Do Geopolitical Risks Raise or Lower Inflation?

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Federal Reserve Board

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Geopolitical Events and Inflation

Adverse geopolitical events often associated with inflation through a variety of channels (public spending, money creation, inefficient use of resources)

Argentines See Jump In Inflatic
By JAMES M. MARKHAMSpecial to T
New York Times (1923-); May 12, 1982; pg. D1

Argentines See Jump In Inflation

War Strains, Spending Cited

By JAMES M. MARKHAM

But the consensus in Argentina's business community is that the financial strains and dislocations that the conflict in the South Atlantic have caused — combined with a wave of spending by the military — have guaranteed that inflation will soar in the months ahead, and that a free-market, belt-tightening experiment under Economics Minister Roberto Alemann is just about over.

Well-placed bankers economists

VAST INFLATION ERUPTS FROM CHINA'S LONG W.
By TILLMAN DURDINSpecial to THE NEW YORK TIMES.
New York Times (1923-); Feb 16, 1947; ProQuest Historical Newspapers: T
pg. E4

VAST INFLATION ERUPTS FROM CHINA'S LONG WARS

End of Mediation Effort and Lack of U. S. Credits Contribute to the Crisis

By TILLMAN DURDIN
Special to THE NEW YORK TIMES.

A major element in the present state of affairs is the long-standing unsatisfactory fiscal position of the Central Government. Throughout eight years of the Japanese war, the Government met most of its domestic expenditures by issuing steadily increasing amounts of paper currency. Revenues during these Japanese war years never amounted to more than 30 per cent of disbursements; thus the new notes consistently represented 70 per cent of heavy wartime costs.

Internal Strife a Factor

By NEIL SHEEHANSpecial to The New York Times
New York Times (1923-); Nov 5, 1965; ProQuest Historical New
pg. 3

INFLATION A PERIL IN SOUTH VIETNAM

U.S. Helps Saigon Wage War on Economic Front

By NEIL SHEEHAN
Special to The New York Times

With much of its transportation system wrecked by war or severed by guerrillas and most of the rice-producing Mekong delta, the economic heartland of the country, in Communist hands, South Vietnam is being squeezed in the vise of a burgeoning money supply but a shrinking market of goods, services and facilities.

WAR BOOM HAS ITS DARK SIDE, BANKERS WA
Forrester, Leland
Chicago Daily Tribune (1923-1963); Oct 1, 1939; ProQuest Historic
pg. B9

WAR BOOM HAS ITS DARK SIDE, BANKERS WARN

Fear Vast Inflation in Long Conflict.

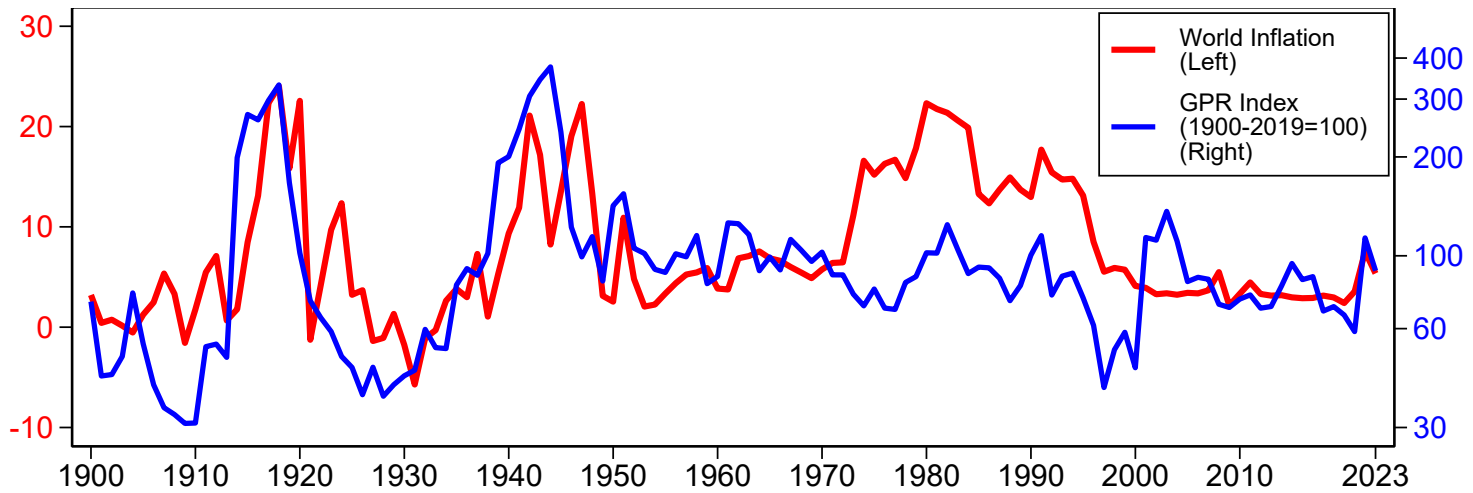
BY LELAND FORRESTER.

