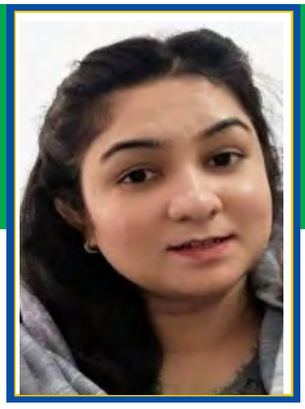
The 2026 US-Iran Geopolitical Shock and Pakistan's Energy Economy



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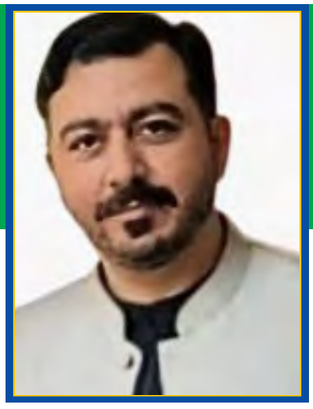

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The 2026 US-Iran military conflict and the Strait of Hormuz blockade can be seen as a canonical exogenous energy supply shock which has asymmetric transmission impacts on emerging economies that rely on imports. The paper presents a rigorous empirical analysis of the dual channel transmission mechanism involving the spread of the geopolitical disruption in the energy economy of Pakistan, namely, in the dynamics of petrol prices and accentuating circular debt in the power sector. Based on high frequency macroeconomic data, IMF and World Bank forecasts, and an extensive review of the modern empirical evidence, the analysis demonstrates that the energy price shock served as the main channel through which the currency depreciated, inflationary pressures reemerged, and the deterioration of the external account was facilitated. Even though the April 2026 ceasefire, coordinated by Pakistan through diplomatic negotiations, avoided disastrous tail-risk, the underlying structural vulnerability of the energy economy has essentially remained unchanged. In the case of the CMA community, the results highlight the urgency of systematizing enterprise-wide energy risk management models and expedited implementation of indigenous renewable energy capacity.

Introduction

Geopolitical upheavals across the Persian Gulf on 28 February 2026 unleashed open hostilities, with United States and Israeli forces launching a coordinated attack on Iranian nuclear and military installations (Hussain, 2026). Its immediate strategic impact, the de facto closure of the Strait of Hormuz, disrupted about 20 percent of global seaborne crude oil flows in addition to significant LNG cargoes in the Gulf (Qadir, 2026). To Pakistan, the shock was existential and immediate, as over 80 percent of its primary energy needs are met through imports.

The timing of the conflict enhanced its disruptive potential. Pakistan had just emerged from the shattering economic crisis of 2022-2023, when the CPI was at an all-time high of 38 percent, foreign exchange reserves had fallen to less than USD 3 billion, and the rupee was trading at PKR 307 to the US dollar (Tresmark, 2025). Significant fiscal consolidation and monetary tightening under the IMF Extended Fund Facility allowed inflation to fall to 5.8 percent by January 2026, the current account to record its first surplus in 14 years and the rupee to be valued at around PKR 280 per US dollar (Mettis Global, 2026; Pasha, 2026). Yet, this stabilization remained fragile, dependent on crude oil prices staying below USD 80 per barrel, uninterrupted Gulf remittance inflows and continued multilateral lender support.

The main research question is twofold: How did the 2026 geopolitical shock transmit through Pakistan's energy economy, and through which specific channels? What particular weaknesses in the petrol pricing framework and power sector financial framework amplified the domestic impact? This investigation provides critical insight to CMA professionals on the financial implications of geopolitical risk.

Literature Review

The body of scholarly literature discussing the nexus between geopolitical risk (GPR) and the macroeconomic instability in emerging economies has grown significantly.

Caldara and Iacoviello (2022) constructed a text-based GPR index that revealed a significant negative relationship between an increase in geopolitical tensions and economic activity in the developing countries, where transmission is mostly achieved through commodity price and exchange rate pressure channels. Ahmed et al. (2023) determined that net-energy-importing emerging economies exhibit about 2.3 times higher macroeconomic sensitivity to geopolitical supply shocks compared to diversified advanced economies.

