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Geopolitical Risk and Macroeconomic Spillovers in a Frontier Market: The Sectoral Transmission of the US–Iran–Israel Conflict to Ethiopia

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Abstract: *The escalating geopolitical tensions between the United States, Iran, and Israel in 2025–2026 have generated significant global economic disruptions through oil price volatility, maritime chokepoint closures, and trade route diversions. Frontier markets, particularly landlocked, net oil-importing economies, face asymmetric vulnerability to such distant geopolitical shocks. This study examines the transmission channels and sectoral impacts of the US–Iran–Israel geopolitical conflict on Ethiopia's economy, providing a disaggregated analysis of how the shock propagates across productive sectors. Drawing on projections from the International Monetary Fund, the World Bank, national authorities, and sectoral reports, the analysis employs a qualitative and analytical approach, synthesizing available data to construct a comprehensive sectoral impact assessment across energy, maritime trade, agriculture, industry, transport, construction, and household welfare. Findings: The conflict transmits through four primary channels; energy prices, maritime logistics, agricultural inputs, and remittances. While Ethiopia's GDP growth remains robust at 9.2 percent, inflation has accelerated to 13.9 percent, reversing prior moderation. The fiscal position faces strain from increased subsidy outlays, and the birr faces persistent depreciation pressure. Agriculture confronts acute vulnerability through fertilizer shortages (a 68% channels: urea price surge) and elevated shipping costs; the industry faces rising energy costs and supply chain bottlenecks; transport experiences soaring operational costs; and urban households bear the regressive burden of rising food prices, with 15–15. 9 million people are facing a crisis or emergency food insecurity. Ethiopia's experience exposes profound structural vulnerabilities characteristic of frontier markets. The crisis offers a strategic opportunity to accelerate the renewable energy transition, diversify supply chains, and strengthen macroeconomic buffers. Recommendations: Policymakers should establish strategic fuel reserves, diversify port access and fertilizer sources, maintain fiscal consolidation while protecting pro-poor expenditures, and adequately fund social safety nets.*

Keywords: *Geopolitical Risk, Frontier Markets, Sectoral Transmission, Macroeconomic Spillovers, Ethiopia*

I. Introduction

1.1 Background and Context

The geopolitical landscape of the Middle East has long been defined by intricate rivalries, yet the escalating confrontation between the United States, Iran, and Israel has emerged as one of the most consequential flashpoints for the global economy in the contemporary era. The tensions represent the culmination of years of strategic rivalry and regional competition, with a decisive turning point arriving with the brief but intense Iran–Israel war of June 2025, which significantly raised the level of confrontation (Samoura, 2026). By 2026, the situation had escalated further after joint U.S. and Israeli strikes targeted Iranian infrastructure and senior regime figures, intensifying fears of a broader regional conflagration (Samoura, 2026). At the center of this confrontation stand three main actors: Iran, seeking to consolidate its position as a regional power; Israel, viewing Iran's nuclear ambitions and Tehran-backed armed groups as a direct security threat; and the United States, aiming to maintain strategic dominance in the region, protect its allies, and ensure the stability of global energy supplies while containing Iranian influence (Samoura, 2026).

The economic consequences of the conflict have been immediately visible worldwide. One of the most pronounced effects has been a sharp increase in oil prices, which exceeded $100 per barrel in March 2026, representing a rise of roughly 30 percent within a short period (Samoura, 2026). This surge is closely linked to Iranian threats to disrupt shipping in the Strait of Hormuz, a route through which approximately 35 percent of global seaborne crude oil and 20 percent of liquefied natural gas transit (Raydan, 2025). The instability has also pushed up natural gas prices, which in turn affects the cost of producing synthetic fertilizers, an essential component of global agricultural systems (Samoura, 2026). International trade has similarly felt the strain, as rising insecurity in maritime routes across the Red Sea and the Persian Gulf has increased freight costs and insurance premiums for shipping companies, slowing global supply chains and creating additional pressure on transportation sectors (Samoura, 2026).

1.2 Ethiopia's Unique Vulnerability

Among the constellation of African frontier markets, Ethiopia presents a particularly instructive case study of geopolitical shock vulnerability. Classified as a quintessential frontier market, Ethiopia exhibits a confluence of structural characteristics that magnify its exposure to distant geopolitical disturbances. First, as a landlocked nation since the independence of Eritrea in 1993, Ethiopia channels more than 95 percent of its trade volume, including essential commodities such as oil, food, and machinery, through the Port of Djibouti (Horn Review, 2025). This profound structural dependency on a single maritime corridor situated adjacent to the volatile Red Sea and Gulf of Aden; renders the economy acutely susceptible to disruptions in regional shipping lanes. The economic stakes are immense: with over 95 percent of import-export traffic channeled through Djibouti, the country faces escalating logistics costs that impede its economic trajectory and regional ambition (Pima County Public Library, n.d.). The closure of Port Sudan due to Sudan's civil war has eliminated a crucial alternative trade route, reinforcing Ethiopia's overreliance on Djibouti and underscoring the strategic necessity of diversified sea access (Horn Review, 2025).

Second, Ethiopia remains a net oil-importing economy with chronic foreign exchange constraints that have persisted for over a decade. The Ethiopian currency, the birr, has experienced frequent devaluations, further deterring trade and complicating payment mechanisms for Djiboutian trucking firms. Any disruption in the Strait of Hormuz would likely trigger a sharp rise in global oil prices, escalating Ethiopia's already high import costs and exacerbating inflation already worsened by the depreciation of the birr and shrinking foreign currency reserves (Horn Review, 2025). The World Bank has identified Ethiopia among financially vulnerable economies in eastern and southern Africa that are particularly exposed to external shocks, with the surge in energy and agricultural input costs expected to add significant strain (World Bank, 2026).

Third, Ethiopia's economy depends heavily on agricultural exports; coffee alone generated a record $3 billion in export earnings during the 2025/26 fiscal year, accounting for a substantial portion of foreign exchange receipts (Xinhua, 2026) while simultaneously relying on imported fertilizers to sustain agricultural productivity. Ethiopia has been importing urea and DAP (diammonium phosphate) for the last 50 years, with the Ethiopian Agricultural Businesses Corporation launching tenders for substantial volumes of these critical inputs (Africa Fertilizer Watch, 2025). Rising fertilizer prices, driven by higher natural gas costs, could significantly affect agricultural production across the continent, where farming remains a cornerstone of many national economies (Samoura, 2026).

