Israel-Iran Conflict

Key risks and the impact on Sri Lanka's economy and markets

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Background and implications of the ongoing hostility between Iran and Israel

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- The conflict between **Israel and Iran** is rooted in decades of ideological hostility, regional power rivalry, and disagreements over nuclear proliferation.

- Israel, backed by the U.S., has targeted Iranian nuclear facilities and Iranian proxies in Syria and Lebanon.

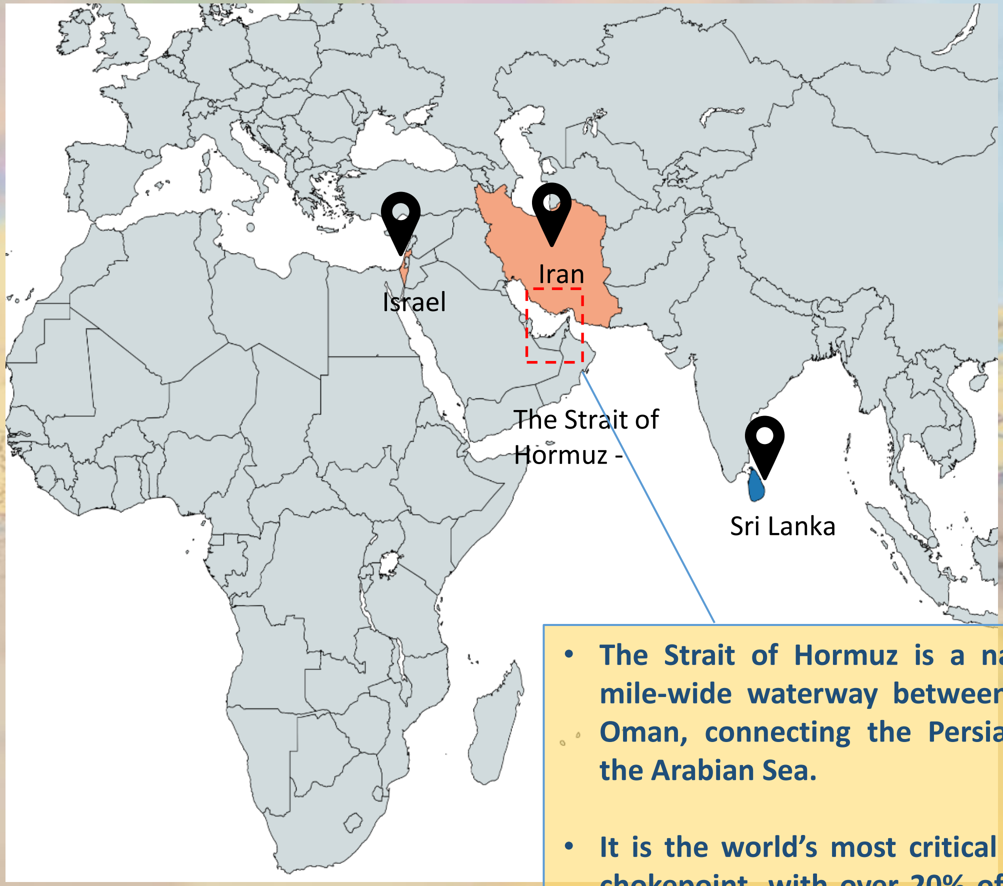
- The conflict intensified sharply following the **Israel–Hamas war in late 2023**, with Iran stepping up support to regional militias and tensions simmering in the Red Sea and Syria.

Strategic consequences for the world and Sri Lanka

- **Strait of Hormuz**: ~20% of global oil and LNG passes through here. Disruptions affect global energy supply → impacts import-dependent countries like Sri Lanka.

- **Safe-haven flow**: Investors flee to USD and gold → emerging markets see capital outflows.

- **Regional uncertainty**: Weakens remittances, trade flows, and tourism in broader Middle East.



- **The Strait of Hormuz is a narrow, 21-mile-wide waterway between Iran and Oman, connecting the Persian Gulf to the Arabian Sea.**

- **It is the world's most critical oil transit chokepoint, with over 20% of global oil trade — nearly 17.0 million barrels per day — passing through.**

- **Key exporters using the route: Saudi Arabia, UAE, Kuwait, Iraq, and Iran.**

Source: FC Research, Bloomberg, Reuters

Latest U.S. involvement escalates the conflict and triggers global market turmoil

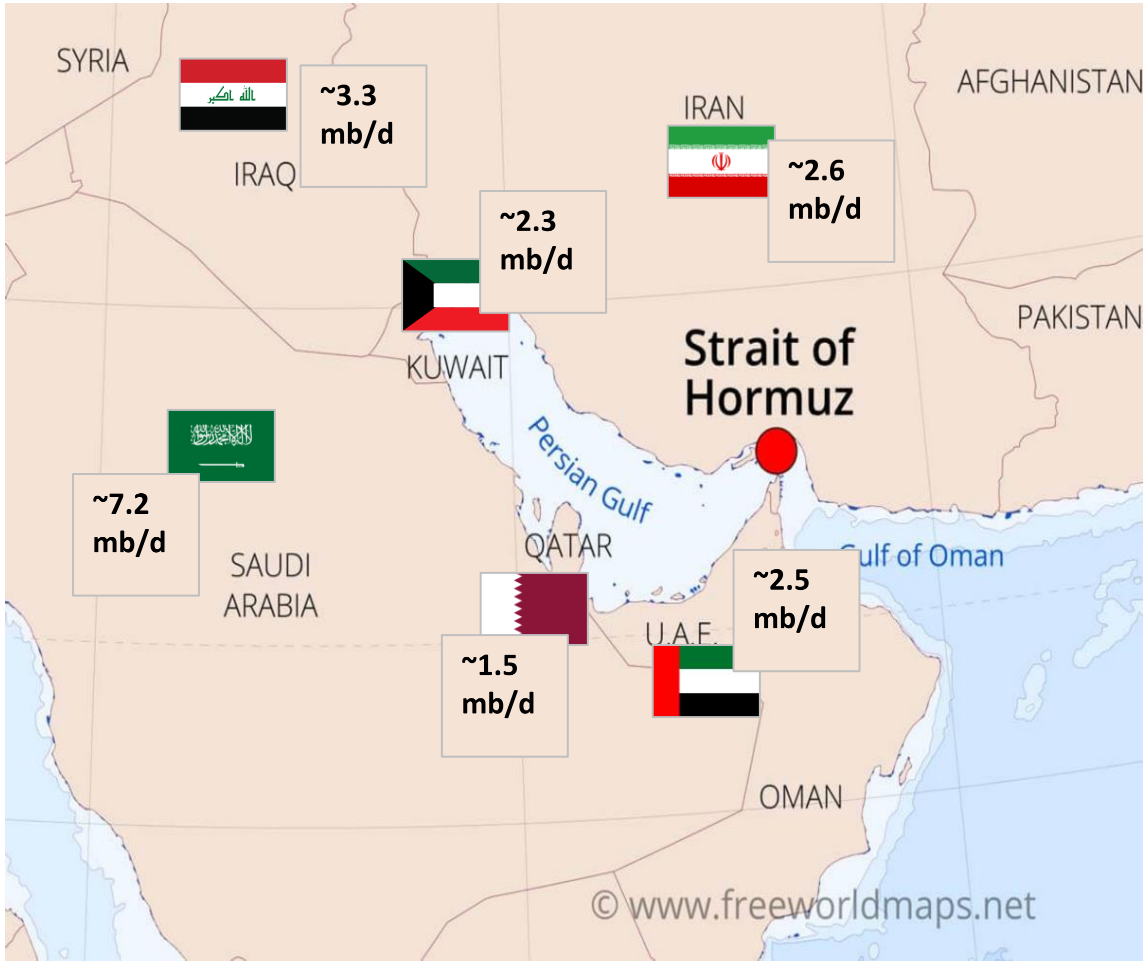
What happened

- On 22nd June 2025, the U.S. launched **"Operation Midnight Hammer"**, striking the **Fordow, Natanz, and Isfahan nuclear sites** in Iran using B-2 bombers and cruise missiles
- Iran responded by firing missiles at Israel, but no U.S. bases were directly hit
- **Iranian parliament voted to consider closing the Strait of Hormuz, which handles ~20% of global oil shipments. Closure of the strait could spark a global recession and affect import dependent nations such as Sri Lanka**