In the framework of Pakistan, empirically based research records asymmetric and lasting effects of exogenous energy price shocks. Using the VAR methodology, Sardar and Hyder (2022) showed that the origin of oil price shocks began to have a functional effect on the dynamics of inflation, where the effects of geopolitically-imposed supply shocks proved to be more enduring and pronounced. Lahore School of Economics Modelling Lab (2025) showed that the pass-through effect on local inflation is most significant with exchange rate movements on all external variables. Springer (2023) established that the ERPT coefficient is systematically higher in economies characterized by higher import dependence and low monetary policy credibility. Studies indicate that a 1 percent rupee devaluation results in about 0.41 percent inflation within six months (INP, 2024).

On the power sector, Khan and Mahmood (2024) documented the structural relationship between circular debt and international fuel price volatility where every USD 10 per barrel increase translates to about PKR 85 billion in annual circular debt via the fuel price adjustment mechanism. Rahman et al. (2023) determined that take-or-pay capacity commitments, indexed to international fuel prices, constitute a direct transmission channel between geopolitical energy threats and financial vulnerability. Hasnat and Siddiqui (2025) revealed that capital flight, informalization of foreign currency holdings and speculative pressure on the rupee accelerate when political and military shocks occur regionally.

Petrol Price Transmission Channel

The US-Israeli raids and instant closure of the Strait of Hormuz on 28 February 2026 triggered immediate changes in international energy benchmarks. Within seventy-two hours, Brent crude futures rose to over USD 105 per barrel, with intraday highs of USD 115-116 per barrel occurring in early March 2026 (Qadir, 2026; Lokmat Times, 2026). At the same time, the spot LNG price increased to USD 8.72 per MMBtu, reflecting market concerns about potential disruptions to Qatari exports (Trade Chronicle, 2026).

In the case of Pakistan, this global price shock was reflected in domestic petrol and HSD prices, as quarterly adjustments are carried out by OGRA. Although estimates vary, PIDE has estimated that every USD 10 per barrel increase adds about USD 1.8-2.0 billion to Pakistan's annual petroleum import bill (Qadir, 2026). With projected crude prices of USD 120-150 per barrel, monthly petroleum imports would rise to USD 3.5-4.5 billion, unsustainable given current foreign exchange reserves.

Domestic price transmission was rapid and broad. PBS statistics reveal that the 18.01 percent month-on-month increase in motor fuel prices in March 2026 was the highest monthly change since the 2022-2023 crisis (Profit, 2026). This shock transmitted through three channels: a direct increase in transport costs, with services recording a 9.15 percent month-on-month increase (PBS, 2026); amplification of agricultural input costs due to the diesel price hike, contributing to a 34 percent annual increase in wheat prices (Profit, 2026); and the erosion of industrial competitiveness.

Power Sector Circular Debt Amplification Mechanism

The shock was transmitted to Pakistan's power sector through a different channel. CPPA sources about 40 percent of its power generation from imported fuels, mainly RLNG and RFO, under long-term power purchase agreements in which fuel costs are pegged to international rates (Khan and Mahmood, 2024). Rising global LNG and fuel oil prices exerted immediate and direct pressure on generation costs. However, the fiscal impact was amplified by the institutional structure, specifically the widening gap between generation costs and end-user tariffs. The politically motivated avoidance of full fuel price adjustments led to further circular debt accumulation.

Circular debt was estimated at about PKR 2.6 trillion pre-conflict, or 3.1 percent of GDP (NTDC, 2025). According to PIDE analysis, a sustained USD 30 per barrel increase would add approximately PKR 250-300 billion to annual circular debt accumulation (Qadir, 2026). This fiscal strain manifests in higher government borrowing, which crowds out private sector credit and pushes up interest rates. Moreover, electricity prices directly contributed to headline inflation, with the 5.08 percent month-on-month increase in March 2026 directly related to electricity costs (PBS, 2026).

Exchange Rate and External Account Implications

Pressures arising from rising petrol import costs and power sector strain quickly translated into exchange rate weakness. The rupee had pre-conflict stabilized at PKR 280 per US dollar, supported by monetary tightening and IMF disbursements (Mettis Global, 2026). However, the already deteriorating current account, which had recorded a USD 1.17 billion deficit in the first half of FY26, further worsened the situation (SBP, 2026). SBP intervention suppressed volatility, but underlying depreciation pressures continued to build. Fitch Ratings estimated a gradual depreciation to PKR 295 by the end of the fiscal year (Pakbanker, 2025) and the energy shock significantly increased the probability of greater adjustment. IMF projections predict a depreciation of the rupee of over 12 percent by June 2026 (Lokmat Times, 2026). SBP research determined that the REER declines significantly in response to rising global oil prices and does not fully recover even when prices normalize (SBP, 2024).

