27th Annual DNB Research Conference

The Macroeconomic Effects of Geopolitical Uncertainty

DeNederlandscheBank
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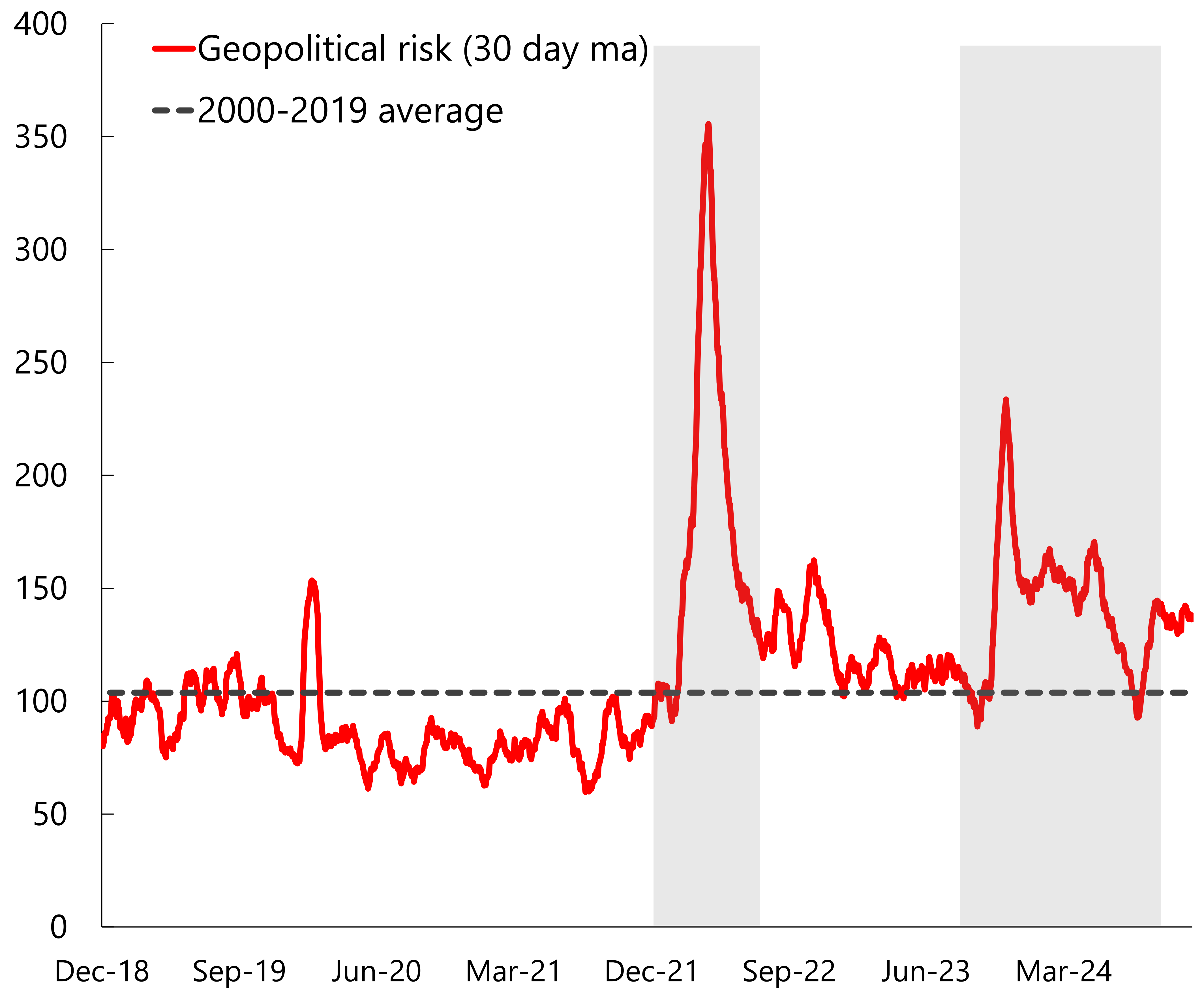
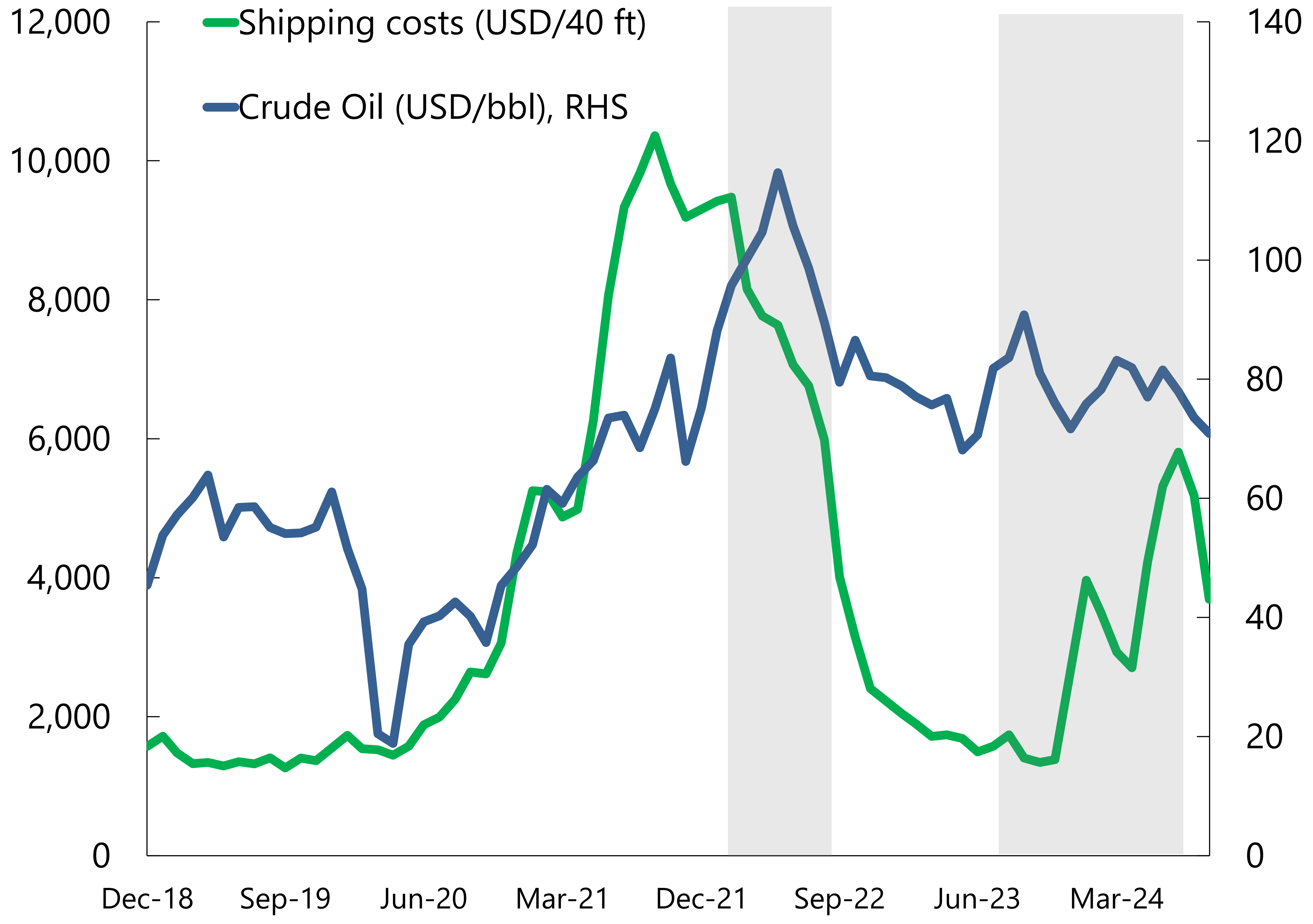
Pierre-Olivier Gourinchas
Economic Counsellor, IMF

