessary.

The IMF is firmly against government spending measures aimed at easing the hit to living standards, as Gourinchas noted in his blog.

“Untargeted measures—price caps, subsidies, and similar measures—are popular. But they are frequently poorly designed and costly. Given the lack of fiscal space with still elevated budget deficits and rising

public debt, any fiscal support should remain narrowly targeted and temporary.”

“Avoiding fiscal stimulus is also critical when inflation is rising, so as not to complicate central banks’ tasks.”

But one of the most significant sources of additional spending is the increased outlays on the military being undertaken by governments around the world financed by cuts to social services. The IMF devoted a chapter of the WEO to what it called the “scaling up of defense spending” which it said risked “crowding out social spending” that “could in turn ignite discontent and social unrest.”

The IMF’s *Global Financial Stability* report, issued along with the WEO, noted that while financial markets have moved in an orderly manner so far, “the longer the conflict continues, the greater the risk that global financial conditions... could tighten further and more abruptly.”

It did not single out any one particular problem but rather pointed to a series of them, presenting a picture of the global financial system as a veritable minefield of potential flashpoints.

Rising debt-to-GDP levels combined with an “increased pressure of price-sensitive investors”—mainly hedge funds—had led to bond yield gyrations on auction days when new government debt is sold. The increased raising of debt at the short-end of the market—two-year rather than ten-year bonds—meant that core sovereign bond markets were more subject to risks in periods of rising inflation.

Emerging markets faced the prospect of currency and capital outflows.

It noted that “an abrupt tightening of financial conditions can lead to forced selling by hedge funds, option sellers, leveraged exchange-traded funds and other nonbank financial intermediaries that have expanded through leverage.”

In the private credit market, which has played a rapidly growing role in the financial system, defaults “could cascade into broader concerns about corporate credit, particularly for highly leveraged borrowers subject to the artificial intelligence (AI) disruption.”

Another potential source of instability was a slowdown in the booming investments in AI if the conflict in the Middle East were to persist.

“This could weigh on the enterprise value of firms

along the AI value chain that have increasingly relied on a circular financial arrangements.”

The report warned that simultaneous sell-offs of equities and bonds have been occurring more frequently during market shocks and “further shocks raise the risk of forced deleveraging in both asset classes.”

Even before the launching of the war, numerous warnings had been issued about the growing fragility of the global financial system. With the downturn in global growth set out in the WEO, those risks have become significantly greater.



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