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GAUGING GEOPOLITICAL RISKS

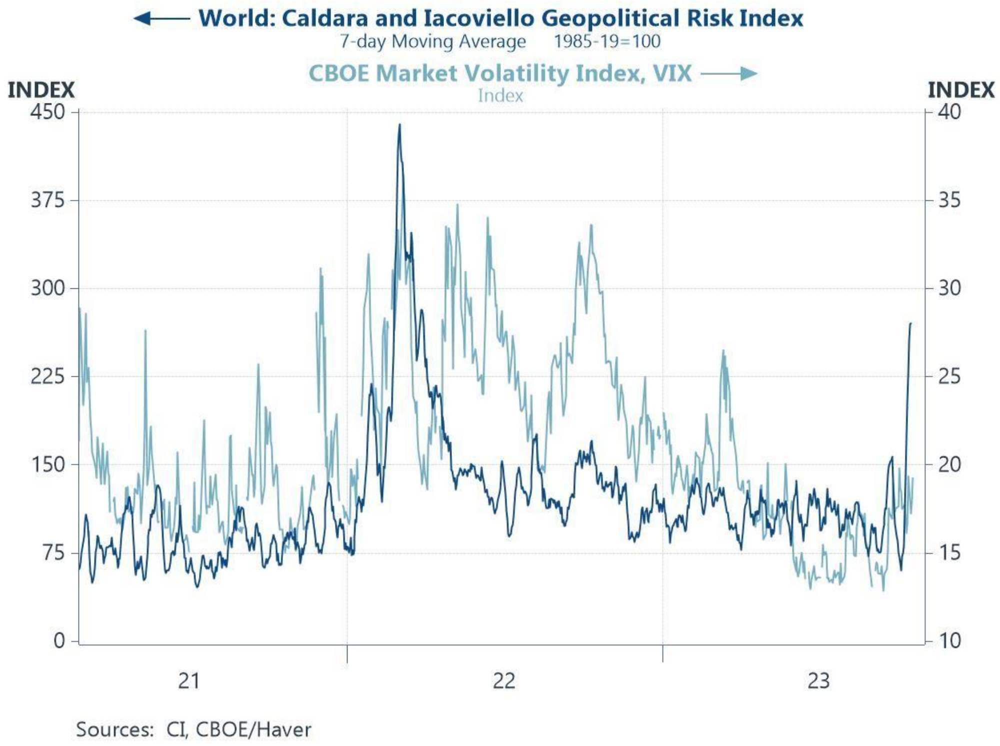
Summary

Geopolitical instability in the Middle East has continued to weigh on sentiment over the last few days not least given its potential to amplify financial instability. In our charts this week we contrast the recent spike in a global gauge of geopolitical risk with the absence – to date – of any meaningful climb in financial market volatility (chart 1). We look too at the oil price – a key bellwether of geopolitical stress – and the critical role this could play in triggering global economic strain in the period ahead (chart 2). On the data front this week's economic news from China was much more upbeat (chart 3). But the longer-term outlook for that economy remains uncertain, one reason for which we focus on next (chart 4). The downward revisions that have been made to the IMF's longer-term forecasts for the world economy is our subsequent port of call (chart 5). That policy makers have felt compelled to deploy fiscal policy levers and ramp up government debt in order to mask a disappointing growth outlook is the message from our final exhibit this week (chart 6).

Middle East tension/Geopolitical risks

The conflict in Israel and Gaza has been – and will likely remain – a key focal point in the weeks ahead. Normally, higher geopolitical risk is linked to a greater likelihood of economic and financial market stress, along with increased downside risks to the global economy. However, straightforward measurement of this link is challenging. Nevertheless, in Chart 1 below, we have depicted an index of global geopolitical risk, which gauges adverse events and associated risks by tallying newspaper articles covering geopolitical tensions. As the chart illustrates, this index has recently experienced a sharp increase. Nevertheless, there hasn't yet been a big follow-through from financial market stress, as measured in this case by the US VIX index.

