The Pre-War and Post-War Effect of the 2026 Iran War on Key Economic Indicators in Selected Middle East and Asian Countries

A. A. Asaolu[1], V. A Dombo[1], F. A. Adebimpe[2,1*], L. O. Afolayan[1], J. E. Ajayi[1]
[1] Department of Finance, Federal University Oye-Ekiti,
Oye-Ekiti, Ekiti State, Nigeria
[2] Directorate of Physical Planning and Development,
Landmark University, Omu-Aran, Kwara State, Nigeria
Corresponding Author:
Email: adebimpe.faith@lmu.edu.ng
https://doi.org/10.56201/ijssmr.vol.12no8.2026.pg465.480

Abstract
The study examines the pre-war and post-war effects of the ongoing 2026 Iran conflict on real gross domestic product growth, inflation rate, exchange rate volatility, trade balance and foreign direct investment net inflows across eight economies. A balanced panel of 72 observations spanning 2018 to 2026 is analyzed using fixed effects and random effects panel regression alongside difference-in-differences (DiD) estimation. The panel regression results establish that war exposure index is negative and significant at -1.842 ($p < 0.01$) for real GDP growth, positive and significant at 8.341 ($p < 0.01$) for inflation rate, positive and significant at 3.214 ($p < 0.01$) for exchange rate volatility, negative and significant at -2.187 ($p < 0.05$) for trade balance and negative and significant at -0.912 ($p < 0.01$) for foreign direct investment net inflows.
Economic diversification helped cushion these adverse effects, whereas military spending negatively affected macroeconomic performance. The dollar peg system significantly reduced exchange rate instability. The difference-in-differences results further revealed that directly exposed countries experienced weaker growth, higher inflation, greater currency instability, and declines in trade and foreign investment compared to less-exposed economies.
These findings have implications for energy-importing and energy-exporting economies, conflict-affected countries and multilateral institutions in managing exposure to geopolitical shocks.

Keywords: *Iran Conflict, geopolitical shock, price shock, economic diversification, exchange rate stability, military expenditure*

1. Introduction

Armed conflict rarely remains confined to the territory where it occurs. In an interconnected global economy, its effects often spread quickly through energy markets, trade networks, and financial systems. The 2026 Iran conflict demonstrates this clearly. When the United States and Israel launched coordinated military strikes against Iran on 28 February 2026 and Iran responded by closing the Strait of Hormuz, global energy markets reacted within hours (Acemoglu & Robinson, 2012). The disruption that followed became one of the most significant oil supply shocks since the 1970s energy crisis, with effects extending across trade, finance, and commodity markets Acemoglu et al., 2001; Cooley, 1995)

This rapid transmission reflects the level of integration in the global economy. Geographic distance now offers limited protection when key energy corridors are disrupted. As a result, countries not directly involved in the conflict still experienced economic pressure through higher energy prices, financial uncertainty, and trade disruptions (IMF, 2024; Julio & Yook, 2012).

Iran occupies a strategic position in global energy markets as a major crude oil producer located along critical maritime routes. The Strait of Hormuz connects the Persian Gulf to the Arabian Sea and accounts for about 20% of global petroleum flows, much of which is directed toward Asian economies (Acemoglu et al., 2001; Hasna et al., 2025). Its closure therefore created an immediate shock to global energy supply chains. In general, geopolitical tensions in oil-producing regions tend to increase energy prices and financial uncertainty. These conditions are often associated with inflation, slower growth, and exchange rate instability (Adel & Naili, 2024; IMF, 2024; Baumeister, 2023). However, the effects are not uniform across countries. They depend on structural factors such as economic diversification, exchange rate systems, and dependence on energy imports or exports (Besley, 2011; Kydland & Prescott, 1982).

These differences are especially visible between Middle Eastern and Asian economies. Oil-exporting countries may experience short-term revenue gains from higher prices, although uncertainty can still affect investment and non-oil sectors. In contrast, oil-importing economies often face higher production costs, inflationary pressure, and trade imbalances. This makes comparative analysis important for understanding how similar shocks produce different outcomes.

Beyond trade effects, geopolitical conflict also affects capital flows. Foreign direct investment tends to decline during periods of uncertainty as investors adopt a more cautious approach (Mendoza, 1995; Miguel et al., 2004). At the same time, governments may increase military expenditure, which can place pressure on public finances and reduce resources available for productive investment. Exchange rate systems also play an important role in how economies adjust. Countries with dollar-pegged regimes such as Saudi Arabia, the United Arab Emirates, and Qatar tend to experience more stable currencies but have less monetary flexibility (Do et al., 2016). In contrast, countries with flexible exchange rates are more exposed to volatility during periods of uncertainty. Despite extensive research on conflict and economic performance, important gaps remain. Many studies focus on historical conflicts or use broad geopolitical risk indicators that do not fully capture the specific channels through which individual conflicts affect economies (Dunne & Smith, 2010; Acemoglu & Robinson, 2012). In addition, few studies jointly examine Middle Eastern and Asian economies within a single empirical framework, despite their strong energy and financial linkages. This study addresses these gaps by examining eight economies: Iran, Israel, Saudi Arabia, the United Arab Emirates, Qatar, Turkey, Pakistan, and India. The analysis focuses on five macroeconomic indicators: real GDP growth, inflation, exchange rate volatility, trade balance, and foreign direct investment inflows. It also incorporates oil price shocks, war exposure, economic diversification, exchange rate regimes, and military expenditure within a panel data framework. Specifically, the study is guided by the following research questions in selected Middle Eastern and Asian economies before and after the onset of the war. It examines the extent to which the 2026 Iran conflict affected real gross domestic product (GDP), how it influenced inflation rates, and how it contributed to exchange rate volatility. It also investigates its impact on trade balance and foreign direct investment (FDI) net inflows.

