

## GLOBAL ECONOMY: THE ECONOMIC CONSEQUENCES OF GEOPOLITICAL UNCERTAINTY

The geopolitical risk index, which is based on the number of newspaper articles mentioning adverse geopolitical events, has recorded a huge increase in October. Whether this influences decisions of households and firms depends, amongst other things, on the (ir)reversibility of these decisions. Based on empirical research on the consequences of a significant increase in uncertainty, there is a concern that the recent jump in geopolitical uncertainty would directly and indirectly -via energy price uncertainty (oil, gas)- weigh on discretionary household spending and hiring decisions by companies, with both reactions potentially reinforcing each other. Considering that these decisions are easily reversible, the impact could be rather swift. In addition, there is a possibility of a gradual, delayed impact if investment plans are being put on hold.

Geopolitical uncertainty has recorded a huge jump this month. The latest observations of the geopolitical risk index, which is based on the number of newspaper articles mentioning adverse geopolitical events, are in the upper two percentiles of the historical distribution (chart 1)<sup>1</sup>. It raises the question of the possible economic consequences should uncertainty stay high. A key factor is the (ir)reversibility of decisions<sup>2</sup>. When it is very expensive to come back on earlier decisions -this is the case for an investment project of a company-, there is value in waiting until the uncertainty has declined sufficiently. However, this also comes with a cost. Postponing a project means that the contribution to a company's profits will be missed -the opportunity cost of waiting- and there is also a risk of losing ground vis-à-vis competitors if the latter have implemented their investment plans. It implies that the longer uncertainty is expected to last -the resolution of uncertainty will take a lot of time-, the less a company will be inclined to postpone its investment plans. However, the ultimate decision also depends on other factors such as the expected loss in terms of company earnings in case of a negative outcome and the likelihood of such an outcome.

Empirical research shows a detrimental economic impact of geopolitical uncertainty. In the US, for the period 1985 to 2019, "a shock to geopolitical risk induces persistent declines in investment, employment, and stock prices, with the decline in activity due to both the threat and the realization of adverse geopolitical events<sup>3</sup>." An economically important question is how quickly these consequences manifest themselves. One would expect that stock prices react quickly due to higher risk aversion and an increase of the required risk premium that lowers the net present value of future cash-flows, which have become more uncertain. Equity investors will be inclined to react promptly to an increase in uncertainty by selling part of their holdings considering that, should uncertainty drop, this decision can easily be reverted given the low transaction costs.

<sup>1</sup>Geopolitical risk is defined as "the threat, realization, and escalation of adverse events associated with wars, terrorism, and any tensions among states and political actors that affect the peaceful course of international relations." The index is based on "the share of articles mentioning adverse geopolitical events in leading newspapers published in the United States, the United Kingdom, and Canada." Source: *Measuring Geopolitical Risk*, Dario Caldara and Matteo Iacoviello, *American Economic Review* 2022, 112(4): 1194-1225. The data are available on [www.matteoiacoviello.com](http://www.matteoiacoviello.com).  
<sup>2</sup>What follows has been inspired by Investment and uncertainty: the value of waiting for news, Speech given by Ben Broadbent, Deputy Governor Monetary Policy, Bank of England, Imperial College Business School, London, 20 May 2019.  
<sup>3</sup>Source: see footnote 1. Using cross-country data and country-specific indices spanning 120 years, the authors also show that higher values of the geopolitical risk index are found to be associated with lower expected GDP growth and higher downside risks to GDP growth.

GEOPOLITICAL RISK INDEX (7-DAY MOVING AVERAGE)

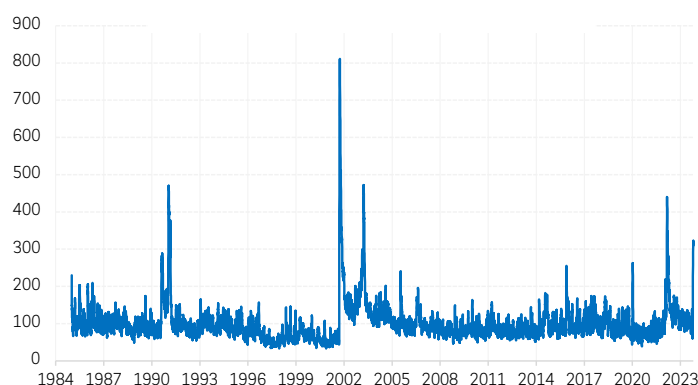


CHART 1

SOURCE: GEOPOLITICAL RISK (GPR) INDEX (MATTEO IACOVIELLO.COM), BNP PARIBAS

With respect to corporate investments, it is necessary to distinguish between projects that have already started and investment plans. The former will probably continue, unless the expected loss in earnings in case of a bad outcome would be huge, whereas the latter may not be executed, at least for the time being. This would imply a gradually increasing negative impact of higher uncertainty on aggregate corporate investments and hence economic growth.