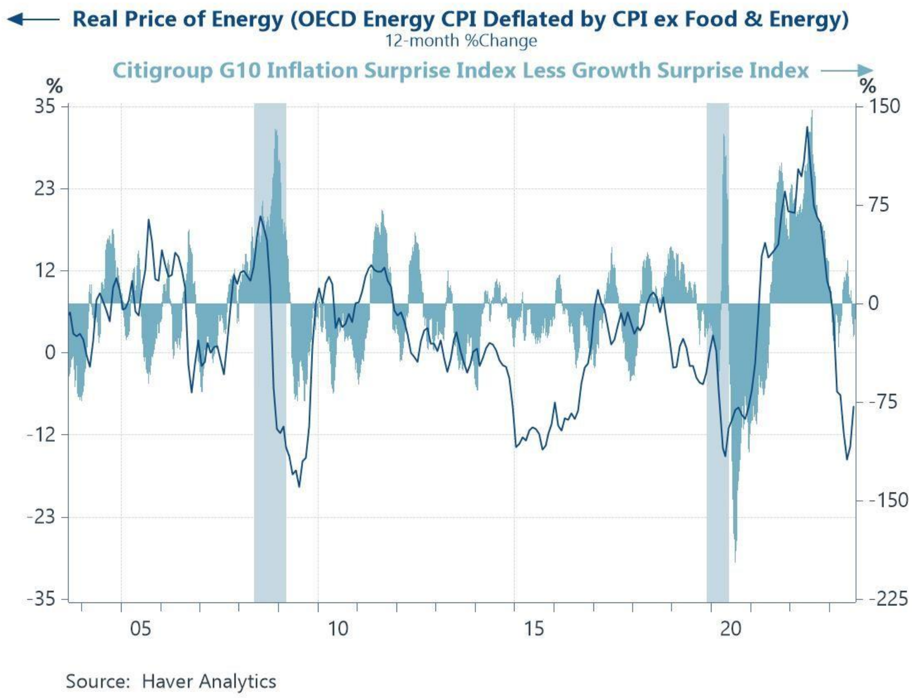
Chart 1: Global geopolitical risk and US financial market volatility



Energy prices and stagflation

The price of oil is likely to continue to play a pivotal role in how geopolitical tensions in the Middle East trigger broader economic and financial instability. In Chart 2 below, we illustrate how oil prices have historically caused significant fluctuations in economic sentiment. For example, changes in the inflation-adjusted consumer energy price in OECD economies, which are closely correlated with oil prices, have often served as indicators of unexpected shifts in economic growth and inflation. In particular, stagflation phases, which are characterized by positive inflation surprises coupled with negative growth surprises, can often be traced to higher oil prices and broader disruptions to the supply side.