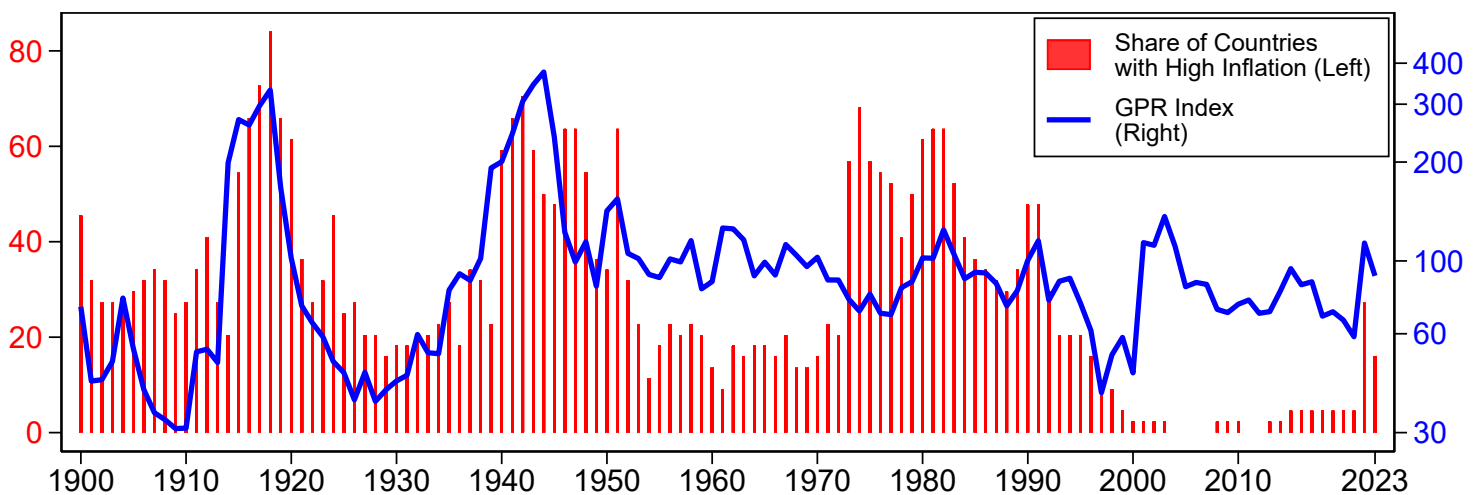
Other bankers, speaking at the meeting, said that unwise laws impair the efficiency of industry at a time when the nation should be using every economic means to make itself secure. They termed the government's cheap money policy a failure and said interest rates now are heading upward.

Introduction

- What is the relationship between adverse geopolitical events (GPR) and inflation?
- Unclear from a theoretical standpoint:
  - Adverse supply effects ($\pi \uparrow$)
  - Monetary & fiscal policy ($\pi \uparrow$)
  - Adverse demand effects, uncertainty ($\pi \downarrow$)
- We use 120 years of data and various empirical techniques to examine the historical association between higher GPR and inflation.