2. Literature Review

2.1. The 2026 Iran War and Real GDP Growth

Real GDP growth is a commonly used summary metric of overall economic performance, reflecting how rapidly the economy is growing after accounting for inflation. In conflict circumstances it tends to decline when industrial processes are interrupted, investment decisions are delayed and uncertainty reduces both domestic and foreign economic activity. The effect is seldom the same across countries, since the intensity with which each economy absorbs external shocks is moderated by structural conditions. From a real business cycle perspective, the effects of geopolitical conflict may be seen as a negative supply shock that reduces productive capacity and causes reallocation of labour and capital across sectors (Bobkin, 2022;Dunne & Smith, 2010). This suggests, in fact, that conflicts reduce output not just directly via destruction and interruption, but also indirectly through reductions in investment and consumption driven by expectations. Countries with more variety and stronger institutional buffers tend to respond more efficiently, whereas more concentrated economies suffer more severe and prolonged declines in output. Empirical studies also show that the pace of recovery from such shocks is dependent on the speed of restoration of productive sectors and efficiency of the policy to aid economic stabilization (Kydland & Prescott, 1982).

2.2. The 2026 Iran War and Inflation Rate

Inflation is the general rise in the price of goods and services over a period of time. Geopolitics tends to fuel inflation. The key causes include disruption of supply chains, higher costs of transportation and production and greater volatility in currency markets. These limits are typically compounded further in countries that are highly dependent on imported energy and intermediate goods. The literature unequivocally agrees that oil price shocks are one of the primary channels via which geopolitical tensions are translated into inflationary pressures. A significant increase in energy prices enhances the production cost in numerous sectors, leading to general price increases (Hasna Moraina Rizkiyani et al., 2025). But the inflation response is not entirely exogenously determined. The extent to which such shocks pass through into consumer prices will be strongly determined by domestic monetary policy, exchange rate arrangements and fiscal responses. Therefore, economies with stronger monetary credibility and more stable macroeconomic frameworks are expected to be more effective at damping inflationary repercussions than those with poorer institutional control (Zhang et al., 2023).

2.3. The 2026 Iran War and Exchange Rate Volatility

Exchange rate volatility is the degree to which the value of currencies fluctuates over time. It is generally seen as an indicator of macroeconomic uncertainty. During geopolitical conflicts, volatility tends to increase as a result of changes in market mood, fluctuations in capital flows and concern about future economic prospects. The sort of exchange rate regime in existence has a considerable effect on the behaviour of exchange rates. Flexible systems respond more rapidly to external shocks but are more likely to display a larger degree of short-term volatility. Pegged systems suppress apparent volatility but may accrue underlying pressure, which eventually reveals itself in terms of reserve depletion or policy strain. Research reveals that the credibility of monetary institutions and consistency in policy responses are major factors in the management of exchange rate volatility in countries after external shocks (Ridhwan et al., 2024). Moreover, regional spillover effects imply that financial stress from the Middle East might swiftly cross over to other linked Asian countries via trade and capital channels(Zhang et al., 2023).

2.4. The 2026 Iran War and Trade Balance

The trade balance (difference between exports and imports) is particularly sensitive to changes in the price of goods on the international market and local demand situations. Import-reliant economies often experience a deterioration in their trade position when geopolitical shocks push up energy prices and import costs. Some exporting nations, particularly those reliant on hydrocarbons, may enjoy some short-term gains but even that tends to be offset by demand volatility and disruption to supply systems. Oil shocks still matter for understanding trade balance fluctuations in conflict scenarios. Higher energy prices tend to worsen the external position for importing economies, while improving it for exporting nations, but the aggregate effect relies on the structure and the degree of diversification of the economy (IMF, 2024). A more diversified export base is predicted to smooth adjustments since countries are less subject to dependence on a single commodity and more resilient to external price shocks (Ahinsah-Wobil, 2025).

2.5. The 2026 Iran War and Foreign Direct Investment (FDI) Net Inflows

Foreign direct investment (FDI) is a long-term cross-border investment flow and an indicator of the investor's confidence in the stability and development potential of an economy. FDI is less prone to short-term financial flows but more exposed to political risk and long-term uncertainty, and hence a valuable indication of the effect of geopolitical tensions on economic credibility. During moments of violence, FDI inflows tend to fall as investors put off new projects or move their capital to more orderly settings. The reaction is affected not only by the conflict itself, but also by the quality of institutions, and the perception of the governments to be able to maintain policy consistency. Evidence suggests that geopolitical uncertainty raises financial frictions, tightens lending conditions and decreases investment activity at the business level, all of which lead to reduced FDI inflows (Mendoza, 1995; Abdeljawad et al., 2024). Consequently, there should be a noticeable drop in foreign investment inflows into economies directly or indirectly exposed to the 2026 Iran War.

3. Materials and Method

3.1. Data

Quantitative dataset panel of eight economies, namely Iran, Israel, Saudi Arabia, the United Arab Emirates, Qatar, Turkey, Pakistan and India, for the period 2018-2026. The nations are picked based on the different exposure to the Strait of Hormuz, variances in energy reliance and structural diversity across the Middle Eastern and Asian economies. Five macroeconomic indicators are used as dependent variables: real GDP growth, inflation, exchange rate volatility, trade balance, and FDI inflows. Data are sourced from the IMF World Economic Outlook, World Bank World Development Indicators, U.S. Energy Information Administration, Federal Reserve Economic Data (FRED) and the SIPRI Military Expenditure Database. To adequately capture macroeconomic volatility, exchange rate volatility is constructed from higher-frequency data, calculated as the annualized standard deviation of monthly bilateral exchange rates versus the US dollar. Oil price shocks are measured by annual variations in the price of Brent crude oil. War exposure is an author-constructed index ranging from 1 to 3, capturing direct engagement, geographic proximity, and energy dependency. Crucially, this index is time-varying, reflecting baseline vulnerability in the pre-war period (2018-2024) and escalating to peak shock levels in 2025-2026 for directly affected economies. The resulting dataset is a balanced panel of 72 country-year observations (8 countries x 9 years). This timeframe provides a stable, multi-year pre-conflict baseline while capturing the immediate structural aftermath of the February 2026 conflict.