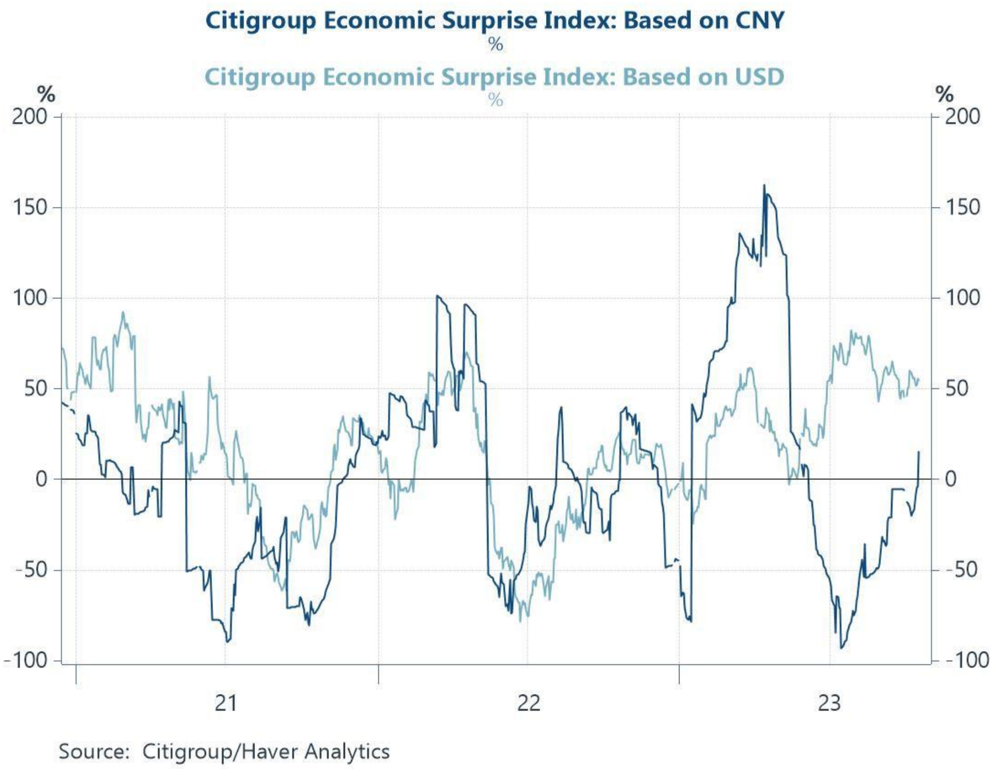
Chart 2: Real energy prices versus growth and inflation surprises in major economies



US and China data surprises

One reason why financial market sentiment has yet to respond too negatively to the instability in the Middle East concerns the incoming dataflow. This week's economic data from China, for example, and most notably the estimate of GDP for Q3, surprised forecasters' expectations on the upside. Coupled with positive surprises from September's retail sales and industrial production, that helped to shift Citigroup's growth surprise index for China into positive territory for the first time since June. Together with still-positive messaging from the incoming US data in recent weeks, investors have arguably started to feel more at ease about the immediate outlook for global growth in the weeks ahead.

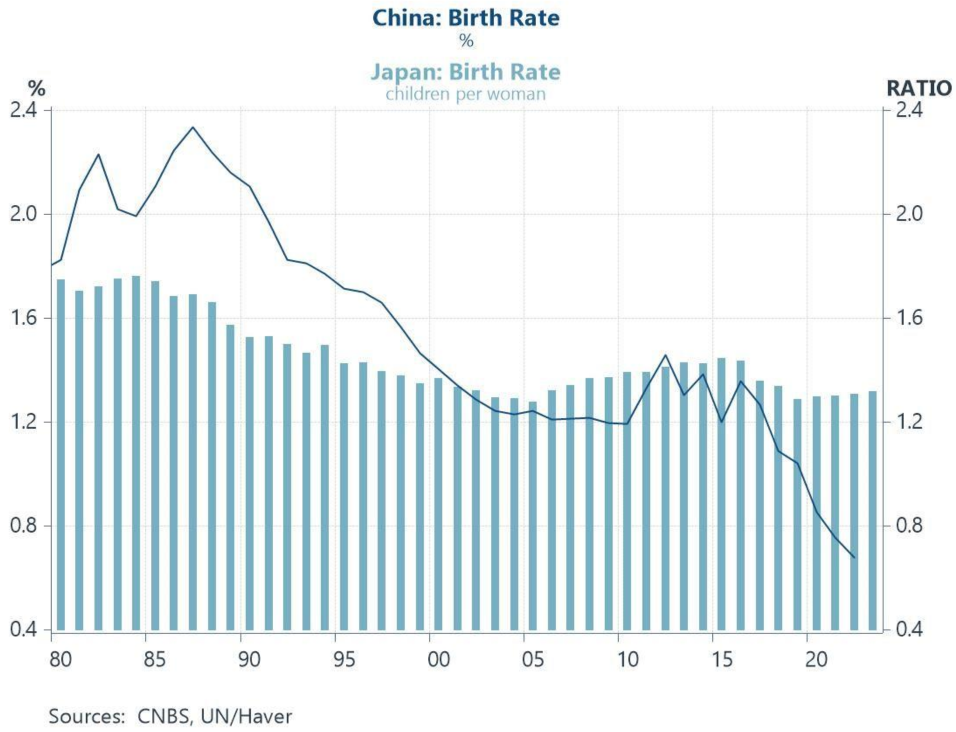
Chart 3: Citigroup's growth surprise index for China, the US and euro area



