

Caught in the Middle: Pakistan's Diplomatic Tightrope and Economic Risk in a US-Iran Conflict

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Abstract

The outbreak of hostilities between the United States, Israel, and Iran on February 28, 2026, have forced major updates to the geopolitical risk factors across the developing world. For Pakistan, an economy that is reliant on money sent back by citizens from the Gulf region and on financing from Gulf States, the situation is likely the largest external economic shock since the 2008 global financial crisis. This paper examines the channels through which the U.S.-Iran War (February 28, 2026 - May 28, 2026) penetrated Pakistan's economic frontiers. Based on U.N. System and International Monetary Fund documents, and reports from major economic and development policy multilateral organizations, the paper identifies four main threats: 1) the partial closing of the Straits of Hormuz and the subsequent spike of crude oil prices, 2) the estimated 5 million Pakistanis who work in the Gulf Cooperation Council and the potential loss of their remittances, 3) the disruption of Pakistan's International Monetary Fund (IMF) program, and 4) volatility in the market, evidenced by a record collapse in one day of the KSE 100 Index. The paper also considers the potential macroeconomic benefits of Pakistan's unique geopolitical position. The findings on geographic and financial structure indicate that the war's impacts on the Pakistan economy will not be fully explained by the choices made in policy.

Keywords: *US-Iran War 2026; Pakistan Economy; Geopolitical Risk; Energy Security; Remittances; Strait of Hormuz; IMF Program; KSE100*

1. INTRODUCTION

On 28 February 2026, the United States and the State of Israel executed a series of coordinated, precision military operations against the Islamic Republic of Iran, marking the formal commencement of what has since been widely documented and assessed by leading geopolitical institutions as the most strategically significant and consequential military confrontation to unfold across the Middle East in several decades. The operations were meticulously planned and deliberately targeted Iran's nuclear research and development infrastructure, its strategic military installations, and key nodes of senior regime leadership, resulting in the reported deaths of several high-ranking officials an event that precipitated immediate and far-reaching regional escalation across multiple theaters of conflict (Britannica, 2026; CFR, 2026). In direct and swift retaliation, Iranian military forces launched a series of retaliatory military responses directed at United States installations throughout the broader region, critical energy infrastructure spanning multiple Gulf Cooperation Council member states, and civilian and commercial maritime traffic traversing the Strait of Hormuz the strategically vital and geographically narrow maritime chokepoint situated between the Omani coastline and the southern border of Iran, through which approximately twenty percent of the world's total daily oil and liquefied natural gas supply is transported, rendering it one of the most consequential passages for global energy security and international trade in the modern era (S&P Global, 2026).

For Pakistan, a country that has a 900-kilometer border with Iran, strong economic relations with the Gulf Cooperation Council, and is under continual supervision by the International Monetary Fund (IMF), the war was not a remote geopolitical event. From the first morning of attacks, the war was an economic crisis on the home front. Prime Minister Shehbaz Sharif even put it that way in his comments stating that the not-so-distant past has seen an increase of USD 300 Million - USD 800 Million in the Oil Import Bill and has virtually undone the gains made in stabilization of the economy over the last two years (Al Jazeera, 2026).

This article uses a systematic literature review approach to contextualize the economic vulnerabilities of Pakistan within the scope of global geopolitical risks. This is the first attempt to go beyond documenting the damage. This involves the identification of the structural pathways through which external military conflict permeates a fragile, open, import-dependent economy. The objective of this is to allow policymakers facing similar situations to learn from these case studies.

