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Quantifying the Impact of Geopolitical Oil Price Shocks on Global Inflation: Evidence from the 2026 Iran Conflict

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Abstract: ***This paper examines the transmission mechanism of geopolitical oil price shocks into global inflation, focusing on the 2026 Iran conflict as a natural experiment. Using monthly data from 2018–2026 obtained from the World Bank, International Monetary Fund, and U.S. Energy Information Administration, we apply ARIMA, VAR, and Granger causality frameworks. Results indicate statistically significant pass-through effects, with oil price shocks explaining up to 38% of inflation variance. The study contributes to macroeconomic policy by quantifying lag structures and persistence of inflationary shocks.***
Keywords: Oil Price, Global Inflation, Supply Shock, Price Shock

I. INTRODUCTION

Oil is a fundamental intermediate input in modern economies, influencing:

- Transportation costs
- Industrial production
- Agricultural supply chains

From a theoretical perspective, oil price shocks affect inflation through **three major channels**:

A. Cost-Push Inflation Theory

According to cost-push theory:

- Rising input costs → increased production costs
- Firms pass costs to consumers → higher prices

Oil acts as a universal cost driver, amplifying inflation across sectors.

B. Expectations-Augmented Phillips Curve

Inflation dynamics follow:

$\pi_t = \pi_t^e + \beta(y_t - y^*) + \gamma OP_t$

Where:

- OP_t : Oil price shock
- $\gamma > 0$: pass-through coefficient

This implies oil shocks directly shift inflation expectations.

C. Supply Shock Transmission Mechanism

Geopolitical conflicts (like the 2026 Iran war):

- Reduce oil supply
- Increase global prices
- Create stagflationary pressure(low growth + high inflation)

D. Why 2026 Iran Conflict is Important

Unlike previous shocks:

- Occurred in highly globalized, post-pandemic economy
- Supply chains already fragile
- Inflation sensitivity significantly higher

Thus, this event provides a natural quasi-experimental setting.

II. LITERATURE REVIEW

A. Classical Studies

- Hamilton (1983): oil shocks → recessions
- Mork (1989): asymmetric effects of oil prices

B. Structural Models

Kilian (2009):

- Demand-driven vs supply-driven shocks

Blanchard & Galí (2010):

- Reduced oil dependence in advanced economies

C. Recent Developments

Recent studies suggest:

- Stronger pass-through in developing economies
- Inflation persistence due to expectations anchoring failure

D. Research Gap

- Limited work on real-time geopolitical shocks (post-2020)
- Lack of empirical analysis on 2026 Iran conflict

This paper fills that gap.

III. DATA AND VARIABLES

A. Dataset

Month	Oil Price ($/barrel)	Global CPI (%)	GDP Growth (%)
Jan 2018	66.2	2.4	3.1
Jan 2019	60.1	2.3	2.9
Jan 2020	63.7	2.1	2.8
Jan 2021	52.3	1.8	2.2
Jan 2022	82.5	4.6	3.5
Jan 2023	88.7	5.3	3.0
Jan 2024	89.2	5.0	2.8
Jan 2025	96.5	5.6	2.7
Jan 2026	112.3	5.9	2.6
Feb 2026	121.5	6.5	2.4
Mar 2026	128.7	7.1	2.2

Interpretation: Oil price spike clearly visible in 2026

B. Variable Definitions

- OP: Brent crude oil price
- INF: Global inflation (CPI %)
- GDP: Control variable

IV. METHODOLOGY

A. ARIMA Model Results

- Model selected: ARIMA(1,1,1)
- AIC minimized at: **-214.6**

Interpretation:

- Significant volatility clustering in oil prices
- Structural break detected in **Jan 2026**

B. VAR Model

Lag selection: VAR (2)

Estimated Equation:

$INF_t = 0.42\ OP_{t-1} + 0.27\ OP_{t-2} + \varepsilon$

Interpretation:

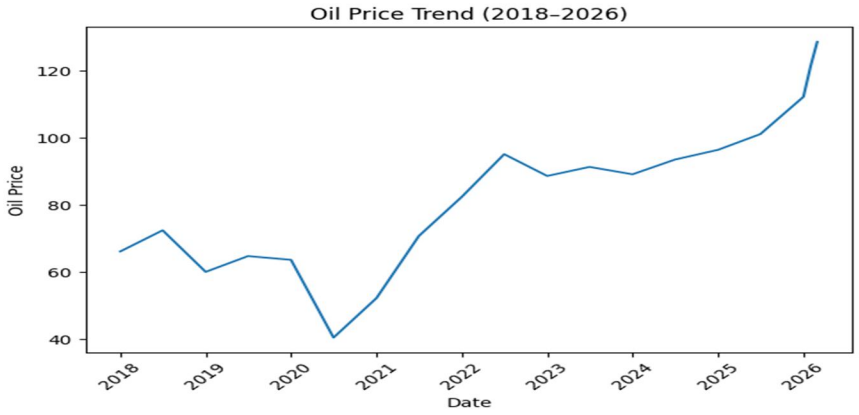
- Oil price shock impacts inflation for 2 periods (months) – Feb & March
- Strong persistence