Geopolitical Risk has been Elevated, Triggering Supply Issues

Geopolitical risk
(index)



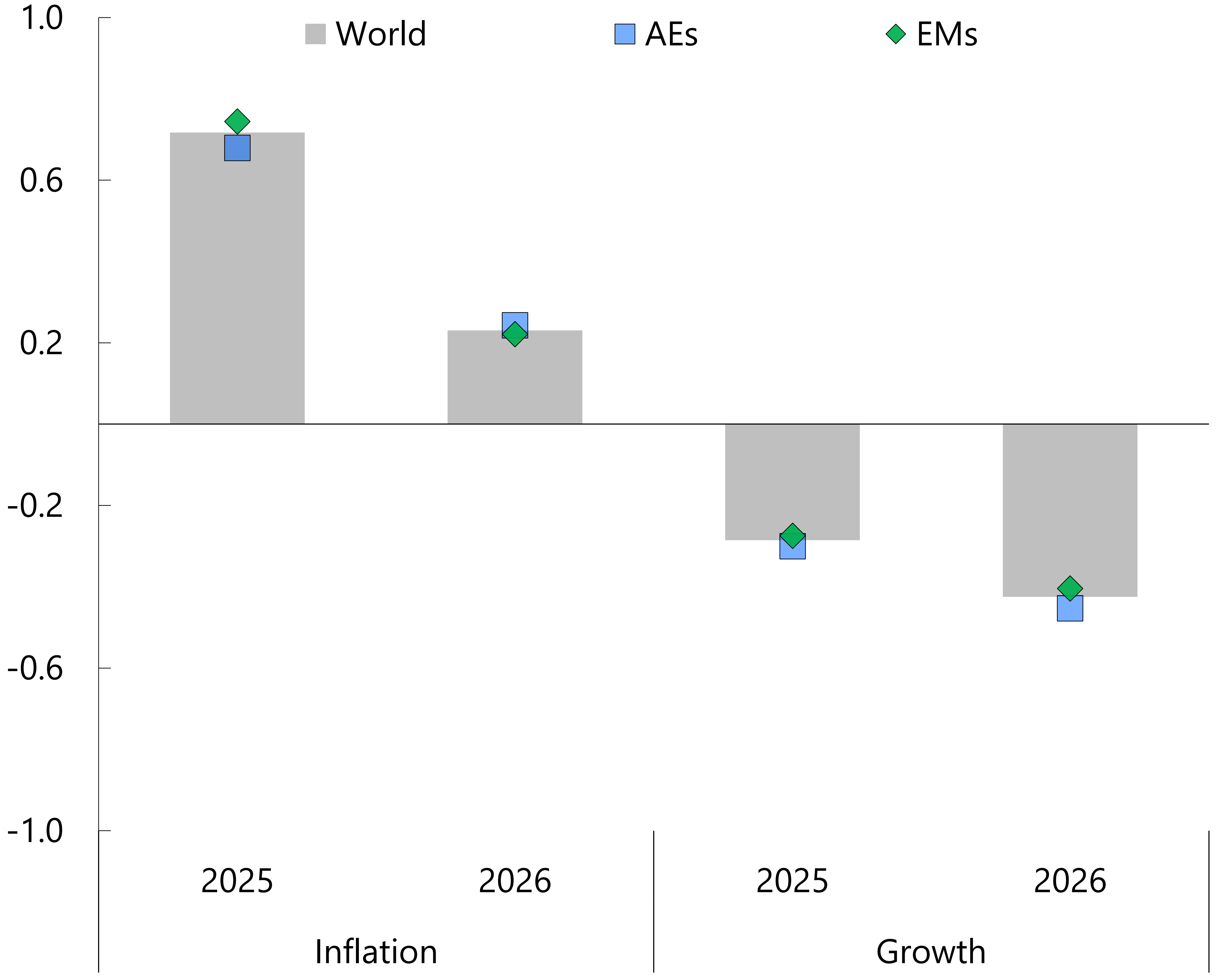
Oil prices and Shipping costs 1/
(rates per unit)