2. THEORETICAL AND CONCEPTUAL FRAMEWORK

This study is built on two interrelated theories. The first is the Geopolitical Risk (GPR) developed by Caldara and Iacoviello (2022). In this context, geopolitical stress is a phenomenon that can be described, analyzed, and measured with respect to its impacts on investments, capital flows, and economic output. The GPR is useful for describing how and why uncertainty, as opposed to actual disruption, is transmitted in financial markets and in the pricing of sovereign risk. The second tradition, Dependency Theory suggests that the economically peripheral regions in the global system of core economies are structurally vulnerable to the decisions of the core economies (Cardoso and Faletto, 1979). Pakistan demonstrates this structural dependency remarkably: it imports nearly all energy from a geopolitically unstable region, has a diaspora in the same region which sends remittances, and funds its current account through international creditors whose confidence is affected by geopolitical stability. Combined, these frameworks demonstrate that Pakistan is impacted by regional conflict in ways far beyond the phenomenon of rising oil prices. This analysis highlights the urgency of the situation, while also demonstrating that the experience Pakistan is facing is qualitatively different from the experience it has suffered during past oil shocks.

3. RESEARCH DESIGN AND METHODOLOGY

3.1. Research Approach

The present study utilizes a qualitative, interpretivist research paradigm. Using qualitative methods is justified due to the emerging, contemporary nature of the topic. Large-scale quantitative data on the economic repercussions of the war remain scarce. Thus, systematic literature reviews are the most effective way to collect research on this contemporary topic. The systematic literature review used for this study adopted the PRISMA framework (Moher et al., 2009), which is a structured literature review protocol that incorporates a series of preliminary steps for identifying, evaluating, and synthesizing research that seeks to reduce research bias.

3.2. Data Sources

The primary source categories were: (1) multilateral agency reports, specifically Oxford Economics, S&P Global Market Intelligence, and IMF country assessments; (2) reliable mainstream international media, specifically Al Jazeera Economy, The Diplomat, Arab News, and CNN International; (3) Pakistan specific financial and policy media, namely Pakistan Today (Profit), The Express Tribune, and The Friday Times; and (4) conflict encyclopedias, namely Britannica Event Tracking, Council on Foreign Relations Global Conflict Tracker, and Wikipedia's

documented series on the 2026 Iran War. All accessed sources were consulted between 28 February and 31 May 2026.

3.3. Analytical Method

The collected data were examined using thematic analysis, revealing four major themes. These include the transmission of energy prices, disruption of remittance channels, fiscal stress to the sovereign level, and uncertainty in capital markets. The findings section below is organized around these theme clusters.

4. BACKGROUND: THE WAR THAT CHANGED THE REGION

To analyze the economic consequences of the conflict on Pakistan, one must first understand the origin and progression of the conflict. Tensions between the US and Iran had been ongoing for decades and worsened after the US's withdrawal from the Joint Comprehensive Plan of Action in 2018 during Trump's first term (CFR, 2026). To strengthen the sanctions, the US and its allies decided to expand the sanctions, making Iran's economy and currency weaker. By late 2025, Iran was in a state of unrest, marked by mass protests against the volatile economy, inflation, and the collapse of the Iranian rial (CNN, 2026).

The military phase began at dawn on 28 February 2026. Joint US-Israeli airstrikes killed Supreme Leader Khamenei and targeted what officials described as existential threats: Iran's nuclear facilities and ballistic missile infrastructure (CFR, 2026; Britannica, 2026). Iran's immediate response was multidirectional it targeted US military facilities across the region, struck energy infrastructure in Gulf States, and moved to restrict shipping through the Strait of Hormuz. By 4 March 2026, the Strait faced effective closure, which the International Energy Agency characterized as "the largest supply disruption in the history of the global oil market" (IEA, as cited in Wikipedia, 2026).

Brent crude closed the day before the strike at about \$72 a barrel, and surged to over \$120 a barrel after the closure of the Hormuz (Wikipedia, 2026). Qatar Energy declared force majeure for all of the exports of contracts of Liquefied Natural Gas (LNG). The combined oil production of Iraq, Saudi Arabia, the UAE and Kuwait fell by 10 million barrels per day. These disruptions were the worst since the 1973 Oil Crisis. For contracting economies like Pakistan, these disruptions were a cause of widespread suffering.

