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Markets and geopolitical uncertainty: (ir)rational complacency?

■ There is a considerable gap between what are considered to be the geopolitical ramifications of the escalating tensions between the US and Iran since the start of the year and the subdued reaction of markets ■ The market reaction probably reflects the investors' view that the probability-weighted impact on growth should be very limited because the risk of a major escalation is considered to be small and/or because of an expectation that the impact of higher oil prices on the economy is limited ■ What also may play a role in the market reaction thus far is that, leaving the geopolitical uncertainty aside, the economic environment is considered to be conducive to taking risk: stabilisation of survey data, reduction in trade-related uncertainty and accommodative monetary policy.

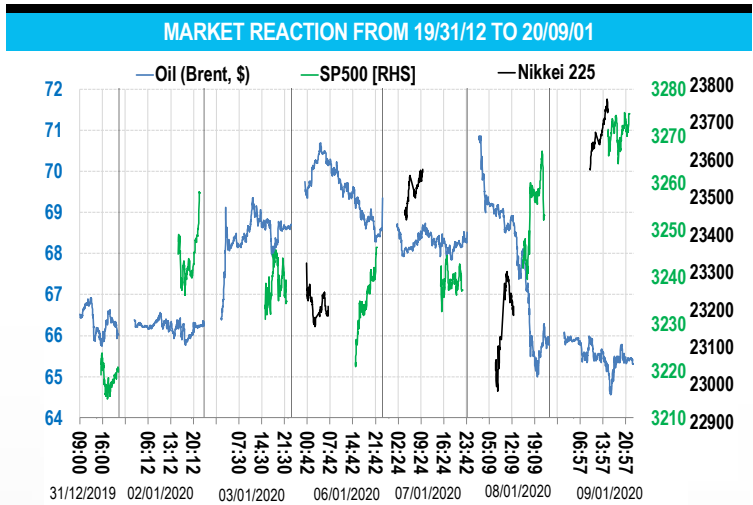
Compared to the analyses from political commentators of the escalation of tensions between the US and Iran since the start of the year, the market reaction has been very subdued. It is tempting to call it an example of irrational complacency, based on a view that risks are being underestimated, although the opposite interpretation can also be defended: what, at first glance, looks like complacency, could be a reflection of rational pricing of uncertainty.

The economic consequences of geopolitical uncertainty¹ are complex and varied. The transition to a regime of higher uncertainty can end up weighing on growth, notably via slower growth of corporate investment. This effect takes time to materialise because it depends on how quickly companies become convinced that the higher uncertainty is there to stay and that it influences their business. Uncertainty spikes, which are short-lived, can trigger knee-jerk market reactions whilst having limited or no lasting consequences, neither on markets nor on the economy. A key question is how exactly uncertainty influences the economy: which variables are impacted in the first place and how do they, in turn, influence production, inflation, spending, interest rates, etc.?

In gauging the consequences of the confrontation between Iran and the US, oil prices play a key role as a channel of transmission considering that an escalation could end up causing supply disruptions. It is worth recalling the developments in August 1990 when the invasion of Kuwait by Iraq caused a doubling of oil prices within three months. After having peaked in October that year, prices stayed at a high level for several months and only approached their pre-invasion level in the spring of 1991.

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¹ In Macrowaves, the podcast of BNP Paribas Economic Research, the topic of geopolitical risk has been addressed in 2019 in three episodes: definition, impact on business and impact on business strategy.



Source: Bloomberg, BNP Paribas

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Hence, it makes a big difference whether an oil price increase is short-lived (because disrupted supply can be restored very quickly) or more lasting. Bringing this all together, investors and company managers need to answer several questions in deciding on how to react to the recent increase in tensions: a) will they continue to escalate? b) will it end up creating oil supply disruptions? c) if so, what would be the impact on oil prices? d) would this impact be very temporary or last for several months? e) how would economic activity react? f) could the reaction be of such a nature that a recession would follow? In such a scenario analysis, the growth impact at the end of the decision tree is equal to the product of the values in decision nodes a) to f). Market reaction thus far suggests that investors consider that the probability-weighted growth impact is likely to be very small. This could reflect a view that risk of a major escalation, all in all, is not that high and/or that the impact of higher oil prices on the economy is limited. Factors in favour of the latter argument are the fact that the oil intensity of production and consumption has declined compared to the 70s, that there is an excess supply of oil on the market (hence the OPEC production ceilings) and that inflation is sufficiently low. This last point means that, even if oil prices were to rise, central banks would not be forced to react hastily to the ensuing higher energy inflation². On the other hand, one should keep in mind that the slower growth environment could actually increase the sensitivity to oil shocks.³

Quite likely, what also plays a role in the market reaction thus far is that, leaving the geopolitical uncertainty aside, the economic environment is conducive to taking risk: business surveys have stabilised in recent months, the prospect of a phase 1 deal between the US and China has eased concerns about further trade clashes and monetary policy is highly accommodative.

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² Interestingly, already in 2006, the point about a reduced sensitivity to oil price increases was made by David Walton, member of the monetary policy committee of the Bank of England, in a speech on "Has oil lost the capacity to shock?".

³ This is considered to have played a role in 1990 where a global slowdown was already underway. Moreover, in several countries, business and consumer confidence was already low before the crisis in the Gulf started. For an analysis of these events, see Michael M. Hutchison, Aggregate demand, uncertainty and oil prices: The 1990 oil shock in comparative perspective, BIS Economic papers No. 31, August 1991.