“A significant increase in geopolitical uncertainty can swiftly impact discretionary household spending and hiring decisions by companies. In addition, one can expect a delayed impact with investment plans being put on hold if uncertainty lasts.”



Companies may also react by cutting into expenses that are easier to reverse such as the use of consultants, the size of marketing budgets or hiring and firing decisions. Research by the Federal Reserve Bank of Dallas<sup>4</sup> concluded that during periods of high macroeconomic uncertainty - which clearly is a broader concept than geopolitical uncertainty - firms in the US reduce hiring. Firms also fire more workers, perhaps because households increase precautionary savings in response to the elevated uncertainty and hence spend less. *"Firms may find it easy to adjust labor in response to lower demand rather than to adjust capital, where costs could be larger."* To the extent that firms invest less, labour demand would also decline due to its complementarity with capital. Research covering European companies in 25 countries comes to similar conclusions<sup>5</sup>. When uncertainty is higher, firms tend to reduce hiring or not renew temporary contracts.

Households also suffer from an increase in uncertainty. Recent research has found that *"higher uncertainty leads to sharply reduced spending by households on both non-durables and services in subsequent months as well as on some durable and luxury goods and services"*.<sup>6</sup> The negative labour market impact of rising uncertainty can also influence household spending. In the Eurozone, there is a close and negative correlation between hiring plans of companies and the unemployment expectations of households (chart 2). Consequently, if firms decide to scale back hiring plans due to an increase in macroeconomic uncertainty, households are likely to become concerned about their employment outlook, which may influence their spending and savings decisions.

To conclude, based on empirical research on the consequences of a significant increase in uncertainty, there is a concern that the recent jump in geopolitical uncertainty would directly and indirectly - via energy price uncertainty (oil, gas) - weigh on discretionary household spending and hiring decisions by companies, with both reactions potentially reinforcing each other. Considering that these decisions are easily reversible, the impact could be rather swift. In addition, there is a possibility of a gradual, delayed impact if investment plans are being put on hold.

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#### EUROZONE: HOUSEHOLDS' UNEMPLOYMENT EXPECTATIONS AND EMPLOYMENT EXPECTATIONS OF COMPANIES

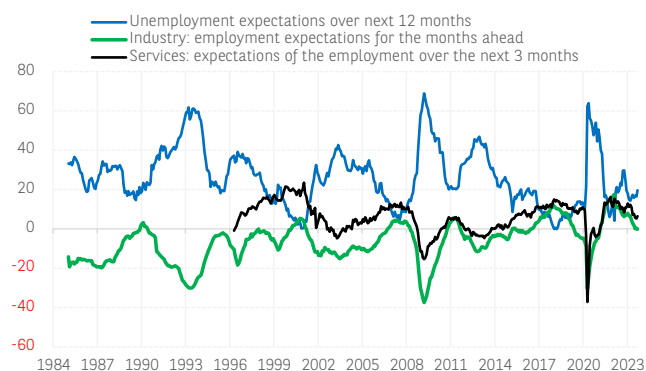


CHART 2

SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

<sup>4</sup> Source: *Uncertainty and Labor Market Fluctuations*, Soojin Jo and Justin J. Lee, Federal Reserve Bank of Dallas working paper 1904, 2 July 2019.

<sup>5</sup> *Uncertainty and firms' labour decisions. Evidence from European countries*, Marta Martínez-Matute & Alberto Urtasun, Journal of Applied Economics, 2022, pp. 220-241.

<sup>6</sup> Source: *The effect of macroeconomic uncertainty on household spending*, Olivier Coibion, Dimitris Georgarakos, Yuriy Gorodnichenko, Geoff Kenny, Michael Weber, IZA - Institute of Labor Economics, discussion paper 14213, March 2021. Health care concerns e.g. health insurance, medical exams, prescriptions. Examples of personal care products and services that are impacted are make-up, cologne, haircuts. Concerning discretionary spending, recreation (e.g. theater and movie tickets, gym memberships, etc.) is negatively impacted as well as purchases of holiday packages and large luxury products (expensive jewelry). *"The coefficients for other categories of durable goods are also negative but are not statistically significant. This likely reflects, in part, the fact that there are fewer purchases of these goods (especially cars and houses) observed in the data which makes the estimation less precise."*