1.3 Problem Statement

Despite the extensive body of scholarship examining the macroeconomic consequences of geopolitical risk, a notable lacuna persists in the literature concerning the sectoral transmission mechanisms through which distant geopolitical shocks propagate into fragile, landlocked frontier African states. The existing GPR literature has predominantly focused on advanced economies and major emerging markets, with limited disaggregated analysis of how such shocks differentially affect productive sectors; agriculture, industry, transport, and services, in structurally vulnerable economies. Caldara and Iacoviello (2022) provided the foundational empirical framework, demonstrating that geopolitical risk shocks generate persistent declines in investment and employment. However, subsequent research has largely aggregated macroeconomic indicators without systematically disaggregating sectoral impacts. As Fitch Solutions (2026) notes, the conflict will impact Sub-Saharan Africa via two primary transmission channels: shifts in global investor sentiment and commodity price volatility. Yet the specific pathways through which energy price shocks, maritime logistics disruptions, agricultural input cost increases, and remittance contractions transmit into the domestic economies of landlocked frontier markets remain empirically underexplored. The Ethiopian case, despite its representativeness as a frontier market with acute structural vulnerabilities, has received scant attention in the GPR literature. This study addresses these gaps by providing a sectorally disaggregated analysis of how the US–Iran–Israel conflict transmits macroeconomic shocks to Ethiopia's economy.

II. Review of Literature

2.1 Geopolitical Risk (GPR) and Macroeconomic Spillovers

The conceptual foundation for understanding the economic consequences of geopolitical tensions is anchored in the Geopolitical Risk (GPR) literature, most notably operationalized by Caldara and Iacoviello (2022), who constructed a news-based measure of adverse geopolitical events and associated risks for 26 countries. Their seminal work demonstrated that shocks to the GPR index lead to persistent declines in investment, employment, and stock prices, with elevated GPR associated with reduced investment and employment, heightened disaster probability, and increased downside risks (Caldara & Iacoviello, 2022). The authors employed a structural vector autoregression (SVAR) framework to estimate the macroeconomic effects of geopolitical risk for the U.S. economy, finding that a GPR shock generates a significant and protracted contraction in real activity.

The empirical literature on geopolitical risk has expanded considerably since the foundational work of Caldara and Iacoviello. Subsequent research has examined the spillover effects of geopolitical tensions across national borders and asset classes. Studies have demonstrated that geopolitical risk raises bond yields and leads to exchange rate depreciation, with stronger and more persistent effects observed in emerging economies compared to advanced economies. Using panel regressions and panel SVAR frameworks, researchers have established that country-specific geopolitical risk significantly affects capital flow volatility and asset market performance across 29 emerging and advanced economies over the period 2000–2023.

The transmission of geopolitical shocks through commodity markets, particularly oil has received substantial attention in the literature. Empirical estimation based on counterfactual shock analysis reveals that a 1 percent positive shock to geopolitical risk amplifies financial stress indices, with the magnitude of transmission varying across regional blocs. Research has also explored how fluctuations in global oil prices and geopolitical tensions reshape the spread of financial risk among firms worldwide, with findings indicating that geopolitical tensions have a stronger impact on energy firms than oil price changes alone, and that developed-country firms show stronger, more significant responses to oil and geopolitical shocks than developing-country firms.

2.2 Transmission Mechanisms in Net-Importing Frontier Economies

The theoretical underpinnings for analyzing how external shocks transmit into small, open, and import-dependent economies draw from the open-economy macroeconomics framework, particularly the Mundell-Fleming model. The Mundell-Fleming framework, developed by Fleming (1962) and Mundell (1963), provides the canonical model for understanding the interactions between the goods market, money market, and balance of payments in an open economy. The model's core insight—that a small open economy cannot simultaneously maintain independent monetary policy, free capital mobility, and a fixed exchange rate—remains fundamental to understanding the policy constraints facing economies like Ethiopia. In the context of oil price shocks, the Mundell-Fleming framework predicts that an exogenous increase in oil prices—which functions as a combined demand and supply shock—should result in decreasing GDP growth. Oil price increases act as a tax on consumption and an adverse productivity shock, raising production costs across sectors that rely on petroleum products as intermediate inputs. For net oil-importing economies, the deterioration in the terms of trade generates a negative income effect, reduces aggregate demand, and puts downward pressure on the domestic currency.

The SVAR approach has emerged as the dominant empirical methodology for estimating the dynamic effects of geopolitical and commodity price shocks. Caldara and Iacoviello (2022) employed a structural VAR framework to identify the causal effects of geopolitical risk shocks. Subsequent research has extended this methodology to emerging markets, employing panel VAR frameworks to examine the effects of geopolitical risk on capital flow volatility and asset markets. Research on African economies has explored how global shocks affect these economies through different transmission channels, with findings indicating that African emerging markets are more resilient to global shocks, whereas fragile and oil-exporting economies remain highly vulnerable.

2.3 Ethiopia's Macroeconomic Structure in Literature

Ethiopia's macroeconomic structure is characterized by persistent and widening trade deficits. Overall, Ethiopia's net trade in goods and services has shown a declining trend, deteriorating from a negative value of less than USD 1 billion in 2000 to a deficit of over USD 14 billion in 2016. This structural imbalance reflects the economy's heavy reliance on imports of capital goods, petroleum products, and consumer goods, juxtaposed against a narrow export base dominated by agricultural commodities.

Fuel import dependency represents a particularly acute vulnerability. Ethiopia spends approximately $4.2 billion on fuel imports annually, straining its foreign currency reserves. The country currently pays $10–15 more per barrel for Brent crude than the global average, a cost that has tested its trade balance and weakened currency market stability. This premium reflects the additional costs associated with landlocked transportation and logistics. Despite being a renewable electricity powerhouse, Ethiopia remains deeply dependent on imported petroleum products for transportation, manufacturing, and logistics, creating a precarious equilibrium: a renewable electricity powerhouse whose broader economy remains vulnerable to fossil-fuel shocks beyond its control. The country's macroeconomy is characterized by a high foreign debt burden, inflation, unemployment, budget deficit, and foreign currency crunch.

