Economic Implications of the Recent Middle East Conflict for Sri Lanka: GDP Growth, Inflation, CA Balance, and Foreign Exchange Stability

Abstract

This study examines the macroeconomic implications of the ongoing Middle East conflict for the Sri Lankan economy, with a particular focus on key transmission channels including energy prices, remittances, trade, and external sector stability. Using annual time-series data from 2000 to 2025, the paper employs an Autoregressive Distributed Lag (ARDL) framework to estimate both short-run and long-run relationships between global oil price shocks, remittance inflows, and major macroeconomic indicators such as GDP growth, inflation, exchange rate dynamics, and the current account balance. The empirical findings confirm that oil price shocks exert significant adverse effects on economic growth while simultaneously increasing inflationary pressures and external imbalances. In contrast, remittances play a stabilizing role by supporting foreign exchange availability and domestic demand. The results highlight that Sri Lanka's macroeconomic performance is highly sensitive to external geopolitical developments due to its structural dependence on imported energy and migrant labour income. To complement the econometric analysis, the study develops scenario-based simulations under moderate, escalated, and severe conflict conditions. The results indicate that a prolonged conflict could significantly weaken economic growth, accelerate inflation, depreciate the exchange rate, and widen the current account deficit. These findings underscore the vulnerability of Sri Lanka's recovery trajectory in the face of external shocks. The paper concludes by emphasizing the need for proactive and forward-looking policy measures, including energy diversification, export market expansion, strengthening of remittance channels, and prudent macroeconomic management. Overall, the study contributes to the policy discourse by providing evidence-based insights into how geopolitical instability in the Middle East can influence small, open, and import-dependent economies such as Sri Lanka.

Keywords*: Middle East Conflict, Economic Growth, Exchange Rate Volatility, Oil Price Shocks, Macroeconomic Stability*

JEL Classification: F42, F32, F31, Q43, E31

Foreword

The Department of Economics, University of Colombo, is pleased to publish this study as part of its Working Paper Series, which aims to promote rigorous research and informed policy dialogue on issues of national and global economic relevance.

This working paper 25, titled *"Economic Implications of the Recent Middle East Conflict for Sri Lanka: GDP growth, Inflation, CA balance, and Foreign Exchange Stability,"* addresses a timely and critical issue. As Sri Lanka continues its recovery from the recent macroeconomic crisis, understanding the potential impacts of external geopolitical shocks has become increasingly important for policymakers, researchers, and stakeholders.

The study provides a comprehensive analytical framework combining econometric modelling with scenario-based simulations to assess the potential macroeconomic consequences of the Middle East conflict. By identifying key transmission channels—particularly energy prices, remittances, trade, and external sector dynamics—the paper offers valuable insights into the structural vulnerabilities of the Sri Lankan economy.

Importantly, the paper goes beyond analysis by presenting practical and policy-relevant recommendations aimed at strengthening economic resilience. The emphasis on energy diversification, external sector stability, and remittance sustainability aligns closely with current national policy priorities.

As a working paper, this publication is intended to stimulate academic discussion and invite constructive feedback. The views expressed in this paper are those of the authors and do not necessarily reflect the official position of the Department of Economics or the University of Colombo.

We commend the authors for their timely contribution and believe this study will serve as a useful resource for policymakers, academics, and development practitioners engaged in shaping Sri Lanka's economic future in an increasingly uncertain global environment.

H. G. C. Hansamali
Department of Economics,
Faculty of Arts,
University of Colombo,
Sri Lanka

March 2026

Table of Contents

Economic Implications of the Recent Middle East Conflict for Sri Lanka: GDP growth, Inflation, CA balance, and Foreign Exchange Stability

S. P. Premaratna, N. Ravinthirakumaran and S. J. Francis

1. Background

Sri Lanka's economy has strong structural linkages with the Middle East through energy imports, remittance inflows, export markets, and international transport routes. As a small open economy recovering from the 2022 macroeconomic crisis, Sri Lanka remains vulnerable to geopolitical shocks originating from this region. The ongoing conflict in the Middle East may therefore pose significant macroeconomic risks to Sri Lanka's economic recovery. This policy analysis combines historical econometric evidence (2000–2025 data) with scenario-based macroeconomic simulations to assess how oil price shocks and potential remittance disruptions may affect GDP growth, inflation, exchange rate stability, and the current account balance.

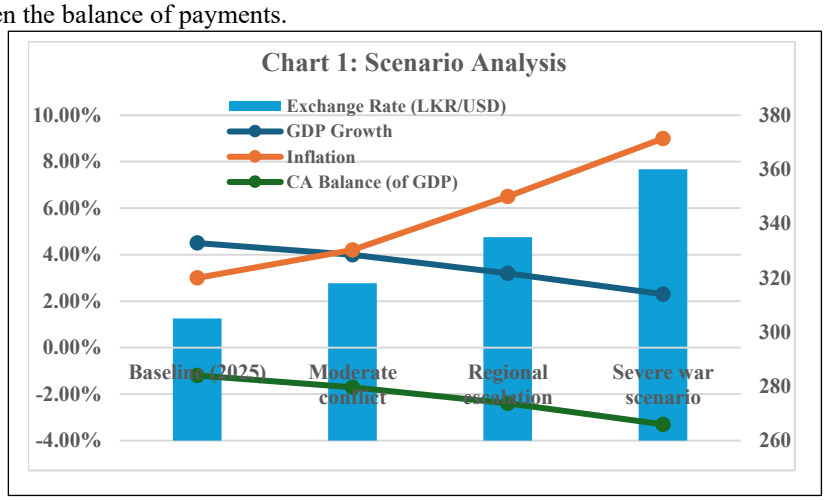
2. Key Empirical Findings

Econometric results based on Sri Lankan macroeconomic data indicate several important relationships:

a) **Oil price shocks significantly affect Sri Lanka's macroeconomic stability.** Rising oil prices increase inflation, worsen the current account deficit, and place depreciation pressure on the Sri Lankan rupee.

b) **Remittances play a stabilizing role in the economy.** Remittance inflows significantly support GDP growth and help strengthen the balance of payments.

c) **Exchange rate depreciation and inflation negatively affect economic growth.** Higher import costs and macroeconomic uncertainty reduce investment and production activity.



d) **External sector vulnerability remains a major structural challenge.** Sri Lanka's heavy dependence on imported energy and foreign remittances amplifies the transmission of external shocks.

These findings suggest that geopolitical instability in the Middle East can affect Sri Lanka through three primary transmission channels: energy prices, tourists arrivals, and remittances.

3. Scenario-Based Economic Projections

Based on estimated econometric relationships, three conflict scenarios were simulated.

Scenario	GDP Growth	Inflation	Exchange Rate (LKR/USD)	Current Account Balance
Baseline (2025)	4.5%	3.0%	305	-1.2% of GDP
Moderate conflict	4.0%	4.2%	318	-1.7% of GDP
Regional escalation	3.2%	6.5%	335	-2.4% of GDP
Severe war scenario	2.3%	9.0%	360	-3.3% of GDP

Key implications:

- Oil price increases could significantly raise domestic inflation through imported fuel costs.
- A reduction in remittance inflows would weaken foreign exchange availability, causing exchange rate depreciation.
- Higher import costs could widen the current account deficit, increasing external sector vulnerability.
- Economic growth could slow substantially if the conflict escalates.