Global markets – Immediate reaction

- **Oil surged** 5.0–7.0% overnight; Brent crude spiked to over **$81.0/bbl** before easing back
- **Global equities** and **Asian stock futures** slumped, with markets adopting a risk-off stance
- **Safe-haven demand** lifted gold & USD, while bond yields fluctuated amid uncertainty

Shipment of oil per day from top exporters



mb/d- million barrels per day

Source: FC Research, Bloomberg, Financial Times

The conflict's escalation has disrupted global markets, fueling uncertainty

Timeline of events

Nov-23 to Feb-24	U.S. & Israel carry out strikes in Syria, Lebanon	
Apr-24	Israel attacks Iranian consulate in Damascus	
May-24	Iran launches drone and missile attacks on Israel	
10th-14th Jun-25	Tensions reignite after Iran's navy conducts drills near Hormuz; oil prices spike	Fear of disruption in the Strait of Hormuz (~20% of global oil flows).
15th Jun-25	Unconfirmed Israeli airstrike hits Iranian radar site	Markets react sharply; Brent crude crosses $78.
17th -18th Jun-25	Missile skirmishes reported in Golan Heights and Southern Syria	
20th -22nd Jun-25	U.S. strikes hit 3 Iranian nuclear sites; Iran threatens Hormuz closure, risking 20% of global oil flow	Oil volatility, gold surge, and emerging market pullbacks observed.

Risk Factors

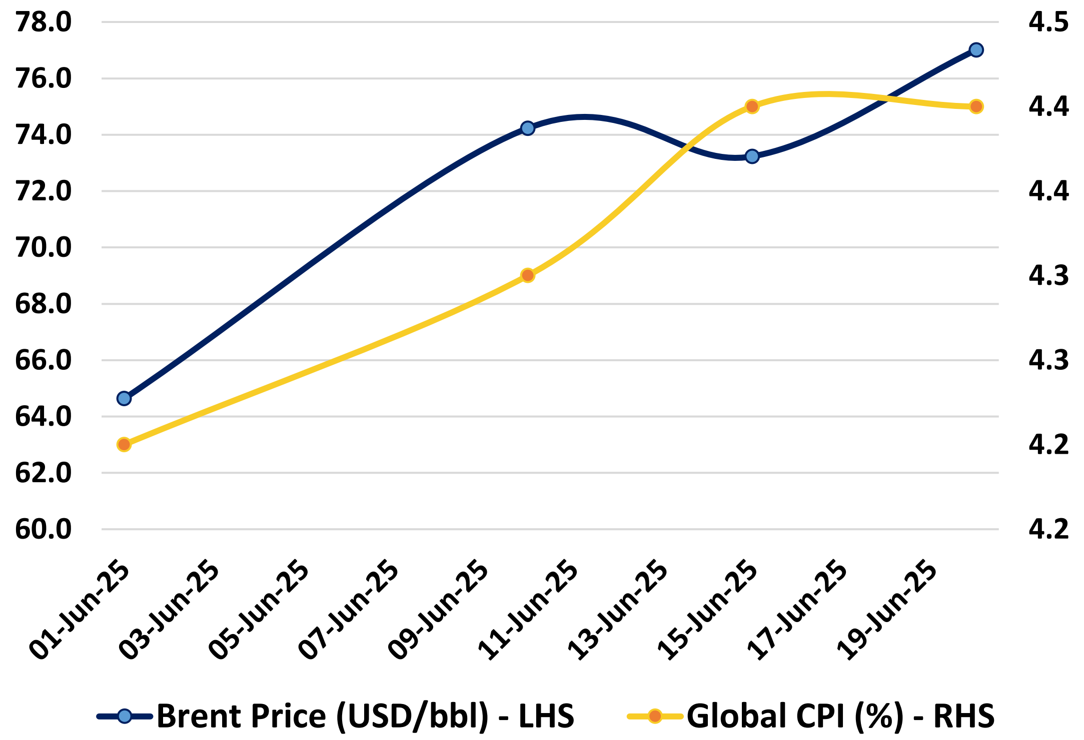
Fuel Import Costs	Brent crude could spike to $100–$120+ if conflict escalates and the strait of Hormuz is blocked
Exchange Rate Risk	LKR under pressure due to stronger USD and higher import bill
Remittance Flow	A Deployment freeze to Israel; Middle East instability may slow inflows
Inflation Spike	Transport, utilities, and food costs may spike from 3Q2025 onwards
Equity & Bond Market	Foreign outflows → pressure on ASPI, rising yields and limited rate cut scope

Source: FC Research, Bloomberg, Reuters

Rising oil prices drive inflation while investors shift to safe-haven assets

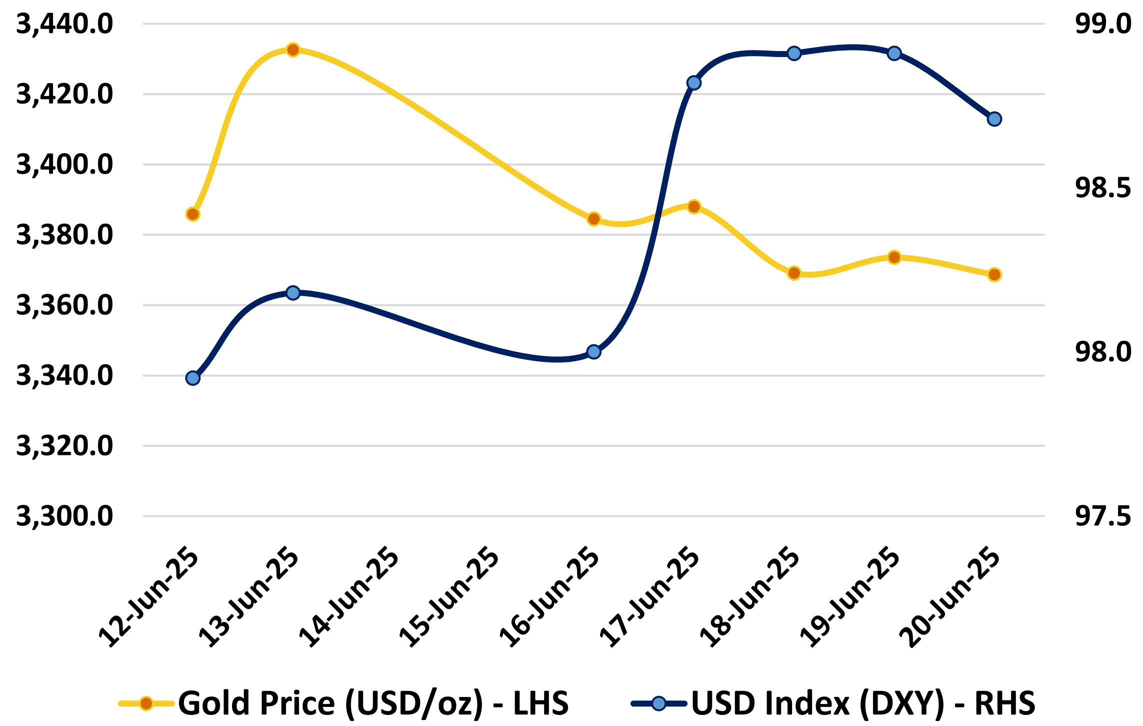
Brent crude climbed from **USD 64.3/bbl on 1st June 2025 to USD 77.5/bbl** by 20th June 2025, reflecting concerns over possible disruptions to oil flows.