2.4 Identification of Research Gap

Despite the extensive body of scholarship examining the macroeconomic consequences of geopolitical risk, a notable lacuna persists in the literature concerning the sectoral transmission mechanisms through which distant geopolitical shocks propagate into fragile, landlocked frontier African states. The existing GPR literature has predominantly focused on advanced economies and major emerging markets, with limited disaggregated analysis of how such shocks differentially affect productive sectors; agriculture, industry, transport, and services, in structurally vulnerable economies.

Caldara and Iacoviello (2022) provided the foundational empirical framework, demonstrating that geopolitical risk shocks generate persistent declines in investment and employment. However, the subsequent literature has largely aggregated macroeconomic indicators without systematically disaggregating sectoral impacts. As the literature on African economies has demonstrated, African emerging markets exhibit heterogeneous responses to global shocks, with fragile and oil-exporting economies remaining highly vulnerable. Yet the specific pathways through which energy price shocks, maritime logistics disruptions, agricultural input cost increases, and remittance contractions transmit into the domestic economies of landlocked frontier markets remain empirically underexplored.

2.5 Conceptual Framework

The conceptual framework guiding this analysis is illustrated in the causal chain below, which traces the transmission of the geopolitical shock from its origin in the Middle East to its ultimate effects on Ethiopia's sectoral output and inflation shown in Figure 1.

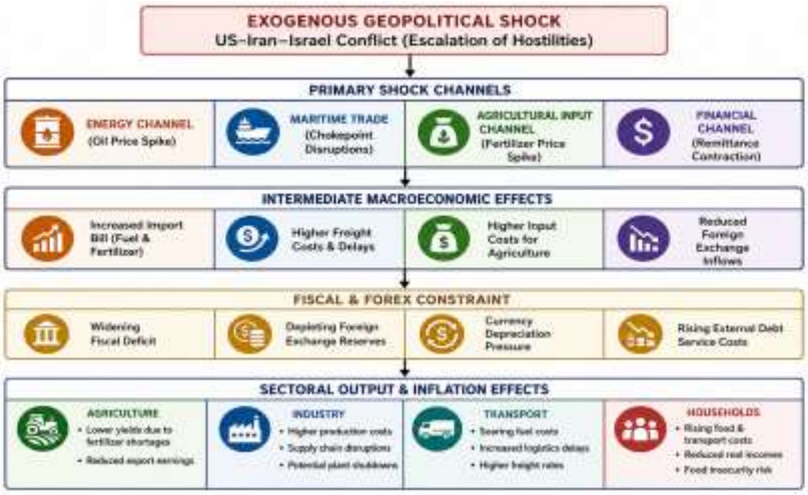

Figure 1. Conceptual framework illustrating how the US-Iran-Israel conflict propagates through energy, trade, finance, and agriculture to generate macroeconomic, fiscal, sectoral, and household impacts

Source: Author's elaboration based on Caldara and Iacoviello (2022) and the open-economy macroeconomics literature.

The framework begins with the exogenous geopolitical shock, the escalation of the US–Iran–Israel conflict. This shock generates four primary transmission channels: (1) the energy channel, operating through oil price spikes; (2) the maritime trade channel, operating through disruptions to critical chokepoints (Strait of Hormuz, Red Sea, Gulf of Aden); (3) the agricultural input channel, operating through fertilizer price increases driven by higher natural gas costs; and (4) the financial channel, operating through reduced remittance inflows from the Gulf region.

III. Research Methods

This section operationalizes the sectoral transmission framework by examining four primary channels through which the US–Iran–Israel geopolitical shock transmits to the Ethiopian economy: energy, maritime trade logistics, agricultural inputs, and external finance. Each channel is analyzed with reference to Ethiopia's structural vulnerabilities and the specific mechanisms through which distant geopolitical disturbances propagate into domestic economic outcomes.

3.1 Energy Channel

Ethiopia's economy exhibits a profound structural dependency on imported petroleum products that permeates virtually every productive sector. The country's economy is heavily dependent on imported petroleum products, with petroleum constituting one of the most important commodities in social, political and economic terms (Ethiopian Petroleum Supply Enterprise, 2025). Diesel fuels agricultural mechanization and freight transport, heavy fuel oil powers industrial facilities, and gasoline sustains urban mobility and the burgeoning logistics sector. This dependency persists despite Ethiopia's remarkable achievements in renewable electricity generation, creating a paradoxical energy profile: a renewable electricity powerhouse whose broader economy remains acutely vulnerable to fossil-fuel shocks (Horn Review, 2025).

The geopolitical escalation in the Middle East has exerted immediate and substantial pressure on Ethiopia's energy import bill. Brent crude prices surged above $107 per barrel following the closure of the Strait of Hormuz, representing a sharp escalation from already elevated levels (Samoura, 2026). Ethiopia currently pays $10–15 more per barrel for Brent crude than the global average, a cost that has tested its trade balance and weakened currency market stability (Horn Review, 2025). This premium reflects the additional logistical costs associated with landlocked transportation and reflects the broader structural disadvantage facing the Ethiopian economy (World Bank, n.d.).

The pass-through of global oil price increases to domestic fuel retail prices has been partially but not completely absorbed through a massive state subsidy program. The Ethiopian government has committed a staggering 272 billion Birr state subsidy program designed to prevent the total pass-through of global price hikes to a population already facing macroeconomic pressures (Ministry of Trade and Regional Integration, 2025). The scale of this fiscal commitment is evident in the operations of the Ethiopian Petroleum Supply Enterprise (EPSE), the country's sole importer of petroleum products. EPSE recorded 457.35 billion Birr in revenue during the 2024/25 fiscal year, nearly doubling the 259.37 billion Birr reported a year earlier (Ethiopian Petroleum Supply Enterprise, 2025). However, the cost of supplying petroleum products reached 496.14 billion Birr, creating a significant operational gap partially offset through government support mechanisms (Ethiopian Petroleum Supply Enterprise, 2025). To bridge this deficit, EPSE recorded 40.39 billion Birr in claims from the fuel price stabilization fund, a sharp increase from 11.9 billion Birr the previous year (Ethiopian Petroleum Supply Enterprise, 2025).