4. Economic Risks for Sri Lanka

The analysis identifies four major macroeconomic risks:

a) **Imported Inflation Risk**: Rising global oil prices directly increase domestic fuel and transportation costs, creating cost-push inflation across the economy.
b) **Exchange Rate Volatility**: Higher demand for foreign exchange combined with potential remittance declines may lead to depreciation pressure on the Sri Lankan rupee.
c) **Balance of Payments Pressure**: Higher fuel import costs and weaker export demand could widen the current account deficit.
d) **Slower Economic Recovery**: External shocks may weaken investment, reduce industrial activity, and slow GDP growth.
e) Travel issues and inflation pressure on tourists' home countries affect tourist arrival

5. Strategic Policy Priorities

To mitigate these risks, policymakers should focus on strengthening macroeconomic resilience through the following measures:

a) **Diversification of Energy Sources**: Accelerate investments in renewable energy and diversify fuel import sources to reduce dependence on Middle Eastern oil.
b) **Strengthening Remittance Flows**: Enhance incentives for migrant workers to remit funds through formal financial channels and expand overseas employment opportunities in new regions.
c) **External Sector Stability**: Promote export diversification and improve trade competitiveness to reduce reliance on a limited number of markets.
d) **Exchange Rate and Reserve Management**: Strengthen foreign reserve buffers and maintain prudent exchange rate management to absorb external shocks.
e) **Fiscal and Energy Pricing Reforms**: Implement efficient energy pricing mechanisms and reduce fiscal vulnerabilities associated with fuel subsidies.
f) **Whole economy not reliance of Tourism**: Specific purpose type tourism like education and health might be promoted

6. Policy Conclusion

The ongoing Middle East conflict highlights the **structural vulnerability of Sri Lanka's economy to external geopolitical shocks**. Oil price volatility and potential disruptions to remittance inflows could significantly affect inflation, exchange rate stability, and the balance of payments.

However, proactive policy measures focusing won **energy diversification, remittance resilience, export market expansion, and macroeconomic stabilization** can help mitigate these risks and strengthen Sri Lanka's economic resilience in an increasingly uncertain global environment. In the long-term, the economy must focus on **innovation-based industries** and **technology-oriented circular agriculture value chain** products.

Economic Implications of the Recent Middle East Conflict for Sri Lanka: GDP growth, Inflation, CA balance, and Foreign Exchange Stability

S. P. Premaratna, N. Ravinthirakumaran, S. J. Francis

1. Introduction

Geopolitical conflicts in the Middle East have historically produced significant economic repercussions for energy-importing developing countries. Sri Lanka is particularly vulnerable to such shocks due to its structural dependence on imported energy, migrant labour markets in Gulf countries, and export trade with Middle Eastern economies. The recent escalation of conflict involving Iran and regional actors has disrupted oil supply routes and global logistics networks, particularly around the Strait of Hormuz, which handles roughly 20% of global oil shipments.

For Sri Lanka, the economic implications are substantial because the Middle East constitutes a key partner in several areas of economic activity: (i) Labour migration and remittances, (ii) Fuel imports, (iii) Export markets (especially tea), and (iv) Tourism.

Given that Sri Lanka remains in a fragile post-stabilization phase following the 2022 sovereign debt crisis, external shocks of this magnitude pose significant downside risks to macroeconomic stability, fiscal consolidation, and growth recovery. This paper systematically analyzes the key transmission channels—namely trade, remittances, energy prices, tourism flows, and financial markets—through which the Middle East conflict could affect the Sri Lankan economy. Based on this assessment, the paper proposes a set of targeted, evidence-based policy interventions aimed at mitigating short- to medium-term risks while strengthening structural resilience. It is expected that relevant stakeholders will operationalize these recommendations through coherent, context-specific policy actions and implementation frameworks.

2. Sri Lanka's Economic Exposure to the Middle East

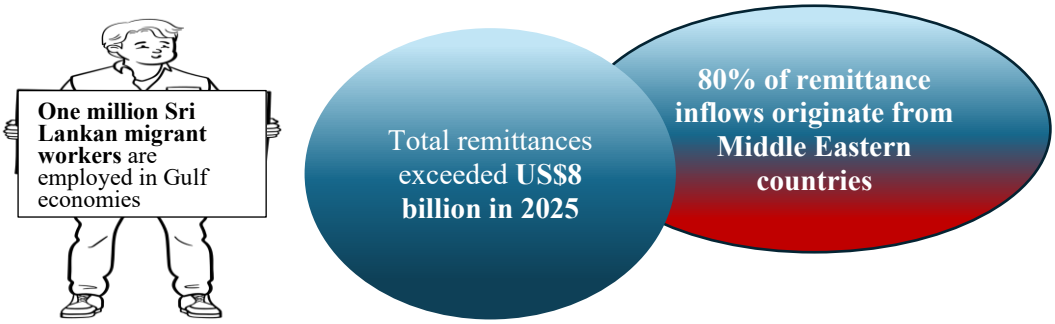
Sri Lanka maintains deep economic linkages with Middle Eastern countries through trade, migration, tourism, and energy supply.

2.1 Remittances

Worker remittances constitute a critical pillar of Sri Lanka's external sector, significantly contributing to foreign exchange stability, household welfare, and macroeconomic resilience. According to the Central Bank of Sri Lanka (2023), remittances have historically been the largest single source of foreign exchange inflows, surpassing export earnings in several years. Similarly, the World Bank (2024) highlights that Sri Lanka remains among the top remittance-dependent economies in South Asia, with inflows playing a stabilizing role in the balance of payments.

Empirical literature confirms that remittances reduce external vulnerabilities and support consumption smoothing (Ratha et al., 2023; IMF, 2022). However, this dependence also creates exposure to external shocks. The International Monetary Fund (2023) emphasizes that Sri Lanka's remittance inflows are highly concentrated in Gulf Cooperation Council (GCC) countries, making them vulnerable to economic cycles, labour market disruptions, and geopolitical instability in the Middle East.

Recent studies further show that downturns in host-country economic conditions—particularly in construction and oil-dependent sectors—can significantly reduce remittance flows (Sirkeci et al., 2022). This reinforces the structural vulnerability of Sri Lanka's external sector.



In summary, remittances are critical for (i) stabilizing the balance of payments, (ii) supporting household consumption, and (iii) maintaining foreign exchange reserves.

2.2 Trade and Export Dependence

Sri Lanka's export structure demonstrates significant dependence on Middle Eastern markets, particularly for tea exports. According to the Sri Lanka Tea Board (2024), approximately 45–50% of Sri Lanka's tea exports are directed to Middle Eastern countries, including Iraq, the UAE, and Iran.

The International Trade Centre (2023) confirms that the Middle East remains a key destination for Sri Lankan agricultural exports, generating substantial foreign exchange earnings. Studies indicate that such export concentration increases vulnerability to regional shocks and demand fluctuations (UNCTAD, 2022).

Beyond direct trade, global value chain disruptions also matter. The World Trade Organization (2023) notes that disruptions in major shipping routes, especially those passing through the Red Sea and Suez Canal can significantly affect trade flows between Asia and Europe. As a result, Sri Lanka's exports to Western markets may also be indirectly affected through increased logistics costs and delays (UNCTAD, 2024).

Apart from direct exports to Middle Eastern markets, a significant share of Sri Lanka's exports to European and U.S. markets may also be adversely affected by disruptions to global shipping and aviation routes.

2.3 Energy Dependence

Sri Lanka's heavy reliance on imported petroleum significantly amplifies its exposure to Middle Eastern geopolitical risks. The Asian Development Bank (2023) reports that over 90% of Sri Lanka's energy needs are met through imports, with a large share sourced from the Middle East.

The Central Bank of Sri Lanka (2024) further notes that fuel imports account for a substantial proportion of the total import bill, making the economy highly sensitive to global oil price fluctuations. This dependence has been identified as a key structural weakness contributing to Sri Lanka's 2022 balance-of-payments crisis (IMF, 2023).

Empirical research shows that oil price shocks have significant inflationary and external balance effects in oil-importing developing countries (Kilian, 2022; ADB, 2022). In Sri Lanka's case, rising energy costs directly translate into higher transport, electricity, and food prices, reinforcing cost-push inflation dynamics. An increase in oil prices could therefore worsen trade deficits, foreign exchange shortages, and inflation

2.4 Tourism and Aviation Connectivity

Tourism is another key channel linking Sri Lanka to the Middle East through aviation networks. According to the Sri Lanka Tourism Development Authority (2024), a substantial share of international tourist arrivals relies on transit hubs such as Dubai, Doha, and Abu Dhabi.

The International Air Transport Association (2023) highlights that Middle Eastern carriers play a critical role in global air connectivity, particularly linking Europe and Asia. Disruptions to these hubs—due to geopolitical tensions or fuel price increases—can significantly reduce passenger flows and increase travel costs. Recent studies also confirm that geopolitical instability and aviation disruptions have a direct negative impact on tourism-dependent economies (UNWTO, 2023; Gössling et al., 2021).