Birth rates in China and Japan

A stronger-than-expected performance from China in Q3, however, does not imply that the economy is in the clear. The challenges associated with property market and debt-related imbalances will require a significant amount of time to resolve. Meanwhile, structural obstacles to growth have been steadily accumulating, with one of these concerning demographics. According to the Science Centre at Peking University, the projected number of births in China for 2023 is anticipated to range between 7 to 8 million. This follows a 40 percent decrease in China's new-born population over the past five years. The uncertainties brought on by the COVID pandemic, coupled with weak income expectations and elevated levels of youth unemployment, can arguably be identified as key factors contributing to this decline. These factors though are further exacerbating an already significant aging trend within the economy at large.

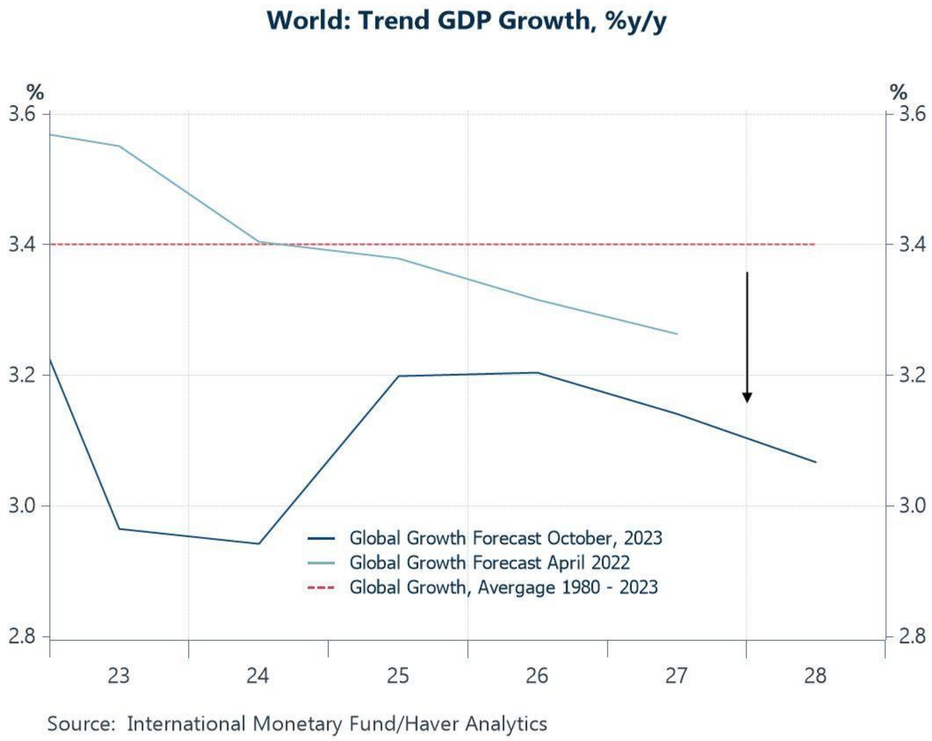
Chart 4: Birth rates in China and Japan



The world economy’s growth potential

Those headwinds for China’s growth potential are one factor that explains the IMF’s heightened pessimism toward the longer-term outlook for the world economy. In Chart 5 below, we compare the IMF’s most recent October forecasts for global growth from 2023 to 2028, firstly with its longer-term projections made in April 2022 (and up to 2027), and secondly with the 40-year historical trend. In summary, the October forecasts have been revised downward and now fall well below the long-term average. There are a number of perhaps familiar reasons for this heightened pessimism but they underscore nevertheless some of the challenges that confront policymakers in the period ahead.