Despite these substantial subsidies, domestic fuel prices have risen appreciably. Effective May 2025, gasoline prices rose by 10 birr to 122 birr per liter, while diesel and kerosene prices increased from 106 birr to 116 birr per liter (Ministry of Trade and Regional Integration, 2025). By December 2025, benzene prices had climbed to 129.12 birr per liter (Ministry of

Trade and Regional Integration, 2025). The government has signaled its intention to phase out fuel subsidies entirely, with authorities continuing to spend around 300 billion Birr subsidizing the import and distribution of petroleum products even after hiking retail prices (Ethiopian Business Review, 2026). This trajectory suggests that any further escalation in global oil prices would necessitate either deeper subsidy commitments or sharper pass-through to domestic consumers, both of which carry significant macroeconomic consequences (International Monetary Fund, 2026) (Table 1).

Table 1. Ethiopia's Fuel Price Evolution and Subsidy Burden (2024–2026)

Indicator	2023/24	2024/25	2025/26 (Projected)
EPSE Revenue (Billion Birr)	259.37	457.35	650+
EPSE Cost of Sales (Billion Birr)	~280	496.14	700+
Fuel Stabilization Fund Claims (Billion Birr)	11.9	40.39	75+
Retail Gasoline Price (Birr/Liter)	~85	122	129+
Retail Diesel Price (Birr/Liter)	~80	116	116+

Note. Data compiled from Ethiopian Petroleum Supply Enterprise (2025) audited financial statements and Ministry of Trade and Regional Integration (2025) price announcements.

3.2 Maritime and Trade Logistics Channel

Ethiopia's landlocked geography creates a structural dependency on the Port of Djibouti that magnifies the transmission of maritime disruptions into the domestic economy. Ethiopia depends on Djibouti for over 95 percent of its foreign trade, with 9.5 million tons of Ethiopian cargo passing through the port in 2025 alone (Institute of Foreign Affairs, 2025). This concentration of trade through a single corridor exposes the economy to acute vulnerability whenever maritime chokepoints—particularly the Red Sea and the Gulf of Aden—experience disruptions (Horn Review, 2025; World Bank, n.d.).

The geopolitical escalation has compounded existing maritime insecurity. Even before the Iran war, global shipping patterns were distorted by attacks on merchant vessels in the Red Sea, pushing major container lines to reroute around the Cape of Good Hope (UNCTAD, 2026c). The escalation with Iran added a second shock, with carriers facing simultaneous disruptions around both the Red Sea and the Gulf (UNCTAD, 2026c). Danish shipping giant Maersk, which maintains a significant footprint in Ethiopia and operates a multi-purpose consolidation centre at Modjo Dry Port, announced it would temporarily reroute certain sailings around the Cape of Good Hope, avoiding the Suez Canal (Institute of Foreign Affairs, 2025). Given that Maersk handles a substantial share of Ethiopia's containerised trade, any disruption in Red Sea operations could ripple through Ethiopian supply chains, affecting manufacturing, exports, and import costs (Institute of Foreign Affairs, 2025).

The financial implications are substantial. Annual port-related fees are estimated between USD 1.5 and 2 billion, nearly one-third of Ethiopia's projected 2025 export earnings of USD 5.3 billion (Institute of Foreign Affairs, 2025). Prime Minister has previously remarked that "the amount of money spent on these charges could be used to build the Renaissance Dam every three years," highlighting the economic pressure of the port dependency (Institute of Foreign Affairs, 2025). Logistics costs account for an estimated 20–30 percent of final goods costs in Ethiopia, far above the global average of 8–12 percent (World Bank, 2025).

The impact extends to inland logistics infrastructure, particularly the Modjo Dry Port. A single missing customs document or a container buried deep in a congested yard incurs steep daily storage and demurrage fees (Institute of Foreign Affairs, 2025). Demurrage charges typically range from US$50 to US$250 per container per day (Institute of Foreign Affairs, 2025). With increased shipping delays and port congestion resulting from Red Sea diversions, container turnaround times have lengthened, and these accumulated overheads force local companies to inflate the shelf prices of everyday consumer goods and factory raw materials (Institute of Foreign Affairs, 2025). The combined effect of Gulf disruptions and existing Red Sea challenges could create serious bottlenecks for trade, particularly for sectors reliant on imports from the Gulf and Asia (UNCTAD, 2026b; World Bank, 2026).

Figure 2: Ethiopia's Maritime Trade Dependency and Cost Structure

Note. Author's elaboration based on data from Institute of Foreign Affairs (2025), World Bank (n.d., 2025), and UNCTAD (2026c).

Figure 2 illustrates Ethiopia's heavy dependence on maritime trade through the Port of Djibouti and demonstrates how geopolitical disruptions in the Red Sea and Strait of Hormuz propagate through the national economy. Shipping rerouting, rising freight charges, insurance premiums, and extended transit times increase logistics costs and port congestion at Modjo Dry Port. These disruptions elevate consumer prices, weaken export competitiveness, and exacerbate supply chain inefficiencies, highlighting Ethiopia's vulnerability to external maritime and geopolitical shocks.

3.3 Agricultural Inputs Channel

Ethiopia's agricultural sector, accounting for approximately 35 percent of GDP and employing over 70 percent of the population, faces acute vulnerability through its dependence on imported fertilizers (Ethiopian Business Review, 2026; World Bank, 2025). The country imports over 90 percent of its nitrogen fertilizer requirements, primarily from Gulf States including Saudi Arabia, the UAE, and Iran, with shipments routed through the Red Sea corridor already strained by months of disruptions (Ethiopian Business Review, 2026). Ethiopia imported $1.2 billion worth of fertilizer in 2023, making it one of Sub-Saharan Africa's largest fertilizer importers (Africa Fertilizer Watch, 2025; Ethiopian Business Review, 2026).

The geopolitical escalation has triggered a surge in global urea prices, with U.S. futures jumping approximately $130 per tonne in the first two days following the strikes (Ethiopian Business Review, 2026). This price shock, combined with supply chain disruptions affecting shipments through the Red Sea corridor, threatens the availability and affordability of critical agricultural inputs just as the critical belg planting season approaches (Ethiopian Business

Review, 2026; Samoura, 2026). Principal staple crops including teff, wheat, maize, sorghum, and barley are deeply dependent on timely fertilizer availability (Ethiopian Business Review, 2026).

The threat to fertilizer supply poses a direct risk to Ethiopia's flagship agricultural initiatives. The wheat self-sufficiency program, which seeded over 2.7 million hectares for the 2025/2026 summer irrigation season and aims for total production of 340 million quintals—depends critically on adequate fertilizer application (Ethiopian Business Review, 2026). Any shortfall in fertilizer availability or affordability could undermine these ambitious production targets and reverse hard-won gains in food self-sufficiency (Ethiopian Business Review, 2026).

