WHAT ARE THE CONSEQUENCES OF THE INCREASED GEOPOLITICAL RISK IN THE MIDDLE EAST?

Although tensions in the Middle East and the geopolitical risk have risen sharply since October 2023, there have been contrasting developments in the maritime trade and energy markets. While the cost of some freight categories has risen, oil prices have fallen, mainly due to abundant supply. An escalation of the conflict is still a possibility and would drive energy prices higher. In an already tense market, the price of LNG on the European market is particularly sensitive to the geopolitical context. It is against this backdrop of geopolitical tension and depressed oil markets that the Gulf countries are seeing their financing requirements increase. Furthermore, as part of their diversification policy, they need a peaceful regional environment, particularly in the Red Sea.

INCREASED GEOPOLITICAL RISK IN A STRATEGIC REGION

The outbreak of war between Israel and Hamas in October 2023 and the subsequent escalation of tensions resulted in a significant increase in geopolitical risk in the Middle East region. The GPR[1] geopolitical risk index rose sharply at that time and has remained at a high level ever since. It is both the changing nature of the conflict and its location that explain why the indicator is remaining at a high level.

Since it broke out, the conflict has increased in intensity, moving from multiple, localised conflicts played out in part via proxies, to a direct confrontation between two regional powers. While the consequences of this escalation of the conflict are relatively limited for the time being, the risk of intensified confrontations persists.

The geopolitical importance of the Middle East is primarily linked to the region's role in the hydrocarbon market. This is because 34% of the world's oil exports and 14% of its liquefied natural gas (LNG) exports come from the Gulf countries. Secondly, the region is home to some of the world's most strategic maritime trade chokepoints. Shipping through the Bab el-Mandeb Strait, south of the Red Sea, accounts for around 12% of global merchandise flows by volume (16% by value), including around 11% of maritime crude oil flows and 23% of wheat flows. In addition, around 27% of maritime trade in petroleum products passes through the Strait of Hormuz (more than 80% of which is destined for Asia), which handles 10% (by volume) of the world's goods flows.

LIMITED IMPACT ON THE OIL MARKET AND MARITIME TRADE

The rise in geopolitical risk initially resulted in only a limited increase in oil prices, before they fell back again. Thus far, various estimates of the "geopolitical risk premium" component in the price of oil put it at around 10% of the price per barrel, corresponding to a limited escalation of the conflict (without any damage to oil production and transport facilities) despite its geographical spillover. The limited reaction of the oil market to geopolitical risk is due to two factors: despite the spillover of the conflict, passage through the Strait of Hormuz has not been affected. A blockage in the strait is not currently deemed a likely scenario, even though its consequences would be very significant given the lack of alternative routes for some major exporters (for example, Kuwait and Qatar). Alternative routes available for Saudi Arabian and Emirati exports have limited capacity (5 mb/d and 1.5 mb/d, respectively, for total exports of 11 mb/d).

HYDROCARBON FLOWS AND CHOKEPOINTS

		2023
	Bab el-Mandeb transit	0.9
Crude oil and other liquids (mb/d)	Strait of Hormuz transit	2.1
	World maritime oil trade	7.8
	Global consumption	102
	Bab el-Mandeb transit	4.1
Liquified Natural Gas (bcm)	Strait of Hormuz transit	108
	World maritime LNG trade	550

TABLE 1 SOURCE: IEA, BNP PARIBAS GROUP ECONOMIC RESEARCH

GEOPOLITICAL RISK INDEX GPR (INDEX 100=JANUARY 2022)

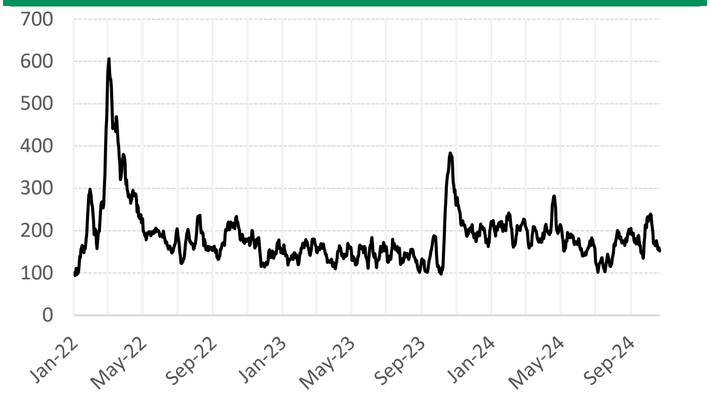

CHART 1 SOURCE: GPR INDEX MATTEOIACOVIELLO.COM, BNP PARIBAS

In addition, the fundamentals of the oil market are currently bearish, partly because of weak demand from China, and partly because of rising production from countries not subject to OPEC quotas, mainly the United States, Canada, Brazil and Guyana.

Maritime transport has been disrupted by the blockage of the Bab el-Mandeb Strait, but the existence of alternative shipping routes has helped to limit the consequences at global level. Traffic in the Red Sea has fallen since the end of 2023, but in different ways depending on the type of goods. The reduction and rerouting via the Cape of Good Hope has affected containers and most raw

1 The GPR index, developed by D. Caldara and M. Iacoviello (Geopolitical Risk (GPR) Index (matteoiacoviello.com)) is a geopolitical risk indicator based on textual research in a dozen or so English-language newspapers.

materials, particularly refined petroleum products. Maritime traffic in the Red Sea decreased by more than 70%, and the Suez Canal's market share of total maritime flows of goods fell from 10% prior to October 2023 to 6% in August 2024[2]. There were two exceptions to these plummeting volume figures: the fall in crude oil flows was limited, mainly due to flows from Russia continuing. For the same reason, wheat transit via the Suez Canal has increased.