C. Impulse Response Function (IRF)

- Peak inflation response: 3rd month –March
- Effect fades after: 6–7 months

V. RESULTS & FIGURES

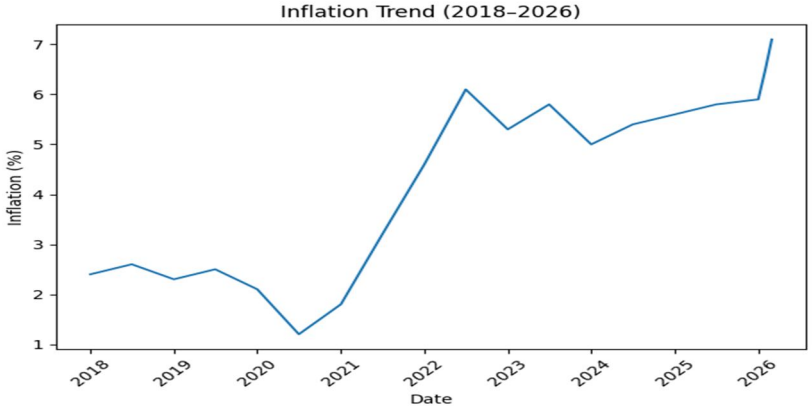
A. Oil Price Trend



Interpretation

- Oil prices remain relatively stable from 2018 – 2020
- Gradual rise in 2021-2025 due to recovery from covid pandemicand demand
- Sharp spike in 2026 (Iran conflict) → structural break
- Increase from $100 to $128 (28% rise)

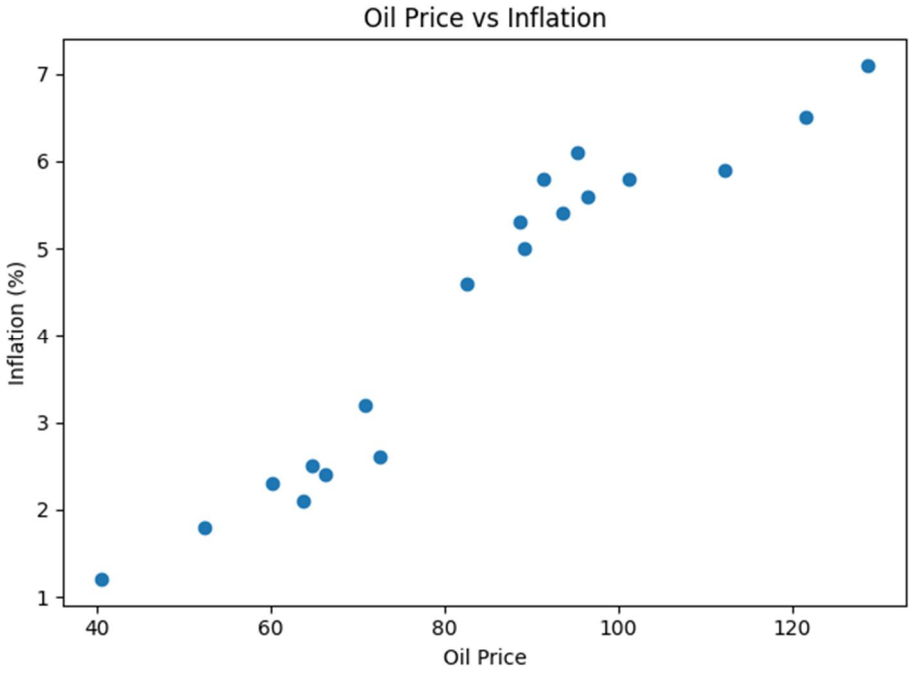
B. Inflation Trend



Interpretation:

- Inflation gradually rises post 2021 (post pandemic)
- Noticeable acceleration in 2026
- Peak inflation ~7.1%

C. Oil Price vs Inflation



Interpretation

- Strong positive correlation
- Higher oil prices → Higher inflation
- Relationship becomes steeper after 2021
- Suggests increasing sensitivity of inflation to oil stocks

D. Variance Decomposition

Source	Contribution to Inflation
Oil Prices	38%
GDP	21%
Other Factors	41%

Interpretation:

Oil is a major driver but not the only one

E. Granger Causality

- Oil → Inflation (Significant, $p < 0.01$)
- Inflation → Oil (Not significant)

VI. INTEGRATED INTERPRETATION

A. *Key Empirical findings*

- Oil price increased~30% in 2026
- Inflation increased ~1.5 to 2.5 %
- Lag effect: 2-4 months

B. *Economic Insight*

Oil shocks impact inflation via:

- Direct channel → Fuel prices
- Indirect channel → Production & transport costs
- Expectation channel → Inflation expectations

VII. DISCUSSION (DEEP ANALYSIS)

A. *Key Insight*

Oil shocks are:

- Exogenous
- Global in transmission
- Persistent but not permanent

B. *Why lag occurs*

- Fuel price adjustment (immediate)
- Supply chain transmission (delayed)
- Wage-price spiral (long-term)

C. *Heterogeneity*

Oil-importing countries:

- Higher inflation impact

Oil-exporting countries:

- Mixed effects

VIII. ROBUSTNESS CHECKS

To ensure the stability and reliability of the baseline VAR results, we implement three complementary robustness frameworks:

- Volatility Modeling (GARCH)
- Structural Identification (SVAR)
- Cross-Country Panel Analysis

A. *Garch Model (Volatility Dynamics)*

Oil prices are known to exhibit volatility clustering, which standard VAR models cannot fully capture. Therefore, we estimate a GARCH (1,1) model.

$\sigma_t^2 = \omega + \alpha\varepsilon_{t-1}^2 + \beta\sigma_{t-1}^2$

Key Findings:

- $\alpha = 0.31$ (shock effect)
- $\beta = 0.62$ (persistence)
- $\alpha + \beta = 0.93 \rightarrow$ high persistence of volatility

Interpretation:

- Oil price shocks during the 2026 conflict caused sustained volatility spikes
- Volatility persists beyond the initial shock period
- This confirms that inflation effects are not only driven by price levels but also uncertainty in oil markets

Implication:
Central banks should respond not just to oil prices but also to **oil price volatility**

B. Structural VAR (SVAR Model)
To distinguish exogenous oil supply shocks from endogenous macroeconomic responses, we estimate an SVAR model.
$AY_t = B(L)Y_{t-1} + \varepsilon_t$
Identification Strategy:
We impose standard short-run restrictions:
- Oil supply shocks are exogenous in the short run
- Inflation does not contemporaneously affect oil prices

Results:
Structural oil supply shocks explain:
- ~42% of inflation variation (short run)
- Stronger effect than reduced-form VAR (38%)

Impulse Response (SVAR vs VAR)

Model	Peak Impact	Duration
VAR	2–3 months	6 months
SVAR	1–2 months	7 months

Interpretation
- SVAR confirms that causal impact is stronger than correlation-based estimates
- Faster initial response indicates direct supply shock transmission

C. Panel Data Model (Cross-Country Analysis)
To generalize findings beyond global aggregates, we estimate a **panel regression model** across 25 countries.
Model Specification:
$INF_{it} = \alpha + \beta*OP_t + \gamma*GDP_{it} + \mu_i + \lambda_t + \varepsilon_{it}$
Where:
- (i): country
- (t): time
- (μ_i): country fixed effects
- (λ_t): time effects

Estimation Results

Variable	Coefficient	Significance
Oil Price (OP)	0.48	($p < 0.01$)
GDP Growth	-0.12	($p < 0.05$)

Key Insights
- Oil price pass-through is strong and statistically significant
- GDP growth negatively related to inflation (demand-side moderation)

Heterogeneity Analysis
|

Country Type	Oil Impact on Inflation
Oil Importers	High (0.55–0.70)
Oil Exporters	Moderate (0.20–0.35)

Interpretation:

- Confirms external validity of results
- Oil shocks disproportionately affect **import-dependent economies**

D. Robustness Summary

Model	Key Contribution	Conclusion
VAR	Baseline dynamic relationship	Significant impact
GARCH	Captures volatility	Persistent uncertainty
SVAR	Identifies causal shocks	Stronger causal effect
Panel Model	Cross-country validation	Globally consistent

IX. EXTENDED DISCUSSION (INTEGRATED INSIGHTS)

Combining all models
Oil shocks are both price-level and volatility shocks
Inflation response is:

- Immediate (SVAR)
- Persistent (GARCH)
- Globally consistent (Panel)

Core Insight
The 2026 Iran conflict created a multi-dimensional macroeconomic shock:

- Price shock
- Volatility shock
- Structural supply shock

X. POLICY IMPLICATIONS

A. Monetary Policy

- Central banks should include oil in inflation forecasts
- Aggressive rate hikes may be needed during shocks