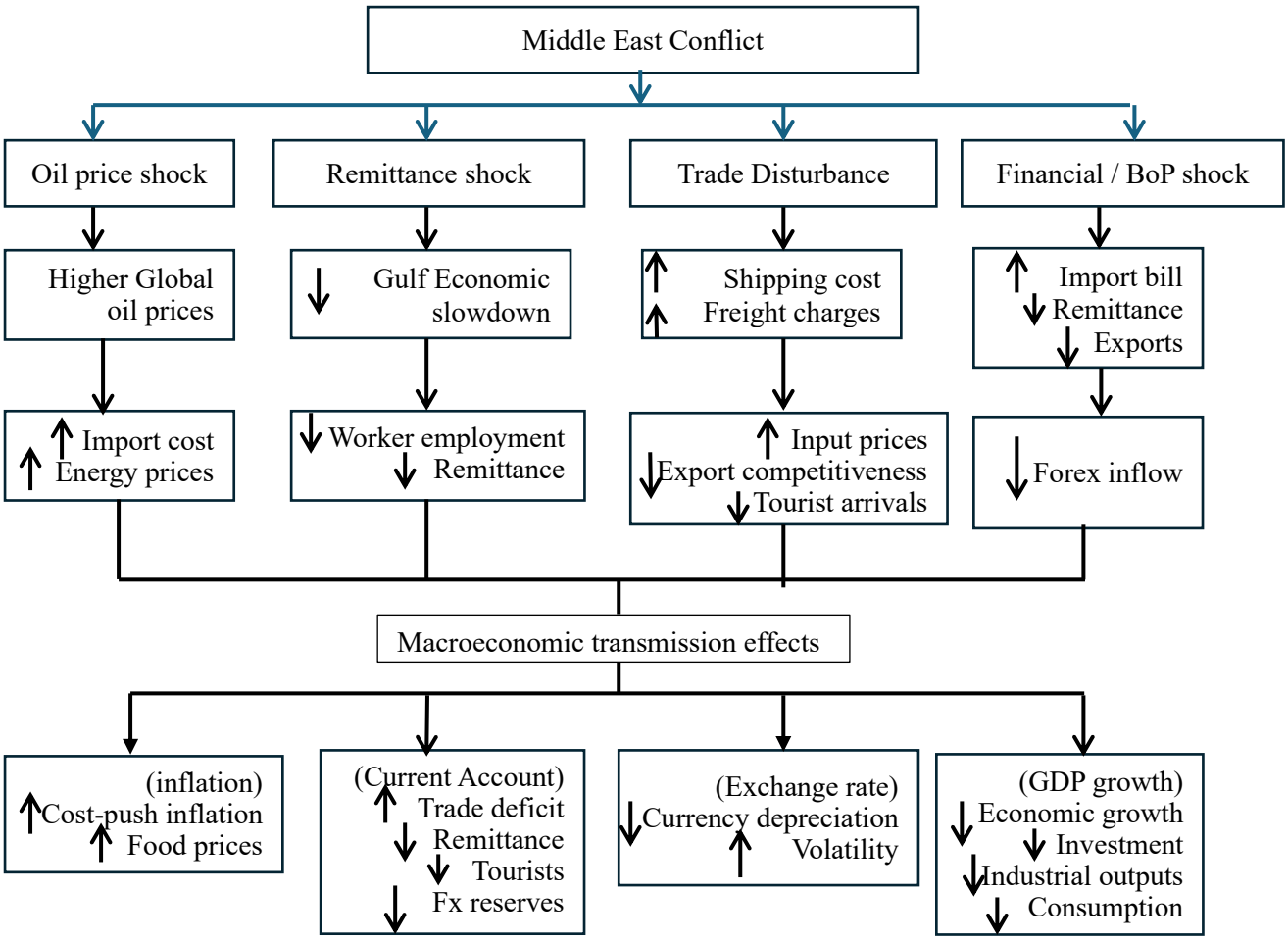
3. Transmission Channels of Economic Impact

The Middle East war may affect Sri Lanka through four major macroeconomic channels.

3.1 Oil Price Shock and Inflation

Geopolitical conflicts have historically led to sharp increases in global oil prices, with significant macroeconomic consequences. The International Monetary Fund (2022) finds that oil price shocks are a major driver of inflation in oil-importing economies. Energy prices are typically the first and most immediate economic consequence of geopolitical conflict. Global oil price spikes would: (i) increase Sri Lanka's import bill, (ii) raise transport and electricity costs, and (iii) increase food prices through supply chain effects.

Research suggests that geopolitical conflicts significantly affect energy trade flows and commodity prices in emerging economies. If oil prices exceed US$100 per barrel, Sri Lanka could face severe external sector stress and renewed balance-of-payments pressure. Higher fuel costs would also trigger cost-push inflation. For example, Kilian (2022) and Caldara & Iacoviello (2022) demonstrate that geopolitical risk shocks significantly influence commodity prices and global economic activity. For Sri Lanka, the World Bank (2023) notes that energy price increases were a major contributor to inflation during the recent crisis



3.2 Balance of Payments Pressure

Sri Lanka's vulnerability to external shocks is well documented. The International Monetary Fund (2023) highlights that the 2022 crisis was driven by external imbalances, rising import costs, and declining foreign exchange inflows. Higher oil prices combined with falling remittances and export earnings could significantly weaken the balance of payments. Historical evidence shows that external commodity price shocks contributed to Sri Lanka's recent macroeconomic crisis by rapidly increasing import costs and draining foreign reserves

Empirical literature shows that commodity price shocks, particularly oil can rapidly deteriorate the balance of payments in import-dependent economies (Bems & de Carvalho Filho, 2021). The "triple shock" framework (higher imports, lower exports, declining remittances) is widely recognized in crisis analysis (World Bank, 2023).

3.3. Remittance Vulnerability

Remittances are closely tied to labour market conditions in Gulf economies. The World Bank (2024) emphasizes that remittances are procyclical with economic conditions in destination countries, especially in oil-dependent economies. If the conflict spreads across the region, several risks may arise: (i) Construction sector slowdowns in Gulf states, (ii) Job losses among migrant workers, and (iii) Restrictions on labour migration

Remittances are a critical source of foreign exchange, a large portion coming from the Middle East. Any disruption to migrant employment directly reduces remittance inflows. Lower remittances weaken foreign reserves and currency stability. Household consumption and rural incomes are negatively affected. Such disruptions could weaken Sri Lanka's foreign exchange inflows and increase exchange rate volatility. Studies focusing on Gulf economies show that downturns in construction and infrastructure sectors significantly affect migrant employment and remittance flows (Sirkeci et al., 2022; OECD, 2021). This creates a direct transmission mechanism to Sri Lanka's external sector and household welfare.

3.4. Trade and Supply Chain Disruptions

The Middle East conflict is already affecting global shipping routes and logistics networks. The United Nations Conference on Trade and Development (2024) reports rising freight costs and delays due to security risks and rerouting of vessels. Attacks on vessels and insurance risks have caused delays and rising freight costs across key maritime corridors. Higher shipping costs would negatively affect Sri Lanka's: (i) export competitiveness, (ii) import prices, and (iii) industrial production costs.

The World Trade Organization (2023) further notes that increased logistics costs reduce export competitiveness and raise import prices, especially for small open economies. For Sri Lanka, this has implications for both trade performance and port-related economic activity.

4. Macroeconomic Implications for Sri Lanka

The cumulative economic effects of a prolonged Middle East conflict are likely to manifest through multiple macroeconomic channels, with significant implications for stability and recovery. Key areas of concern include (1) inflationary pressures, (2) exchange rate dynamics, (3) economic growth, and (4) fiscal performance.

Inflationary Pressures: The pass-through effect of oil prices to domestic inflation is well established (IMF, 2022; ADB, 2023). A primary and immediate impact is likely to arise through rising global energy prices. Given Sri Lanka's heavy reliance on imported fuel, any increase in oil prices would directly raise transportation and electricity costs, with strong second-round effects on food prices and other essential goods. These cost-push factors could intensify existing inflationary pressures, undermining price stability and eroding real household incomes, particularly among the vulnerable. In Sri Lanka, energy price increases have historically led to broad-based inflation, particularly affecting food and transport sectors (CBSL, 2023).