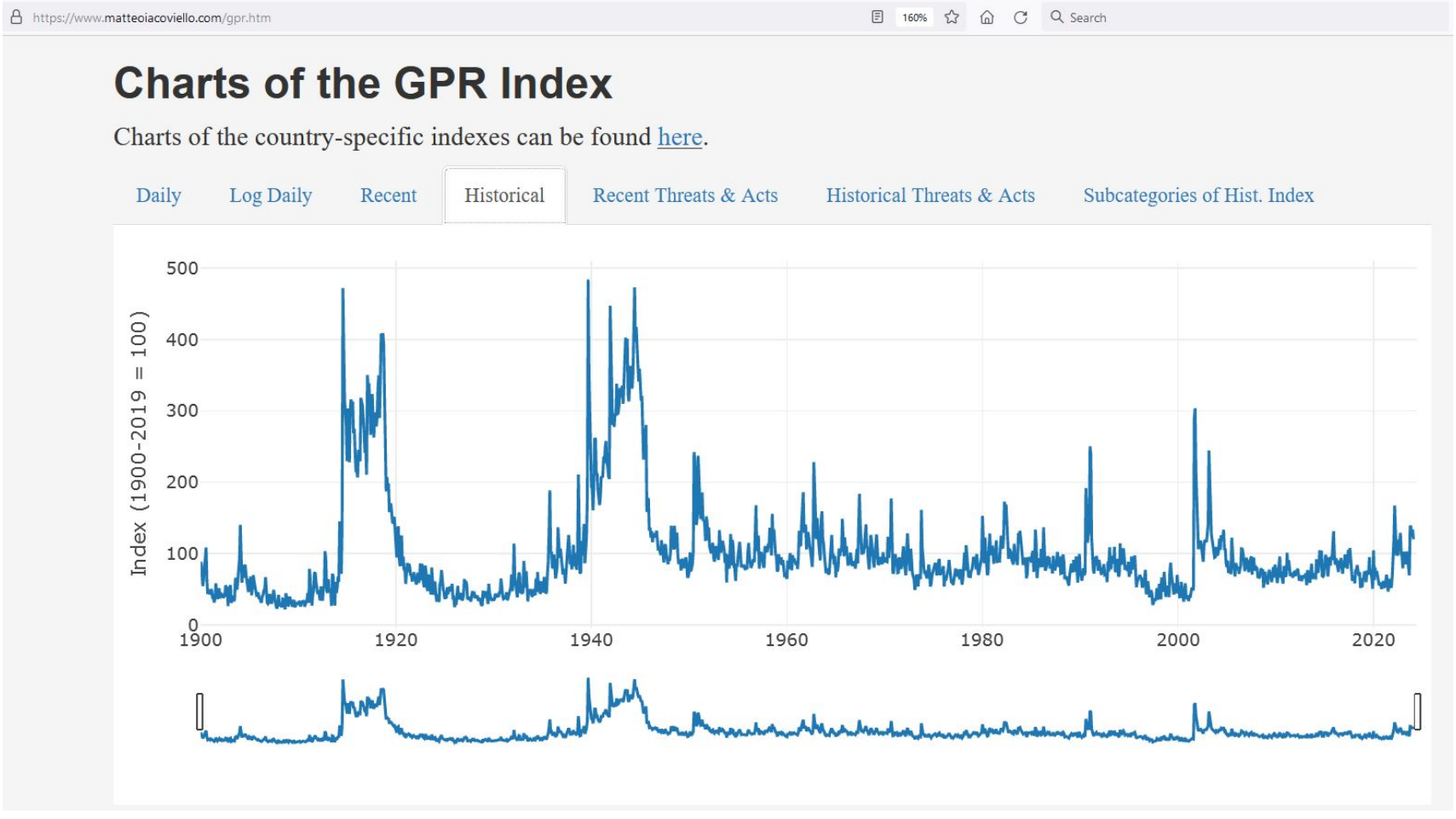
Main Finding: Geopolitical Risks Raise Inflation





Global Inflation is a GDP-weighted aggregate of inflation in 44 countries. Geopolitical Risk is indexed to 100 in the 1900-2019 period. Inflation winsorized at 97.5 percentile in each country.

