Geopolitical Surprises and Macroeconomic Shocks: A Tale of Two Events

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Discussion by
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27th Annual DNB Research Conference, Amsterdam, 22nd November 2024

[1]The views expressed in this paper are solely the responsibility of the authors and should not be interpreted as reflecting the views of the European Central Bank.

The paper in a nutshell

A straight to the point research question:

- Through which channels did the Israel-Hamas war and war in Urkaine transmit to EA macroeconomic aggregates?

Baseline assumptions:

- There is no single geopolitical risk shock ("Every time it's different").
- Rather, GP events manifest as orchestra of structural shocks.

→ Need to look at historical decomposition to understand GP events.

Results:

- Ukraine war was inflationary, Israel-Hamas war deflationary.
- Transmission of geopolitical risk shocks largely attributed to demand.

Discussion

First of all, the paper...

- ...is a well motivated contribution.
- ...provides an interesting new angle and is great to read!

However, opportunities to strengthen the paper beyond the current draft.

During this discussion, I am going to focus on two key elements:

- The identification, i.e. the "IP demand shock".
- The results.

Identification

GPR shocks are generally hard to identify:

- The authors rely on a mix of statistical identification and sign restrictions.
- Shocks are the common part shared by all surprises that induce a change in a given variable (i.e. a spike in GPR).

→ The sign restrictions are imposed to support identification which otherwise relies purely on ex-post labelling.

The authors identify a demand, supply, "IP demand", GPR, and oil supply shock.

What is IP demand?

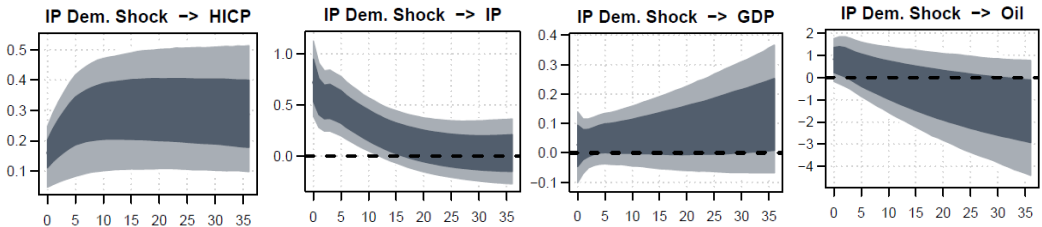

Figure: Impulse response functions to a shock in "IP demand". Source: Anttonen & Lehmus (2024). Response of GPR is omitted.

The shock...

- ...drives IP but not GDP (so, inventories/intermediate goods?)
- ...does not seem to drive oil (so not an energy price shock!)

What is IP demand?

In addition, the shock is very inflationary:

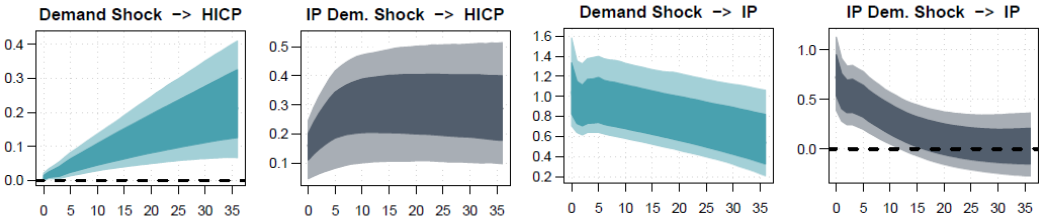

Figure: Impulse response functions to a shock in "IP demand". Source: Anttonen & Lehmus (2024).

→ Response of inflation to the IP demand shock appears to be about 10 times larger than to the "standard" demand shock!

→ So a shock that largely drives inflation, but not energy prices - that drives IP but not GDP?

