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The importance of geopolitics

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Abstract

In the past few decades, political factors have had a short-lived impact on the world economy and policy. The rise in geopolitical tensions in recent years, however, suggest that this trend could be changing. In the years following the 2008-09 Global Financial Crisis (GFC), investors seemed less concerned with political dynamics and more focussed on economic performance, such that global policy mostly reflected economic conditions rather than political risk at the time. Recently, geopolitics has become a complex mix of events, exogenous factors, and thematic risks. This complexity poses a heightened risk to the global economy, potentially leading to more frequent geopolitical surprises in the coming decade. Geopolitical tensions, including the ongoing Russia-Ukraine war, the Israel-Hamas conflict, and the impact of climate change on food prices, are likely to remain on the radar for South Africa over the medium term, while general elections later this year also pose a threat to political stability.

1. Introduction

Geopolitical risk typically arises from tensions that disrupt the normal course of international relations and tends to increase when peaceful conditions shift due to war, the threat of war, sanctions, or diplomatic conflicts. Geopolitics studies the interactions of geography, politics, and economics. These relationships often shape economic growth, foster good business operating environments as well as efficient market conditions. However, geopolitical risk often occurs alongside other global macroeconomic events, making it difficult to assess its impact on the world economy.

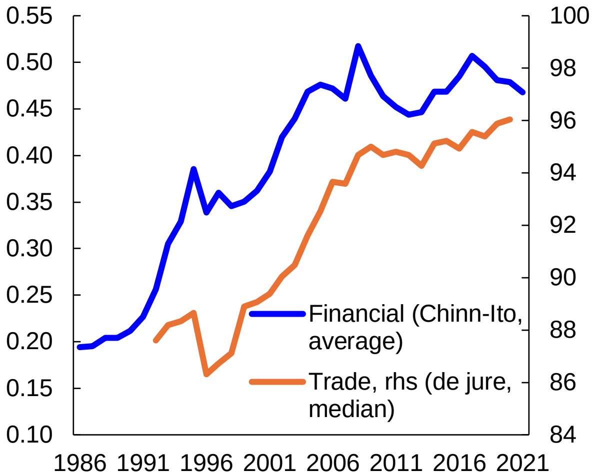
In the past few decades, political factors seemed to have had a short-lived impact on the world economy. In this economic note, we investigate whether the economic impact of geopolitics is changing. We assess whether such factors significantly affect global supply/demand balances, as well as capital flows and financial risk premia.

2. A brief history of geopolitics

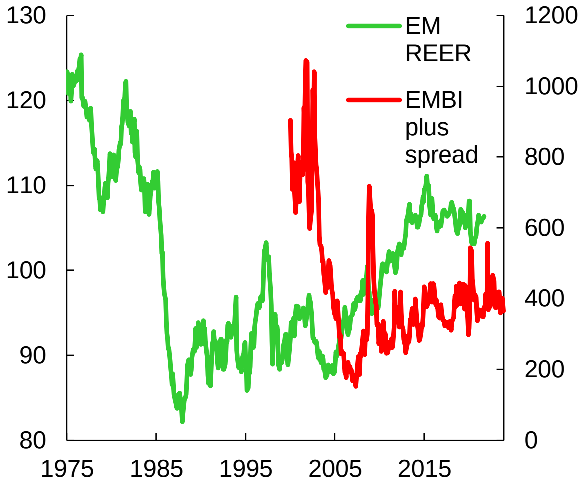
The term *geopolitics* gained popularity at the time of World War I (WW1) and World War II (WWII). Although geopolitical theory has experienced a decline in usage after the two world wars, geopolitics continued to influence international politics and was instrumental in the US Cold War strategy. The end of the Cold War, however, ushered in a "new world order" that was dominated by the West (and primarily the US) and where the free-market, rules-based approach to domestic policy and international economic relations became the norm. Francis Fukuyama asked in 1989 if this situation marked the "end of history"[1].