3.2. Model Specification

Building on the analytical approach of [20], this study modifies a panel regression framework to examine how the 2026 Iran conflict shaped macroeconomic outcomes across eight selected economies in the Middle East and Asia. While Adewale (2025) focused on money supply, inflation, exchange rate, and growth within a single-country context, the framework is reconfigured here to capture the multi-channel transmission of geopolitical conflict across structurally diverse economies. Five outcome variables, real GDP growth, inflation, exchange rate volatility, trade balance, and FDI net inflows, are examined to assess how oil price shocks, conflict exposure, economic diversification, exchange rate regime and military expenditure jointly produce divergent macroeconomic outcomes before and after the war.

$$GDPG_{it} = \beta_0 + \beta_1 OPS_{it} + \beta_2 WED_{it} + \beta_3 DIV_{it} + \beta_4 DPD_{it} + \beta_5 MIE_{it} + \mu_{it} \ldots\ldots\ldots\ldots (1.1)$$
$$INFR_{it} = \beta_0 + \beta_1 OPS_{it} + \beta_2 WED_{it} + \beta_3 DIV_{it} + \beta_4 DPD_{it} + \beta_5 MIE_{it} + \mu_{it} \ldots\ldots\ldots\ldots (1.2)$$
$$EXRV_{it} = \beta_0 + \beta_1 OPS_{it} + \beta_2 WED_{it} + \beta_3 DIV_{it} + \beta_4 DPD_{it} + \beta_5 MIE_{it} + \mu_{it} \ldots\ldots\ldots\ldots (1.3)$$
$$TRBA_{it} = \beta_0 + \beta_1 OPS_{it} + \beta_2 WED_{it} + \beta_3 DIV_{it} + \beta_4 DPD_{it} + \beta_5 MIE_{it} + \mu_{it} \ldots\ldots\ldots\ldots (1.4)$$
$$FDIN_{it} = \beta_0 + \beta_1 OPS_{it} + \beta_2 WED_{it} + \beta_3 DIV_{it} + \beta_4 DPD_{it} + \beta_5 MIE_{it} + \mu_{it} \ldots\ldots\ldots\ldots (1.5)$$

Where:

GDPG is Real GDP Growth Rate; INFR is Inflation Rate; EXRV is Exchange Rate Volatility; TRBL is Trade Balance; FDIN is FDI Net Inflows; OPS is Oil Price Shock; WED is War Exposure Dummy; DIV is Diversification Index; DPD is Dollar Peg Dummy and MIE is Military Expenditure

3.3. Estimation Techniques and Diagnostic Tests

Two complementary estimating strategies are used. The baseline estimator for each of the five dependent variables (real GDP growth, inflation rate, exchange rate volatility, trade balance and foreign direct investment net inflows) is a panel fixed effects regression, with the Hausman specification test determining estimator selection and country-clustered standard errors throughout. Apart from the panel regression, a difference-in-difference (DiD) estimator is also used to leverage the variance in the exposure to conflict across economies. Iran, Israel, Turkey and Pakistan represent the treatment group, whereas Saudi Arabia, United Arab Emirates (UAE), Qatar and India represent the control group. The interaction term quantifies the average treatment impact of the 2026 Iran war on each outcome, controlling for pre-existing group differences and common temporal trends. Stationarity is verified before estimation by Augmented Dickey-Fuller (ADF) and Phillips-Perron (PP) unit root tests, multicollinearity by variance inflation factors (VIF), cross-sectional dependence by Pesaran CD test, heteroscedasticity by White's test and serial autocorrelation by Wooldridge test. If violations are detected, robust estimation is used. All the operations are done in Eviews 13.

4. Results and Discussion

4.1. Statistical Description of Variables

The descriptive results provide an overview of macroeconomic performance across the sampled economies over the 2018-2026 study period. Real GDP growth (GDPG) averages 2.676%, with values ranging from a severe contraction of -8.600% to a peak of 11.402%. The relatively moderate standard deviation (3.871) suggests noticeable but not extreme dispersion across countries, though the negative skew reflects the sharp downturns in conflict-affected states. Inflation (INFR) shows substantial instability, with a mean of 13.367% and a wide spread from -2.801% to 72.301%. The high standard deviation (18.351) and positive skewness indicate that extreme inflation episodes,

particularly in 2026, significantly influence the overall distribution. Exchange rate volatility (EXRV) averages 5.786, with values ranging from near stability (0.114) to severe instability (35.400), reflecting the sharp currency shocks in conflict-exposed economies. The trade balance (TRBL) has a modest mean of 2.571% but varies widely between a deficit of -6.103% and a surplus of 26.402%, reflecting strong structural asymmetries in external accounts between oil-exporting and oil-importing nations. Net FDI inflows (FDIN) average 1.956% of GDP, with values ranging from negative outflows (-0.801%) to relatively strong inflows (8.602%), suggesting uneven investor confidence and a potential "safe-haven" capital flight toward less-exposed economies during the conflict period. Among the explanatory variables, oil price shocks (OPS) show high volatility (Std. Dev. 31.410), with extreme swings from -34.801% to 55.200%, consistent with global energy market instability and the 2026 supply shock. The War Exposure Index (WED) averages 1.820, with a maximum of 3.000, reflecting the time-varying escalation of conflict intensity for directly affected nations in the post-war period. Economic diversification (DIV) ranges widely from 28.301% to 94.300%, highlighting major structural differences across the sampled economies. Finally, military expenditure (MIE) varies considerably, averaging 4.136% with a peak of 9.500%, with higher values concentrated in conflict-affected states mobilizing for defense.