As a result, the global CPI (Consumer Price Index) estimate for June ticked up from **4.2% to 4.4%,** highlighting that modest increases in oil prices can reheat inflation, especially for energy-importing countries. This inflationary pressure is expected to influence central bank decisions globally, potentially delaying interest rate cuts that were previously anticipated for 3Q2025E.

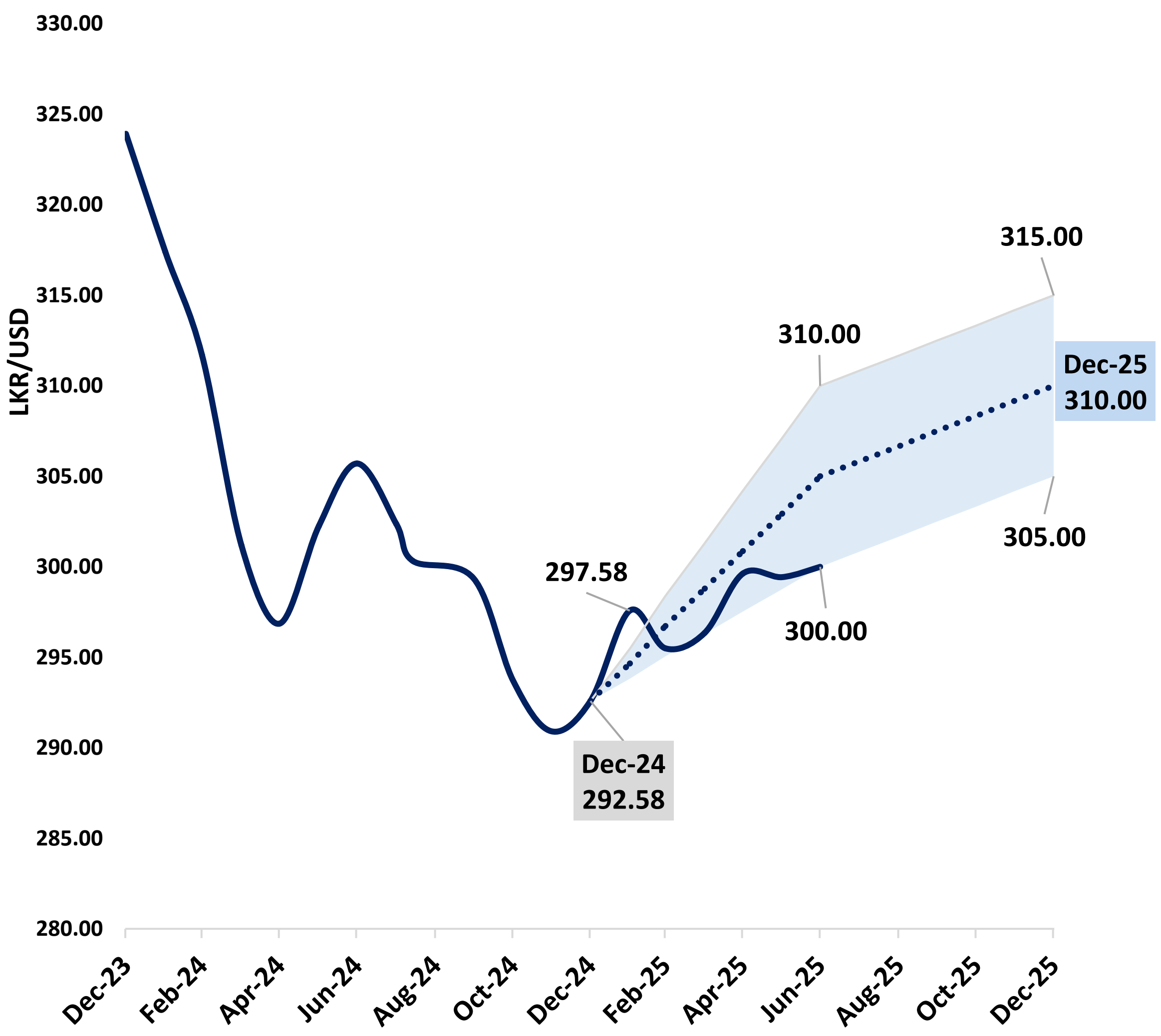


The price of **gold rose from USD 3385.8/oz to a peak of USD 3,432.5/oz** by 13-Jun, while the **DXY (US Dollar Index)** strengthened from **97.2 to 98.8**, signaling increased global demand for dollar-denominated assets.

The surge in safe-haven assets reflects market anxiety and its direct impact on global capital flows, with emerging markets like Sri Lanka likely to experience secondary effects through currency depreciation and capital outflows.



The LKR weakens amid increased oil costs and dollar demand



Rising global oil prices and capital outflows triggered by the Israel–Iran conflict are pressuring Sri Lanka's currency. A rising fuel import bill, softening remittance inflows, and stronger USD demand, may have weakened the LKR modestly in June. Unless tensions ease or oil stabilizes, further depreciation may follow.

- Sri Lanka is a net oil importer, and each $1 rise in oil adds ~$50.0–70.0Mn to the annual import bill.

- Worker remittances, particularly from the Middle East (which accounts for 50.0–55.0% of inflows), are at risk if the conflict affects employment, mobility, or banking channels.