In advanced economies, this often meant a political space dominated by centre-left and centre-right parties.[2] Investors generally came to see electoral changes and other political dynamics as having limited impact on the economic outlook. Meanwhile, in emerging markets, most governments strove to be part of the new economic order and get a slice of global capital flows. To that extent, most emerging market economies ended up endorsing stability-oriented, investor-friendly policies[3]. Simultaneously, trade and financial openness increased across emerging market economies (Figure 1). Again, this meant investors got less concerned about political risk and more about economic performance[4]. Consequently, emerging market volatility abated, and real exchange rates improved (Figure 2).

Figures 1 and 2: Measures of trade and financial openness (left) and average EM real effective exchange rate vs EMBI+ sovereign spread (right)



Source: World Bank and Chinn-Ito



Source: JP Morgan

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1 "The End of History?", Francis Fukuyama, The National Interest, No. 16, Summer 1989

2 In practice these parties differed little on key economic issues and generally endorsed independent central banks, free trade, lesser regulation, multilateralism, and regional integration. An example was the UK, where "New Labour" under Prime Minister Tony Blair became a softer version of *Thatcherism*, with no significant reversal of liberalization policies undertaken by previous Conservative governments.

3 In the 1990s, South Africa's ruling party, the African National Congress (ANC), went within a few years from "command economy" plans to the pro-market GEAR (Growth, Employment and Redistribution) strategy. This was not an isolated case in the emerging world.

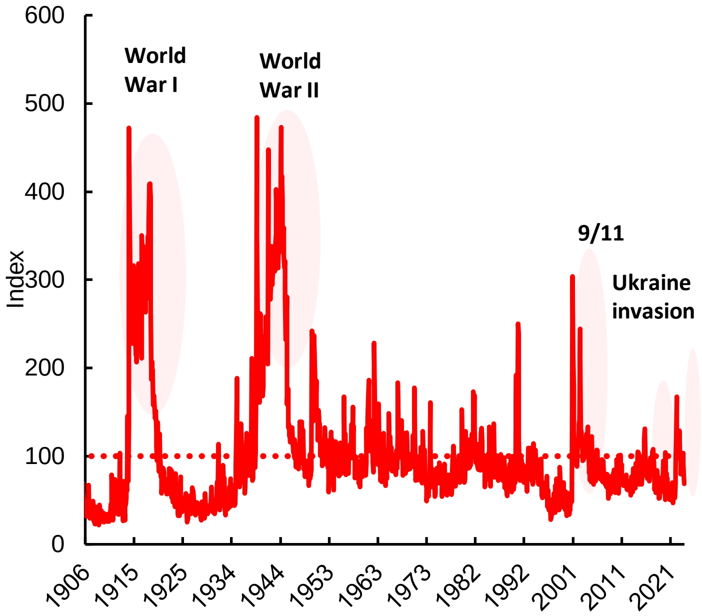
4 A trend emerged where rating agencies focused more on government's ability rather than their willingness to pay its debt.

The model's ability to engineer stronger growth and convergence towards living standards of high-income countries, however, faltered following the 2008-09 Global Financial Crisis (GFC).[5] Moreover, emerging powers that integrated into the global market such as China, India and Russia began to be perceived as threats rather than merely fast-growing markets for western multinationals.[6] In a slowing global economy, and at a time when governments failed to deliver on growth, populism gained ground, creating a situation where policy changes relevant to economic performance and structure became more prevalent.[7]

3. Types of geopolitical risk

Geopolitical risk[8] has been fluctuating over the last few centuries, spiking around the two world wars, and again at the start of the Korean War in the early-1950's, the Cuban Missile Crisis in the 1960's, and after the 9/11 terrorist attacks. Each successive spike in the geopolitical risk index however, failed to reach the levels seen at the time of the two world wars (Figure 3). While Russia's invasion of Ukraine in 2022 pushed the index higher, it still fell short of previous spikes seen after 9/11 and has recently fallen to levels below the long-run average.

Figure 3: Geopolitical risk index



Source: US Federal Reserve

5 This era also faced growing opposition amid the uneven spread of growth benefits both across countries and income groups within countries.

6 COVID-19, cybercrime as well as climate change illustrated the emergence of new threats.

7 For example, trade restrictions which the Trump administration placed on Chinese exports between 2017 and 2021 were largely kept in place by the Biden administration.

8 Illustrated by the Geopolitical Risk Index was calculated by Caldara, Dario, and Matteo Iacoviello (2021), "Measuring Geopolitical Risk," working paper, Board of Governors of the Federal Reserve Board, November 2021.