5. FINDINGS: FOUR TRANSMISSION CHANNELS

5.1. The Energy Price Shock and the Disintegration of Fiscal Progress

Pakistan fulfills almost all its petroleum needs through imports, purchasing both crude and refined oil from the Gulf. Because of this, Pakistan's economic issues from oil price fluctuations go beyond the cycle, and are of a structural nature. Pakistan's energy concerns worsened when it effectively closed the Strait of Hormuz in March 2026.

Oxford Economics predicted that in the second quarter of 2026, oil would be around \$113, and this price had nothing to do with the assumptions from the prewar period used for Pakistan's fiscal plans (Arab News, 2026). Pakistan's Prime Minister Sharif said that the oil imports had gone from \$300 million to \$800 million a month and this was not just a number, it means that for the previous two years of reforms, the fiscal account had improved by \$6 billion, this was now all gone, the two years of economic reforms had been completely wasted in a matter of weeks (Al Jazeera, 2026).

Analysts claimed the government was faced with a politically volatile "either-or" choice. Option A demanded the government pass the full price hike on to consumers. Option B demanded the government violate the IMF's \$7 billion Extended Fund Facility (EFF) conditionality to offer consumers the price difference. Initially, the government attempted to negotiate subsidy approval from the IMF, but that offer was rejected in April 2026 (Al Jazeera, 2026). Consequently, on April 3, 2026, Pakistan reported an unprecedented increase in fuel prices, which reached PKR 458.40 per liter for petrol, and high speed diesel was PKR 520.35. This improvement was over 40 percent in a month, which caused nationwide protests that worsened inflation (Wikipedia - Pakistan in the 2026 Iran War, 2026).

Disruption in the supply chain of fertilizers additionally stressed Pakistan's food supply and the economy's most rural sector, agriculture. Pakistan relies on the import of ammonium phosphate (DAP), and sales of this fertilizer input had already fallen 23 percent during the previous Rabi season before the full war shock was felt (The Diplomat, April 2026). In financial analysis, the energy shock of this war carried a largely neglected agricultural component; it will have lasting effects on rural employment and food inflation which are likely to survive the war long after it is concluded.

5.2. The Remittance Threat: Pakistan's Hidden External Lifeline at Risk

Pakistan's remittances aren't a side resource. They are the structural foundation. The 2025-2026 fiscal year showcased a trade deficit of \$28 billion. Incoming remittances totaled almost \$30 billion, entirely closing the trade deficit. Over 50% of remittances originate from countries of the Gulf Cooperation Council. There are about 5 million Pakistani workers in the GCC (The Diplomat, April 2026b). The dependency on remittances is so deep that annual remittance inflows are greater than annual export earnings (The Diplomat, April 2026b).

The US-Iran war intensified the stress on this lifeline in two major ways. First, the Iranian strikes on Gulf Emirate energy facilities and Gulf commercial and transport networks disrupted the working environment for the Gulf economies and lowered the demand for migrant workers. Also, the Iranian strikes on critical Gulf infrastructure caused an exodus of Western workers. This diminished the demand for construction, hospitality, and retail work, further limiting the employment opportunities for Pakistani and Indian workers (The Diplomat, April 2026b).

Second, lack of clarity of the region's stability has curtailed new migration outflows. Each year, between 700k-800k Pakistanis move to the Gulf for work. With the crisis, this pipeline of outmigration has become uncertain. It has been projected that 1.4 million Pakistani migrants in the Gulf may have to return showing that a remittance loss of \$3-4 billion may be possible (The Diplomat, April 2026a). Such a situation will worsen Pakistan's current account at the same time the oil imports are worsening the economy.