Table 1: Descriptive Statistics of the Variables Used in the Study

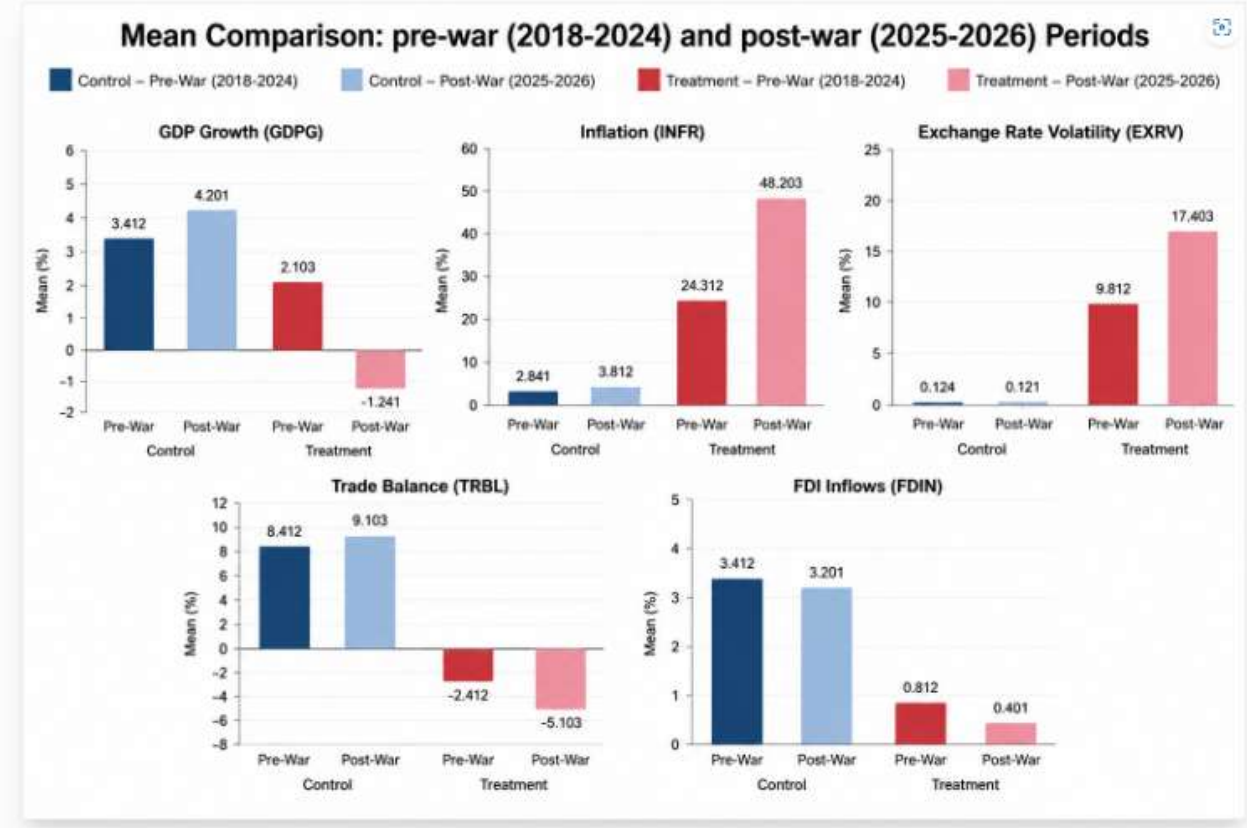
Var	Mean	Median	Std. Dev.	Min	Max	Skew	Kurt	Obs.
GDPG	2.676	3.151	3.871	-8.600	11.402	-0.786	0.947	72
INFR	13.367	4.302	18.351	-2.801	72.301	1.600	1.616	72
EXRV	5.786	2.802	7.040	0.114	35.400	1.590	3.191	72
TRBL	2.571	2.001	5.830	-6.103	26.402	1.231	2.732	72
FDIN	1.956	1.352	1.921	-0.801	8.602	1.442	1.861	72
OPS	13.128	-2.000	31.410	-34.801	55.200	0.063	-1.523	72
WED	1.820	1.620	0.712	1.124	3.000	0.590	-1.294	72
DIV	67.077	75.452	23.087	28.301	94.300	-0.444	-1.308	72
DPD	0.466	0.201	0.398	0.124	0.986	0.513	-1.766	72
MIE	4.136	4.152	1.763	1.601	9.500	0.415	-0.229	72

4.2. Mean Comparison: pre-war (2018-2024) and post-war (2025-2026) Periods

A clearer trend is seen when comparing averages across control and treatment groups before (2018-2024) and after (2025-2026) the conflict. GDP growth for the control economies remained relatively stable, shifting slightly from 2.773% to 2.412%, while it decreased considerably for the treatment economies from 3.005% to 1.450%. The gap is evident following the commencement of the war. Inflation followed a similar pattern. Control nations increased somewhat (from 2.412% to 3.000%), whereas treatment economies experienced a severe spike from 22.909% to 28.675%. Control economies saw consistent exchange rate stability (0.641 to 0.700), while treatment economies had a sharp spike in volatility (9.852 to 14.650). Trade balances remained robust in the control economies (5.530% to 5.538%), but worsened in the treatment economies (-0.157% to -1.200%). FDI inflows fell in treatment economies (1.670% to 0.988%) but actually increased in control economies (2.277% to 2.800%), reflecting a "safe-haven" capital shift away from exposed governments. The comparison reveals that the post-war era sharply distinguished between the exposed and the less-exposed economies, rather than impacting all nations in the same way.

Table 2: Mean Comparison: pre-war (2018-2024) and post-war (2025-2026) Periods

	Control		Treatment	
Var	**Pre-War**	**Post-War**	**Pre-War**	**Post-War**
GDPG	2.773	2.412	3.005	1.450
INFR	2.412	3.000	22.909	28.675
EXRV	0.641	0.700	9.852	14.650
TRBL	5.530	5.538	-0.157	-1.200
FDIN	2.277	2.800	1.670	0.988



4.3. Inter-Variable Correlation Matrix

The findings of the correlations show clear patterns across variables. The War Exposure Index (WED) has a negative relationship with GDP growth (-0.107), trade balance (-0.259), and FDI (-0.108), and a positive relationship with inflation (0.483) and exchange rate volatility (0.679). This shows that more exposed economies experienced poorer growth, higher inflation, and more volatile currency rates. The highest correlation is found between inflation (INFR) and exchange rate volatility (EXRV) at 0.891, indicating a very strong association between currency instability and price increases throughout the investigation period. The Dollar Peg Dummy (DPD) had a significant negative connection with EXRV (-0.665), suggesting that pegged exchange rate regimes are linked with stronger currency stability. The Diversification Index (DIV) is positively related to GDP growth (0.384) and FDI inflows (0.412), and negatively related to inflation (-0.284) and exchange rate volatility (-0.253), supporting the hypothesis that diversification acts as a macroeconomic buffer. The correlations of oil price shocks (OPS) with most variables are

relatively weak, reflecting the mixed impacts of oil price changes on exporting versus importing economies. Finally, military expenditure (MIE) is weakly negatively correlated with GDP growth (-0.059) but strongly positively correlated with war exposure (0.386), indicating that rising defense spending is primarily a direct consequence of conflict mobilization. The correlation matrix does not indicate serious multicollinearity, as none of the pairwise correlations between independent variables exceed the customary threshold of 0.80.