In this note, we characterize geopolitical risk as event risk, exogenous risk, or thematic risk. Event risk evolves around an expected political event such as an election outcome e.g., Brexit in 2016, that could have negative implications for prevailing conditions and potentially result in changes to a country's cooperative stance. Exogenous risk, conversely, is a sudden or unanticipated risk and include events such as natural disasters, political unrest, pandemics, and other unexpected events. Thematic risks are generally anticipated events that evolve and expand over time, which include issues such as climate change, cyber threats, the regulation of artificial intelligence as well as the ongoing threat of terrorism. Meanwhile, the issues of energy security as well as the potential re-organisation of global supply chains can also be grouped under thematic risks. In recent years, geopolitics have been characterised by a complex mix of event, exogenous as well as thematic risks, posing increasing risks to open market economies.

4. How does geopolitical risk affect the global economy?

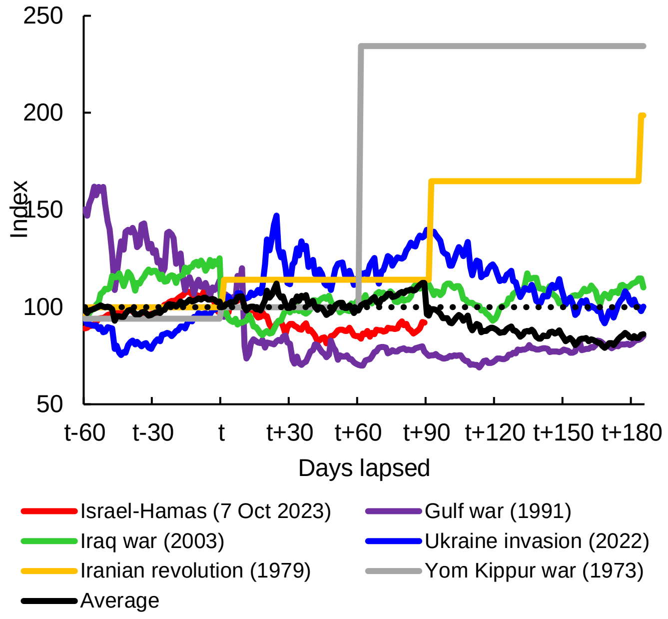
4.1 Short term impact on the world economy

Geopolitical risks mostly materialise as a surprise, making it difficult to monitor, forecast as well as assess their impact on the global economy. There are various transmission channels of geopolitical risk on the economy, some of which we will consider in this section. We first analyse the impact of geopolitics on global financial markets, as this is usually the quickest transmission channel.

Contrary to what one would expect, the oil price does not always rise in response to increased geopolitical risk[9]. The Middle East should continue to be a geopolitical "hotspot" but should have less of an impact on the oil price today compared to say in the 1970s and 1990s, when the region controlled a larger share of the global oil market.

[9] In our analysis, the oil price is indexed to 100 at time *t*, which coincides with the start of the geopolitical crisis. In 1973 and 1979, there was not yet a developed free market for oil where prices were determined daily, so price indices adjusted based on OPEC decisions – hence explaining the lagged response to the start of the geopolitical event.

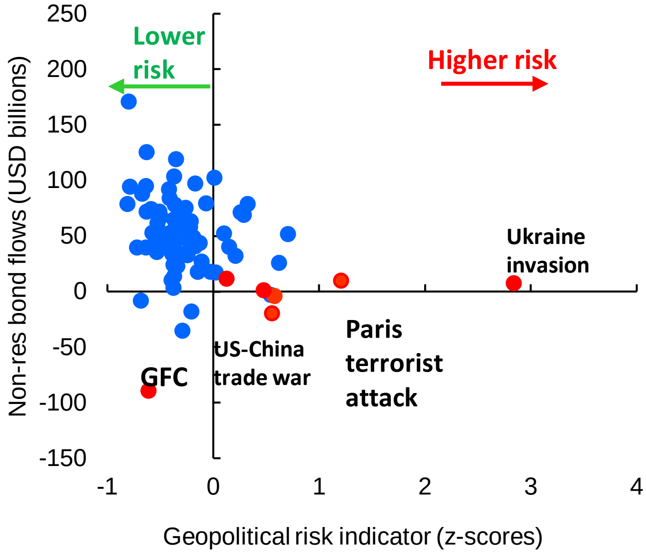
Figure 4: Oil price around major geopolitical crises



