

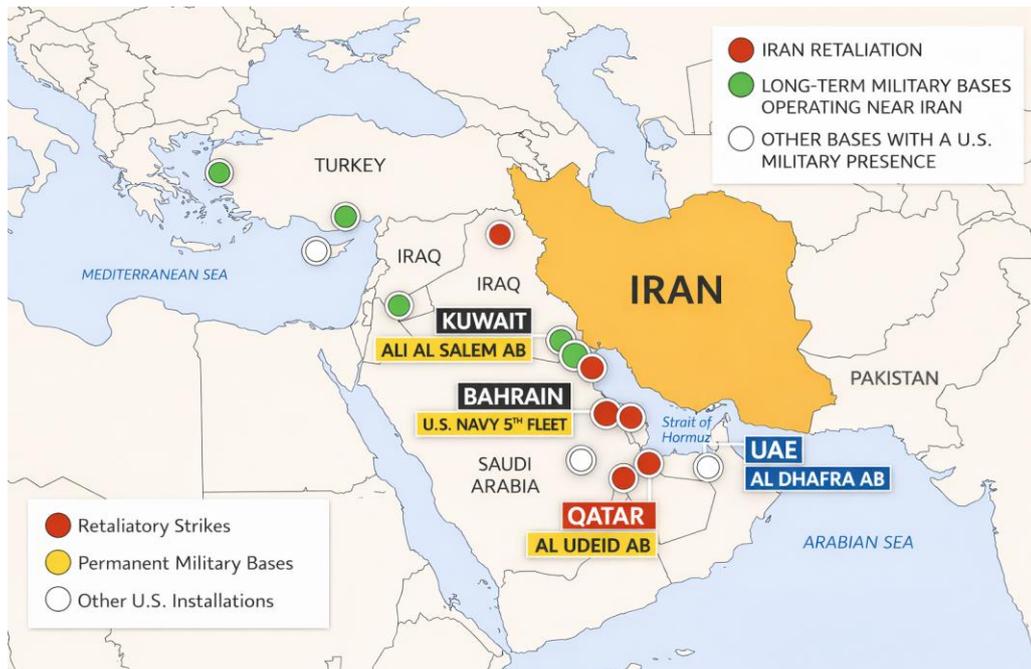


ECONOMIC OUTLOOK AMID THE IRAN CONFLICT

FLASH NOTE

ASSESSING THE MARCH 2026 IRAN WAR AND ITS IMMEDIATE AND EMERGING ECONOMIC CONSEQUENCES FOR SRI LANKA

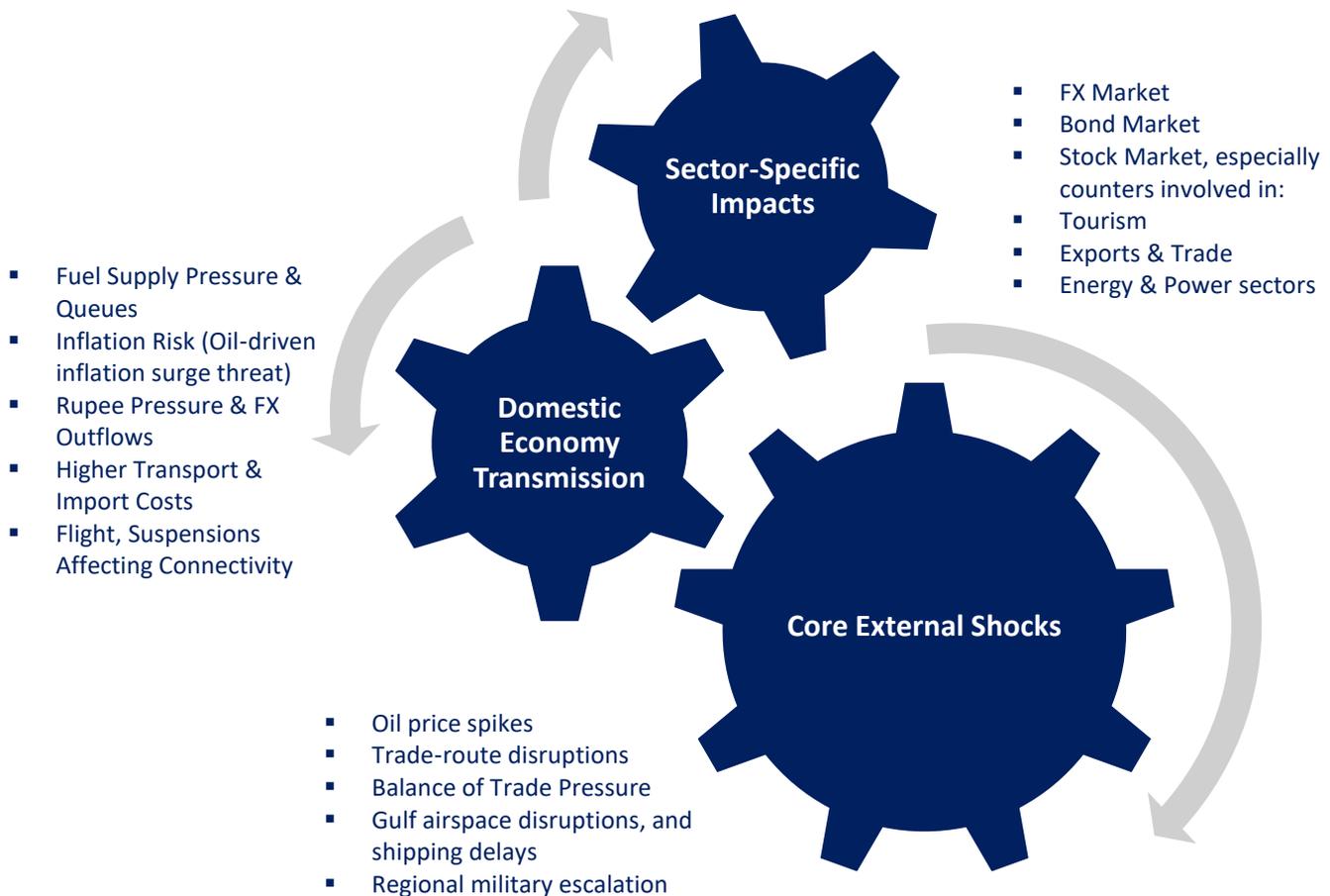
Overview



- **Major US–Israel Strike on Iran:** After months of escalating tensions in the Middle East, marked by rising hostility between Iran and the US-Israel alliance and a significant US military buildup in the region, the conflict intensified between 28 Feb and 1 March, 2026. During this period, the US and Israel launched a major coordinated strike on multiple Iranian strategic targets, killing Ayatollah Ali Khamenei, Iran’s Supreme Leader, along with several of the country’s senior leaders.
- **Iran’s Regional Retaliation:** Iran retaliated with large-scale missile and drone attacks across the region, targeting Israel and United States military bases in several Middle Eastern countries. This immediately expanded the confrontation into a full-scale regional conflict.
- **Oil, Trade, and Regional Disruptions:** As an immediate consequence of the escalating conflict, the Strait of Hormuz, which carries about 20% of the world’s oil supply, was effectively paralysed, and multiple flight routes across the Middle East were disrupted or suspended, particularly around major Gulf hubs, due to heightened security concerns. The escalation also led to protests in several countries, attacks on oil infrastructure, and continued missile and drone strikes across the Gulf, including Kuwait, Qatar, Bahrain, Saudi Arabia, and the UAE. These developments have heightened regional uncertainty and are affecting Sri Lanka’s trade, worker remittances, and the cost of key energy imports such as crude oil.
- **Implications for Sri Lanka’s Economy:** We evaluate the situation by weighing the short- and medium-term implications for the Sri Lankan economy, focusing on both the risks and the potential opportunities arising from the conflict. However, the assessment is largely conditional on how long the war persists; a quick resolution could return conditions to normal, as seen in previous similar situations.

Major Economic Impacts, Provided the War Continues

❖ We map the core external shocks, their transmission into the domestic economy, and the resulting sector-level impacts.