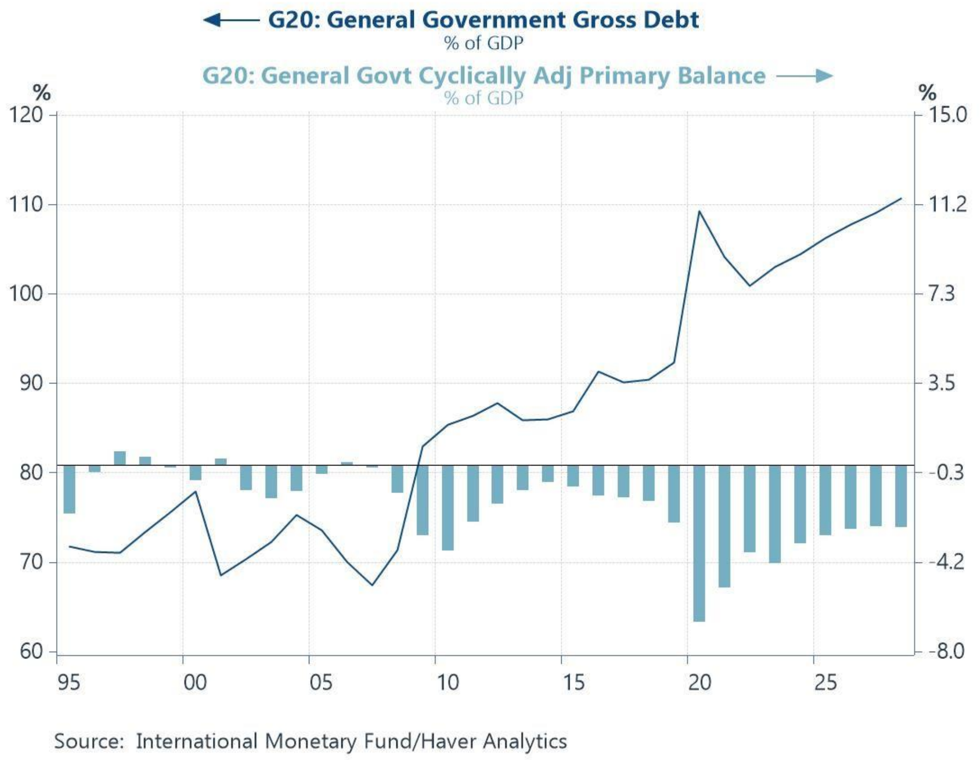
Chart 5: IMF long-term forecasts for global growth versus the 30 year global growth trend



Fiscal policy space

One of these challenges pertains to monetary policy and the inflationary pressures that have arisen due to reduced supply potential. However, substantial challenges also exist on the fiscal policy front. Fiscal policy tools, after all, have been used more extensively in recent years, partly due to the support required to bolster growth during the pandemic. But they have been more actively employed as well because of pressures that have surfaced from factors like ageing demographics, particularly in areas such as healthcare and pensions. As a consequence, government debt-to-GDP ratios have risen significantly (as shown in Chart 6). However, that means there is now far less room to actively employ fiscal policy tools in the period ahead, especially in an environment of higher interest rates and increased debt service costs.

Chart 6: Government debt and structural deficits in the G20



ABOUT THE AUTHOR

Haver Analytics is pleased to bring [Andrew Cates's](#) commentaries on the state of the global economy to its clients.

Andy Cates has more than 25 years of experience forecasting the global economic outlook and in assessing the implications for policy settings and financial markets. He has held various senior positions in London in a number of Investment Banks including as Head of Developed Markets Economics at Nomura and as Chief Eurozone Economist at RBS. These followed a spell of 21 years as Senior International Economist at UBS, 5 of which were spent in Singapore. Prior to his time in financial services Andy was a UK economist at HM Treasury in London holding positions in the domestic forecasting and macroeconomic modelling units.

He has a BA in Economics from the University of York and an MSc in Economics and Econometrics from the University of Southampton.