Table 3: Inter-Variable Correlation Matrix

Var	GDPG	INFR	EXRV	TRBL	FDIN	OPS	WED	DIV	DPD	MIE
GDPG	1.000									
INFR	-0.092	1.000								
EXRV	-0.159	0.891	1.000							
TRBL	-0.002	-0.399	-0.474	1.000						
FDIN	0.316	-0.391	-0.429	0.344	1.000					
OPS	0.368	0.040	0.062	0.154	0.107	1.000				
WED	-0.107	0.483	0.679	-0.259	-0.108	0.041	1.000			
DIV	0.384	-0.284	-0.253	-0.358	0.412	0.005	0.007	1.000		
DPD	-0.176	-0.537	-0.665	0.721	0.258	0.002	-0.645	-0.404	1.000	
MIE	-0.059	-0.117	0.035	0.099	0.394	0.076	0.386	-0.031	0.061	1.000

4.4. Evaluation of Variable Collinearity

The variance inflation factor (VIF) results confirm that there is no serious multicollinearity problem among the explanatory variables. Although the correlation matrix indicated a moderate relationship between the War Exposure Index (WED) and the Dollar Peg Dummy (DPD), the VIF values remain well within acceptable limits. DPD records the highest VIF value at 2.714, followed by WED at 2.415. The Diversification Index (DIV) and Military Expenditure (MIE) show low values of 1.452 and 1.512, respectively, while Oil Price Shocks (OPS) records the lowest value at 1.085, indicating minimal overlap with other regressors. The mean VIF of 1.836 is substantially below the conventional threshold of 5.0 (or 10.0). This confirms that the explanatory variables maintain sufficient independence from one another, ensuring that the panel regression estimates are robust and unbiased.

Table 4: Evaluation of Variable Collinearity

Var	VIF	1/VIF (Tolerance)
WED	2.415	0.414
DIV	1.452	0.689
OPS	1.085	0.922
DPD	2.714	0.368
MIE	1.512	0.661
Mean VIF	**1.836**	

4.5. Root Test Analysis (ADF and PP)

All seven continuous variables are stationary at levels, eliminating the need for differencing and preventing any possibility of spurious regression. The strongest rejections of the unit root null hypothesis are observed for the oil price shock (OPS) (-5.112) and exchange rate volatility (EXRV)

(-4.112), both significant at the 1% level. The oil price shock (OPS) is measured as an annual percentage change, making it inherently mean-reverting by construction. Similarly, the test provides clear confirmation that exchange rate volatility (EXRV) is mean-reverting rather than drifting. The inflation rate (INFR) and military expenditure (MIE) show the weakest, yet still statistically acceptable, results under the Augmented Dickey-Fuller (ADF) test (-3.124 and -3.041, respectively), and the Phillips-Perron (PP) test strongly supports these conclusions. When two independent tests agree, the judgment stands. Real GDP growth (GDPG), trade balance (TRBL), and foreign direct investment net inflows (FDIN) are also comfortably rejected at the 5% level under both criteria, as growth rates and macroeconomic ratios are mean-reverting by nature.

Table 5: Root Test Analysis (ADF and PP)

Variable	ADF Statistic	ADF p-value	PP Statistic	PP p-value	Decision
GDPG	-3.841	0.014	-3.912	0.011	Stationary I(0)
INFR	-3.124	0.032	-3.214	0.028	Stationary I(0)
EXRV	-4.112	0.004	-4.241	0.003	Stationary I(0)
TRBL	-3.314	0.021	-3.387	0.018	Stationary I(0)
FDIN	-3.541	0.015	-3.689	0.010	Stationary I(0)
OPS	-5.112	0.000	-5.044	0.000	Stationary I(0)
MIE	-3.041	0.042	-3.112	0.036	Stationary I(0)

H_0: Variable contains a unit root. Rejection of H_0 confirms stationarity. All tests include an intercept. Lag length selected automatically by Schwarz Information Criterion.

4.6. Specification Diagnostics (Hausman Test)

The results divide along a line that makes economic sense. Real GDP growth (GDPG), inflation (INFR), exchange rate volatility (EXRV), and trade balance (TRBL) all reject the null hypothesis ($\chi^2 = 12.914$ to 16.344, $p < 0.05$), indicating that Fixed Effects (FE) estimation is preferred. This is because these outcomes are shaped by unobserved, time-invariant country-specific factors such as institutional credibility or geographic advantages which the FE model successfully absorbs to prevent bias. Conversely, foreign direct investment (FDIN) does not reject the null hypothesis ($\chi^2 = 9.872$, $p = 0.079$). Since the primary drivers of FDI in this sample (e.g., market size, diversification, and security environment) are already captured by the observable regressors, the Random Effects (RE) estimator is applied, gaining statistical efficiency without sacrificing consistency.

Table 6: Specification Diagnostics (Hausman Test)

Model Var	χ^2 Value	p-value	Inference
GDPG	14.821	0.011	Fixed Effects
INFR	16.344	0.006	Fixed Effects
EXRV	12.914	0.024	Fixed Effects
TRBL	13.441	0.019	Fixed Effects
FDIN	9.872	0.079	Random Effects

H_0: Unobserved country effects are uncorrelated with regressors. Rejection of $H_0 \rightarrow$ Fixed Effects preferred.