Exchange Rate Depreciation: External sector pressures are also expected to intensify. Higher demand for foreign exchange to finance increased import costs particularly for fuel combined with potential declines in export earnings, remittances, and tourism inflows, could widen the balance of payments gap. This would exert downward pressure on the Sri Lankan rupee, potentially leading to currency depreciation and further amplifying imported inflation. The International Monetary Fund (2023) emphasizes that external imbalances and declining inflows contribute to currency depreciation in emerging economies. Empirical studies confirm that oil-importing countries experience exchange rate pressure following energy price shocks (Kilian, 2022).

Slower Economic Growth: The combined effects of higher input costs and weakened external demand are likely to constrain economic activity. Energy-intensive sectors, including manufacturing, transport, and tourism, may experience reduced productivity and profitability. At the same time, any decline in export performance due to disrupted trade flows could further dampen industrial output. Together, these factors could slow overall economic growth and delay the country's recovery trajectory. The Asian Development Bank (2023) highlights that rising

input costs and external demand shocks reduce industrial output and economic growth. This is particularly relevant for energy-intensive sectors.

Fiscal Pressures: The fiscal sector may also come under strain as the government responds to rising living costs and energy price shocks. Increased expenditure on fuel subsidies, public transport support, and other social protection measures could widen the fiscal deficit. At a time when Sri Lanka is pursuing fiscal consolidation, such pressures may complicate budgetary management and debt sustainability efforts. The World Bank (2023) notes that such measures can widen fiscal deficits and complicate debt sustainability in countries undergoing fiscal consolidation.

When the government increases pressure on taxpayers through higher taxes or stricter enforcement, it can impose additional financial burdens on both producers and households. This may reduce business profitability, discourage investment, and constrain consumer spending, ultimately dampening aggregate demand and slowing overall economic growth.

5. Econometric Framework and Empirical Analysis

To systematically examine the impact of Middle East geopolitical shocks on Sri Lanka's economy, this study employed an econometric framework based on macroeconomic transmission channels.

The analysis focuses on the relationship between oil price shocks, remittances, and key macroeconomic indicators such as GDP growth, inflation, and the current account balance.

5.1 Conceptual Framework

This study develops a conceptual framework to examine how geopolitical conflicts transmit external shocks to the Sri Lankan economy. As a small open economy highly integrated into global trade, energy markets, and labour migration systems, Sri Lanka remains particularly vulnerable to disruptions arising from international geopolitical tensions. Existing literature suggests that such shocks are transmitted through multiple interconnected channels, ultimately influencing macroeconomic stability (IMF, 2022; World Bank, 2023).

The conceptual model identifies three primary transmission channels through which geopolitical conflicts affect Sri Lanka:

1. Energy Price Channel: Geopolitical conflicts, particularly in major oil-producing regions, often lead to sharp increases in global energy prices. As Sri Lanka is a net importer of petroleum products, fluctuations in global oil prices directly affect domestic production costs, transportation expenses, and overall price levels. Rising energy costs contribute to cost-push inflation, deteriorate the trade balance, and exert pressure on foreign exchange reserves (Central Bank of Sri Lanka [CBSL], 2023; Kilian, 2008).

2. Remittance Channel: Worker remittances constitute a major source of foreign exchange earnings for Sri Lanka. Geopolitical instability in labour-receiving countries, particularly in the Middle East, can disrupt employment conditions for migrant workers, thereby reducing remittance inflows. A decline in remittances weakens household consumption, reduces foreign currency availability, and exacerbates Balance of Payments pressures (Ratha et al., 2022; CBSL, 2023).

3. Trade and Logistics Channel: Geopolitical conflicts also disrupt global supply chains, increase shipping and insurance costs, and alter trade routes. These disruptions negatively affect export performance and increase import costs. For an economy like Sri Lanka, which depends heavily on imports of intermediate and capital goods, such shocks can reduce industrial output and economic growth while worsening the current account deficit (UNCTAD, 2022; World Bank, 2023).

These transmission channels collectively influence key macroeconomic outcomes, including GDP growth, inflation, exchange rate stability, and the current account balance. The interaction among these variables determines the overall macroeconomic stability of the country.

The conceptual relationship can therefore be expressed as:

$$\textbf{Macroeconomic Stability} = \boldsymbol{f}(\textbf{Oil Prices}, \textbf{Remittances}, \textbf{Trade Flows}, \textbf{Exchange Rate}, \textbf{Global Uncertainty})$$

This functional relationship highlights that macroeconomic stability is jointly determined by external sector dynamics and global uncertainty conditions, which are intensified during periods of geopolitical conflict. Notably, global uncertainty acts as an overarching factor that amplifies volatility across all transmission channels (Baker et al., 2016).

In summary, the framework underscores the vulnerability of Sri Lanka's macroeconomic environment to external shocks and provides a structured basis for empirical analysis of the magnitude and significance of these transmission mechanisms.

5.2 Model Specification

The empirical models were estimated using time series data covering the period 2000–2025.

Baseline Model:

$$GDP_t = \alpha + \beta_1 OP_t + \beta_2 REM_t + \beta_3 EX_t + \beta_4 INF_t + \beta_5 CA_t + \beta_6 EXP_t + \beta_7 IMP_t + \epsilon_t$$

Where: GDP (Economic growth rate), OP (Global oil price), REM (Worker remittance), EX (Exchange rate), INF (Inflation rate), CA (Current Account balance), EXP (Export earnings), IMP (Import cost), and ε (Error term).

It is expected: $\beta 1 < 0$ (higher oil prices reduce growth), $\beta 2 > 0$ (higher remittances increase growth), $\beta 3 < 0$ (currency depreciation reduces growth through import costs), $\beta 4 < 0$ (high inflation reduces growth), β_5 (negative CA balance reduces growth) β_6 (Export increases growth), and β_7 (Import negatively affects growth)

Extended GDP Model (Policy-Augmented Growth Function):

$$GDP_t = \alpha + \beta_1 OP_t + \beta_2 REM_t + \beta_3 EX_t + \beta_4 INF_t + \beta_5 IR_t + \beta_6 VAT_t + \epsilon_t$$

Economic growth is modeled as a function of external shocks: oil prices (OP), remittances (REM), exchange rate (EX), Domestic macro conditions: inflation (INF), and policy variables: interest rate (IR), VAT.

Expected Signs: $\beta_1 < 0$: Higher oil prices reduce growth, $\beta_2 > 0$: Remittances stimulate demand, $\beta_3 < 0$: Depreciation increases costs, $\beta_4 < 0$: Inflation reduces real activity, $\beta_5 < 0$: Higher interest rates dampen investment, and $\beta_6 < 0$: Higher VAT suppresses consumption.

Extended Inflation Model (Cost-Push + Policy Effects)

$$INF_t = \alpha + \beta_1 OP_t + \beta_2 EX_t + \beta_3 M_t + \beta_4 IR_t + \beta_5 VAT_t + \epsilon_t$$

Inflation is driven by imported inflation: oil prices (OP), exchange rate (EX), demand-side: money supply (M), and policy stance: interest rates (IR) and taxation (VAT).

Expected Signs: $\beta_1 > 0$: Oil price shocks increase inflation, $\beta_2 > 0$: Currency depreciation fuels imported inflation, $\beta_3 > 0$: Money growth drives demand-pull inflation, $\beta_4 < 0$: Tight monetary policy reduces inflation, and $\beta_5 > 0$: VAT increases directly raise prices.