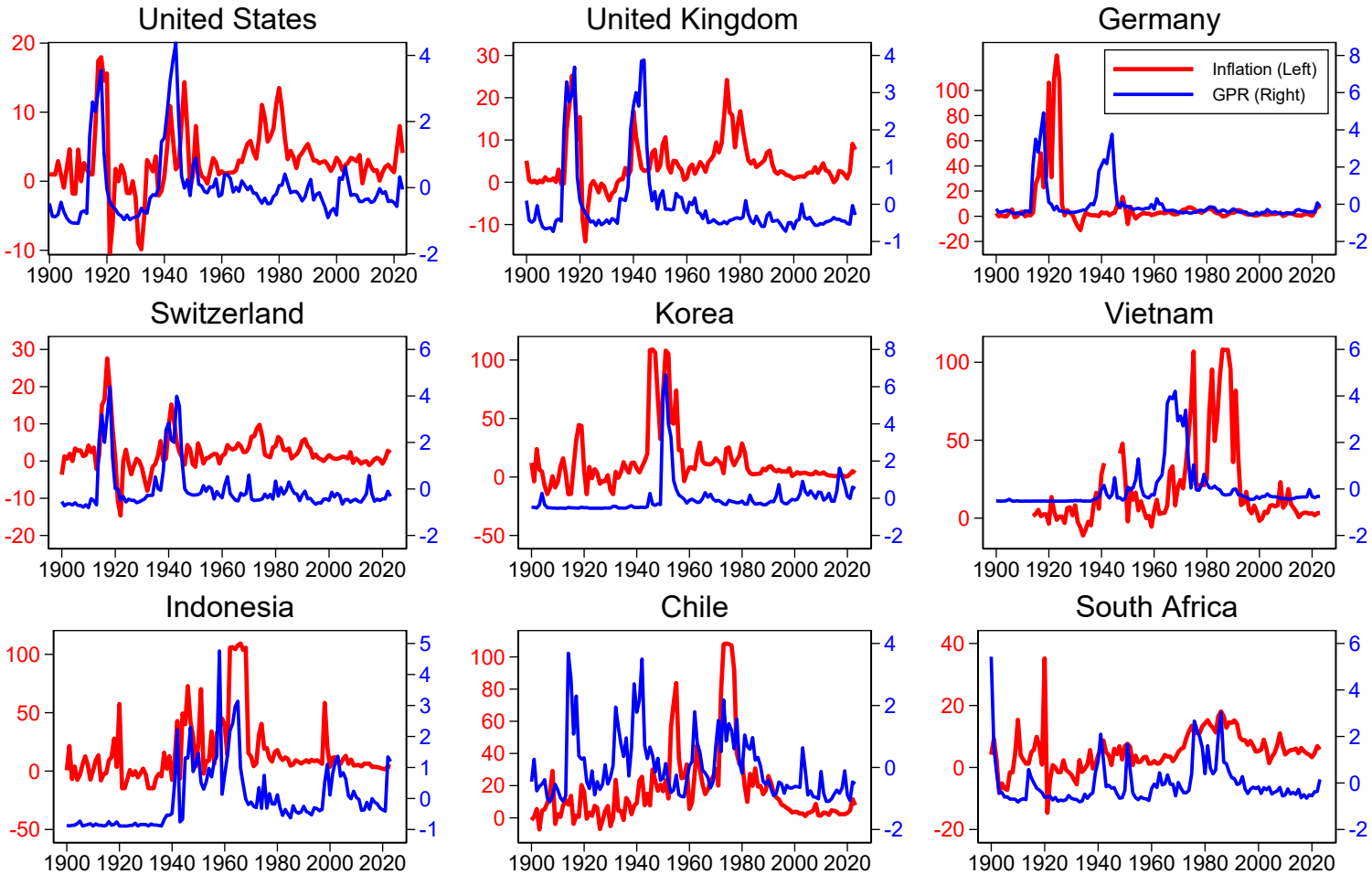
The Geopolitical Risk Index



Monthly Historical Geopolitical Risk, indexed to 100 in the 1900-2019 period. Last observation is for December 2023. GPR available at https://www.matteoiacoviello.com/gpr.htm