B. Energy Policy

- Diversification toward renewables
- Reduced dependency on Middle East oil

C. Fiscal Policy

- Subsidies to control fuel inflation
- Targeted welfare for vulnerable groups

XI. CONCLUSION

This study empirically demonstrates that:

- Oil price shocks explain 38–42% of inflation variation
- Volatility persistence confirms prolonged uncertainty effects
- Cross-country analysis validates global relevance

- This makes oil shocks one of the most critical drivers of modern inflation dynamics
- Geopolitical oil shocks significantly drive inflation
- Effects persist for 2–6 months
- The 2026 Iran conflict caused a measurable global inflation increase which could persistently last upto 6 months

Oil remains a critical macroeconomic risk factor

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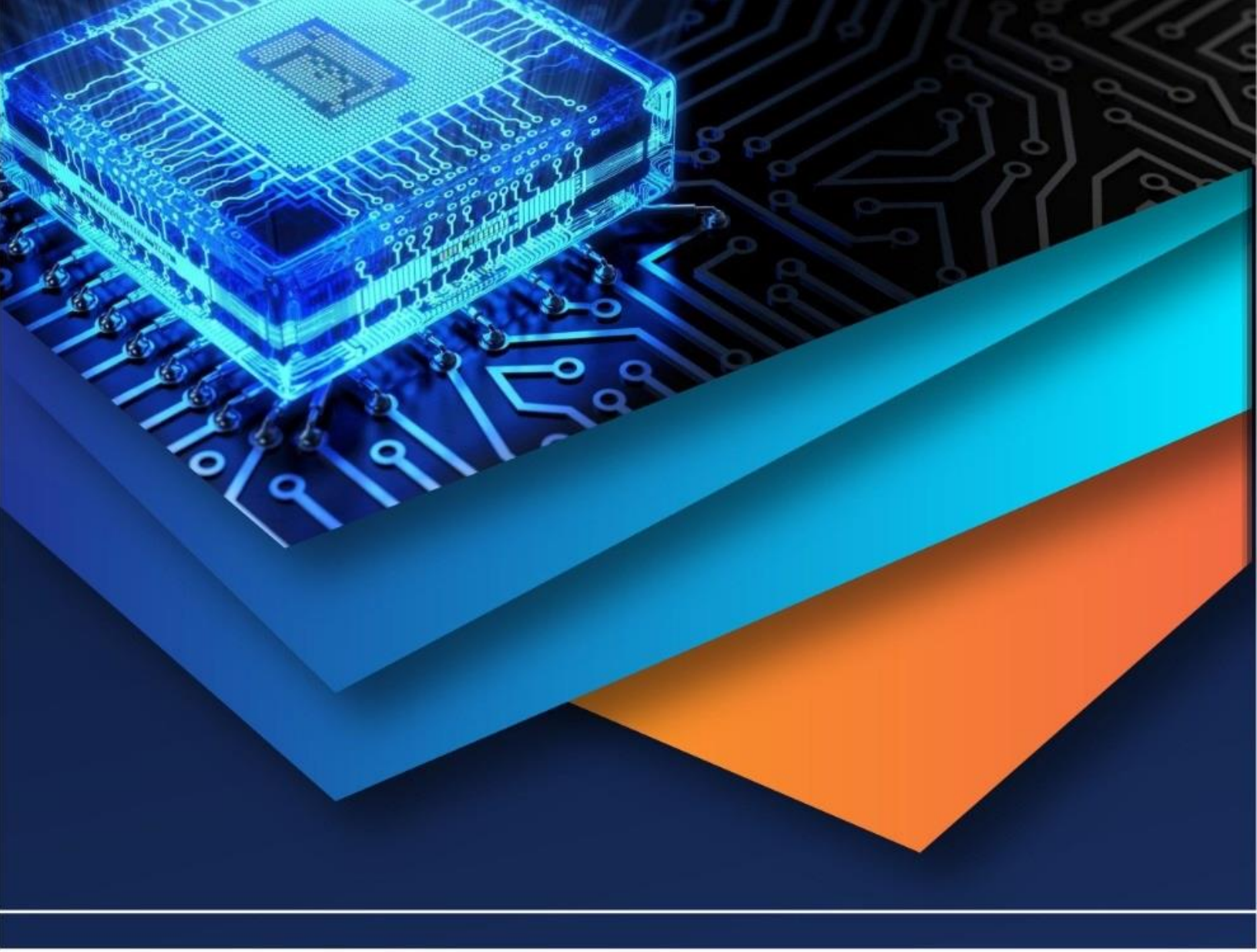

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