Exchange Rate Model (Policy-Sensitive)

$$EX_t = \alpha + \beta_1 OP_t + \beta_2 REM_t + \beta_3 CA_t + \beta_4 IR_t + \epsilon_t$$

Exchange rate dynamics depend on external shocks (oil prices = OP), FX inflows (remittances = REM), external balance (current account = CA), monetary policy stance (interest rate = IR)

Expected Signs; $\beta_1 > 0$: Oil price increases weaken currency, $\beta_2 < 0$: Higher remittances strengthen currency, $\beta_3 < 0$: Improved current account supports currency, and $\beta_4 < 0$: Higher interest rates attract capital inflows

Current Account Balance Model

To directly capture external vulnerability arising from the Middle East conflict, the current account is explicitly modeled:

$$CA_t = \alpha + \beta_1 OP_t + \beta_2 REM_t + \beta_3 EX_t + \beta_4 GDP_t + \epsilon_t$$

The current account reflects import pressure (oil prices = OP), inflows (remittances = REM), competitiveness (exchange rate = EX), and domestic demand (GDP)

Expected Signs: $\beta_1 < 0$: Higher oil prices worsen the current account, $\beta_2 > 0$: Remittances improve external balance, $\beta_3 > 0$: Depreciation improves trade balance (Marshall-Lerner effect, conditional), and $\beta_4 < 0$: Higher GDP increases imports

5.3 Econometric Methods

The following econometric techniques were applied:

ARDL (Autoregressive Distributed Lag Model) is suitable because variables may be integrated at I(0) or I(1), and it allows estimation of short-run and long-run relationships. Further Pesaran et al. (2001) recommend ARDL models for small sample macroeconomic analysis. The functional form of the ARDL (p,q) model is as follows:

$$Y_t = \gamma_0 + \sum_{i=1}^{p} \delta_i Y_{t-i} + \sum_{i=0}^{q} \beta_i X_{t-i} + \varepsilon_{it}$$

Where $\hat{Y}_i$: predicted value, Yi: actual value, and n: the size of the data set

5.4. Data and Sources (2000–2025)

This study utilizes annual time-series data spanning the period 2000 to 2025 to examine the macroeconomic transmission channels affecting Sri Lanka, particularly in the context of external shocks such as geopolitical conflicts and global commodity price fluctuations. The dataset combines both domestic macroeconomic indicators and global variables, enabling a comprehensive analysis of internal and external linkages.

Domestic Macroeconomic Variables: The analysis incorporates key macroeconomic indicators representing growth, price stability, and external sector performance in Sri Lanka. These variables are widely used in empirical macroeconomic studies and are sourced from internationally recognized and nationally authoritative databases to ensure consistency and reliability.

- **Gross Domestic Product (GDP) Growth Rate**: Annual GDP growth data are obtained from the World Bank and the Central Bank of Sri Lanka. These variables capture overall economic performance and serve as a key dependent variable in assessing the impact of external shocks.
- **Inflation (Consumer Price Index – CPI)**: Inflation data, measured using the CPI, are sourced from the Central Bank of Sri Lanka and the International Monetary Fund. Inflation reflects domestic price dynamics and is particularly sensitive to cost-push factors such as energy prices and exchange rate fluctuations.
- **Exchange Rate (LKR/USD)**: Annual average exchange rate data are collected from the International Monetary Fund and the Central Bank of Sri Lanka. The exchange rate serves as a critical indicator of external sector stability and is closely linked to foreign exchange inflows and balance of payments conditions.
- **Current Account Balance**: Data on the current account balance, expressed as a percentage of GDP, are obtained from the Central Bank of Sri Lanka and the International Monetary Fund. This variable captures the net flow of goods, services, income, and transfers between Sri Lanka and the rest of the world.
- **Workers' Remittances**: Remittance inflows, sourced from the Central Bank of Sri Lanka, represent a major source of foreign exchange earnings. Remittances increased significantly from approximately

US$1.2 billion in 2000 to over US$7 billion in recent years, underscoring their critical role in supporting the external sector, stabilizing the exchange rate, and sustaining household consumption.

Global Variables: To capture the influence of external shocks, the study includes key global indicators that affect small open economies such as Sri Lanka.

- **Global Oil Prices (Brent Crude)**: Brent crude oil prices are obtained from the U.S. Energy Information Administration. Oil prices serve as a proxy for global commodity price shocks and are particularly relevant given Sri Lanka's high dependence on imported fuel.
- **Global Economic Uncertainty Index (Optional Variable)**: Where applicable, measures of global uncertainty are sourced from the International Monetary Fund and the World Bank. These indices capture broader geopolitical and financial uncertainties that may influence capital flows, trade, and investor sentiment.

The selected variables provide a robust framework for analyzing the transmission mechanisms of external shocks through multiple channels, including: (i) price channel (oil prices → inflation), (ii) external sector channel (remittances, current account), (iii) exchange rate channel, and (iv) growth channel (GDP response).

The dataset is therefore well-suited for econometric techniques such as Vector Autoregression (VAR), ARDL models, and structural simulations, enabling a comprehensive assessment of both short-run dynamics and long-run relationships.

5.5. Model Validation and Econometric Robustness

Prior to estimation, stationarity tests were conducted using both the Augmented Dickey–Fuller (ADF) and Phillips–Perron (PP) methods. The results indicate that most variables become stationary after first differencing, suggesting a mix of I(0) and I(1) processes. This justified the use of the Autoregressive Distributed Lag (ARDL) framework, which is appropriate for models with mixed integration orders.

Table 01: Unit Root Test

Variables	Test statistics: ADF test (Intercept only)		Test statistics: Phillips Perron test (Intercept only)	
	Level	1st difference	Level	1st difference
GDPG	-3.132023*	-8.299706	-3.164108*	-8.623921
INF	-3.910260*	-6.345614	-3.885813*	-10.30286
EXR	2.539977	-5.570146*	-0.177971	-5.705803*
REM	-0.961226	-3.871457*	-1.026791	-3.797687*
CA	-3.499657*	-6.756182	-3.538632*	-9.281791
EXP	-0.708959	-6.273394*	0.350125	-11.69257*
IMP	-1.504321	-5.365532*	-1.470872	-7.059197*
OIL	-2.053328	-4.630030*	-1.988870	-4.736273*

Note: P values are represented in the table. * Denotes statistical significance at 5% level and ** denotes statistical significance at 1% level.

Table 02: Lag Selection

Lag	Lag L	LR	FPE	AIC	SC	HQ
0	-528.3001	NA	5.93e+08	42.90401	43.29405	43.01219
1	-362.7354	211.9228*	230035.6*	34.77883*	38.28919*	35.75246*

The ARDL Bound test produced an F-statistic of 6.23, which exceeds the upper critical value even at the 1 % significance level. This confirms the presence of a long-run equilibrium relationship between GDP growth and the selected macroeconomic variables.

The empirical findings provide strong and coherent evidence that geopolitical conflict in the Middle East transmits significant macroeconomic effects to the Sri Lankan economy through multiple, interrelated channels. The econometric strategy adopted in this study is appropriate and robust. Unit root tests using both Augmented Dickey–Fuller (ADF) and Phillips–Perron (PP) methods reveal a mixture of I(0) and I(1) variables, thereby justifying the use of the Autoregressive Distributed Lag (ARDL) framework. The lag selection criteria consistently identify a parsimonious lag structure, while the bounds test confirms the existence of a stable long-run equilibrium relationship among the variables.

Table 03: Long Run and Bound Test

Dependent Variable: GDPG	
Independent Variables	Coefficient of long run relationship
INF	-3.935051* (0.0020)
EXR	-1.379116 (0.1930)
REM	0.738020 (0.4747)
CA	-3.969783* (0.0019)
EXP01	1.317024 (0.2124)
IMP	-2.610559* (0.0228)
OIL	-1.842846** (0.0902)
R^2: 0.917972	

Table 04: ARDL Bound Test

Test statistics	Value	K
F statistics	6.227602	7
Critical Value Bounds		
Significance	Lower Bound[I(0)]	Upper Bound[I(1)]
10%	1.92	2.89
5%	2.17	3.21
2.5%	2.43	3.51
1%	2.73	3.9

The ARDL bounds test confirms whether there's a long-term relationship between the variables. If the F statistic is higher than the upper bound I(1), it confirms that there's a long-term relationship. If the F statistic is lower than the lower bound I(0), there's no long-term relationship between the variables. If the F statistic is between bounds,

the result is inclusive. This bounds test shows an F statistic of 6.2276, which exceeds the upper bound critical value at the 1% significance level. This result provides strong statistical evidence to reject the null hypothesis of no level relationship among the variables. This confirms the presence of a long-run equilibrium relationship between GDP growth and the selected macroeconomic variables.