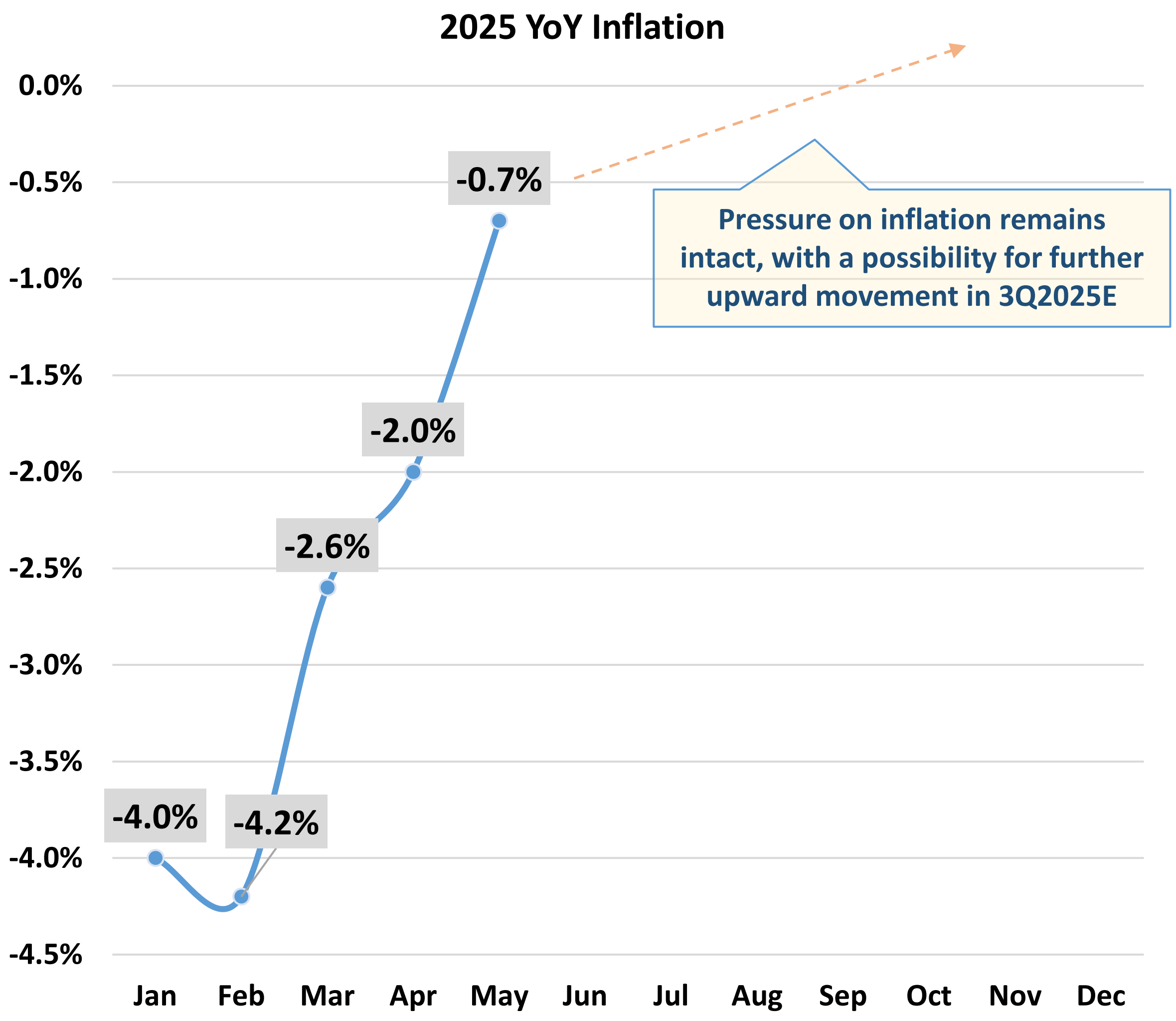
- Foreign investors have turned cautious, leading to slower portfolio flows into CSE and SL debt markets.

- Global shift to the US dollar has strengthened the USD, putting pressure on emerging market currencies like the LKR.

- The Central Bank has allowed a gradual depreciation, with the LKR slipping from ~LKR 300/USD in early June to ~LKR 305+ by mid-June.

- Sri Lanka's external buffers (reserves) are being preserved, but further currency stability may depend on oil trends and geopolitical developments.

Inflation risks resurface as external shocks ripple through prices and supply chains



The Israel–Iran conflict is pushing up global oil prices and strengthening the U.S. dollar, which directly raises Sri Lanka's fuel import bill and weakens the rupee. This leads to higher local fuel, transport, and food costs, while imported goods become more expensive. As businesses pass on costs and inflation expectations rise, overall consumer prices could climb by 0.5–1.2% in the short term, potentially pushing headline inflation to around 4–5% by Aug-25.

- Energy-driven cost pressures are intensifying, with elevated global fuel prices filtering into local transport, manufacturing, and electricity costs.

- Supply chain disruptions in the Middle East raise shipping insurance and freight charges, increasing landed costs of essentials like food, medicine, and fertilizers.

- Imported inputs for industry (chemicals, textiles, plastics) are seeing price hikes, squeezing margins and passing costs to consumers.

- Currency depreciation amplifies the inflationary effect by making dollar-denominated imports more expensive.

- Consumer goods prices are gradually rising, especially in food, fuel, and utilities, with downstream effects expected over 3Q2025E.

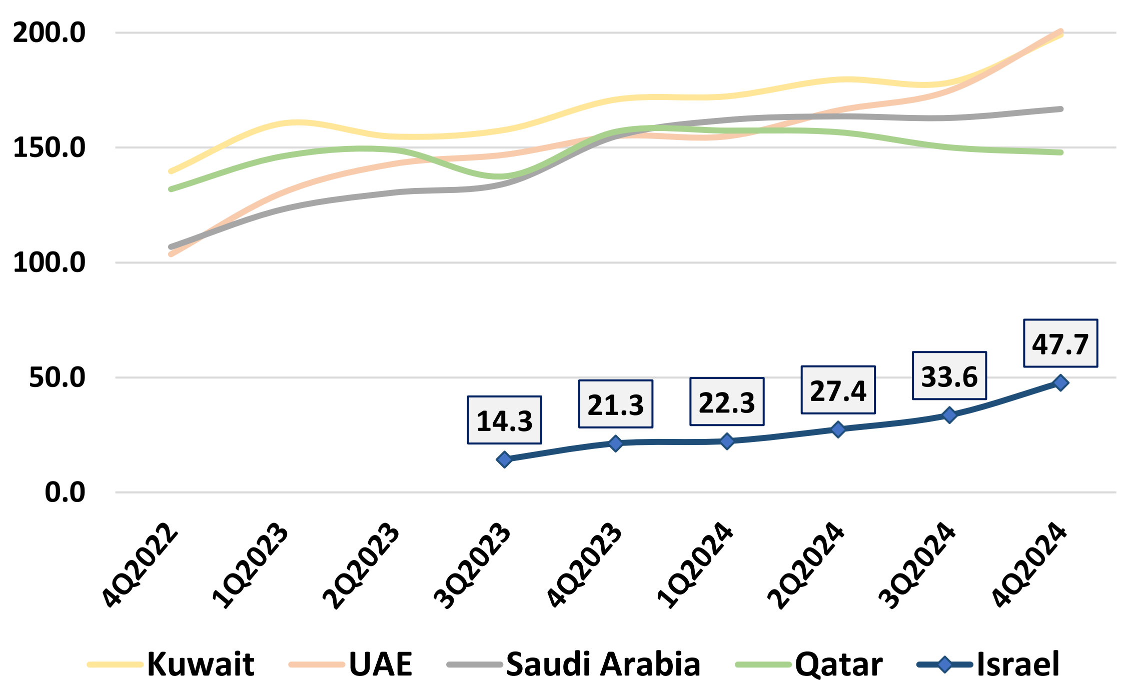
- Core inflation may remain sticky, even if global commodity prices stabilize, due to structural passthrough lags.