Source: OECD, Bloomberg

Rising geopolitical tensions tend to heighten risk aversion, impacting capital flows and global equities. During times of elevated geopolitical risk, emerging market economies generally experience mild bond and equity outflows. However, a period of unusually elevated risk – the Ukrainian invasion – did not result in major outflows, possibly because markets differentiated across flow recipients with respect to the vulnerability to the event shock.

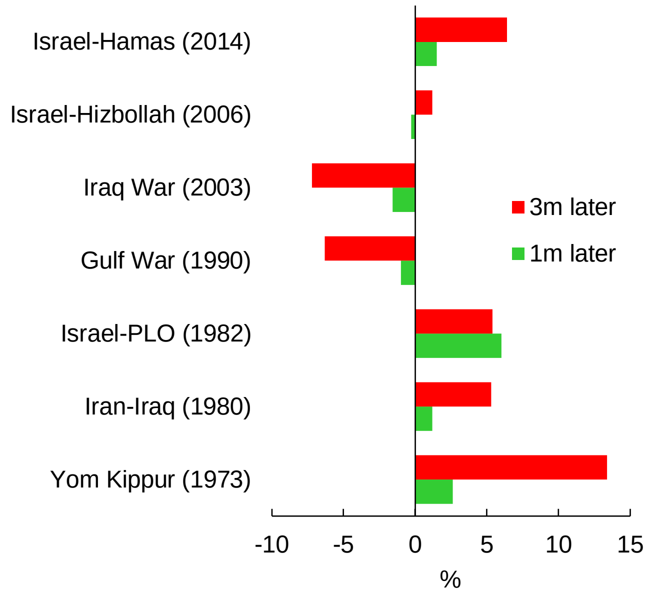
Figure 5: Emerging market bond and equity flows



Sources: IIF, SARB

When analysing the performance of the US dollar one and three months after the start of key geopolitical events in the Middle East, it is evident that the US dollar typically appreciates, except for two instances[10]. Other factors like the global economic climate and the state of the US monetary policy cycle also influence currency markets during geopolitical events.

Figure 6: Change in US dollar index after start of Middle East conflicts



Source: Bloomberg

4.2 Long-term impact on the world economy

Geopolitics typically influences the world economy through sentiment, generating uncertainty that directly impacts trade and investment decisions. It can also distort the allocation of resources: for example, higher geopolitical risk of the military type can force an increase in defense expenditure, which can easily crowd-out other, more productive investments. We consider two major channels by which we think geopolitics can impact the world economy – trade and foreign direct investment (FDI).

4.2.1 Impact on global trade

Recent geopolitical events[11] have likely triggered a geopolitical rift in the global economy. Concerns are rising that the world is leaning towards a more fragmented trading environment, where major economies are becoming more inward-looking. Trade uncertainty has also risen amid persistent geopolitical conflicts, partly contributing to weaker global trading conditions (Figures 7 and 8).

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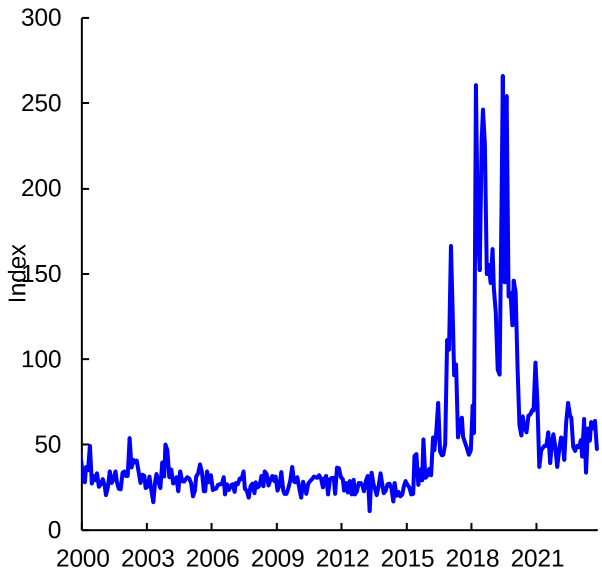
10 In the early-1990s, after the start of the Gulf War, and at the time of the 2003 Iraq War the US dollar depreciated against emerging market currencies.