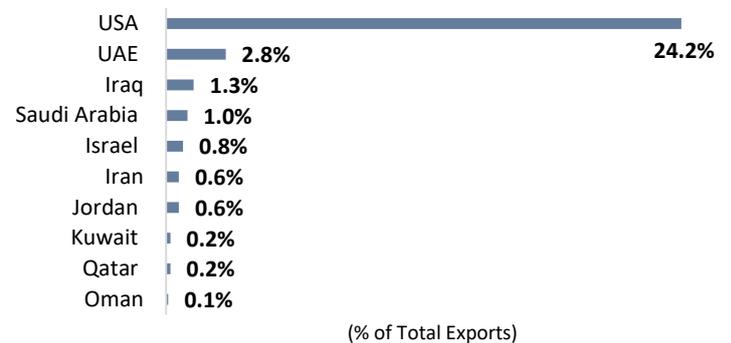


❖ **Oil Price Spike Expected to Translate into Higher Inflation:** Since the Feb 28–Mar 1 escalation, Brent has risen roughly 6–10%, and major international outlets warn that prices could reach USD 95–110 if supply risks through the Strait of Hormuz persist. This directly feeds into Sri Lanka’s inflation outlook through higher transport, fuel, and electricity costs, which contributes to short-term price pressures. The impact will also spill over into Sri Lanka’s growth outlook, particularly as the country is already recovering from recent climate-related disruptions. Higher imported inflation increases the passthrough effect on domestic prices, placing additional pressure on the Central Bank, which must balance inflation risks against the need to sustain lower interest rates to support the fragile growth recovery.

❖ **Trade-Route and Gulf Airspace Disruptions Likely to Create Ripple Effects Across the Broader Economy:** Ongoing disruptions across Gulf maritime corridors and widespread airspace closures have pushed up freight rates and insurance premiums, increasing the landed cost of Sri Lanka’s imports. Export logistics also face higher cost structures, with potential upward price adjustments in international markets. However, some disruptions may also create opportunistic rerouting advantages for regional shipping players, as discussed under the positive counter-effects below.

❖ **Decaying Export Demand May Place Additional Pressure on the BoT:** Nearly a quarter of Sri Lanka’s coffee, tea, and spice exports are directed to markets currently affected by geopolitical tensions, which include the United States, Iran, Iraq, and the Gulf region, leaving this key export segment exposed to elevated external risks. Combined with potential increases in freight and insurance costs, the overall impact is negative for Sri Lanka’s balance of trade (BoT) and could place further downward pressure on the rupee.

Sri Lanka's Exports to the ME & the USA



❖ **Regional Military Escalation Could Affect Worker Remittances:** The conflict’s intensity poses a risk to Sri Lanka’s remittance flows, which is one of its largest foreign-exchange sources. A prolonged or intensified escalation could force labour displacement or evacuation in Gulf host countries, reducing worker inflows and pressuring the balance of payments. Past regional conflicts, such as the Gulf War (1990), saw large-scale worker evacuations, illustrating the vulnerability of Sri Lankan migrant labour in Middle Eastern economies.

❖ **Positive Counter-Effects and Emerging Opportunities:** Despite the negative shocks, some counter-effects may cushion the impact or open new opportunities depending upon the length and the intensity of the ongoing war.

- **A potential high demand for labour under a moderate conflict situation:** Periods of geopolitical disruption and oil-driven sectoral shifts have historically increased labour demand in certain Gulf markets, potentially benefiting Sri Lankan migrant workers. For example, after the 2003 Iraq conflict and the subsequent construction boom in Dubai, Qatar, and Abu Dhabi significantly boosted demand for Sri Lankan labour. These benefits, however, materialise only under a moderate and non-prolonged conflict scenario, where Gulf economies continue functioning and investment cycles remain intact.
- **Shipping-lane realignments may create niche opportunities for Sri Lanka’s maritime and logistics sectors:** Due to disruptions near the Bab-el-Mandeb Strait caused by insurgent groups such as the Iran-aligned Houthis, major carriers have earlier suspended Suez/Red Sea routes and diverted vessels around the Cape of Good Hope. These diversions increase traffic across the Indian Ocean, potentially strengthening Colombo’s position as a key mid-Indian Ocean transshipment hub, particularly if Iran-aligned groups become more active as the war escalates.