Short term hit on worker remittances to Sri Lanka can be anticipated

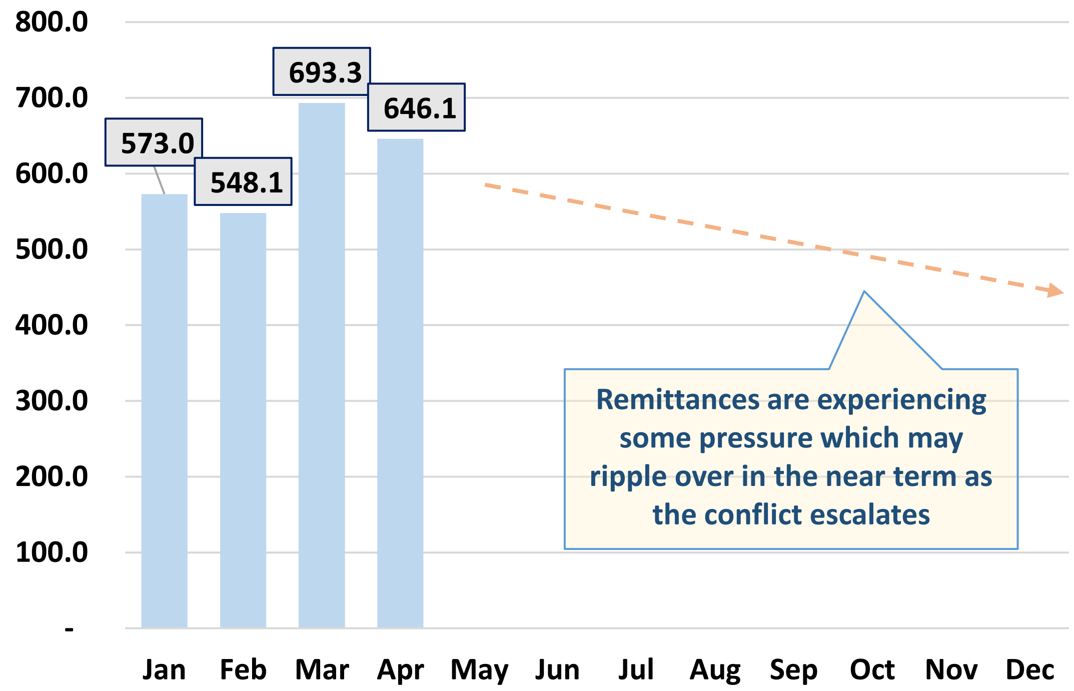
Sri Lanka relies heavily on **remittances** from overseas workers — a key source of **foreign exchange**, often exceeding **USD 6.0Bn annually**. The Middle East, particularly **Saudi Arabia, UAE, Qatar, and Israel**, accounts for over **50.0% of these inflows**.
If tensions expand to Gulf nations, a significant decline in inflows could emerge, tightening Sri Lanka's external financing position and weakening the rupee further.

- Following rising tensions, Sri Lanka Bureau of Foreign Employment (SLBFE) confirmed it is **halting fresh deployments to Israel** until further notice (especially in caregiving and construction sectors).
- Approximately **20,000** Sri Lankans are currently employed in Israel.
- Monthly remittances from Israel alone range between USD 8.0–12.0Mn, which may now dip in the short term.