Does it matter? - Yes

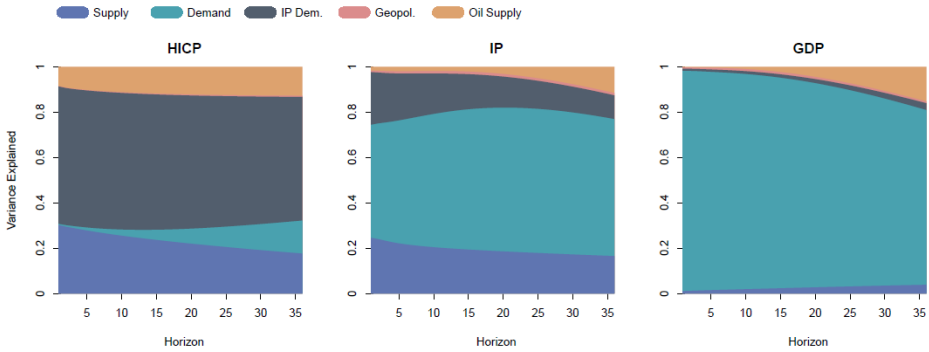

Figure: FEVD. Source: Anttonen & Lehmus (2024).

→ The "IP demand" shock explains about 50-60% of variations in HICP, much less of IP, but almost nothing of GDP!

→ GPR shocks seem to explain less than 1%.

The unknown shock drives most of the results...

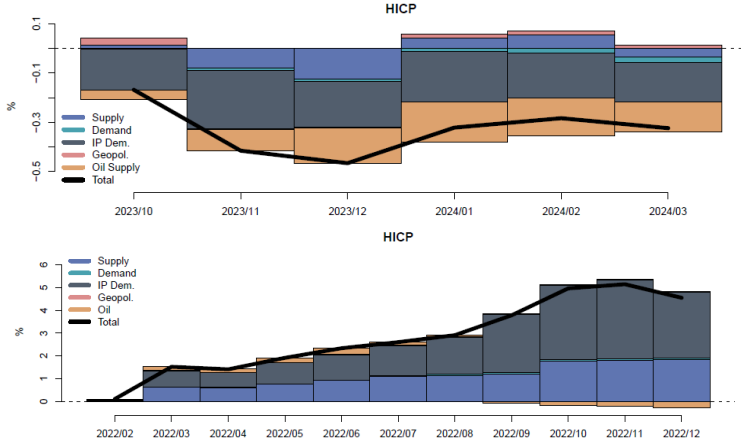

Figure: Historical decomposition for the Israel-Hamas war (top) and Ukraine war (bottom). Source: Anttonen & Lehmus (2024).

Suggestions

Let's take the results as given...If there is a factor that is way more important than supply and demand during GPR episodes that has so far been missed...

- ...we need to understand better what it is.
- ...would benefit greatly from some economic intuition (so far missing).

Alternatively, "IP demand" appears to be the "bottomless pit" where all other variation ends up:

- Would additional sign restrictions help?
- Perhaps we could drop monthly GDP (in my opinion it adds little to the current draft) and hence identify only 5 shocks that might be more interpretable?
- Would adjusting the set of variables aid identification/interpretation?

Additional Comments

A few additional remarks:

- If GPR shocks contribute almost nothing, does this mean there is no uncertainty channel (is it all sponged up by demand/inventory demand)? If not, what does the GPR shock measure?
  - → Plotting the structural shocks eye-balling whether spikes coincide with e.g. important GPR events would serve as a simple validity check. (Does the GPR shock spike during the war in Ukraine/Gaza?)
- Perhaps country level geopolitical risk indicators for Israel/Ukraine might be more suitable to study these two events than the overall index.
- Would be careful to label the last shock "oil supply". The oil price literature usually distinguishes between 4 or 5 drivers of oil prices (might be muddled together here).

Final Remarks

Opportunities to improve the paper are manageable and will significantly bolster the contribution!

With adjustments, paper has the potential to:

- advance our understanding of the transmission of geopolitical risk
- set the stage for future interesting research in this area.

→ highly encouraging project!