Three intersecting domestic stresses compound the external shock. Ongoing conflict in Amhara, Tigray, and Oromia regions has severed logistics corridors critical for fertilizer distribution, with Amhara alone accounting for roughly half of national millet and cereal production (Ethiopian Business Review, 2026). The International Committee of the Red Cross distributed only 1,550 metric tonnes of fertilizer across all three regions in mid-2025, highlighting the structural gap (Ethiopian Business Review, 2026). Concurrently, an IMF-linked subsidy reform program is compressing farmer purchasing power at precisely the wrong moment (International Monetary Fund, 2026). The government spent 16 billion birr on fertilizer subsidies in 2024 and is committed to reducing them to 0.3 percent of GDP by FY 2026 (Ethiopian Business Review, 2026). Smallholders have almost no ability to absorb price increases without reducing application rates (Ethiopian Business Review, 2026).

Ethiopia's landlocked position adds another layer of vulnerability. Its primary import corridor runs through the Port of Djibouti, exposed to the same Red Sea disruptions affecting the broader region. While a small but growing share of fertilizer is beginning to flow through Kenya's Lamu Port following a maiden 60,000 metric ton discharge from Morocco in May 2025, this diversification is nascent and unlikely to cover a meaningful supply gap during the 2026 planting season (Ethiopian Business Review, 2026). FEWS NET's November 2025 analysis already placed large portions of East Hararghe at Emergency food insecurity levels, with Crisis conditions widespread across the south and southeast (Ethiopian Business Review, 2026). Any additional squeeze on fertilizer availability or affordability in early 2026 will land on communities with little remaining resilience (Ethiopian Business Review, 2026; World Bank, 2026) (Table 2).

Table 2. Ethiopia's Fertilizer Dependency and Supply Chain Vulnerabilities

Dimension	Indicator	Source
Import Dependency	Over 90% of nitrogen fertilizer imported	Ethiopian Business Review (2026)
Primary Suppliers	Saudi Arabia, UAE, Iran	Ethiopian Business Review (2026)
Import Value (2023)	USD 1.2 billion	Ethiopian Business Review (2026)
GDP Contribution	Agriculture: ~35% of GDP	World Bank (2025)
Employment	Over 70% of population	World Bank (2025)
Wheat Program	2.7M hectares seeded (2025/26)	Ethiopian Business Review (2026)
Subsidy Spending (2024)	16 billion birr	Ethiopian Business Review (2026)
Price Shock	U.S. urea futures +$130/tonne	Ethiopian Business Review (2026)

Note. Data compiled from Ethiopian Business Review (2026) analysis and World Bank (2025) country reports.

3.4 External Finance and Remittances Channel

The external finance channel encompasses two distinct but interconnected transmission mechanisms: diaspora remittances and sovereign credit dynamics. Both are sensitive to geopolitical uncertainty and risk perception, and both have significant implications for Ethiopia's foreign exchange position and fiscal sustainability (World Bank, 2025, 2026).

IV. Result and Discussion

This section assesses the aggregate macroeconomic impacts of the US–Iran–Israel geopolitical shock on Ethiopia's economy. Drawing on projections from the International Monetary Fund (IMF), the World Bank, and national authorities, the analysis examines five interconnected dimensions: economic growth, inflation dynamics, fiscal balances, balance of payments and foreign exchange constraints, and foreign direct investment.

4.1 Economic Growth (GDP)

Ethiopia's economic growth trajectory has been remarkably resilient in the face of the geopolitical shock, though the conflict has introduced significant headwinds that temper the otherwise optimistic outlook. The IMF projects Ethiopia's real GDP growth at 9.2 percent in 2026, more than double the Sub-Saharan Africa regional average (International Monetary Fund, 2026a). This projection positions Ethiopia as the second-fastest-growing economy in the world, behind only Guyana (International Monetary Fund, 2026a). The Ethiopian government has adopted an even more optimistic stance, revising its GDP growth forecast upward to 10.2 percent in February 2026, the first double-digit growth projection since 2016/17 (Ministry of Finance, Ethiopia, 2026). The government predicts economic growth of 10.1 percent for the 2026/27 fiscal year (Ministry of Finance, Ethiopia, 2026) (Table 4). However, these headline figures obscure the adverse sectoral impacts already manifesting as a result of the Middle East conflict. The United Nations Development Programme (UNDP, 2026) notes that all sectors; industry, agriculture, and services are expected to expand during this period, yet the transmission channels identified in Section 3 are exerting differential pressures. The industrial sector faces particular vulnerability. Power shortages exacerbated by diverted diesel supplies, as fuel shipments are redirected to meet emergency needs or face delays due to maritime disruptions have constrained manufacturing output (UNDP, 2026). Energy-intensive industries including cement, textiles, and agro-processing have experienced operational cost hikes that threaten production continuity (UNDP, 2026). The services sector, while expected to grow, faces slowing momentum as elevated transport costs and reduced household purchasing power dampen domestic demand (UNDP, 2026).

The World Bank has lowered its growth forecast for Sub-Saharan Africa to 4.1 percent in 2026, down from an earlier 4.4 percent forecast, reflecting the economic fallout from the US–Iran conflict (World Bank, 2026a). For Ethiopia, an oil-importing economy already grappling with macroeconomic pressures, the surge in energy and agricultural input costs is expected to add strain (World Bank, 2026a). The World Bank identifies Ethiopia among financially vulnerable economies in eastern and southern Africa that are particularly exposed to external shocks (World Bank, 2026a). Andrew Dabalen of the World Bank noted that "energy and fertilizer prices have risen sharply," with the duration and scale of disruptions remaining uncertain (as cited in World Bank, 2026a). The combined pressures of rising import costs, constrained fiscal space, and uncertain external inflows could weigh heavily on Ethiopia's economic outlook in the near term (World Bank, 2026a; UNDP, 2026).