Worker Remittances USD'Mn



Monthly Worker Remittances in 2025 - USD'Mn

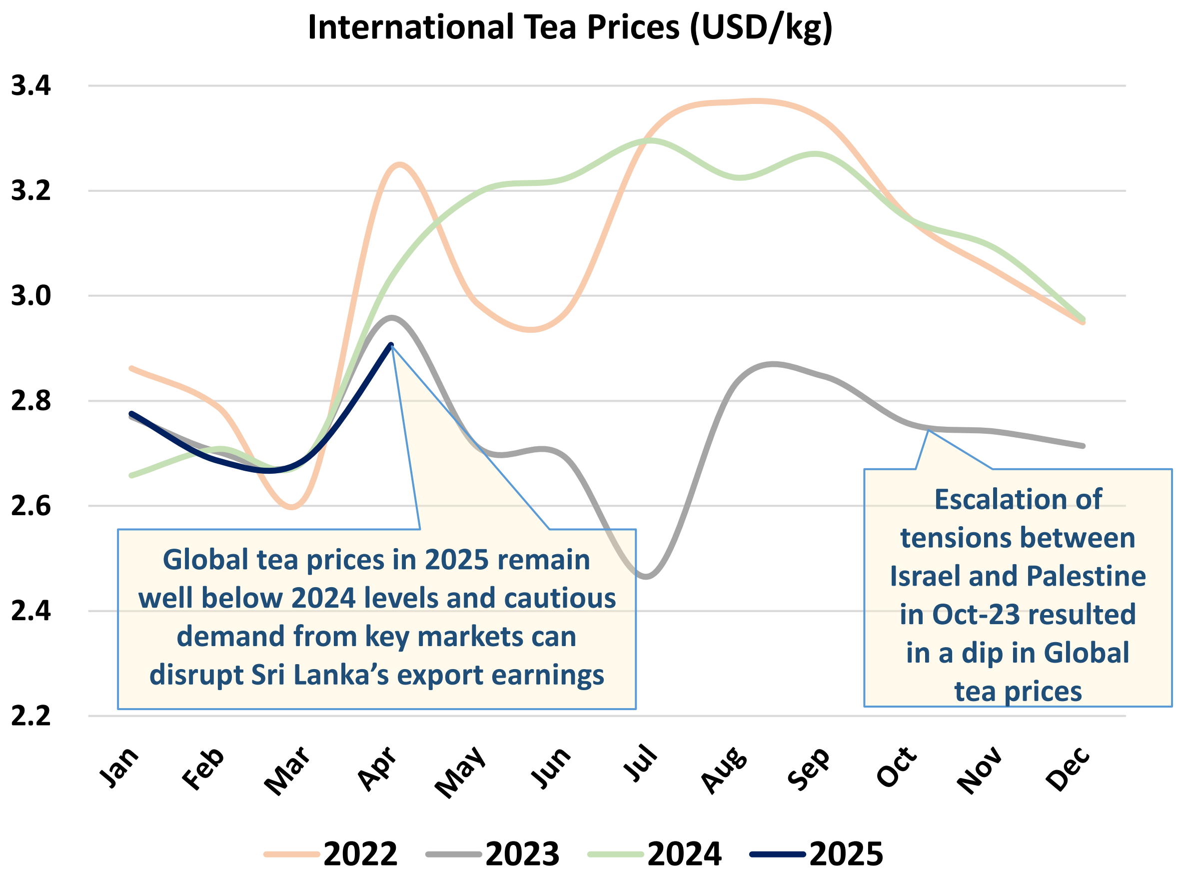


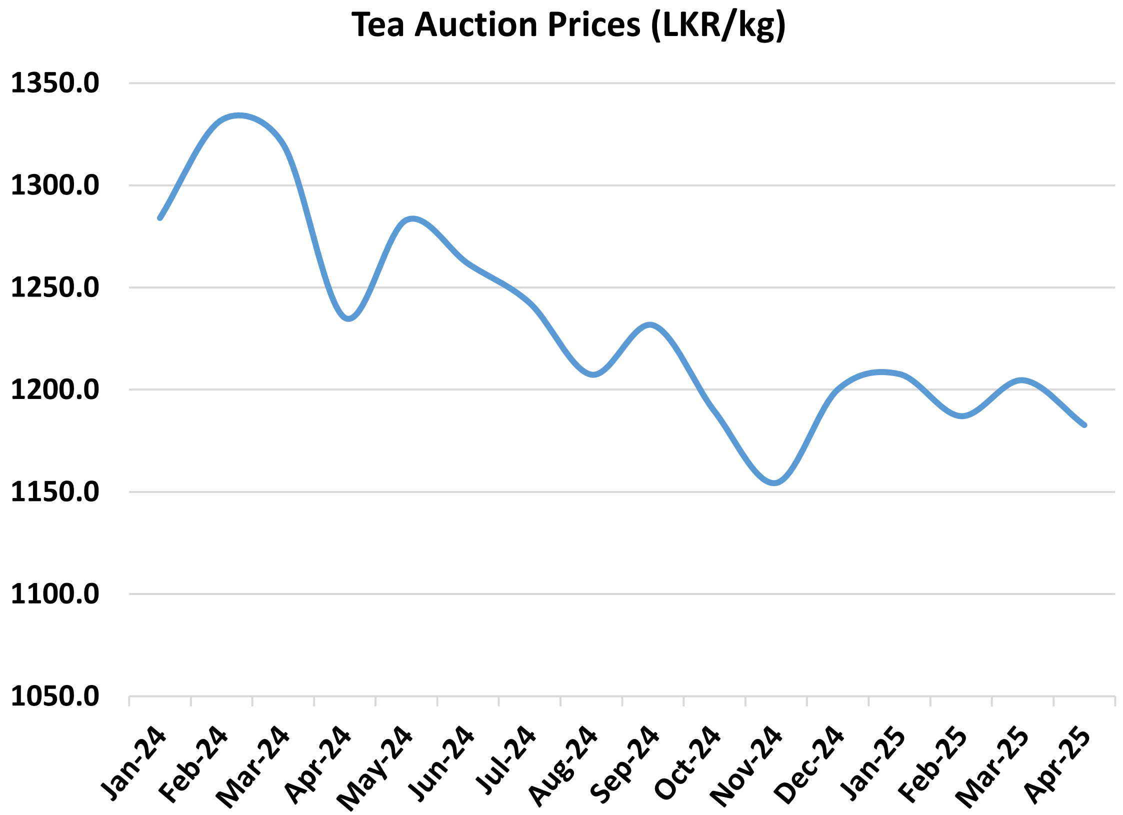
Source: FC Research, CBSL

The Gulf is a key market for Sri Lanka's tea, and rising tensions may dampen export earnings

In 2024, tea export earnings totaled **USD 1.3Bn**, with **Middle East contributing over USD 200.0–250.0Mn**. If conflict escalates the **demand from these countries may drop** due to economic disruption or currency depreciation while s**hipping and logistics delays** may reduce or delay orders.

According to the Sri Lanka Tea Board, monthly auction prices have been fluctuating in June due to cautious overseas demand. The Middle East, **especially countries like UAE, Iran, Iraq and Saudi Arabia are major buyers** of Ceylon Tea — accounting for ~15.0–20.0% of total export volume and earnings.