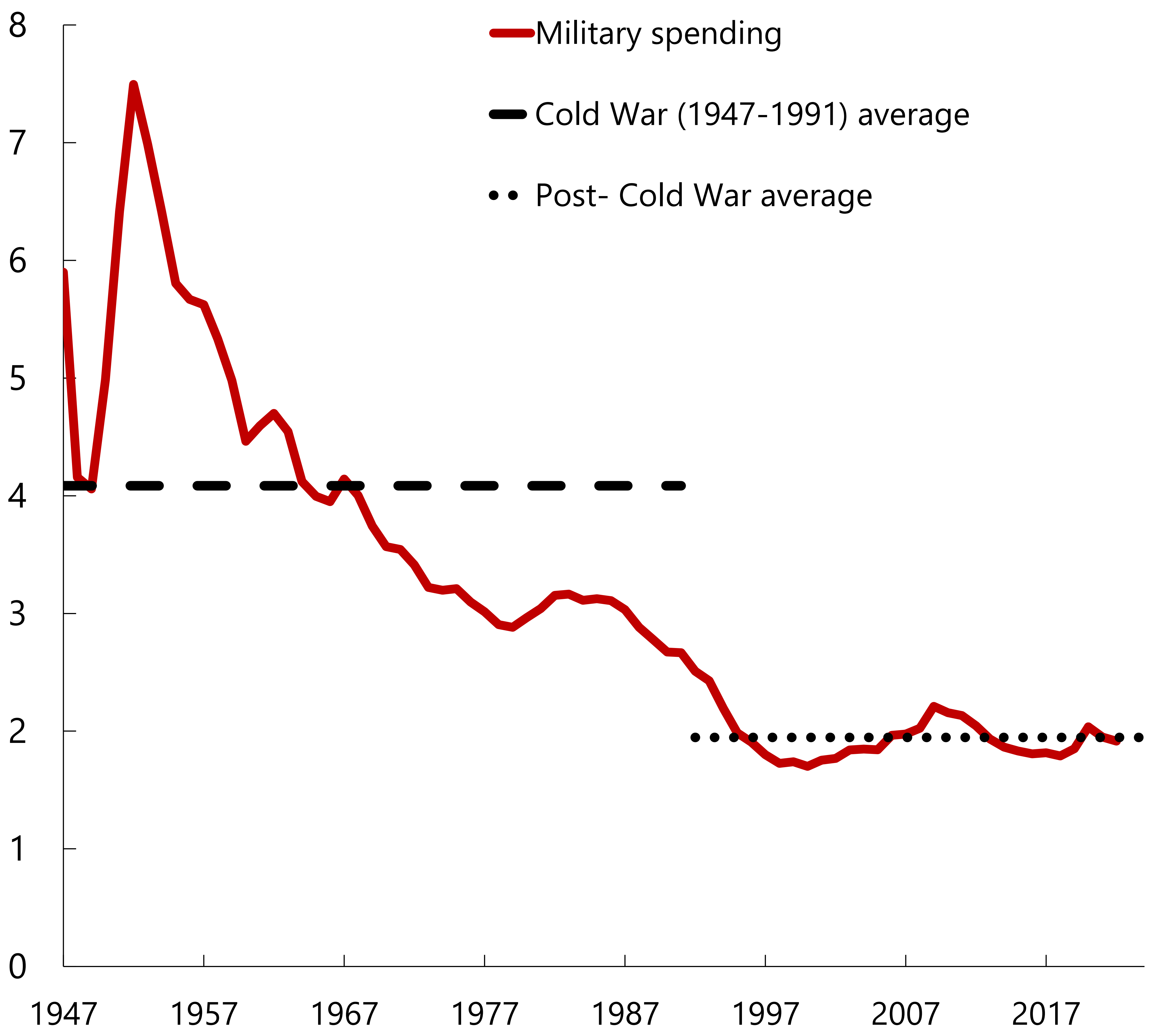
Sources: Haver Analytics; Caldara, Dario and Matteo Iacoviello (2022); and IMF staff calculations.
1/ Shipping costs are based on Drewry container index: Composite freight rate. Crude oil costs are WTI future prices.

Geopolitical Risk Affects Near-Term Prospects and Increases Fiscal Risks

Geopolitical Risk Scenario 1/ *(impact on global growth and headline inflation; percentage point deviation from baseline)*



Military spending in G7 countries
(percent of GDP; unless noted otherwise)