On a more general level, the impact on prices of the disruption to shipping in the Red Sea has not been uniform, with the cost of transporting containers mainly affected. Thus, the Shanghai Containerized Freight Index rose by 120% between October 2023 and June 2024 and, according to UNCTAD[3], more than 80% of this increase is due to the disruption in the Red Sea (the disruption caused by the lower water level in the Panama Canal played only a marginal role). In terms of volumes, global maritime freight has continued to grow (+2.9% in volume year-on-year over 8M 2024, after +2.6% for 2023 as a whole).

OIL AND FREIGHT PRICES (INDEX 100=JANUARY 2023)

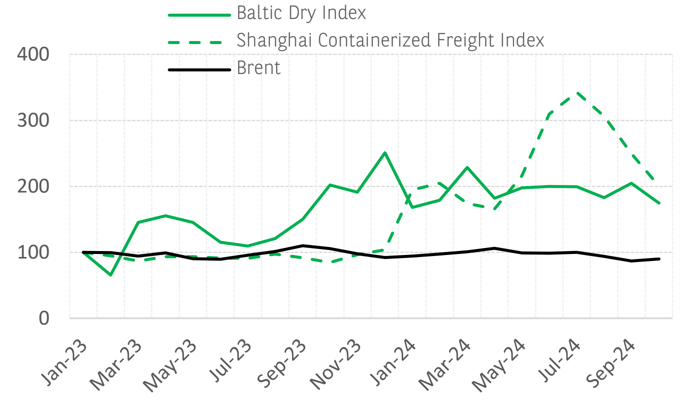

CHART 2 SOURCE: DATASTREAM, BNP PARIBAS

PROSPECTS

- **Geopolitical risk set to remain high**

According to our central scenario, geopolitical risk is likely to remain high in the region for at least part of 2025. As in 2024, there could be periods of very high tension, but the most likely scenario remains one of targeted military operations.

The Middle East policy of the new US administration is a new element of uncertainty. The policy of the first Trump administration (diplomatic rapprochement with some Gulf monarchies and Israel and economic pressure on Iran) will have to take into account the current conflict, and therefore a very different geopolitical backdrop, where the risk of escalation is high. Added to this is the partly "transactional" nature of Trump's diplomacy, which complicates any forecasting exercise.

- **LNG market**

Although around 3/4 of LNG exports from the Gulf are to Asia, the rise in the share of flexible contracts that facilitate arbitrage opportunities between Asian and European markets increases Europe's vulnerability to geopolitical tensions in the Middle East. The two main risks are: a blockage in the Strait of Hormuz, which would push prices to new heights given Qatar's importance in global LNG exports (20% in 2023), and constraints on production in the eastern Mediterranean. Israeli gas production is expected to reach 27 bcm in 2024, with around 10 bcm exported to Egypt. A hit to Israeli production capacity or a disruption to exports to Egypt would increase regional demand for gas, and could have repercussions on the price of European LNG. Indeed, the balance of the European market is relatively tight in the short term, for seasonal reasons (increased consumption in winter), as well as the likely end of Russian exports to Europe via Ukraine at the end of 2024, and delays in some liquefaction and export units starting up in the United States.

- **Oil market**

A blockage in the Strait of Hormuz would be the main factor that could significantly push up oil prices (above $100/bbl). Apart from this potential event, which is not part of our central scenario, the fundamentals of the oil market should tend to push prices down, as evidenced by the recent decision by the OPEC cartel to postpone raising its production quotas. For the time being, the oil market has not really reacted to the election of the new US President. Apart from his stated desire to boost US production, one of the main short-term uncertainties will be potential further sanctions on Iranian exports (around 1.6 mb/d). In this case, the willingness of Gulf producers (who have the main spare production capacities) to quickly offset the reduced supply will determine the direction of prices, at least in the short term. Indeed, it may be in their interest, at least temporarily, to allow the price of oil to rise.

- **Gulf countries**

This backdrop of a relatively depressed oil market and high geopolitical risk in the region is affecting certain Gulf countries in particular. While the region is still a net exporter of capital due to portfolio investments by the main sovereign wealth funds (notably in the UAE and Qatar), the financing of budget deficits (Saudi Arabia) and investments supporting economic diversification (the "Vision" programmes) is increasing capital inflows. The situation in Saudi Arabia is significant in this respect. Given the very large investment projects (Vision 2030), foreign direct investment that is falling short of expectations (equivalent to 0.9% of GDP in H1 2024) and the high fiscal breakeven oil price (around $100/bbl for Saudi Arabia), the kingdom's financing requirements are increasing significantly. Thus, the government and the Public Investment Fund (PIF) have issued more than USD50 billion in international bonds this year (around 5% of GDP), the largest amount among emerging economies outside China. In addition, the PIF has announced its intention to reduce its exposure to foreign assets (from 30% to 18% of the total) in order to give priority to investment in the kingdom. In the medium term, the Red Sea region is set to become increasingly important to Saudi Arabia's economy under Vision 2030. The areas of development include the tourism sector, which is particularly vulnerable to geopolitical risk, and other sectors which are partly export-oriented (mining resources, renewable energies and hydrogen) and which therefore depend on secure and available maritime routes.

According to our central scenario, the economic impact of the increased geopolitical risk on the Gulf countries should remain limited in the short term. However, in the medium and long term, the security of the straits will continue to adversely affect their economic prospects.

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2 Kpler, Update on Red Sea trade flow impacts, 1 Oct 2024.
3 UNCTAD, 2024 Review of maritime transport.