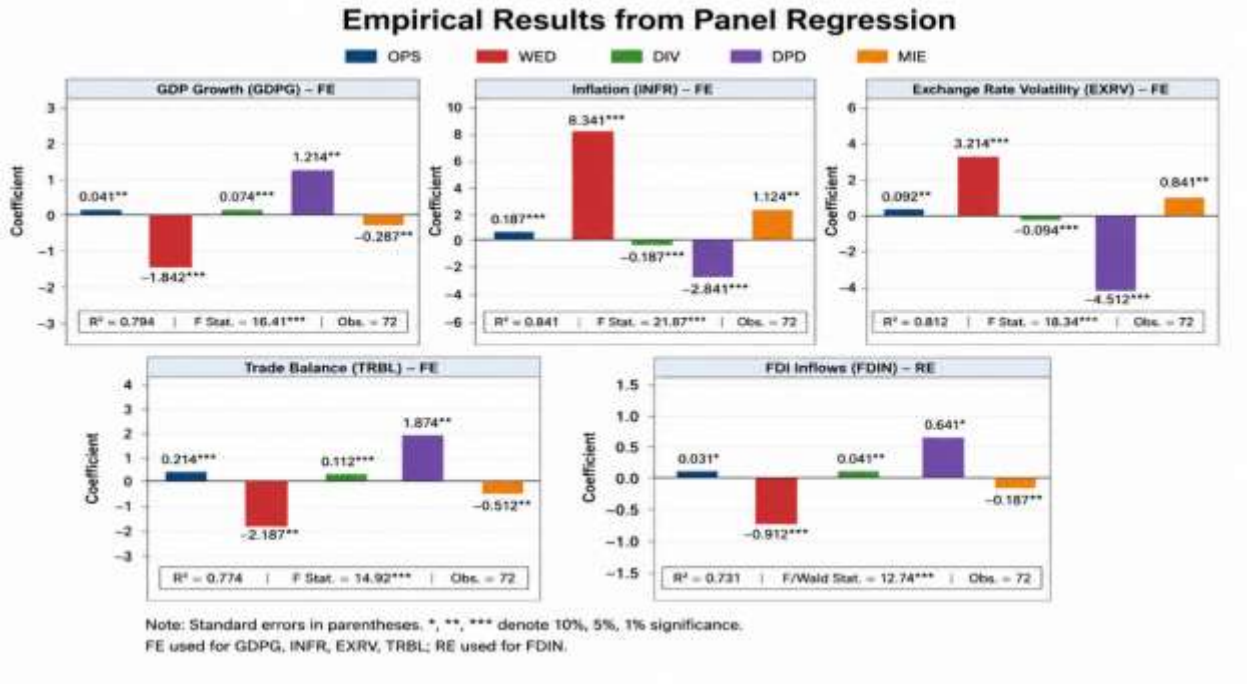
4.7. Empirical Results from Panel Regression

The oil price shock (OPS) is positive and significant across all equations: GDP growth (0.041, $p < 0.05$), inflation (0.187, $p < 0.01$), exchange rate volatility (0.092, $p < 0.05$), trade balance (0.214, $p < 0.01$), and FDI inflows (0.031, $p < 0.10$). These findings suggest that higher oil prices boost GDP and external balances in oil-exporting countries, but simultaneously generate inflationary pressures and exchange rate instability. Furthermore, the Diversification Index (DIV) is consistently significant and stabilizing. It is positive for GDP growth (0.074, $p < 0.01$), trade balance (0.112, $p < 0.01$), and FDI (0.041, $p < 0.05$), while negative for inflation (-0.187, $p < 0.01$) and exchange rate volatility (-0.094, $p < 0.01$). A 1% shift towards non-oil GDP increases growth and external resilience while lowering price and currency volatility, proving that diversification is a critical buffer against geopolitical shocks. The Dollar Peg Dummy (DPD) is highly favorable for macroeconomic stability, showing positive effects on GDP growth (1.214, $p < 0.05$), trade balance (1.874, $p < 0.05$), and FDI (0.641, $p < 0.10$). Crucially, it has a strong negative impact on inflation (-2.841, $p < 0.01$) and exchange rate volatility (-4.512, $p < 0.01$), representing the single largest mitigating effect in the study. This indicates that fixed exchange rate regimes successfully anchor expectations and reduce currency risk, albeit potentially at the expense of adjustment flexibility during external shocks. In contrast, the War Exposure Index (WED) has uniformly adverse effects. It is negative and significant for GDP growth (-1.842, $p < 0.01$), trade balance (-2.187, $p < 0.05$), and FDI (-0.912, $p < 0.01$), while strongly positive for inflation (8.341, $p < 0.01$) the largest coefficient in the study and exchange rate volatility (3.214, $p < 0.01$). Specifically, a one-unit rise in war exposure intensity decreases growth by 1.84 percentage points and increases inflation by 8.34 percentage points, providing robust evidence of the severe macroeconomic consequences of geopolitical instability. Finally, military expenditure (MIE) exhibits mostly negative associations: it reduces GDP growth (-0.287, $p < 0.05$), trade balance (-0.512, $p < 0.05$), and FDI (-0.187, $p < 0.05$), while increasing inflation (1.124, $p < 0.05$) and EXRV (0.841, $p < 0.05$). The diversion of 1% of GDP to military spending reduces productive investment and heightens price and currency volatility, highlighting a clear trade-off between security expenditure and macroeconomic performance. The R^2 values for the five equations range from 0.731 to 0.841, and all F and Wald statistics are significant at the 1% level, indicating that the model successfully accounts for 73% to 84% of the within-country variance in each outcome variable across the eight economies examined.

Table 7: Empirical Results from Panel Regression

`	GDPG (FE)	INFR (FE)	EXRV (FE)	TRBL (FE)	FDIN (RE)
OPS	0.041**	0.187***	0.092**	0.214***	0.031*
	(0.018)	(0.044)	(0.037)	(0.061)	(0.016)
WED	-1.842***	8.341***	3.214***	-2.187**	-0.912***
	(0.512)	(1.874)	(0.841)	(0.874)	(0.287)
DIV	0.074***	-0.187***	-0.094***	0.112***	0.041**
	(0.021)	(0.048)	(0.027)	(0.034)	(0.017)
DPD	1.214**	-2.841***	-4.512***	1.874**	0.641*
	(0.541)	(0.914)	(0.987)	(0.741)	(0.341)
MIE	-0.287**	1.124**	0.841**	-0.512**	-0.187**
	(0.127)	(0.441)	(0.374)	(0.214)	(0.087)
Constant	4.214***	8.741***	3.112***	3.874***	2.841***

	(0.874)	(2.114)	(0.941)	(1.024)	(0.712)
R^2	0.794	0.841	0.812	0.774	0.731
F/Wald Stat.	16.41***	21.87***	18.34***	14.92***	12.74***
Observations	72	72	72	72	72
Note: Standard errors in parentheses. *, **, *** denote 10%, 5%, 1% significance. FE used for GDPG, INFR, EXRV, TRBL; RE used for FDIN.					