Reversal of Disinflationary Gains

The immediate effect has been the reversal of the disinflationary gains achieved. After the highest CPI inflation of 38 percent in May 2023, Pakistan brought inflation down to 2.4 percent by January 2025 and 5.8 percent by January 2026 (Dawn, 2026; Pasha, 2026). The moment the Strait of Hormuz was closed, this trend saw a sudden reversal: February 2026 inflation soared to 7.0 percent, and the rate further increased to 7.3 percent year-on-year in March (PBS, 2026). Under a sustained severe oil price shock, PIDE scenario analysis projects headline inflation would rise again to 15-17 percent (Qadir, 2026). This disproportionately impacts lower-income households, which spend approximately 42 percent and 7 percent of their income on food and energy respectively (Household Integrated Economic Survey, 2024). From a monetary policy perspective, the resurgence of inflation limits the SBP's ability to promote growth through rate reductions.

CMA Professionals and Policymaker Strategies

The 2026 crisis vividly reminds us how vulnerable Pakistan is to energy supply disruptions due to geopolitical reasons. In the case of the CMA community, there are a number of strategic imperatives:

1) **Enterprise Energy Risk Management:** There is a need to institutionalize effective enterprise-wide ERM models with the explicit inclusion of geopolitical scenario analysis and energy price stress testing. This includes the systematic use of forward contracts, currency options and natural hedging mechanisms to reduce exchange rate and commodity price exposure.

2) **Gharo-Keti Bandar Corridor:** Developing the Gharo-Keti Bandar corridor through utility-scale solar, wind and hydropower would lower the import bill, reduce current account vulnerability and hedge the economy against future oil price volatility. The government should provide greater incentives through accelerated depreciation allowances and investment tax credits.

3) **Reforming the Petrol Pricing Architecture:** Mechanisms to cushion the domestic pass-through of international price volatility should be considered, possibly through capitalizing a price stabilization fund during high-oil price periods, without compromising cost-recovery pricing strategies.

4) **Improving Remittance Formalization and Geographic Diversification:** As remittances proved resilient, with March 2026 inflows reaching USD 3.83 billion (Dawn, 2026), the concentration of 54 percent from GCC countries poses correlated risks given Middle East instability. Policy initiatives focused on formalization of remittance channels and diversification of labour export destinations should be prioritized.

5) **Enhancing Domestic Debt Capital Markets:** Developing deeper, more liquid domestic debt markets would reduce dependence on external commercial borrowing and expensive Eurobond issuances, providing stable, non-inflationary government financing that would reduce exposure to exchange rate risk.

6) **Enhancing Monetary-Fiscal Coordination:** The SBP should remain vigilant on inflation expectations and fiscal policy must complement monetary prudence by rationalizing expenditures and providing targeted social protection, especially through the Benazir Income Support Programme.

Conclusion

The 2026 US-Iran military crisis and the accompanying disruption of the Strait of Hormuz have exposed deep-rooted structural weaknesses in Pakistan's energy-dependent economic structure. The shock spread rapidly through the petrol pricing mechanism, transmitting immediate cost-push pressures to the transport, agriculture and industrial sectors, while the power sector circular debt mechanism increased fiscal vulnerabilities. Despite Pakistan's successful diplomatic mediation of the April 2026 ceasefire, which prevented disastrous tail-risk scenarios, the fundamental structural exposure remains unchanged.

This analysis reinforces emerging empirical studies on the asymmetric and amplified effects of geopolitical energy shocks on import-dependent emerging economies. Sustainable economic resilience for Pakistan cannot be built on periodic IMF bailouts and dependence on international commodity market fluctuations. The analytical and strategic capabilities of the CMA profession should be deployed to develop a more shock-resilient economic structure — reducing energy import dependence, institutionalizing commodity and currency risk management, and decoupling domestic economic performance from instability in the Persian Gulf. The 2026 shock is a clarion call for structural change.

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