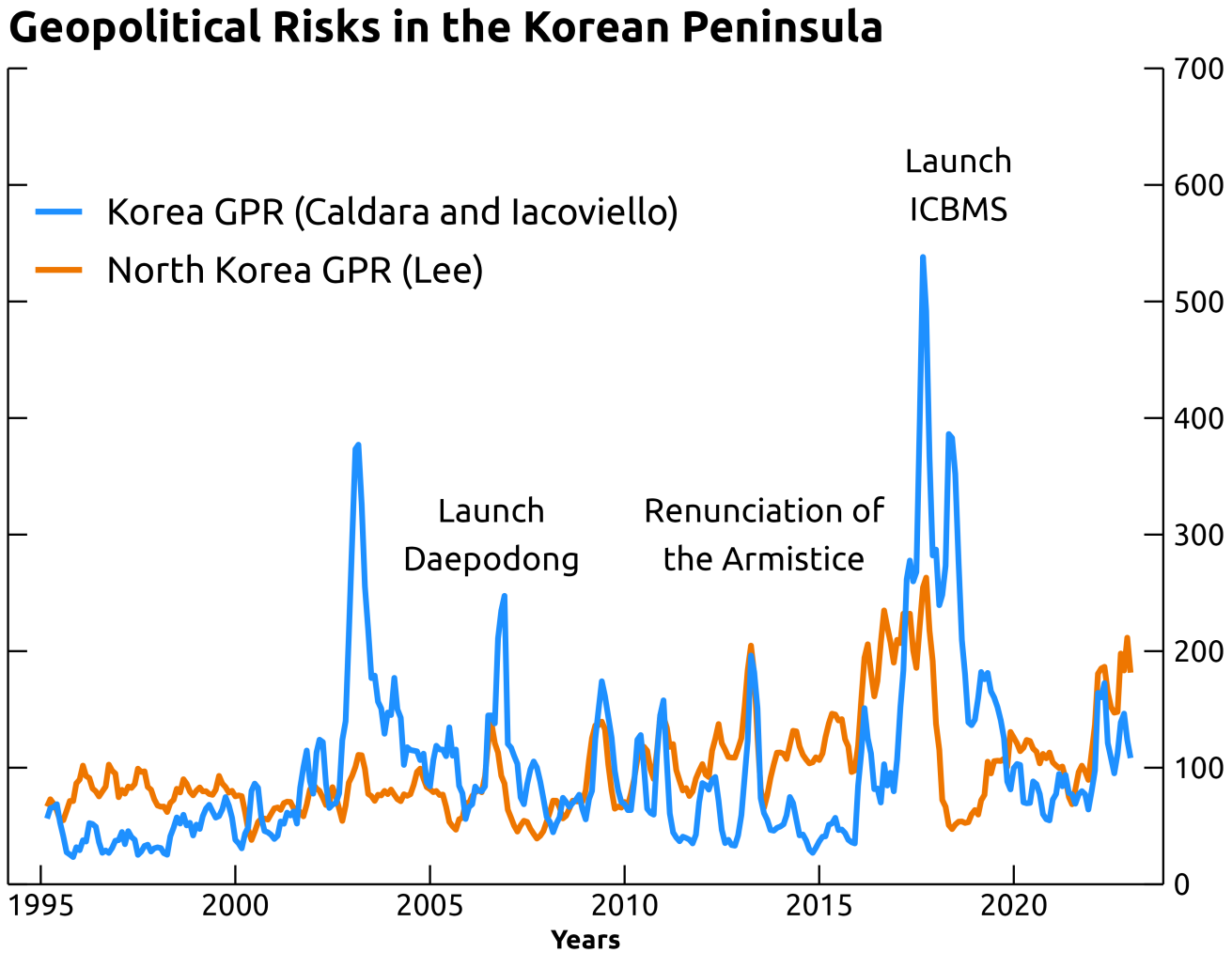
Country-Specific GPR & Inflation

- GPR-related articles also covering country in question.
- High country-GPR correlated with higher inflation at the country level.