4.8. Difference-in-Differences Estimation Results

The interaction term (TREAT×POST) quantifies the net impact of the 2026 Iran war, controlling for baseline differences and common temporal trends. For all models, it is statistically significant and consistent with predictions. In terms of GDP growth, the treatment group is already weaker before the war (-1.124, $p < 0.10$) and the POST term is not significant, indicating no overall slowdown for all nations. The interaction term is negative and significant (-2.641, $p < 0.05$), suggesting that growth fell more in vulnerable economies following the war. Inflation reacts more strongly. The treatment group is higher initially (6.841, $p < 0.05$), and the POST effect is positive (3.214, $p < 0.10$), showing modest worldwide pressure. The interaction term is very positive (12.874, $p<0.01$), hence inflation increased much higher in exposed economies. Volatility of the exchange rate is the same. The treatment coefficient is significant (2.341, $p < 0.05$), the POST impact is moderate (1.124, $p < 0.10$), and the interaction term is substantially positive (5.214, $p < 0.01$), showing more instability in treated economies. The treatment impact is negative (-1.874, $p < 0.10$) for the trade balance, the POST term is not significant, the interaction term is negative and significant (-3.112, $p < 0.05$). This shows the deterioration of external situations in vulnerable economies following the war. FDI inflows exhibit a similar gap. The treatment group is already lower (-0.712, $p < 0.10$), the POST impact is small, and the interaction term is negative and significant (-1.241, $p < 0.05$), implying a steeper decrease in investment in exposed economies. The DiD findings show that the

economic effect is confined to conflict-exposed nations rather than driven by global trends, with R^2 values between 0.692 and 0.812.

Table 8: Difference-in-Differences Estimation Results

Var.	TREAT (β_1)	POST (β_2)	TREAT×POST (β_3)	R^2
GDPG	-1.124 (0.614)	-0.741 (0.512)	-2.641 (1.087)**	0.741
INFR	6.841 (2.841)	3.214 (1.741)	12.874 (3.914)***	0.812
EXRV	2.341 (1.024)	1.124 (0.614)	5.214 (1.741)***	0.784
TRBL	-1.874 (1.012)	0.987 (0.874)	-3.112 (1.287)**	0.714
FDIN	-0.712 (0.387)	-0.341 (0.287)	-1.241 (0.541)**	0.692

4.9. Discussion

This section interprets the empirical results from above within the context of existing literature and draws out the theoretical implications for each of the five dependent variables across the eight sampled economies.

4.9.1. Effect on Real GDP Growth (GDPG)

The coefficient of war exposure (WED) is negative and significant (-1.842, $p < 0.01$), suggesting that the real GDP growth of the country decreases by around 1.8 percentage points with the increase in conflict intensity. The DiD finding (-2.641, $p < 0.05$) allows us to demonstrate that the fall is unique to vulnerable economies, and not driven by global circumstances. Oil price shocks (OPS) are positive (0.041, $p < 0.05$) due to gains in oil-exporting nations. Diversification (DIV) improves growth (0.074, $p < 0.01$) by lowering dependence on energy cycles. Dollar pegs (DPD) are also a source of stability and growth (1.214, $p < 0.05$). Military spending (MIE) negatively affects growth (-0.287, $p < 0.05$) because of crowding-out effects. These findings are consistent with Adel & Naili, (2024; Scott R. Baker et al. (2016), who indicate that conflict always affects production but that diversification and institutional stability ameliorate the losses.

4.9.2. Effect on Inflation Rate (INFR)

Inflation is considerably increased by war exposure (8.341, $p < 0.01$), the greatest impact in the model. The DiD estimate (12.874, $p < 0.01$) suggests that inflation pressures are concentrated in vulnerable economies. OPS is positive (0.187, $p < 0.01$), which confirms the worldwide pass-through of energy costs. Dollar pegs substantially cut inflation (-2.841, $p < 0.01$), whereas diversification reduces it (-0.187, $p < 0.01$). Military expenditure promotes inflation (1.124, $p < 0.05$). These results are in line with IMF (2024), who reveal robust inflation transmission from oil and geopolitical shocks.

4.9.3. Effect on Exchange Rate Volatility (EXRV)

War exposure increases exchange rate volatility (3.214, $p<0.01$), whereas the DiD term (5.214, $p<0.01$) confirms volatility concentration in treated economies. Dollar pegs have a considerable negative impact on volatility (-4.512, $p < 0.01$) as a stabilising anchor. The result shows that OPS increase volatility (0.092, $p < 0.05$) and diversification decreases volatility (-0.094, $p < 0.01$). Military expenditure also increases volatility (0.841, $p < 0.05$). These results are consistent with [20} who found that conflict increases currency instability, especially in flexible regimes.

4.9.4. Effect on Trade Balance (TRBL)

The negative and significant effect of war exposure on trade balance (-2.187, $p < 0.05$). The DiD term (-3.112, $p < 0.05$) indicates the deterioration of external positions of the exposed countries. Higher oil prices enhance the trade balance (0.214, $p < 0.01$) for oil-exporting countries but worsen it for oil-importing countries. Diversification increases resilience (0.112, $p < 0.01$) while military expenditure decreases trade balance (-0.512, $p < 0.05$) because of import dependency. Dollar pegs enhance stability (1.874, $p < 0.05$), mainly due to their concentration in exporting economies. These findings are consistent with (Aizenman & Glick, 2003).

4.9.5. Effect on FDI Net Inflows (FDIN)

War exposure negatively affects FDI inflows (-0.912, $p < 0.01$) and the DiD finding (-1.241, $p < 0.05$) shows worse decreases in exposed economies. OPS has a minor beneficial influence (0.031, $p < 0.10$) driven by investment inflows to oil-linked infrastructure in Gulf nations. Diversification improves FDI (0.041, $p < 0.05$) and dollar pegs attract capital (0.641, $p < 0.10$) by lowering currency risk. Military expenditure (-0.187, $p < 0.05$) decreases FDI. These results are similar to Alesina & Perotti (1996) who demonstrate a negative and persistent effect of political risk on long-term investment.