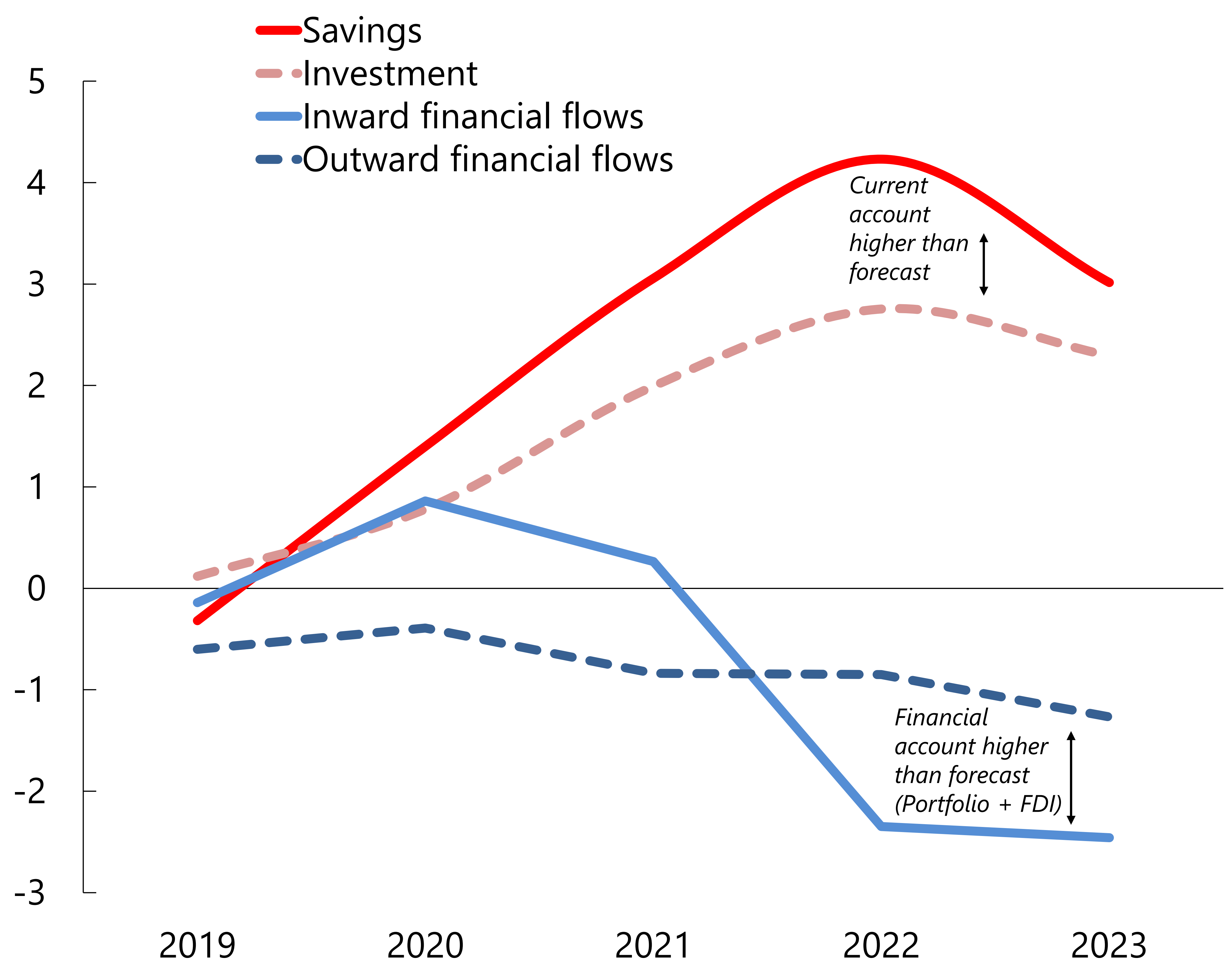


Sources: IMF, *World Economic Outlook*; Consensus Forecast; and IMF staff calculations.
1/ Scenario assumes that an escalation of the middle east conflict leads to a surge in oil prices and in shipping costs. Oil prices and average container prices are 15 and 150 percent higher, respectively, in 2025.

