Geopolitical risk in the euro area: Measurement and transmission

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How does geopolitical risk affect the euro area economy? While existing measures of geopolitical risk are largely US-centric, this study introduces a new euro area-specific indicator. The findings reveal that geopolitical shocks have significant recessionary and inflationary effects in Europe, underscoring the need for region-specific tools to guide monetary policy.

Introduction

Geopolitical risk (GPR) is a growing concern for policymakers, as it influences economic output, inflation, and financial stability. However, most existing GPR measures, such as the widely used Caldara and Iacoviello (2022) index, are based on US and Anglosphere media sources, potentially overlooking region-specific dynamics. This paper addresses this gap by developing a Euro Area Geopolitical Risk (EA GPR) indicator tailored to capture the unique risk perceptions of European economies. The study demonstrates that EA GPR shocks have distinct and significant economic effects, including output contraction and inflationary pressures, which are not fully captured by US-centric measures. These findings have important implications for European central banks, particularly in assessing inflation risks and calibrating monetary policy.

From newspaper articles to the risk indicator

The EA GPR indicator is constructed using newspaper coverage from the five largest euro area economies: Germany, France, Italy, Spain, and the Netherlands. We analyze the frequency of terms related to war, conflict, and terrorism in leading local newspapers, using GDP weights to aggregate country-specific indices into a single euro area measure. The study employs a Bayesian Vector Autoregression model adjusted for the COVID-19 pandemic, to estimate the economic impact of EA GPR shocks. This approach allows for a comparison between the effects of EA GPR and the global GPR index, while also accounting for structural shocks and high-frequency variations in geopolitical risk.

Different regions experience different risks

We argue that geopolitical risk is inherently region-specific, shaped by local media narratives and proximity to conflicts. While the global GPR index provides valuable insights, it fails to capture the euro area’s unique economic and geopolitical circumstances. For instance, the EA GPR index responds to events like the Russo-Ukrainian War more strongly and persistently than the US-centric measure. This divergence highlights the importance of a localized perspective in understanding the economic implications of geopolitical shocks. The study also explores two key transmission channels – sanctions and supply shortages – that amplify the economic effects of geopolitical risk in the euro area.

What happens after a geopolitical risk shock?

A one-standard-deviation shock to the EA GPR index reduces euro area GDP by 0.26 % within three months and increases consumer prices by 0.36 % within a year. This combination of falling output and rising inflation is consistent with the effects of adverse supply shocks, such as those caused by wars. The US-centric GPR index underestimates the economic impact of geopolitical shocks on the euro area. While both indices show similar patterns, the EA GPR index captures stronger and statistically significant effects on GDP and inflation. A “No-War” scenario, which assumes no rise in geopolitical risk following the Russo-Ukrainian War, suggests that euro area GDP would have been 0.8 % higher and prices 0.4 % lower by mid-2022. This highlights the substantial economic costs of geopolitical risk.

The study identifies sanctions and supply shortages as key mechanisms through which geopolitical risk affects the euro area economy. However, the direct economic impact of sanctions on the euro area is limited, while supply shortages play a more significant role in driving inflationary pressures.

Conclusion

This research underscores the importance of a region-specific approach to measuring and analyzing geopolitical risk. The EA GPR index provides a more accurate representation of the euro area’s exposure to geopolitical shocks, revealing significant recessionary and inflationary effects overlooked by US-centric measures. These findings have critical implications for European central banks, as they suggest that inflation risks may be underestimated if geopolitical risk is assessed solely through a global lens. The study recommends incorporating the EA GPR index into monetary policy frameworks to better account for the economic consequences of geopolitical events. Future research could further explore the role of specific transmission channels, such as energy markets and trade disruptions, in shaping the economic impact of geopolitical risk.

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