5.3. Sovereign Risk, the IMF Program, and the Fragility of Stabilization

By early 2026, Pakistan had reason to be cautiously optimistic about its economy. In March, a current account surplus was achieved for the first time in 14 years (Pakistan Today, 2026). The recovery from the inflationary spike and the rupee stabilize with a recent trading range of PKR 278-279 per dollar, and a reported 6.5% year-on-year growth rate of large-scale manufacturing for the month of February 2026. Additionally, the sovereign credit rating of Pakistan was confirmed to 'B' with a stable outlook in April 2026 by Fitch (Pakistan Today, 2026). By Pakistan's standards, this fragile recovery was an improvement.

The ongoing Iran War has placed this recovery at existential risk. From an extended Middle Eastern conflict in the major Asia Pacific economies, Pakistan is classified as the highest risk from macro financial stress as a result of its reliance on external trade and especially the large-scale external financing needs, as well as remittances, especially for on-going financing (Arab News, May 2026). Concerns are focused on the gross external financing requirement of Pakistan for the years 2026-2030, which is projected to be an average of \$24 billion a year (Arab News, May 2026).

Under the revised commodity price baseline, Oxford Economics' projections show a dismal picture. Declines in Pakistan's foreign exchange reserves post-War, which were at \$20.8 billion, would plummet to \$6.8 billion by 2026 and reach a dangerous level of \$1.6 billion by 2028 (Arab News, April 2026). The figures indicate the onset of a balance of payments crisis. The situation is equally concerning politically and economically. The IMF's conditionality impacts the government's fiscal space at the same time as the public's needs for government spending to provide relief are the greatest.

5.4. Capital Market Volatility: The KSE100 as a Barometer of Fear

The outbreak of hostilities resulted in immediate, severe volatility in the Pakistani capital markets. On the first trading day, March 2, 2026, following the US and Israeli attacks, the Pakistan Stock Exchange (PSX) suffered a market halt due to a circuit breaker failure. By the end of the trading day, the KSE100 had recorded a loss of 16,089 points, down 9.57% closing at 151,973. This was the largest percentage decrease in the PSX's history (Express Tribune, 2026).

A paradox noted in the market collapse was the fact that, at the time, Pakistan was not directly militarily involved in the hostilities and the immediate macroeconomic impact was, at that time, still negligible. In the words of Mohammed Sohail, Chief Executive Officer of Topline Securities, "panic selling was the result of leveraged and overbought positions" and the Pakistani Rupee and government bonds remained stable implying that the collapse was the result of a psychological phenomenon instead of a structural event (Express Tribune, 2026). This phenomenon, described above, is consistent with the evidence that in a frontier market like Pakistan, geopolitical events affect market behavior beyond the impact of the event itself and result in a self-reinforcing cycle of collapsing market confidence. The weeks after the April ceasefire saw a partial recovery. On the ceasefire's first trading day, the KSE100 climbed between 1,000 to 1,500 points. There was a big recovery in the energy, cement, and banking sectors, which are the sectors most affected by fuel costs and macroeconomic stability (The Friday Times, 2026). In the early hours of interbank trading, the rupee gained ground by 0.5 to 1 percent. These market movements confirmed the relationship. Pakistan's capital markets are very sensitive to the US-Iran conflict, and the KSE100 has become, in a sense, a real time index of the war's economic impact.

6. PAKISTAN AS DIPLOMATIC MEDIATOR: A STRUCTURAL NECESSITY

One of the notable developments from the 2026 war was the recognition of Pakistan's diplomatic mediation between the US and Iran. Pakistan facilitated a two-week ceasefire, which was further extended, and conducted the first Islamabad Talks on 10 and 11 April 2026. A second round was to occur later in April (Wikipedia -- Pakistan in 2026 Iran War, 2026). This was Pakistan's most vital diplomatic activity since Pakistan's role in the US-China rapprochement in the early 1970s.

Beyond the historic diplomatic significance of this development is a structural economic necessity. Pakistan has a 900 km border with Iran and has deep historical ties with Iran, and, simultaneously, Pakistan has a security and economic relationship with the US and the Gulf States. Due to these relations, Pakistan can communicate with all the involved parties, and is also vulnerable to the high costs of an elongated war (The Diplomat, April 2026a). As the following analysis indicates, each week of war adds about \$500 million to Pakistan's yearly import bill, while also threatening remittance inflows and reducing the confidence of potential investors.