Table 3. Ethiopia's GDP Growth Projections (2025–2027)

Source	2025	2026	2026/27
IMF	9.2%*	9.2%	—
Government of Ethiopia	10.1%**	10.2% (revised)	10.1%
UNDP	7.2%	7.1%	—

Note. IMF projects 9.2% for 2026 (International Monetary Fund, 2026a). Government projects 10.1% for 2025/26 and 2026/27 (Ministry of Finance, Ethiopia, 2026). UNDP projects 7.2% for 2025 and 7.1% for 2026 (UNDP, 2026).
*2025 estimate; **2025/26 fiscal year projection.

4.2 Inflation Dynamics

The geopolitical shock has exerted significant upward pressure on Ethiopia's inflation trajectory, reversing a prior trend of moderation and threatening household purchasing power. The IMF had projected consumer prices to increase by 11.8 percent in 2026 (International Monetary Fund, 2026a), but actual outturns have exceeded this forecast. The annual inflation rate in Ethiopia rose to 13.9 percent in June 2026, marking the highest level in a year and accelerating from 13.4 percent in the previous month, according to the Ethiopian Statistical Service (Ethiopian Statistical Service, 2026). The Ethiopian Statistical Service confirmed that annual consumer inflation stood at 13.9 percent in June, rising from 13.4 percent in May (Ethiopian Statistical Service, 2026; BusinessDay, 2026).

The inflationary pressures are predominantly cost-push in nature, driven by escalating transport and production costs that feed into headline inflation through multiple channels (BusinessDay, 2026). Food inflation rose to 15.1 percent in June, maintaining a steady upward trajectory from 15 percent in May, 13.5 percent in April, and 11.7 percent in June 2025 (Ethiopian Statistical Service, 2026). According to the Ethiopian Statistical Service (2026), the monthly surge in food prices was largely driven by higher costs for vegetables, fruit, bread, cereals, meat, fish, and seafood, alongside price increases for milk, cheese, eggs, coffee, tea, and cocoa (BusinessDay, 2026). Non-food inflation accelerated to 12.2 percent in June, up from 11.1 percent in May, 9.1 percent in April, and 7.0 percent in March (Ethiopian Statistical Service, 2026). In the non-food category, upward price pressure was primarily felt in clothing and footwear, household furnishings, restaurants and hotels, as well as alcoholic beverages and tobacco (Ethiopian Statistical Service, 2026; BusinessDay, 2026).

The central bank has acknowledged the role of the Middle East conflict in driving inflationary pressures. According to a statement from the National Bank of Ethiopia's Monetary Policy Committee, "Inflation, which had eased following the macroeconomic reforms introduced in July 2024, began accelerating again from April, partly due to fuel supply disruptions linked to the conflict in the Middle East" (National Bank of Ethiopia, 2026, para. 3). In response, the National Bank raised its benchmark policy rate by 100 basis points to 16 percent and lifted the 14 percent annual credit growth cap previously placed on commercial banks (National Bank of Ethiopia, 2026).

The inflationary impact is eroding real household incomes, particularly in urban centers including Addis Ababa and Dire Dawa, where households are more dependent on purchased food and transport services (BusinessDay, 2026; Ethiopian Statistical Service, 2026). The earlier moderation in consumer prices proved short-lived, despite monetary policy tightening (National Bank of Ethiopia, 2026). The World Bank has warned that Sub-Saharan Africa's growth is projected to remain at 4.1 percent in 2026, but rising geopolitical risks threaten that outlook (World Bank, 2026a).

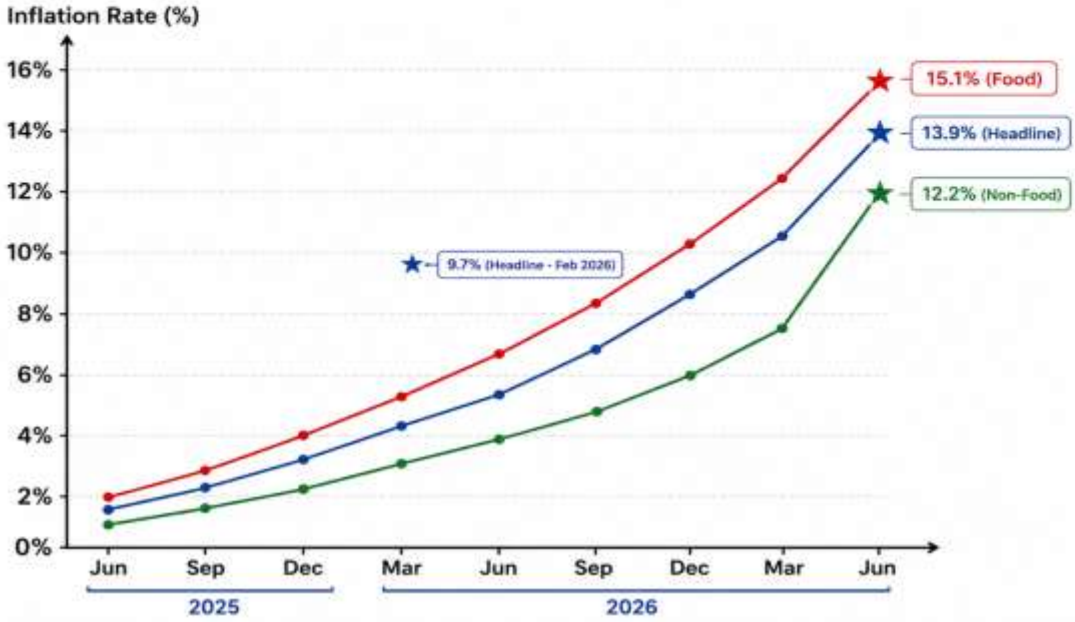

Figure 3. Projected evolution of headline, food, and non-food inflation under escalating geopolitical disruptions affecting Ethiopia's import-dependent economy and prices

Note. *Author's elaboration based on data from Ethiopian Statistical Service (2026) and National Bank of Ethiopia (2026).*

Figure 3 illustrates the projected acceleration of Ethiopia's inflation under intensified geopolitical disruptions affecting global energy and trade corridors. Headline inflation is expected to rise from 9.7% in February 2026 to approximately 13.9%, while food inflation reaches 15.1%, substantially exceeding non-food inflation (12.2%). The divergence reflects the stronger sensitivity of food prices to higher fuel costs, fertilizer shortages, transportation bottlenecks, and import disruptions triggered by instability in the Red Sea and Strait of Hormuz (World Bank, 2025a; IMF, 2025). Although non-food inflation also increases because of elevated production and logistics costs, the steeper rise in food inflation highlights Ethiopia's dependence on imported agricultural inputs and external supply chains. These inflationary pressures erode household purchasing power, intensify food insecurity, and complicate macroeconomic stabilization and monetary policy implementation (FAO, 2024).