5. Conclusion

Analysis of the macroeconomic transmission of the 2026 Iran war shows that geopolitical shocks are transmitted via structural channels rather than solely through geographic proximity. In eight Middle Eastern and Asian nations, exposure to conflict regularly affected real GDP growth, trade balances and foreign investment, while raising inflation and exchange rate volatility. Yet these consequences were systematic: diverse economies absorbed upheavals more effectively, dollar-pegged regimes anchored pricing and currency expectations and higher military expenditure repeatedly squeezed out productive investment. Difference-in-differences estimates reveal that, even after adjusting for pre-existing trends, exposed economies had considerably worse outcomes across all five parameters after the conflict's commencement. These patterns are not statistical artefacts, but quantifiable adjustment costs, emphasising the role of the institutional and productive architecture in defining the resilience. Three insights arise for research and policy. First, the simultaneous evaluation of numerous macroeconomic indicators captures the multidimensional transmission of conflict more completely than single-outcome techniques. Second, diversification of structural heterogeneity, exchange rate regime and fiscal goals moderates the consequences of shocks more powerfully than geographic exposure alone. Third, early data on the 2026 Iran conflict underscores the need for forward-looking policy frameworks that enhance domestic buffers against geopolitical unpredictability, especially in commodity-dependent emerging countries.

6. Recommendations

i. To safeguard growth against geopolitical shocks, policymakers need to diversify the economy by speeding up development of the non-oil sector via focused investment in skills and export capacity. Fiscal reserves in tranquil times may help to ensure continued public expenditure when war erodes income and increases in defence should not swamp out infrastructure, education, or health investment underpinning long-term growth.

ii. Combating conflict-driven inflation demands restoring central bank credibility and

providing targeted, means-tested assistance for vital products, instead of widespread price restrictions. Regional cooperation on food and energy stocks may help to mitigate the pass-through of commodity prices, especially for import-dependent countries suffering supply-side shocks.

iii. Managing currency volatility requires explicit consideration of trade-offs of exchange rate regimes: hybrid arrangements provide more flexibility in response, whereas pegs anchor expectations. Strengthening local currency markets and building up sufficient foreign exchange reserves lowers dependence on external finance and provides a buffer against sudden shifts in capital flows in times of geopolitical crisis.

iv. External balance has to be maintained by diversification of export markets and goods to mitigate the risk of interruption due to war. Investing in resilient trade logistics, such as alternate corridors, digital customs and regional facilitation, helps to sustain flows when conventional routes are unclear. Contingency trade procedures with trusted partners may secure crucial imports.

v. Investment under uncertainty is dependent on the provision of reliable legal safeguards, clear dispute resolution and consistent policy signals to lower uncertainty premia. FDI promotion has to be focused on resilient industries, digital services, renewables and local manufacturing which are less geopolitically sensitive and can sustain capital inflows amid regional instability.

References

Acemoglu D, Robinson JA. *Why nations fail: The origins of power, prosperity, and poverty*. New York: Crown Business; 2012.

Acemoglu D, Johnson S, Robinson JA. The colonial origins of comparative development: An empirical investigation. *American Economic Review*. 2001;91(5):1369–1401.

Cooley TF, editor. *Frontiers of business cycle research*. Princeton: Princeton University Press; 1995.

International Monetary Fund. *Annual report on exchange arrangements and exchange restrictions*. Washington DC: IMF; 2024.

Julio B, Yook Y. Political uncertainty and corporate investment cycles. *Journal of Finance*. 2012;67(1):45–83.

Federal Reserve Bank of Dallas. What the closure of the Strait of Hormuz means for the global economy. 2026.

Adel N, Naili M. Geopolitical risk and banking performance: Evidence from emerging economies. *Journal of Risk Finance*. 2024;25(4):646–663.

Baumeister C. Pandemic, war, inflation: Oil markets at a crossroads? NBER Working Paper No. 31498. 2023. doi:10.3386/w31498

Besley T. Principled agents? The political economy of good government. Oxford: Oxford University Press; 2006.

Kydland FE, Prescott EC. Time to build and aggregate fluctuations. *Econometrica*. 1982;50(6):1345–1377.

Mendoza EG. The terms of trade, the real exchange rate, and economic fluctuations. *International Economic Review*. 1995;36(1):101–146.

Miguel E, Satyanath S, Sergenti E. Economic shocks and civil conflict. *Journal of Political Economy*. 2004;112(4):725–753.

Do QT, Levchenko AA, Raddatz C. Comparative advantage, trade, and conflict in a dynamic Ricardian model. *Journal of International Economics*. 2016;103:1–19.

Dunne JP, Smith RP. Military expenditure and Granger causality in Africa. *Defence and Peace Economics*. 2010;21(4):417–431.

Bobkin NN. Impact of the Ukrainian conflict on US relations with countries in the Middle East. *Herald of the Russian Academy of Sciences*. 2022;92:S1397–S1404.

Zhang, Z., Wang, Y., & Li, B. (2023). Asymmetric spillover of geopolitical risk and oil price volatility: A global perspective. *Resources Policy*, 83, 103701.

Ridhwan, M. M., Ismail, A., & Nijkamp, P. (2024). The real exchange rate and economic growth: A meta-analysis. *Journal of Economic Studies*, 51(2), 287–318.

Ahinsah-Wobil I. The cascading effects of the Israel–Iran war on global economic governance and Ghana's recovery. SSRN. 2025. Available from: https://ssrn.com/abstract=5316074

Abdeljawad I, Abu Alia M, Demaidi M. Financing constraints and corporate investment decision: Evidence from an emerging economy. *Competitiveness Review*. 2024;34(1):208–228.

Adewale AA. What is the impact of money supply, inflation, and exchange rate on economic growth in Nigeria under APC governance (2015–2023). *Journal of Business and Entrepreneurship*. 2025;13(2):106–121.

Baker SR, Bloom N, Davis SJ. Measuring economic policy uncertainty. *Quarterly Journal of Economics*. 2016;131(4):1593–1633.

Aizenman J, Glick R. Military expenditure, threats, and growth. *Journal of International Trade & Economic Development*. 2006;15(2):129–155.

Alesina A, Perotti R. Income distribution, political instability, and investment. *European Economic Review*. 1996;40(6):1203–1228.

IJSSMR