Geopolitical Concerns are also Triggering Financial Fragmentation

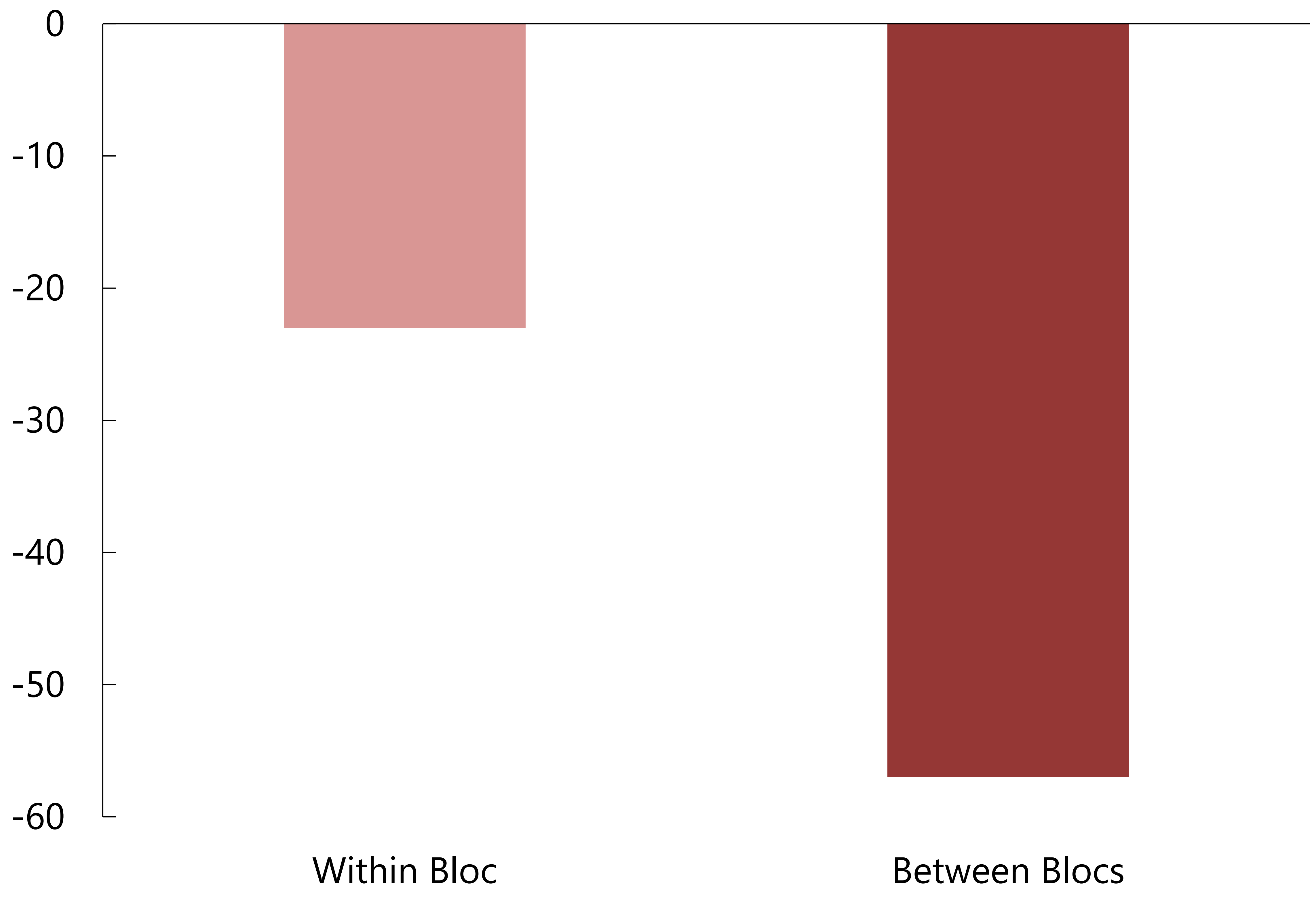
China external balance revision 1/

(deviations from the pre-pandemic projection in percent of GDP)