4.3 Fiscal Balances

The geopolitical shock has placed substantial strain on Ethiopia's fiscal position through two primary channels: increased subsidy outlays and potential revenue contraction. The Ethiopian government has increased fuel subsidies since the Iran war started (TRT Afrika, 2026). Finance Minister Ahmed Shide announced that overall spending was projected to rise to roughly 2.34 trillion birr ($14.69 billion) in the 2026/27 fiscal year, up from 1.92 trillion birr in the current fiscal year (TRT Afrika, 2026). "This increase mostly takes into account expenses related to the Middle East crisis," the minister told lawmakers (as cited in TRT Afrika, 2026, para. 4).

Despite the significant rise in expenditures, the government expects the budget deficit to decrease to 1.4 percent of GDP during the upcoming fiscal year, compared to 2.2 percent in the current year (TRT Afrika, 2026). This indicates the continuation of the fiscal discipline policy implemented by Addis Ababa as part of the economic reform program supported by international institutions (Ministry of Finance, Ethiopia, 2026). Trading Economics (2026) projects the government budget deficit to reach -1.80 percent of GDP by the end of 2026. Prime Minister Abiy Ahmed has stated that his administration has managed to bring budgetary deficits below 1.2 percent (as cited in Trading Economics, 2026).

However, the fiscal outlook faces significant downside risks. If imports contract due to reduced purchasing power or supply chain disruptions, customs revenue, a critical source of government income could decline (UNDP, 2026). The UNDP (2026) notes that Ethiopia is returning to fiscal prudence in the aftermath of shocks, with the fiscal deficit-to-GDP ratio projected to remain below 2 percent in 2025 thanks to expenditure rationalization and prioritization, coupled with a strong push for domestic revenue mobilization (UNDP, 2026). Tax revenues have continued to perform well (UNDP, 2026). Yet the increased subsidy burden—which the government has signaled it intends to phase out—creates a structural tension between short-term stabilization objectives and medium-term fiscal sustainability (Ministry of Finance, Ethiopia, 2026; International Monetary Fund, 2026b).

The pressure on domestic borrowing presents another concern. Increased government borrowing to finance the fiscal deficit could crowd out private investment, as limited domestic savings are channeled toward government securities rather than productive private sector activities (UNDP, 2026; International Monetary Fund, 2026b). This crowding-out effect could dampen the private sector-led growth that the government's Homegrown Economic Reform Agenda seeks to promote (UNDP, 2026).

Table 4. Ethiopia's Fiscal Indicators (2024/25–2026/27)

Indicator	2024/25	2025/26	2026/27 (Projected)
Total Spending (Billion Birr)	1,920	—	2,340
Total Spending (USD Billion)	~12.0	—	14.69
Budget Deficit (% of GDP)	2.2%	1.2–1.8%	1.4%
Export Revenue (USD Billion)	—	10.5 (projected)	—

Note. Data compiled from TRT Afrika (2026), Trading Economics (2026), and Ministry of Finance, Ethiopia (2026).

4.4 Balance of Payments and Foreign Exchange Crunch

The geopolitical shock has exacerbated Ethiopia's longstanding balance of payments vulnerabilities, though recent reforms have provided some cushion. The current account deficit as a percentage of GDP is expected to reach -2.50 percent by the end of 2026 (Trading Economics, 2026). From July to December 2025, the current account deficit (excluding official transfers) stood at **$991 million**, marking a significant improvement from the $1.8 billion deficit in the same period of the previous year (UNDP, 2026). However, the balance of payments surplus shrunk to $1.2 billion from $1.7 billion in the same period (UNDP, 2026). The foreign exchange position has been strengthened by the IMF-supported reform program (International Monetary Fund, 2026a). Foreign exchange reserves stood at $4.7 billion**, equivalent to **2.3 months of import cover**, as of June 2025 (International Monetary Fund, 2026a; UNDP, 2026) (Table 6). The reserve position has more than tripled between 2024 and 2025 to over 3 months of imports and provided a strong buffer (UNDP, 2026). The IMF expects Ethiopia's foreign exchange reserves to approach **$6 billion as the reform program advances (International Monetary Fund, 2026a). Foreign exchange deposits held by banks reportedly reached around $1.4 billion by the end of April 2026 (National Bank of Ethiopia, 2026). The National Bank of Ethiopia has conducted 14 foreign exchange auctions over the past eleven months, distributing approximately **$2.5 billion** to commercial banks (National Bank of Ethiopia, 2026). Ethiopia's dollar sales this year have exceeded the $2 billion mark through special auctions (National Bank of Ethiopia, 2026).

Despite these improvements, the currency has faced significant pressure. Following the currency float in July 2024, the birr depreciated by 30 percent in the official market against major foreign currencies (World Bank, 2026b). As of January 2026, banks were selling birr at close to 151 Birr/US**, while the parallel market reached above** (Bloomberg, 2026; Trading Economics, 2026). The gap between the official and parallel foreign exchange markets has persisted (Bloomberg, 2026). The parallel market premium remains above 15 percent according to some analysts (Bloomberg, 2026); though NBE officials indicate it has fallen below 11 percent (National Bank of Ethiopia, 2026). The parallel market has faced renewed pressure recently, particularly following escalating tensions in the Persian Gulf region (Bloomberg, 2026).

The deterioration of the current account is driven by surging import bills for fuel and fertilizer, while export earnings lag (World Bank, 2026a). Coffee and gold together account for roughly 64 percent of export earnings (UNDP, 2026). Ethiopia's export revenue over the first 10 months of the 2025/26 fiscal year stood at $8.7 billion**, and by the end of the year the country expects to earn **$10.5 billion from its exports (UNDP, 2026). Exports of coffee and gold, remittances, and services pushed the balance of payments into surplus in the first eight months of 2025/26, the central bank reported in March (National Bank of Ethiopia, 2026). However, the structural "double inelasticity trap", where exports and imports fail to respond meaningfully to price signals haunts the reform effort (World Bank, 2026b).