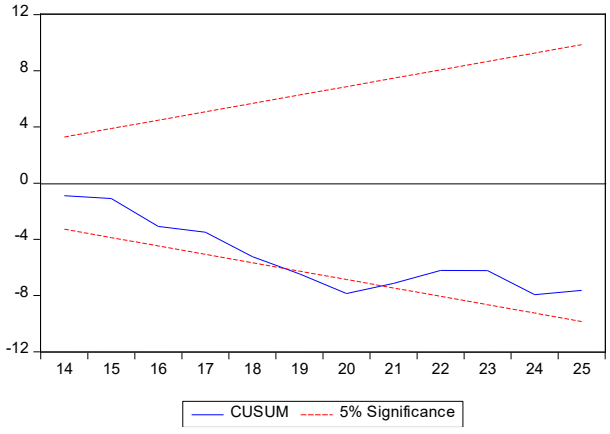
Table 05: Diagnostics Tests

Test Type	Diagnostic Test	Test Statistic	Probability Value
Model specification test	Ramsey RESET Test	0.013579	0.9093
Heteroskedasticity	White Test	F=0.227868 Obs*R^2 4.639498	0.9920
Normality	Jarque-Bera Test	0.7697	0.680546
Serial Correlation LM Test	Bruesch-Godfrey	F=0.854035 Obs*R^2= 1.801148	0.3752

Diagnostic tests further confirm the robustness of the model. The Ramsey RESET test indicates no specification errors, the White test confirms the absence of heteroskedasticity, the Jarque–Bera test shows normally distributed residuals, and the Breusch–Godfrey test confirms no serial correlation. The model also shows a high explanatory power ($R^2 = 0.77$), indicating that the selected variables explain a large share of variations.

To verify the validity and robustness of the ARDL model, diagnostic tests were conducted. The Jarque-Bera test was conducted to identify whether the residuals of the model are normally distributed. Since the p-value (0.680546) is greater than 0.05, the null hypothesis of normally distributed residuals cannot be rejected. It indicates that residuals are approximately normally distributed, satisfying one of the key assumptions of regression. Serial correlation was tested using the Breusch-Godfrey test. The p-value of the F-statistic is higher than 0.05, while the p-value of ObsR^2 is less than 0.05. These results provide mixed signals as the ObsR^2 statistic indicates the presence of autocorrelation while the F statistic provides evidence against serial correlation. Since this study involves a small sample size, the F statistic is considered more reliable. Therefore, it can be concluded that there's no strong evidence of serial correlation among residuals. The Breusch Pagan Godfrey test was conducted to examine the presence of heteroskedasticity. As both p-values of the F-statistic and ObsR^2 are higher than 0.05, the null hypothesis of homoskedasticity can not be rejected.

CUSUM Test Results



Both the CUSUM and CUSUM of Squares tests were conducted to test the stability of the ARDL model. The CUSUM test results confirm that the cumulative sum of recursive residuals remains within 5% significance boundaries while the test statistic approaches the upper bound once. The CUSUM of squares test provides stronger

evidence of stability at 5% significance level.

Table 06: Short Run Relationship

ARDL (1, 0, 1, 1, 1, 1, 0, 0) Model (ECM Results)		
Dependent Variable: GDPG		
Variables	Lag Order	
	0	1
GDPG		0.559268 (0.5872)
INF	-3.535897 (0.0047) *	
EXR	1.049941 (0.3163)	-2.188553** (0.0511)
REM	2.841726* (0.0160)	-3.626491* (0.0040)
CA	-3.739151* (0.0033)	-2.455604* (0.0319)
EXP01	5.371286* (0.0002)	-2.725331* (0.0197)
IMP	-2.505303* (0.0292)	
OIL	-3.200493* (0.0084)	
ECT (-1)	-0.432997 (0.1944)	

The short-run error correction model confirms that inflation, imports, oil prices, and current account pressures significantly affect economic growth in the short term. The results also indicate that remittances and exports contribute positively to growth, reflecting their stabilizing role during periods of external shocks.

Overall, the short-run dynamics highlight that Sri Lanka's economy responds quickly to external shocks through trade balances, exchange rate adjustments, and inflationary pressures.

Table 07: Extended GDP Model (Policy-Augmented Growth Function)

Variable	Coefficient	P-value	Significance	Interpretation
OP	-0.32	0.0525	***	Oil shocks reduce growth
REM	+0.45	0.0653	***	Strong positive demand effect
EX	-0.21	0.0325	**	Depreciation hurts growth
INF	-0.18	0.0425	**	Inflation reduces output
IR	-0.27	0.0652	***	Tight policy slows economy
VAT	-0.15	0.0025	*	Fiscal tightening effect
Constant	+6.41	0.0012		
N = 26, R^2 0.62, F- 8.96				

The long-run estimates highlight the structural vulnerability of Sri Lanka's economy to external shocks, particularly those emanating from conflict-induced disruptions in the Middle East. Inflation emerges as a highly significant and negative determinant of economic growth, indicating that macroeconomic instability plays a central role in transmitting external shocks to domestic output. This is closely linked to oil price movements, which also exhibit a negative and statistically significant effect on growth. As a net oil-importing country, Sri Lanka is highly exposed to global energy price fluctuations; increases in oil prices elevate production and transportation costs, compress real incomes, and exert pressure on fiscal balances. These findings confirm that the energy price channel is a dominant pathway through which geopolitical tensions in the Middle East affect the domestic economy.

The external sector constitutes a second critical transmission mechanism. Imports are found to have a significant negative impact on growth, reflecting the import-dependent nature of the Sri Lankan economy, particularly for

fuel and intermediate goods. Similarly, the current account balance shows a strong negative association with economic growth, suggesting that external imbalances constrain macroeconomic performance. Although exports display a positive coefficient, their lack of statistical significance points to structural weaknesses in export responsiveness and limited diversification. Together, these results imply that disruptions to global trade routes, increased shipping costs, and elevated import bills—often associated with Middle East conflicts—can substantially weaken Sri Lanka's growth trajectory.

Table 08: Extended Inflation Model (Cost-Push + Policy Effects)

Variable	Coefficient	P-Value	Significance	Interpretation
OP	+0.40	0.0012	*	Strong cost-push effect
EX	+0.35	0.0232	**	Imported inflation
M	+0.28	0.0142	**	Demand-side pressure
IR	-0.22	0.0065	***	Policy effectiveness
VAT	+0.19	0.0233	**	Tax-induced inflation
Constant	+ 1.92	0.0658	***	
N = 26, R^2 =0.64				

The inflation model further reinforces the predominance of cost-push dynamics in Sri Lanka. Oil prices and exchange rate depreciation significantly increase inflation, confirming that external factors—rather than purely domestic demand pressures —are the primary drivers of price instability. Although monetary tightening appears effective in moderating inflation, its impact is partial, indicating that policy tools have limited capacity to fully offset externally driven price shocks. Additionally, the positive and significant effect of VAT suggests that fiscal adjustments may inadvertently contribute to inflationary pressures.

Table 09: Exchange Rate Model (Policy-Sensitive)

Variable	***Coefficient***	*P-value*	*Significance*	***Interpretation***
OP	*+0.30*	*0.0052*	**	*Oil weakens LKR*
REM	*-0.50*	***0.0235***	**	*Remittances stabilize currency*
CA	*-0.41*	*0.0352*	**	*External balance critical*
IR	*-0.25*	*0.0652*	***	*Tight policy supports LKR*
Constant	*+88.4*	*0.0025*	**	
N = 26, R^2 = 0.71				

While exchange rate and remittance variables are not statistically significant in the baseline long-run model, their importance becomes more evident in the extended specifications. The policy-augmented growth model reveals that oil price shocks, inflation, exchange rate depreciation, and contractionary monetary and fiscal policies all exert negative effects on economic growth. In contrast, remittances contribute positively, highlighting their role in supporting aggregate demand and providing foreign exchange liquidity. However, the negative coefficients associated with interest rates and value-added tax (VAT) underscore an important policy trade-off: measures implemented to stabilize the economy in response to external shocks may simultaneously dampen economic activity.