Change in FDI shares post war 2/

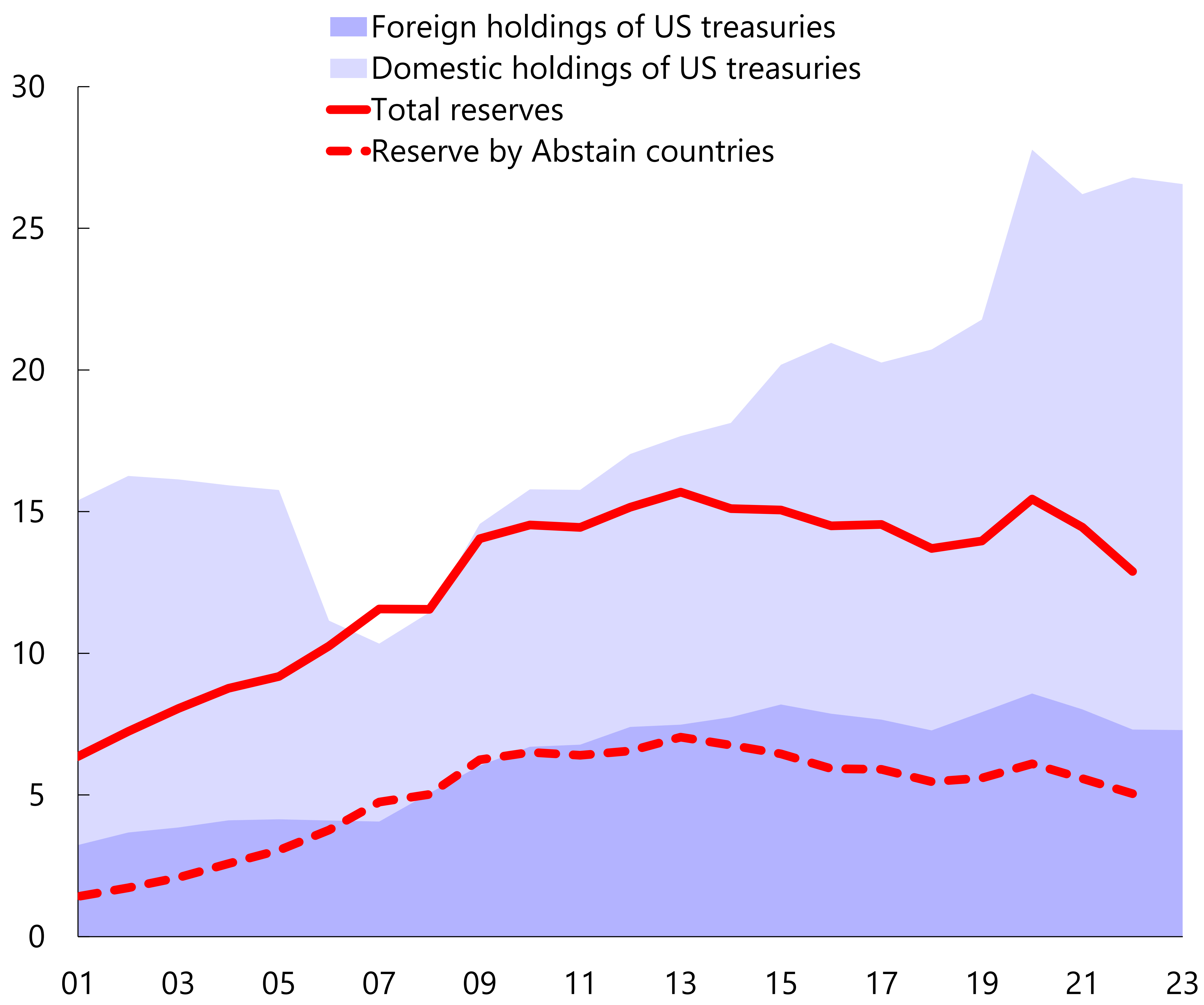
(percentage points)