The mediation role has positive economic benefits for Pakistan. A ceasefire that is either brokered or maintained through Pakistani diplomatic engagement would be economically beneficial to Pakistan due to: (1) the relief granted to the commodity price shock on Pakistan's import bill, (2) stabilization in remittances due to stable Gulf labor markets, (3) further strengthening of Pakistan's position to multilateral lenders, and (4) goodwill from both the US and the Gulf that could improve economically through aid funding or debt relief. Pakistan's Foreign Minister Ishaq Dar's meeting with US Secretary of State Marco Rubio in July 2025 and the subsequent hosting of the Islamabad Talks suggests that these assumptions are correct and that the situation has largely been planned and positional (CNN, 2026).

7. DISCUSSION

This article provides evidence that demonstrates structural pathways, as opposed to the generally expected cyclical pathways, of Pakistan's economic exposure to the US-Iran war. Pakistan's energy dependency, the concentration of its remittances in the Persian Gulf, the presence of an IMF programmed with restricted fiscal space, and a capital market that demonstrates geopolitical panic are not recent issues. They are the result of Pakistan's structural decisions over decades.

The 2026 war has systematically and in a mutually reinforcing manner, activated Pakistan's geopolitical

vulnerabilities. Increased oil prices worsen fiscal space. Reduced remittances also worsen the current account. A capital market sell-off increases the cost of funding. The IMF programmed limits the fiscal response. The ongoing diplomatic mediation, while economically rational, puts Pakistan in a position of reduced investor certainty.

The current geopolitical situation is unprecedented because of the unique simultaneous nature of the vulnerabilities. There have been times of acute stress on Pakistan's geopolitical economy. For example, Pakistan was in a financially rewarding position on the side of the US after 9/11. There was also an unprecedented situation during the 2008 Financial Crisis when the price of oil decreased. The 2026 war is a totally negative shock to all of Pakistan's vulnerabilities.

The findings suggest how policymakers in Pakistan and economically similar countries on the frontiers should treat the challenges of structural economic reform. The depth of crises borne of an inability to diversify energy sources, export markets, and remittance is also a function of relative periods of stability. For example, Pakistan's exposure to the 2026 War could have been substantially lower had it had a less concentrated profile of remittances, a greater diversity of export markets, or a greater diversity of energy sources.

8. CONCLUSION AND POLICY IMPLICATIONS

This article posits that the US-Iran war of 2026 constitutes a major stress test for Pakistan's macroeconomic architecture not for any potential direct military engagement, but for Pakistan's systemic, structural integration with the Gulf Region's economic system. The four transmission channels identified energy price shocks, remittance disruption, IMF program stress, and capital market instability are not standalone phenomena. Rather, they represent an interconnected exposure, wherein every transmission channel amplifies the others.

Pakistan's role as a mediator in the Iran–US conflict is of great value, both from a geopolitical and an economic perspective, as each day of facilitated ceasefire is, in fact, a day of economic respite for the people of Pakistan. The crisis has created five urgent immediate tasks for Pakistan's policymakers: (1) engage with multilayered creditors to create emergency liquidity frameworks, (2) implement temporary, targeted energy subsidies to high-vulnerability households while protecting IMF program integrity, (3) invest diplomatically to maintain and widen the ceasefire, (4) diversify energy in the medium term by developing domestic renewable energy to reduce structural import reliance, and (5) enhance trade and remittance diversification to reduce the high concentration of Gulf Region reliance.

The implications for international political economy are evident: as geopolitical tensions escalate, frontier

economies that are structurally homogeneous and highly concentrated will experience greater collateral damage from events that they are not involved in. Recognizing and addressing these issues is an important aspect of economic prudence and necessary for national resiliency.

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