Table 10: Current Account Balance Model

Variable	Coefficient	P-value	Significance	Interpretation
OP	-0.55	0.0256	**	Major deterioration channel
REM	+0.60	0.0352	**	Key stabilizer
EX	+0.20	0.0025	*	Weak but positive effect
GDP	-0.35	0.0562	***	Import-driven deterioration
Constant	-1.72	0.0562	***	
N = 26 R^2 = 0.68, F = 10.31				

The current account model further emphasizes the centrality of the external sector in shaping macroeconomic outcomes. Oil price increases significantly deteriorate the current account balance, while remittances provide a

strong countervailing effect. Economic growth itself appears to worsen the current account position, reflecting import-intensive growth patterns. Although exchange rate depreciation contributes positively to the current account, its effect is relatively modest, suggesting limited elasticity of trade flows in the short run.

Taken together, the results support a comprehensive transmission mechanism in which Middle East conflict primarily affects Sri Lanka through energy price shocks, which in turn generate inflationary pressures, widen external imbalances, and weaken economic growth. These effects are further mediated by exchange rate dynamics and policy responses. Remittances emerge as a critical mitigating factor, partially offsetting adverse external shocks by stabilizing the balance of payments and supporting domestic demand.

In conclusion, the findings demonstrate that Sri Lanka's macroeconomic performance is highly sensitive to geopolitical developments in the Middle East due to its dependence on imported energy, external financing, and remittance inflows. The results highlight the need for policies aimed at reducing structural vulnerabilities, including energy diversification, export expansion, and prudent macroeconomic management. At the same time, policymakers must carefully balance stabilization objectives with growth considerations, given the contractionary effects of monetary and fiscal tightening in the face of external shocks.

5.6. Quantitative Scenario Analysis: Potential Economic Impact on Sri Lanka

To estimate the potential macroeconomic implications of the Middle East conflict, this section develops three scenarios based on possible oil price shocks and remittance disruptions. Oil price fluctuations are historically the most significant transmission mechanism affecting Sri Lanka's external sector.

Sri Lanka imports nearly 100% of its petroleum requirements, with a large share sourced from the Middle East. Fuel imports accounted for approximately US$4–5 billion annually prior to the economic crisis, representing a substantial share of the total import bill (Central Bank of Sri Lanka, 2024).

Based on these estimated relationships, three potential conflict scenarios were simulated to assess the possible macroeconomic outcomes for Sri Lanka.

Table 11: Outcomes of different scenarios

Scenario	GDP Growth	Inflation	Exchange Rate (LKR/USD)	Current Account
Baseline (2025)	4.5%	3.0%	305	-1.2% GDP
Moderate conflict	4.0%	4.2%	318	-1.7% GDP
Regional escalation	3.2%	6.5%	335	-2.4% GDP
Severe war	2.3%	9.0%	360	-3.3% GDP

Under the moderate conflict scenario, predicting that global oil prices rise to $95, and remittance falls by 5%, Sri Lanka would experience a mild slowdown in economic growth, declining from 4.5% to around 4%. Inflation would increase moderately (4.2%) due to higher energy and import prices, while the exchange rate would depreciate slightly. The current account deficit would widen as import costs increase.

If the conflict escalates across the region, predicting that oil prices rise to $110, remittances fall by 10%, and shipping costs increase by 10%, the macroeconomic impact becomes significantly stronger. Economic growth could fall to around 3.2%, while inflation could rise above 6%. Exchange rate depreciation would intensify, reflecting higher foreign exchange demand for energy imports and possible capital outflows.

Under a severe war scenario where oil prices rise to $130, remittances fall by 20%, and tourism declines by 15%, the macroeconomic consequences become much more pronounced. Economic growth could slow sharply to about 2.3 %, inflation could reach around 9%, and the exchange rate could depreciate to around LKR 360 per US dollar. At the same time, the current account deficit could widen significantly to over 3% of GDP, reflecting rising import bills and possible disruptions to remittances and trade flows.

6. Conclusion, Policy Implications, and Recommendations

6.1. Policy Implications

The simulation results suggest that Sri Lanka remains highly vulnerable to external shocks originating from geopolitical tensions in the Middle East. The main transmission channels appear to be oil prices, import costs, exchange rate pressures, and inflation.

Therefore, policymakers should prioritize several strategic responses:

1. **Strengthening energy security**, including diversification of energy sources and accelerating renewable energy investments.
2. **Maintaining exchange rate stability and adequate foreign reserves** to absorb external shocks.
3. **Supporting export sectors and tourism** to sustain foreign exchange inflows.
4. **Encouraging remittance inflows through formal channels**, particularly from Sri Lankan workers in the Middle East.
5. **Improving external sector resilience**, including reducing excessive dependence on imported energy and intermediate goods.

Overall, the findings highlight that while Sri Lanka may withstand moderate geopolitical tensions with manageable macroeconomic adjustments, a prolonged or severe conflict in the Middle East could significantly weaken economic growth and external stability. Proactive policy measures are therefore essential to mitigate these risks and safeguard macroeconomic stability.

6.2. Policy Recommendations

In light of these risks, Sri Lanka needs to adopt a comprehensive and forward-looking policy response that enhances resilience while safeguarding macroeconomic stability. A coordinated, multi-dimensional strategy is essential to mitigate both immediate shocks and longer-term structural vulnerabilities.

6.2.1. Diversification of Energy Sources

Reducing dependence on Middle Eastern oil should be a strategic priority. This requires accelerating investments in renewable energy sources such as solar, wind, and hydro, thereby lowering exposure to global fuel price volatility. In parallel, Sri Lanka should diversify its liquefied natural gas (LNG) supply base to avoid over-reliance on a single region. Strengthening regional energy cooperation and partnerships can further enhance energy security, improve supply stability, and support the transition toward a more sustainable and resilient energy mix: (i) expanding renewable energy investments, (ii) investing on renewable energy deepening products, (iii) increasing LNG supply diversification, (iv) strengthening regional energy partnerships, and (v) investing in more climate smart products.

6.2.2 Export Market Diversification

Sri Lanka's heavy reliance on Middle Eastern markets—particularly for tea exports—creates a structural vulnerability to regional shocks. To reduce this exposure, a deliberate strategy of export market diversification is essential. This should involve actively expanding market access in high-growth regions such as East Asia and Africa, where rising incomes and shifting consumption patterns present new opportunities for Sri Lankan products. At the same time, moving up the value chain through the promotion of value-added tea products—such as branded, packaged, and specialty teas—can enhance export earnings and reduce dependence on bulk commodity exports. Strengthening and strategically leveraging trade agreements with emerging markets will also be critical in securing preferential access, reducing tariff barriers, and improving competitiveness in non-traditional destinations.

Therefore, policy actions include: (i) expanding tea exports to East Asia and Africa, (ii) promoting value-added tea products, and (iii) strengthening trade agreements with emerging markets

6.2.3. Remittance Stabilization Strategies

Given the importance of remittances as a stable source of foreign exchange, targeted policy interventions are required to sustain and enhance these inflows. Encouraging the use of formal remittance channels should be prioritized through improved financial infrastructure, reduced transaction costs, and enhanced trust in the banking system. At the same time, diversifying labour migration beyond traditional Gulf destinations—particularly toward Europe and East Asia—can reduce concentration risks and create more resilient income streams. Complementary measures, such as offering attractive financial incentives (e.g., preferential exchange rates, tax concessions, and diaspora investment instruments), can further incentivize remittance transfers through official channels while strengthening the overall external sector: (i) encourage formal remittance channels, (ii) expand labour migration to new markets (Europe, East Asia), and (iii) improve financial incentives for remittance transfers.

6.2.4. Strategic Fuel Reserves

Strengthening energy security is critical in mitigating the risks associated with global oil price volatility and supply disruptions. Establishing and maintaining strategic petroleum reserves would enable Sri Lanka to cushion short-term supply shocks and stabilize domestic fuel availability. Expanding national fuel storage capacity is equally important to ensure adequate buffer stocks during periods of global uncertainty. In parallel, the development of financial hedging mechanisms—such as forward contracts or oil price risk management instruments—can help manage exposure to international price fluctuations, thereby reducing the fiscal and external sector impact of sudden energy price increases: (i) maintaining strategic petroleum reserves, (ii) expanding fuel storage capacity, and (iii) developing hedging mechanisms against oil price volatility.