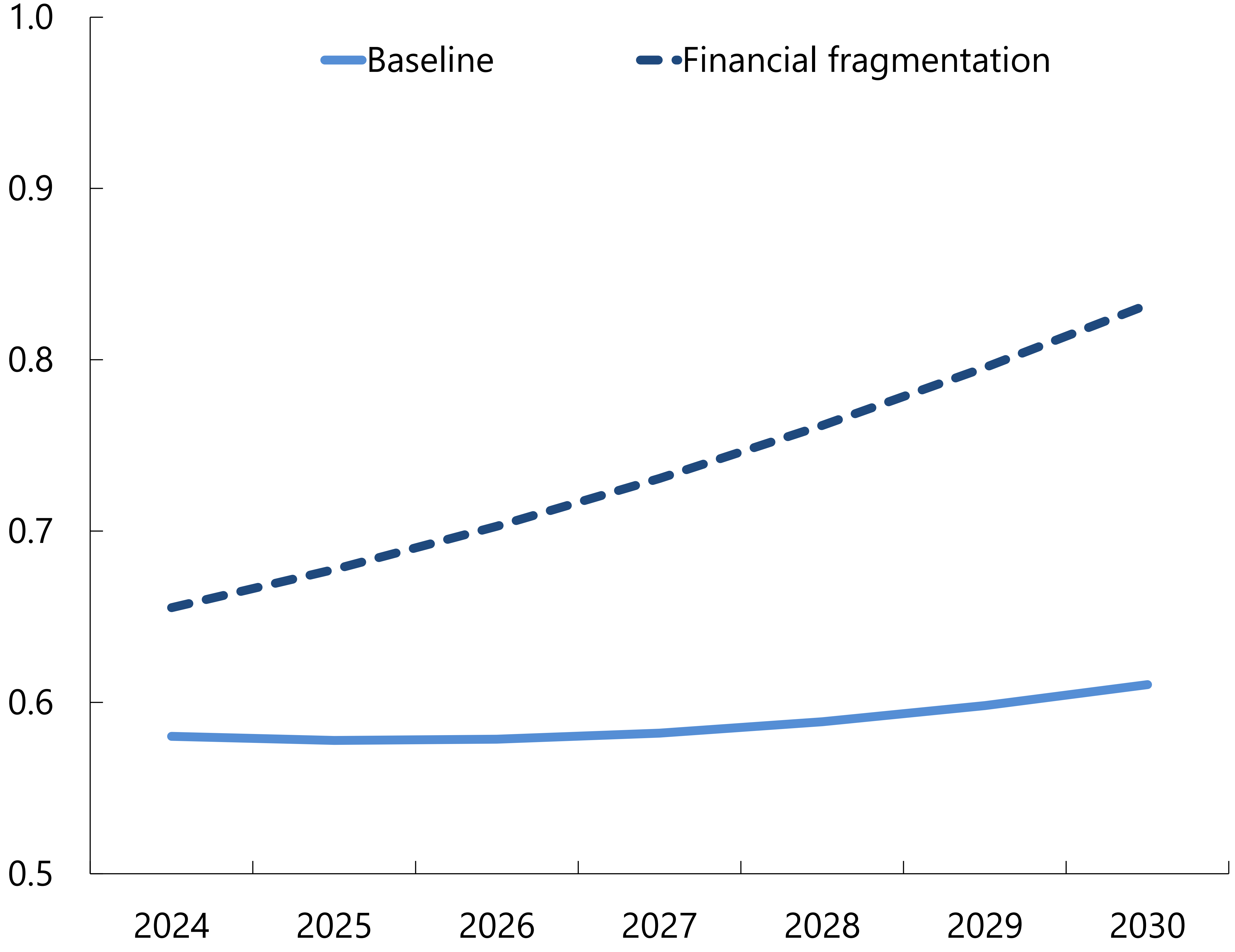
Sources: Gopinath et al. (2024), Trade Data Monitor, fDi Markets; *World Economic Outlook* and IMF staff calculations.
1/ Inward and Outward Financial flows are for FDI and portfolio investment. Pre-pandemic projections are based on WEO January 2020 vintage.
2/ The chart shows the share of announced FDI project share during 2022Q2 - 2023Q3 minus the equivalent for the period 2017Q1 - 2022Q1 within blocs, and between blocs

Financial Fragmentation Poses Risk to r* and Medium-Term Prospects

Demand and supply of safe assets 1/
(percent of world GDP)



Simulated path for natural rate of interest: USA 2/
(percent)



Source: COFER, *World Economic Outlook Ch2 April 2023;* and IMF staff calculations
1/ Domestic holdings of US treasuries is calculated as the difference between total holdings and foreign holdings, and thus includes the discrepancy.
2/ In the financial fragmentation scenario, the China bloc reduces its exposure to the US bloc's Treasury China bloc; it is modeled by reducing the premium paid by foreigners on US Treasury bonds. The China bloc disposes of net foreign assets, which pushes down their domestic interest rate by 40 basis points.

Policies to Mitigate Geopolitical Risk

An intensification of geoeconomic fragmentation (GEF) can cause global output losses and make it more difficult to provide global public goods (Aiyar and others, 2023).

- GEF poses **upside risks to inflation and macro-stabilization** in US and other advanced economies. Degree to which domestic imbalances can be remedied through external linkages will fall as rival blocs decouple.

- Restrict the use of **industrial policies (IP) to address externalities and market distortions**; But even in narrow cases, to be effective, IP measures should be well-targeted, time-bound, cost-effective and transparent.

- Evidence from the US that IP works best when R&D support is provided across a whole sector while encouraging competition (DARPA, Renewable energy, Sematech). “Hard” IP tools, such as tariffs or subsidies rarely efficient.

- IP on strategic or **national security grounds should be confined to a narrow perimeter**; else it can become a pretext for protectionism (e.g., estimates for the EU show about 0.5% of imports involve “strategic dependencies”).

- IPs should be **consistent with international obligations** so as not to undercut level playing field.

- With geopolitical risk increasing, **policy buffers to smooth shocks are important**. So GEF provides additional motivation to build up fiscal buffers in several countries (IMF Fiscal Monitor, April 2024).