❖ **Sector-Specific Impacts to directly weigh on FX, Bond and Stock Markets:**

- **FX Market-Rupee to Depreciate more than initially predicted:** With the escalating tensions in the Middle East, the US Dollar has strengthened as global investors shift toward safe-haven assets. As of 3 March, the Dollar Index had risen sharply to around 99.20, up from the 97.60 range at which it had been hovering prior to the escalation, while the Sri Lankan rupee opened weaker but ultimately settled largely unchanged at 309.24, according to the CBSL indicative rate. First Capital currently forecasts a 5% depreciation in the Rupee for the year. However, given the increased external pressure and strain on the current account, there is a clear risk that the depreciation could exceed initial projections.
- **Bond Market to Face Selling Pressure as EM Risk Intensifies:** Globally, safe-haven flows are moving toward U.S. Treasuries, pushing emerging-market yields higher. Sri Lanka is experiencing the same trend, with rising oil prices linked to Middle Eastern instability lifting inflation expectations and reducing the likelihood of further rate cuts by the Central Bank. At the same time, disruptions to key trade routes are heightening concerns over weaker external balances, wider current-account pressures, and increased sovereign-funding needs, all of which add to the upward pressure on long-term Sri Lankan bond yields.



- **Stock market likely to remain volatile with earnings under pressure:** The Colombo Stock Exchange reopened on 03 March 2026 amid heightened volatility following the recent US-Israel strikes on Iran, with the S&P SL20 declining by over 5% at the open and triggering a temporary trading halt under the Securities and Exchange Commission of Sri Lanka directive. This correction follows a strong rally in 2025, during which the market gained in excess of 40%. Over recent months, the index had been trading close to the 24,000 level, with intermittent profit-taking limiting sustained upward momentum. Should the Iran conflict evolve into a prolonged war, the resulting rise in global energy prices, supply chain disruptions, and currency volatility could place pressure on corporate earnings across sectors. In such a scenario, if market prices remain elevated despite weakening earnings expectations, the ASPI may begin to trade at stretched valuations, rendering the market relatively expensive on a fundamental basis.

Sector	Impact	Analysis
Bunkering	POSITIVE	Rising Middle East tensions may lead shipping lines to reroute vessels, potentially increasing traffic through the Port of Colombo and supporting marine fuel and port service providers. Key beneficiaries could include John Keells Holdings PLC and Hayleys PLC .
Maritime & Logistics	POSITIVE	Geopolitical disruptions typically elevate freight rates due to supply chain dislocations, higher insurance premiums, longer transit times, and route diversions. Elevated spot rates can materially expand margins for logistics operators and shipping service providers, at least in the short to medium term.
Power & Energy	POSITIVE	A prolonged conflict could sustain upward pressure on global crude oil prices. While this poses macroeconomic risks, energy distributors with excess stocks may benefit from higher selling prices. Notable exposures include Lanka IOC PLC (LIOC) and Laugfs Gas PLC (LGL) .
Tourism	MIXED	The tourism sector may experience mixed outcomes. Sri Lanka could emerge as an alternative destination for travellers avoiding the Middle East. However, inbound tourism from Europe may face temporary disruptions due to altered flight paths and reduced transit connectivity through Middle Eastern hubs.
Banks	NEGATIVE	More than 50% of Sri Lanka’s worker remittances are sourced from the Middle East, notably Saudi Arabia, the UAE, Qatar, and Israel. Sustained geopolitical instability in the region could disrupt employment conditions and income streams, leading to a moderation in remittance inflows. A decline in such flows would likely exert pressure on banks’ fee and commission income, ultimately impacting overall profitability.
Diversified Financials	NEGATIVE	A slowdown in remittance inflows and broader economic uncertainty could constrain household disposable income, increasing credit stress and non-performing loans (NPLs) across leasing and finance companies.
Consumer Goods	NEGATIVE	Erosion of disposable income and elevated inflationary pressures stemming from higher energy costs may dampen consumer spending, affecting earnings visibility for consumer-oriented businesses.
Plantations	NEGATIVE	The Middle East, particularly the UAE, Iran, Iraq, and Saudi Arabia accounts for approximately 15-20% of Sri Lanka’s Ceylon Tea export volumes and earnings. A prolonged conflict could weaken demand from these markets, thereby pressuring revenues and margins of listed plantation companies.



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