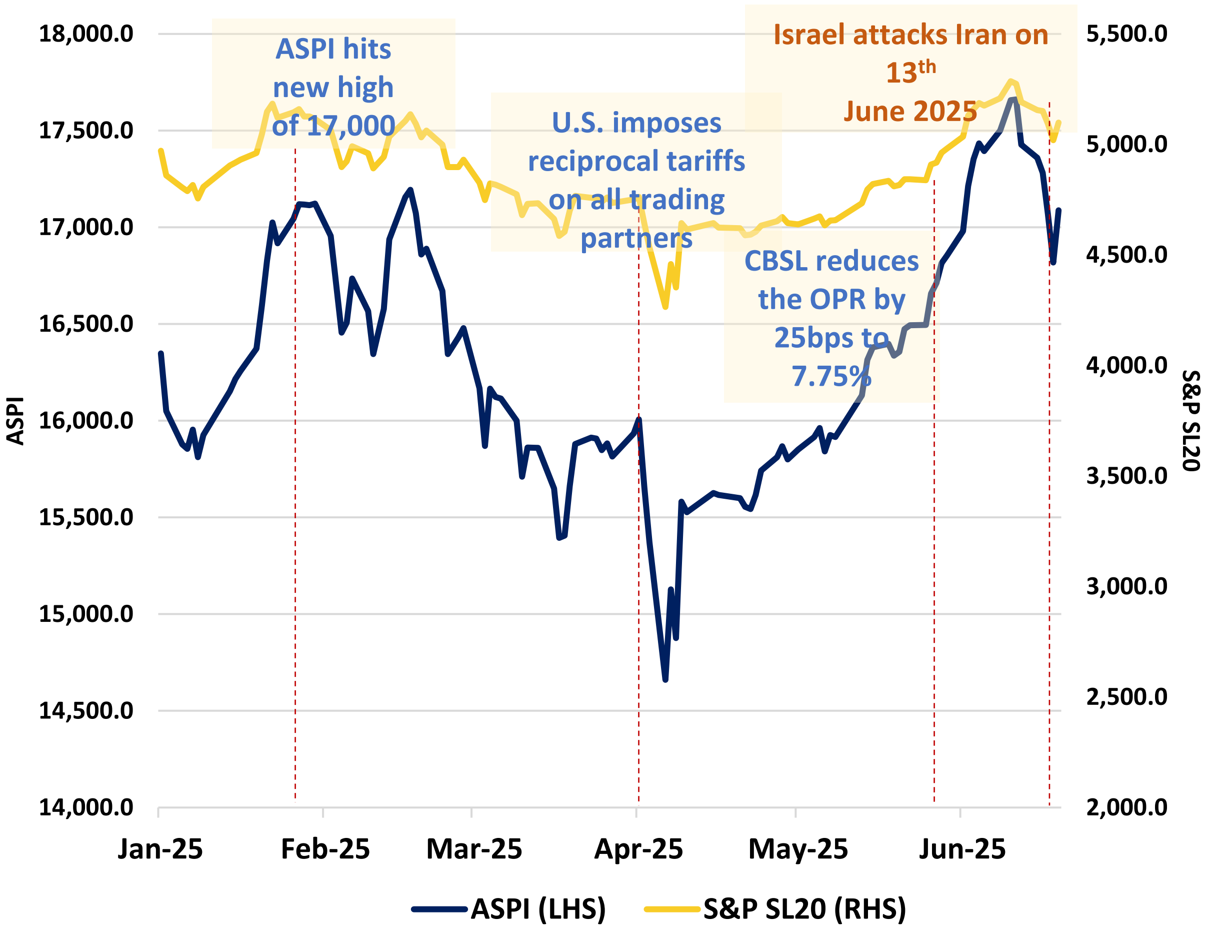




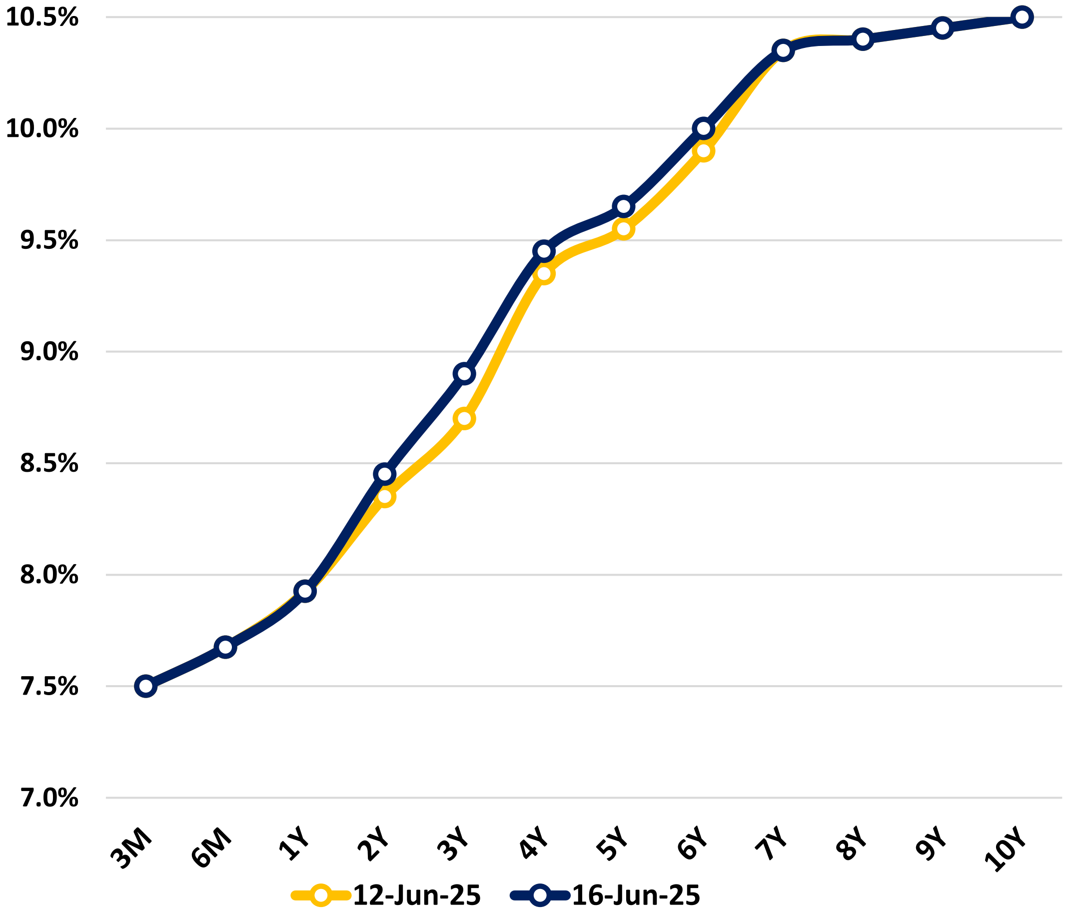
Source: FC Research, SLTB, Tea Exporters Association SL, World Bank

Sri Lanka's markets had notable reactions, mirroring that of markets worldwide

Sri Lankan equities saw cautious trading amid global tensions, with mild foreign selling and pressure on import-reliant sectors. Market sentiment remains fragile.

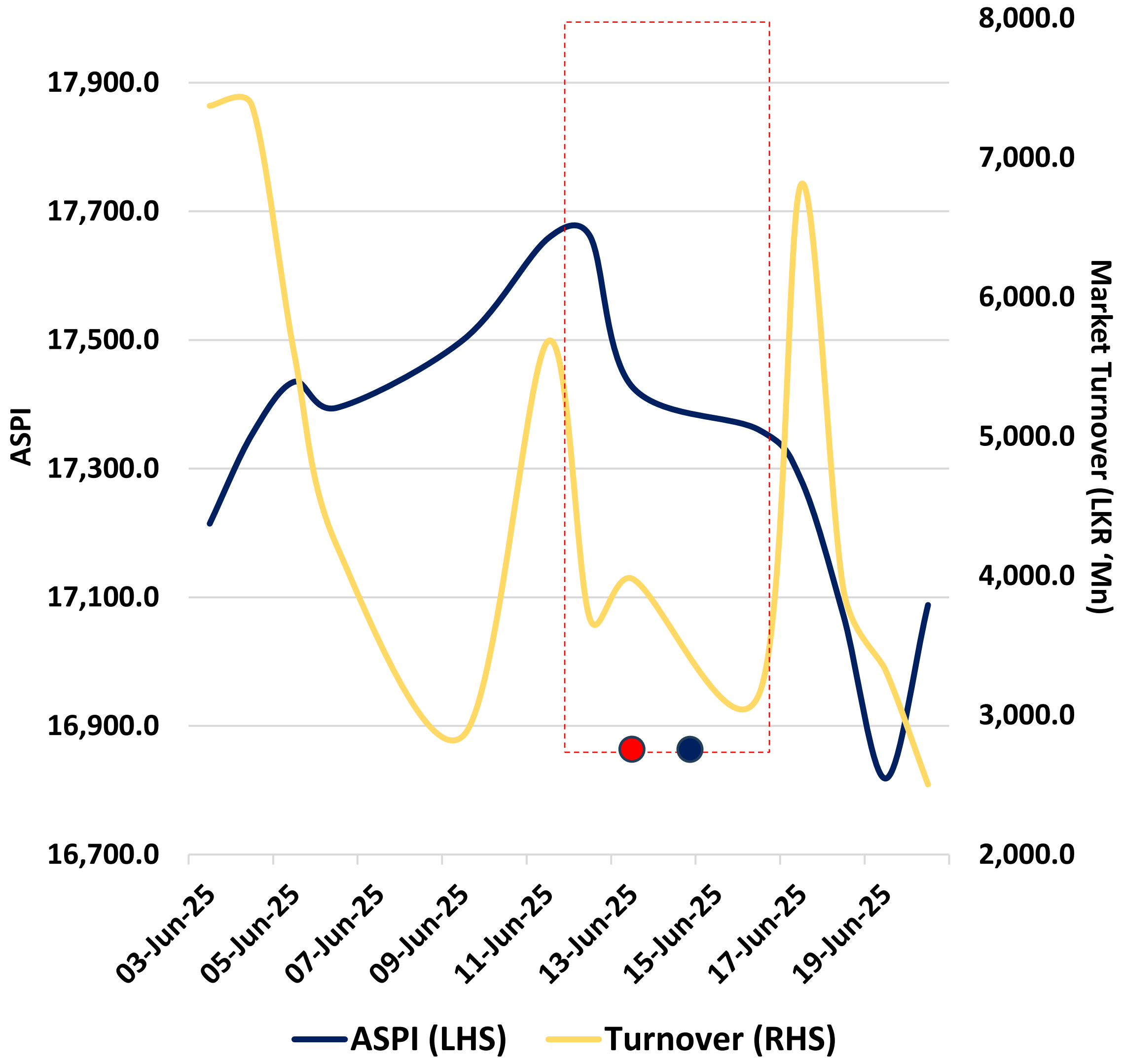


Sri Lanka's bills and bonds market remained stable but saw slight upward pressure on yields as investors priced in higher inflation risks and a weaker rupee. Demand remains cautious.



Source: FC Research, CBSL,CSE

Equity market stays fragile as external shocks weigh on sentiment and earnings outlook



- The **ASPI** showed moderate volatility in mid-June as geopolitical fears triggered global risk-off sentiment.
- Foreign investor activity **slowed**, especially in liquid blue chips, though local retail support kept prices from falling sharply.
- **Market turnover dipped** in the week of June 10–14 as investors await clarity on oil and rates.
- ASPI dropped ~1.3% on 13-Jun amid crude oil spike, but recovered on 17-Jun as global markets stabilized.

13-Jun – Markets reacted as conflict escalated sending shockwaves and spiking oil prices. The ASPI dipped sharply while turnover levels fell.