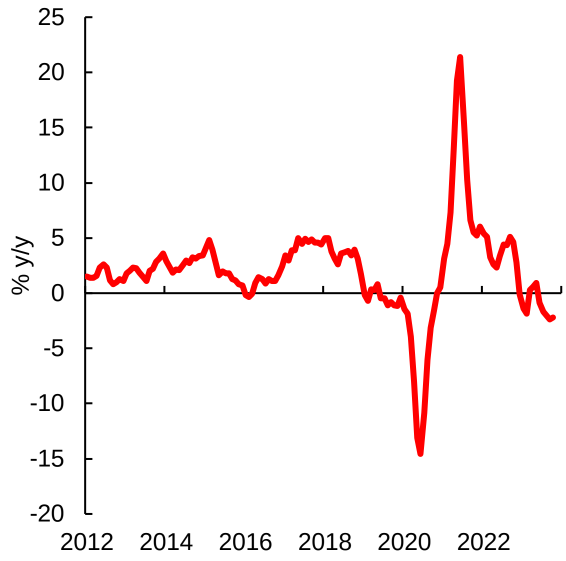
11 The US-China trade war that started in 2016, followed by the COVID-19 pandemic and then the war in Ukraine in 2022.

Figure 7: Trade policy uncertainty



Source: OECD

Figure 8: Global trade

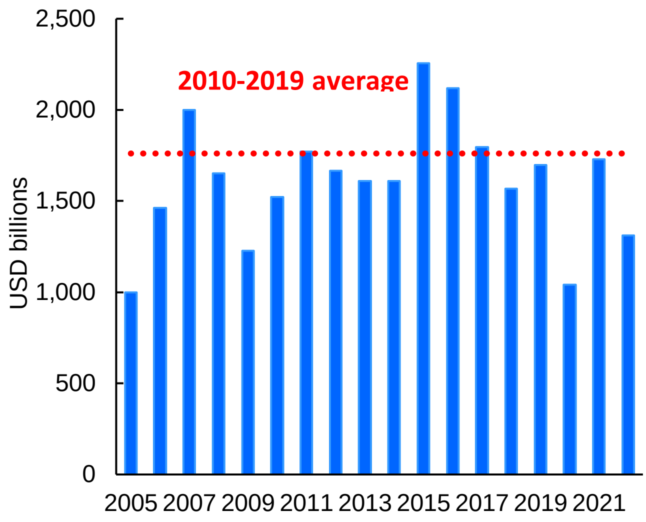


Source: Haver

4.2.2 Impact of geopolitics on investment

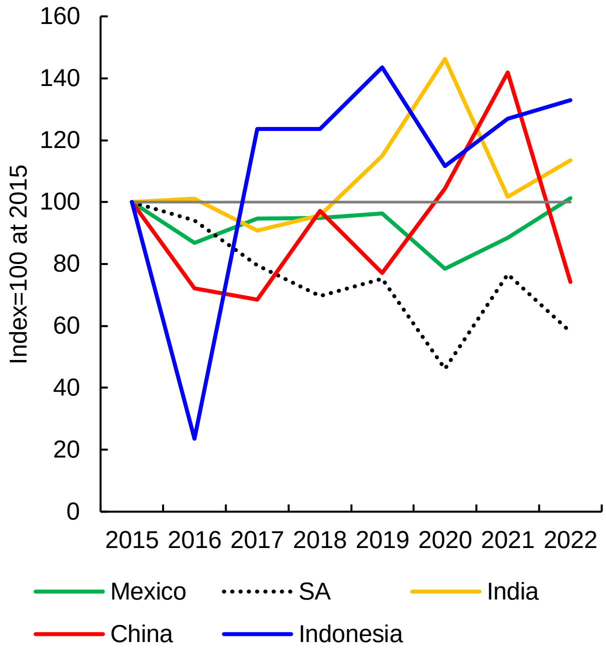
The size and direction of capital investment is likely to change in a world where countries are more geopolitically aligned. Global foreign direct investment has also fallen steadily in recent years (Figure 9). There are also emerging signs of investment reorientation along geopolitical lines. Notably, FDI inflows to China have continued to decline following the start of US-China trade tensions, while inflows into countries such as India, Mexico, Indonesia appears to have benefitted (Figure 10). More and more it would appear that FDI flows are increasingly concentrated among geopolitically aligned countries.

