

## [Geopolitical Risk and Inflation: The Role of Energy Markets](#)

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The paper examines the transmission of different classes of geopolitical risk shocks to inflation and economic activity. In particular, the paper aims to empirically investigate the role of energy markets, providing evidence in support of their importance for the transmission of geopolitical risk to the macroeconomic environment.

Recent events have brought to policymakers' attention the macro effects of geopolitical risks, especially in light of the recent global surge in inflation. The work of Caldara and Iacoviello (2022) has quantified geopolitical risk fluctuations, measured via their GPR index, and shown that these can negatively impact economic activity through various mechanisms. This paper investigates the role of different classes of shocks underlying geopolitical risk dynamics and assesses their macro consequences. Different events might be characterised by different transmission mechanisms and have distinct macro implications. Given the distinct nature of each geopolitical episode, disentangling the heterogeneity characterising different classes of shocks is crucial to identify the macro impact of each individual shock in a given context.

The empirical analysis identifies two different classes of geopolitical risk by exploiting the co-movement of the geopolitical risk index and oil prices around key events. The negative co-movement is attributed to news associated with a contraction of macroeconomic activity (a geopolitical macro shock). The positive co-movement, on the other hand, is attributed to news regarding developments in energy markets, as it is associated with an increase in oil prices (a geopolitical energy shock). Based on these premises, the empirical analysis of the paper exploits two techniques from the VAR literature to disentangle these two classes of shocks and assess their macro consequences. The baseline methodology is based on the VAR model with high-frequency sign restrictions developed by Jarocinski and Karadi (2020). This specification exploits the idea that the co-movement of the geopolitical risk index and oil prices is exclusively driven by geopolitical shocks within selected event days. In order to ensure the robustness of the results, the paper also proposes a VAR specification based on narrative sign restrictions as in Antolin-Diaz and Rubio Ramirez (2018).

The findings suggest that an increase in geopolitical risk leads to contractionary effects on US economic activity, regardless of the nature of the shock. However, the inflation response depends on the nature of the shock. A rise in geopolitical risk associated with geopolitical macro risk has deflationary effects, while a rise in geopolitical risk associated with geopolitical energy risk leads to inflationary pressures. This crucial distinction between these two classes of shocks has straightforward implications for the conduct of monetary policy.