The IMF has responded to the balance of payments pressures by front-loading approximately $200 million** under Ethiopia's program to help ease near-term financing pressures and address immediate war impacts (International Monetary Fund, 2026c). The IMF Executive Board completed the fifth review of the 48-month Extended Credit Facility arrangement, allowing for an immediate disbursement of about **$464 million to help Ethiopia meet its balance of payments and fiscal financing needs (International Monetary Fund, 2026c). The completion of the review brings total disbursements under the arrangement to about $2.647 billion (International Monetary Fund, 2026c). The IMF noted that while strong macroeconomic performance to date has created resilience, the war in the Middle East represents a substantial external shock (International Monetary Fund, 2026c).

Table 5. Ethiopia's Balance of Payments and Foreign Exchange Indicators

Indicator	Value	Period
Current Account Deficit (% of GDP)	-2.50%	2026 (projected)
Current Account Deficit (USD Billion)	$0.991B	Jul–Dec 2025
Foreign Exchange Reserves	$4.7B (2.3 months import cover)	Jun 2025
Foreign Exchange Reserves (Target)	~$6B	2026 (projected)
Official Exchange Rate	~151 Birr/US$	Jan 2026
Parallel Market Rate	~180+ Birr/US$	Jan 2026
Birr Depreciation (Post-Float)	30%	Jul 2024–Jun 2026
Export Revenue (Annual Projection)	$10.5B	2025/26
IMF Disbursement (5th Review)	$464M	Jul 2026
IMF Front-Loading (War Response)	$200M	Jul 2026

Note. Data compiled from UNDP (2026), International Monetary Fund (2026a, 2026c), Trading Economics (2026), and Bloomberg (2026).

V. Conclusion

Short-term Mitigation Measures

The Ethiopian government has implemented several immediate measures to cushion the impact of the geopolitical shock. These include fuel rationing to manage scarce supplies, targeted fuel subsidies to prevent the full pass-through of global price increases to consumers, and prioritization of foreign exchange allocation for essential imports, including fuel, fertilizer, and critical industrial inputs (Ministry of Trade and Regional Integration, 2025; Ministry of Finance, 2026). The government has committed approximately 272 billion Birr in fuel subsidies, though it has signaled intent to phases these out.

Multilateral support has played a crucial role in cushioning the balance-of-payments shock. The IMF has front-loaded approximately $200 million** under Ethiopia's Extended Credit Facility arrangement to address immediate war impacts. The completion of the fifth review in July 2026 enabled an immediate disbursement of about **$464 million, bringing total disbursements to approximately $2.647 billion. The World Bank has also provided emergency financing to support food security and social protection programs. This multilateral support has provided a critical buffer during a period of acute external pressure.

6.2. Medium-to-Long-term Resilience Strategies

The crisis underscores the imperative for Ethiopia to accelerate its transition to domestic renewable energy sources to reduce fossil fuel dependency. The Grand Ethiopian Renaissance Dam (GERD), Africa's largest hydroelectric dam with a cost of US$4.8 billion was officially inaugurated in September 2025 and is now fully operational. While GERD cannot substitute for petroleum products used in transportation and logistics, it provides a strategic buffer against electricity-sector oil volatility and can free up resources for other sectors. Ethiopia's substantial renewable energy potential, including hydropower, solar, and wind, offers a pathway to reduce fossil fuel import dependency over the medium term.

Diversification of fertilizer sources and port access represents another critical resilience strategy. Ethiopia imports over 90 percent of its nitrogen fertilizer requirements, primarily from Gulf States. Investing in local fertilizer blending plants and developing alternative supply sources could reduce vulnerability to supply disruptions (Ethiopian Business Review, 2026). Negotiations for access to the Berbera port in Somaliland, while facing political complexities, offer a potential alternative to the Djibouti corridor. Deepening domestic resource mobilization to reduce reliance on volatile external finance through tax reform, expenditure rationalization, and anti-corruption measures is equally essential for building fiscal resilience.

Summary of Findings

This analysis has demonstrated that the US–Iran–Israel geopolitical shock transmits to Ethiopia through four primary channels; energy, maritime trade logistics, agricultural inputs, and external finance with differential impacts across productive sectors. While Ethiopia's GDP growth remains among the fastest in the world at 9.2 percent (International Monetary Fund, 2026a), the conflict has introduced significant headwinds. Inflation has accelerated to 13.9 percent, reversing a prior trend of moderation (Ethiopian Statistical Service, 2026). The fiscal position faces strain from increased subsidy outlays, while the birr faces persistent depreciation pressure and a parallel market premium. Sectorally, agriculture faces acute vulnerability through fertilizer shortages and elevated shipping costs; industry confronts rising energy costs and supply chain bottlenecks; transport experiences soaring operational costs; and urban households bear the regressive burden of rising food and fuel prices.

Policy Recommendations

Based on the analysis, several actionable recommendations emerge for Ethiopian policymakers. First, the government should calibrate the flexible exchange rate regime carefully to balance competitiveness gains against inflationary risks, avoiding abrupt adjustments that could destabilize the economy. Second, establishing a strategic fuel reserve; sufficient for 60–90 days of imports would provide a buffer against future supply disruptions. Third, the government should accelerate negotiations for diversified port access, including the Berbera corridor, to reduce the risks associated with the Djibouti monopoly. Fourth, fertilizer supply diversification—through local blending plants and alternative sourcing would mitigate agricultural vulnerability to external shocks (Ethiopian Business Review, 2026). Fifth, the Productive Safety Net Program should be adequately funded and expanded to protect vulnerable households during periods of acute food price inflation. Sixth, the government should pursue fiscal consolidation while protecting pro-poor expenditures, maintaining the trajectory toward deficit reduction while cushioning the most vulnerable.

Limitations and Avenues for Future Research

This study has several limitations that suggest avenues for future research. First, the analysis is primarily qualitative and analytical, synthesizing available data from international financial institutions and government reports. Future research should employ rigorous empirical methodologies, particularly monthly Structural Vector Autoregression (SVAR) or Computable General Equilibrium (CGE) modeling, to quantify the precise magnitude of the shock's impacts when high-frequency data becomes available. Second, the analysis focuses on the immediate and short-term impacts; future research should examine the longer-term structural transformations and adaptation strategies. Third, the study is delimited to Ethiopia; comparative analyses across multiple frontier markets in Sub-Saharan Africa would enhance generalizability. Fourth, the distributional impacts across different income groups and regions within Ethiopia deserve more detailed investigation.

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