Figure 9: World FDI flows



Source: OECD

Figure 10: China net FDI inflows



Source: OECD

5. Outlook for geopolitics

Geopolitical risks are likely to remain elevated, and potentially increase, in the next decade or so. Among the top ten risks for 2024 mentioned by investors in a Deutsche Bank survey, three were of a geopolitical nature: the US 2024 election, an escalation of the Israel-Hamas conflict, and Taiwan becoming a global flashpoint[12]. With many countries also expected to hold elections this year, political dynamics could generate regulatory and policy uncertainty, further raising the likelihood of geopolitical surprises over the short term. [13]

Over the medium term, the lack of quick convergence of emerging market economies towards high-income countries could continue to intensify migratory flows in advanced economies, which are already struggling to manage an influx of immigrants, causing political backlash against open-border policies.[14] Meanwhile, in poorer economies, demographic pressures and the climate crisis could increase competition for basic resources, such as land or water. Such risks are likely to result in a greater probability of growth-unfriendly geopolitical dynamics, be it conflicts, internal military instability or the election of “illiberal” governments, not to mention climate events. It may be no surprise that conflict frequency has already been rising in recent years, both between and within countries (Figure 11).

Politically weakened governments may also struggle to enforce world order, while multilateral organisations like the United Nations see their authority undermined amid growing global

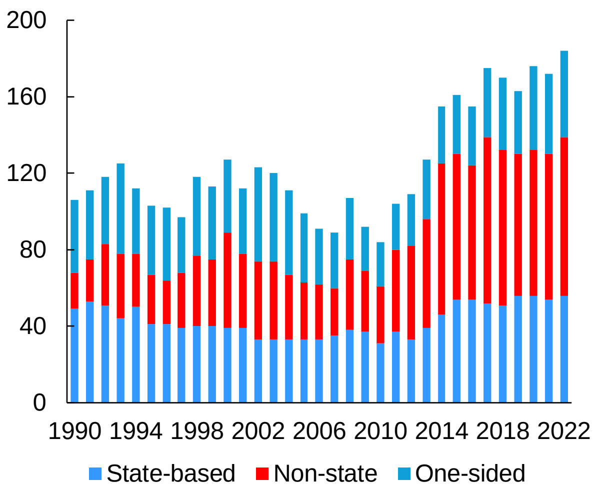
12 See December 2023 Global Markets Survey, Deutsche Bank Research, 11 December 2023.

13 This year, voters will go to the polls in countries that account for about 54% of the global population and nearly 60% of global GDP.

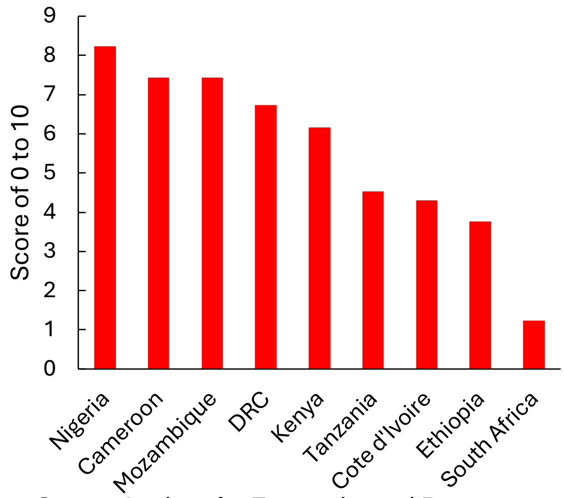
14 This contributes to politics in major democracies becoming more polarized, while lower voter participation can potentially reduce government legitimacy.