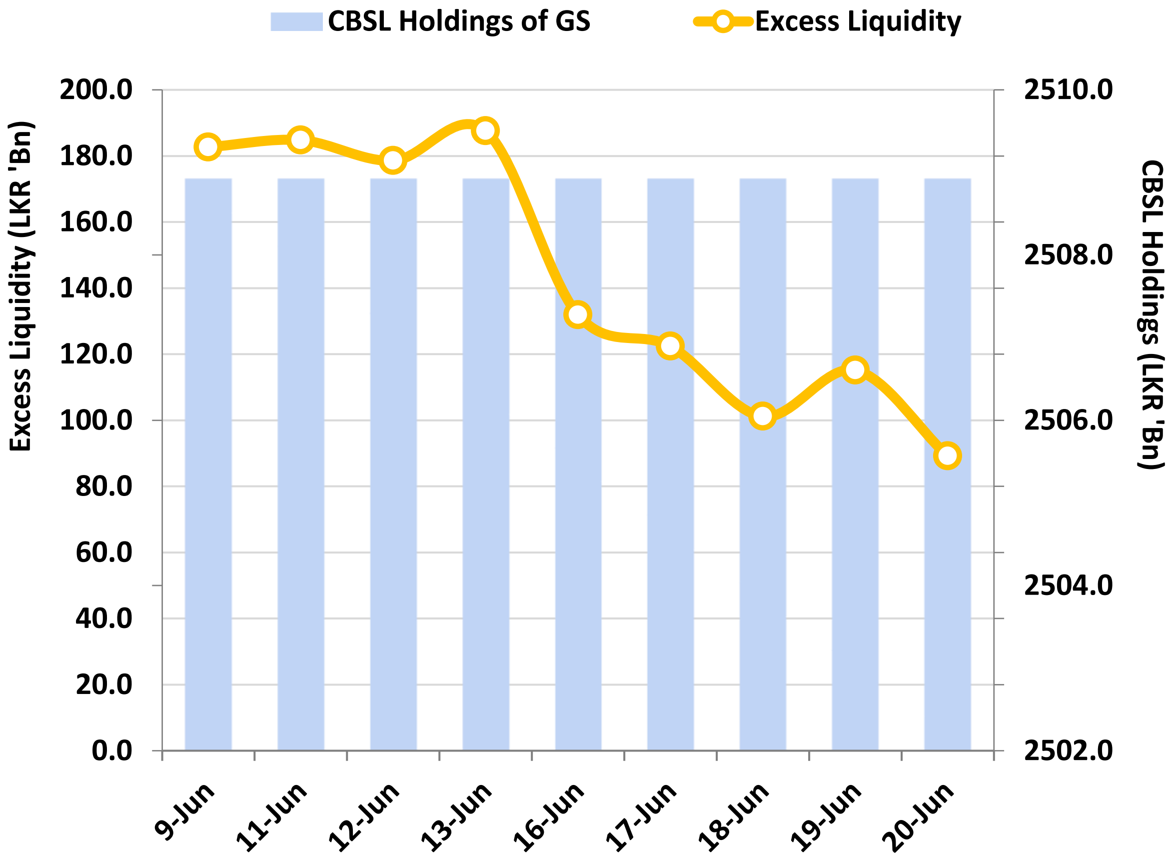
15-Jun – Brent crude reached USD 78.0/bbl causing turmoil and selling at the CSE.

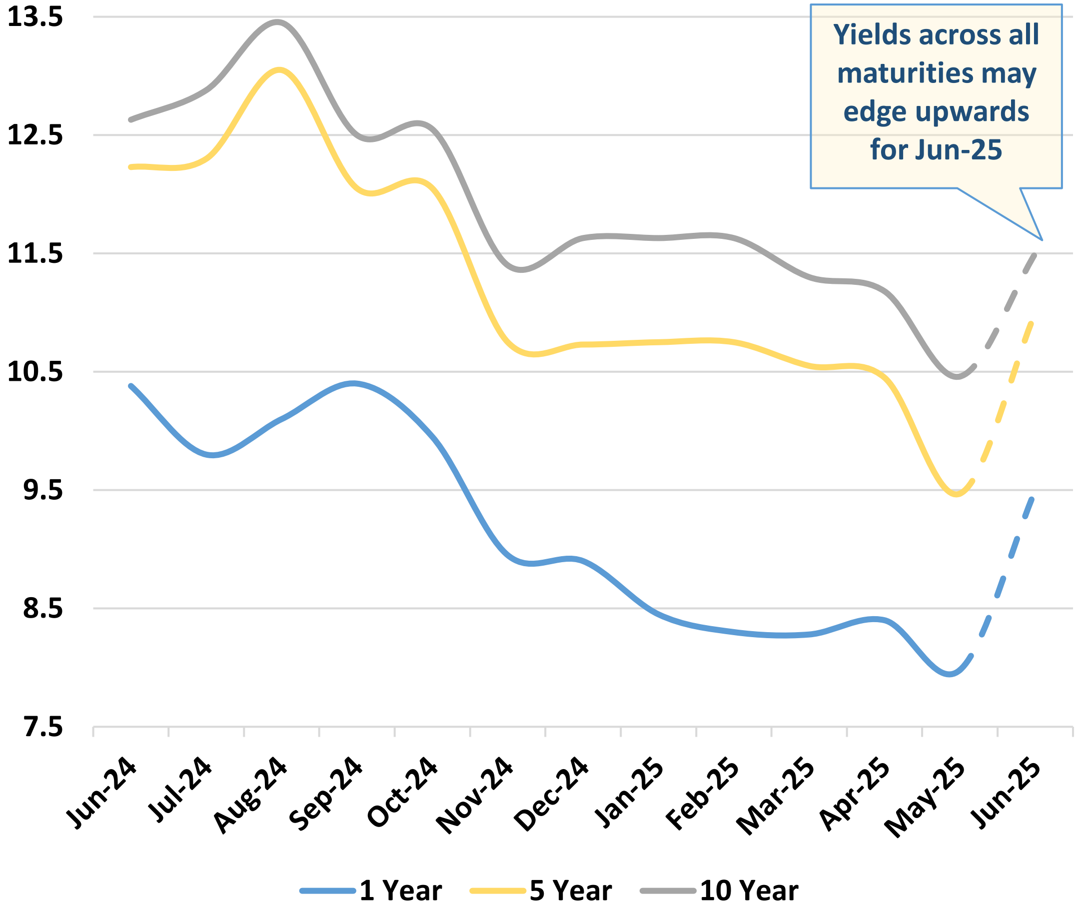
Source: FC Research, CSE

Fixed income market turns cautious with upward yield pressure likely if tensions escalate

The fixed income market has turned increasingly cautious amid rising geopolitical tensions, with upward pressure on yields likely if risks escalate further.

Notably, the Central Bank's overnight excess liquidity has contracted in recent weeks, reflecting tighter domestic liquidity conditions. This, combined with the potential for higher risk premiums and imported inflation through elevated oil prices, could push yields higher as investors demand greater compensation for uncertainty.





Source: FC Research, CBSL

Looking ahead: how U.S. intervention could reshape the strategic landscape

BBC

Watch: The US has joined the Iran-Israel war. What happens now?

President Donald Trump says the US has carried out a "successful" bombing attack on three nuclear sites in Iran and said they have been...

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Israel-Iran war live: Iran parliament votes to shut Hormuz strait in response to US attack raising fears of oil price shock

US defense secretary Pete Hegseth says attacks have devastated Iran's nuclear programme.

Shift in global power dynamics

A direct U.S. military role would signal a hardening of geopolitical lines, increasing long-term instability in the Middle East. Strategic chokepoints like the Strait of Hormuz could become militarized, disrupting maritime flows vital to Sri Lanka's trade routes.

Supply chain & trade disruptions

Naval deployments and rising conflict risks could reroute shipping traffic, increasing freight costs and delivery timelines. For Sri Lanka, this poses risks to key export sectors like apparel and increases input costs across the board.

Financial spillovers

Heightened geopolitical risk may tighten global USD liquidity, trigger capital flight from emerging markets, and raise risk premiums. Sri Lanka could face renewed pressure on debt servicing, refinancing, and foreign reserve management.

Labour & migration headwinds

Conflict escalation may lead to tighter visa regimes in Middle Eastern host nations, potentially affecting Sri Lankan migrant worker flows and remittance income.

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