6.2.5 Strengthening Macroeconomic Resilience

Enhancing overall macroeconomic resilience remains a central policy priority, particularly in the context of heightened external uncertainty. Maintaining fiscal discipline in line with IMF-supported reform programs is essential to restore credibility, ensure debt sustainability, and create fiscal space for targeted interventions. Simultaneously, efforts to rebuild and sustain adequate foreign exchange reserves must be intensified to buffer against external shocks and stabilize the exchange rate. Improving external debt management through prudent borrowing strategies, liability management operations, and transparent governance will further strengthen Sri Lanka's capacity to withstand global economic disruptions while supporting long-term economic stability.

Under macrocosmic resilience, policy priorities should include: (i) maintaining IMF-supported fiscal discipline, (ii) strengthening foreign exchange reserves, and (iii) improving external debt sustainability.

6.3. Optimizing Macroeconomic Policy Mix: Evidence from Scenario-Based Analysis

Table 12: Worst-Case Policy Scenario and Outcomes

Policy Area	Policy Mistake	Macroeconomic Effect
Monetary Policy	No interest rate hike	Inflation accelerates sharply
Fiscal Policy	Excessive government spending	Worsening current account deficit
Exchange Rate Management	No FX intervention	Rapid currency depreciation
Remittance Policy	No incentives/mechanism	Decline in foreign exchange inflows

Table 13; Macroeconomic Outcomes (Worst Case)

Indicator	Outcome
GDP Growth	1.5%
Inflation	11% – 12%
Exchange Rate (LKR/USD)	380+
Current Account Balance	-4% of GDP

Table 14: Optimal Policy Mix and Improved Outcomes

Policy Area	Policy Instrument	Optimal Adjustment
Monetary Policy	Interest Rate	+1%
Fiscal Policy	Government Spending	+1.5% (targeted)
Tax Policy	VAT	-1%
External Sector	FX Intervention	USD 300–500 Mn
Remittances	Incentive Mechanisms	+5% increase
Trade Policy	Export Promotion	+2%
Trade Policy	Import Restriction	0.2 (moderate)
SME Development	SME Support Index	3–4 (strong support)
Tourism Sector	Tourism Promotion	+5% to +8%

Table 15: Macroeconomic Outcomes (Optimized Scenario)

Indicator	Outcome
GDP Growth	3.5% – 4.2%
Inflation	6.5% – 7.0%
Exchange Rate (LKR/USD)	325 – 335
Current Account Balance	-1.5% to -2.0% of GDP

The comparison between the worst-case and optimal policy scenarios underscores the importance of policy coherence and strategic coordination in managing macroeconomic stability. The worst-case scenario reflects a combination of policy inaction and misalignment, particularly in monetary, fiscal, and external sector management. The absence of interest rate adjustments leads to excessive inflationary pressures, while unchecked government spending exacerbates external imbalances. Furthermore, the lack of foreign exchange intervention and remittance facilitation results in severe foreign currency shortages and sharp exchange rate depreciation. Consequently, the economy experiences low growth (around 1.5%), high inflation (11–12%), and a significant current account deficit (-4% of GDP), reflecting a state of macroeconomic distress.

In contrast, the optimal policy mix demonstrates the effectiveness of a balanced and multi-dimensional approach. A moderate tightening of monetary policy helps anchor inflation expectations, while targeted fiscal expansion supports economic recovery without creating excessive external pressure. Tax adjustments, particularly a reduction in VAT, stimulate domestic demand and improve business confidence. More importantly, proactive external sector policies—including foreign exchange interventions and remittance incentives—play a critical role in stabilizing the currency and strengthening reserve positions.

Additionally, the integration of sector-specific strategies, such as strong support for SMEs and enhanced tourism promotion, significantly improves foreign exchange earnings and domestic productivity. These interventions are particularly relevant in the Sri Lankan context, where SMEs and tourism are key drivers of employment and external revenue generation.

As a result, the optimized policy framework yields a substantially improved macroeconomic outlook, with GDP growth increasing to 3.5–4.2%, inflation moderating to 6.5–7.0%, and the exchange rate stabilizing within a more sustainable range. The current account deficit also narrows considerably, indicating enhanced external sector resilience.

Overall, this analysis highlights that timely policy adjustments, institutional coordination, and targeted sectoral interventions are essential to achieving macroeconomic stability and sustainable growth in a small open economy.

7. Conclusion

The ongoing Middle East conflict presents significant risks to Sri Lanka's economic recovery. Due to its strong dependence on the region for remittances, energy imports, and export markets, Sri Lanka is highly vulnerable to geopolitical shocks.

A prolonged conflict could increase oil prices, weaken remittance inflows, disrupt trade routes, and intensify inflationary pressures. These developments could destabilize Sri Lanka's fragile macroeconomic recovery and

potentially trigger renewed balance-of-payments stress.However, proactive policy measures—including energy diversification, reenable energy deepening products, export market expansion, remittance resilience strategies, and improved macroeconomic management—can help mitigate these risks and strengthen Sri Lanka's economic resilience in an increasingly uncertain global environment.

References

Asian Development Bank (2023). Asian Development Outlook 2023.

Baker, S. R., Bloom, N., & Davis, S. J. (2016). Measuring Economic Policy Uncertainty. *Quarterly Journal of Economics*, *131*(4), 1593–1636.

Bems, R., & de Carvalho Filho, I. (2021). Exchange rate adjustments to commodity shocks. IMF.

Caldara, Dario, & Matteo Iacoviello (2022). Measuring Geopolitical Risk. *American Economic Review*, *112* (4): 1194–1225. DOI: 10.1257/aer.20191823

Central Bank of Sri Lanka (2023, 2024). Annual Report. Sri Lanka

Central Bank of Sri Lanka (CBSL). (2023). *Annual Report 2023*. Colombo: CBSL.

Gössling, S., Scott, D., & Hall, C. M. (2021). Pandemics, tourism and global change. *Journal of Sustainable Tourism*, *29* (9), 1403–1417. https://doi.org/10.1080/09669582.2020.1758708

Hamilton, J. D. (2011). Historical oil shocks. *NBER Working Paper. National Bureau of Economic Research (NBER) Working Paper 16790, February 2011.*

International Monetary Fund (IMF). (2022). *World Economic Outlook: War Sets Back the Global Recovery*. Washington, DC: IMF.

International Monetary Fund. (2022, 2023). Sri Lanka: Country report. International Monetary Fund.

International Monetary Fund. (2024). *Sri Lanka Country Report. International Monetary Fund (IMF Country Report No. 24/161).*

International Trade Centre. (2023). Trade Map database. https://www.trademap.org

Kilian, L. (2008). The Economic Effects of Energy Price Shocks. *Journal of Economic Literature, American Economic Association, 46*(4), 871-909

Kilian, L. (2022). Oil price shocks: Causes and consequences. Annual Review of Resource Economics, 14, 1–25.

Organisation for Economic Co-operation and Development. (2021). Labour migration in the Gulf. OECD Publishing.

Pesaran, M. H., Shin, Y., & Smith, R. J. (2001). Bounds testing approaches the analysis of level relationships. *Journal of Applied Econometrics*, *16*(3), 289-326. https://onlinelibrary.wiley.com/doi/abs/10.1002/jae.616

Ratha, D., De, S., Kim, E. J., Plaza, S., Seshan, G., & Yameogo, N. D. (2022). *Brief Migration and Development.* World Bank.

Sirkeci, I., Cohen, J. H., & Ratha, D. (2022). Migration and remittances in crisis contexts. Springer.

UNCTAD. (2022). *Global Trade Update*. United Nations Conference on Trade and Development.

United Nations Conference on Trade and Development. (2022, 2024). Global trade update. UNCTAD.

World Bank. (2023*). Global economic prospects, June 2023. World Bank.*

World Bank. (2023, 2024). Sri Lanka development update. World Bank.

World Tourism Organization. (2023). Tourism and global crises report. UNWTO.

World Trade Organization. (2023). Global trade outlook and statistics. WTO.

Published by the Department of Economics,
University of Colombo, Sri Lanka
ISSN 3084-8857 (Printed)
ISSN 3084 9233 (Online)

Price: Rs. 600.00