geopolitical divisions. Meanwhile, countries that are not part of formal military alliances or economic unions (NATO, the EU), or which do not have strong enough institutions to effectively allocate resources, combat the risk of terrorism or prepare against potential climate events, appear more at risk. Low-income countries, particularly in Sub-Sahara Africa (SSA), with strong population growth and urbanisation, may be more affected and have faced a growing terrorism risk over the years (Figure 12). These nations also stand to lose more from geo-economic fragmentation into rival blocs.[15]

Figures 11 and 12: Number of conflicts in the world (left) and degree of terrorism threat in major African economies (right)



Source: Uppsala Conflict Data Programme



Source: Institute for Economics and Peace

5.1 Implications for South Africa

Geopolitical tensions, including the ongoing Russia-Ukraine war, the Israel-Hamas conflict, and the impact of climate change on food prices, are likely to remain on the radar for South Africa. General elections this year also pose a threat to political stability if the ruling African National Congress fails to secure a majority.

Moreover, South Africa remains vulnerable to spillovers from global thematic risks. For instance, if perceived as aligning with one geopolitical bloc over another, South Africa may experience reduced access to certain markets or foreign direct investment (FDI). The country's neutral stance on Russia and the war in Ukraine could potentially reshape its future diplomatic relations with the US. This could, for instance, result in the potential exclusion from the African Growth and Opportunities Act (AGOA) programme[16], which poses a risk to local financial institutions' participation in the global system. There is also the increased likelihood of

[15] "Geoeconomic Fragmentation: Sub-Saharan Africa Caught between the Fault Lines," Regional Economic Outlook Analytical Note, International Monetary Fund, April 2023.

[16] The African Growth and Opportunity Act (AGOA) provides duty-free treatment to products from designated sub-Saharan African countries. According to a Brookings article, following the AGOA forum in August 2023, the U.S congress. released a draft bill to renew the programme for 16 years but would require an immediate "out-of-cycle" review of South Africa's eligibility for AGOA. Such a review could lead to an expulsion from the programme.

secondary sanctions, with long-term implication of further isolation from US-aligned trading partners.

Following the Israel-Hamas conflict, oil prices seem to have to have reacted mildly thus far, primarily due to concerns about global growth. However, if the conflict were to escalate and disrupt oil supplies, risks of higher energy prices and volatility could increase. More recently the Suez Canal developments have raised concerns about shipping costs[17]. Should the attacks on container ships escalate, supply chain disruptions similar to what was seen during the COVID-19 lockdowns could reappear. South Africa's sea ports are inefficient even without the disruptions in the global shipping industry. Hence, risks of running out of critical supplies, including liquid fuels, would be high.

Additionally, South Africa is increasingly becoming more vulnerable to adverse weather conditions. The more frequent bouts of extreme weather conditions in different parts of the country – particularly, floods in KZN and the Western Cape - and the ongoing El Nino event[18] remain key risks to the agricultural sector. This may impact food prices with implications for the future stance of monetary policy.

Within the region though, South Africa maintains its prominence, enjoying positive relations with neighbouring countries and currently facing no direct terrorism exposure and little to no internal strife. However, this stability may be challenged, particularly if issues like poverty and criminality escalate, potentially testing the effectiveness of South Africa's institutions and the rule of law in specific areas, thus altering the geopolitical landscape. An additional risk could be increased migration from the rest of the continent were violent conflict in African "hotspots" to intensify, at a time when unemployment in SA is high and peri-urban infrastructure would struggle to cope with significant new population inflows.

6. Conclusion

In recent decades, geopolitics has had a diminished impact on the global economy. However, the recent escalation in political tensions, coupled with a heightened awareness of geopolitical factors, indicates a potential shift in these dynamics. Geopolitics have also been characterised by various types of risk in recent years, making it even more difficult to predict and raising the likelihood of more frequent geopolitical surprises in the short to medium term. As tensions continue to escalate, investors are likely to adjust their business models, strategies, and supply chains to become more resilient to geopolitical disruptions. Meanwhile, South Africa, is no exception and remains vulnerable to a volatile and unstable geopolitical backdrop.

[17] Shipping is core to the global economy, accounting for 90% of the world trade carriage.

[18] Though the probability of a severe drought has been declining, concerns about the extreme heat conditions in certain parts of the country, i.e. Limpopo and Mpumalanga remain a risk.