Annual Country-Specific Geopolitical Risk (Standardized) and Annual Inflation. Last observation is 2022. Inflation winsorized at 97.5 percentile.

Geopolitical Risks in the Korean Peninsula

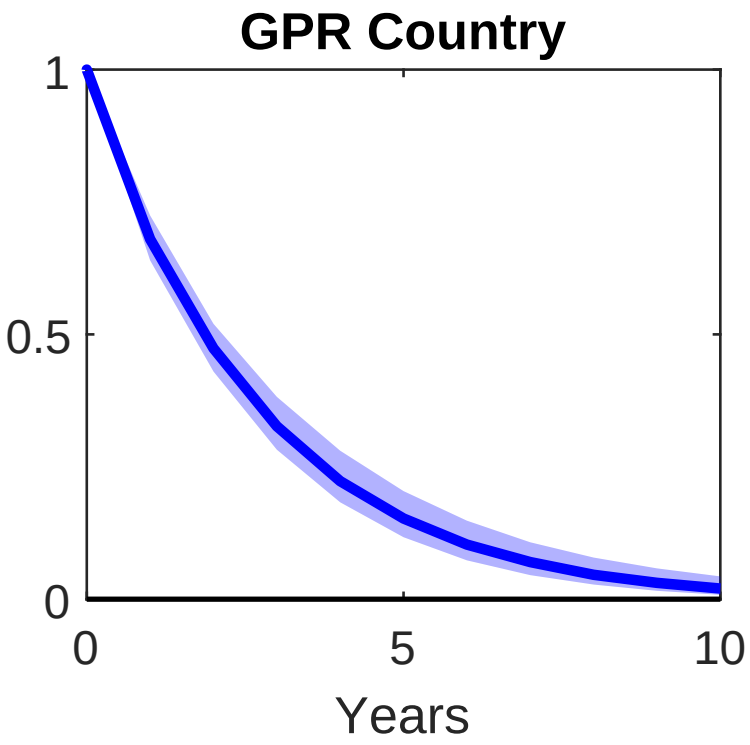


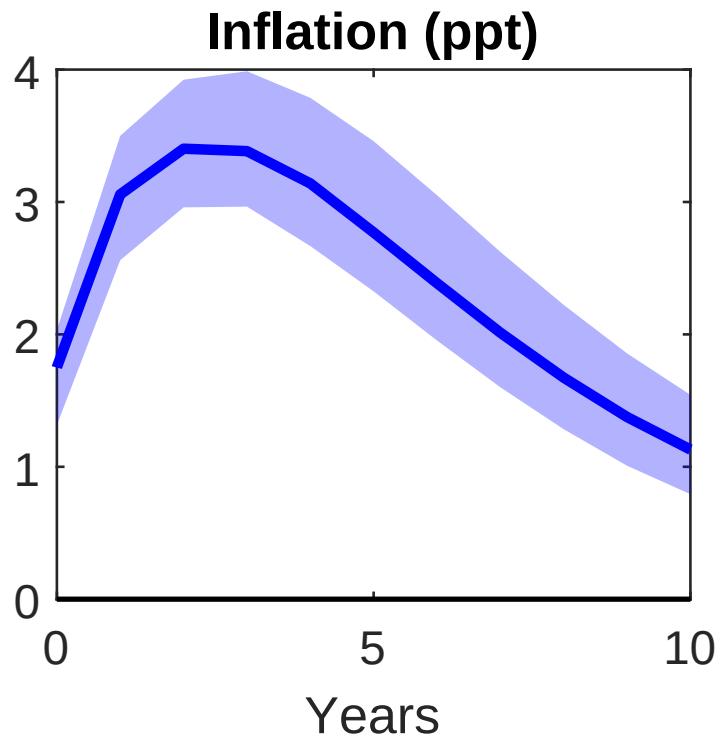
Sources: Caldara & Iacoviello (2022); Jung, Lee, Lee (2021) "The Impact of Geopolitical Risk on Stock Returns: Evidence from Inter-Korea Geopolitics".

Bivariate Panel VAR: GPR and Inflation

- Annual, 1900-2022, 43 countries
- Start with two-variable model to maximize number of observations

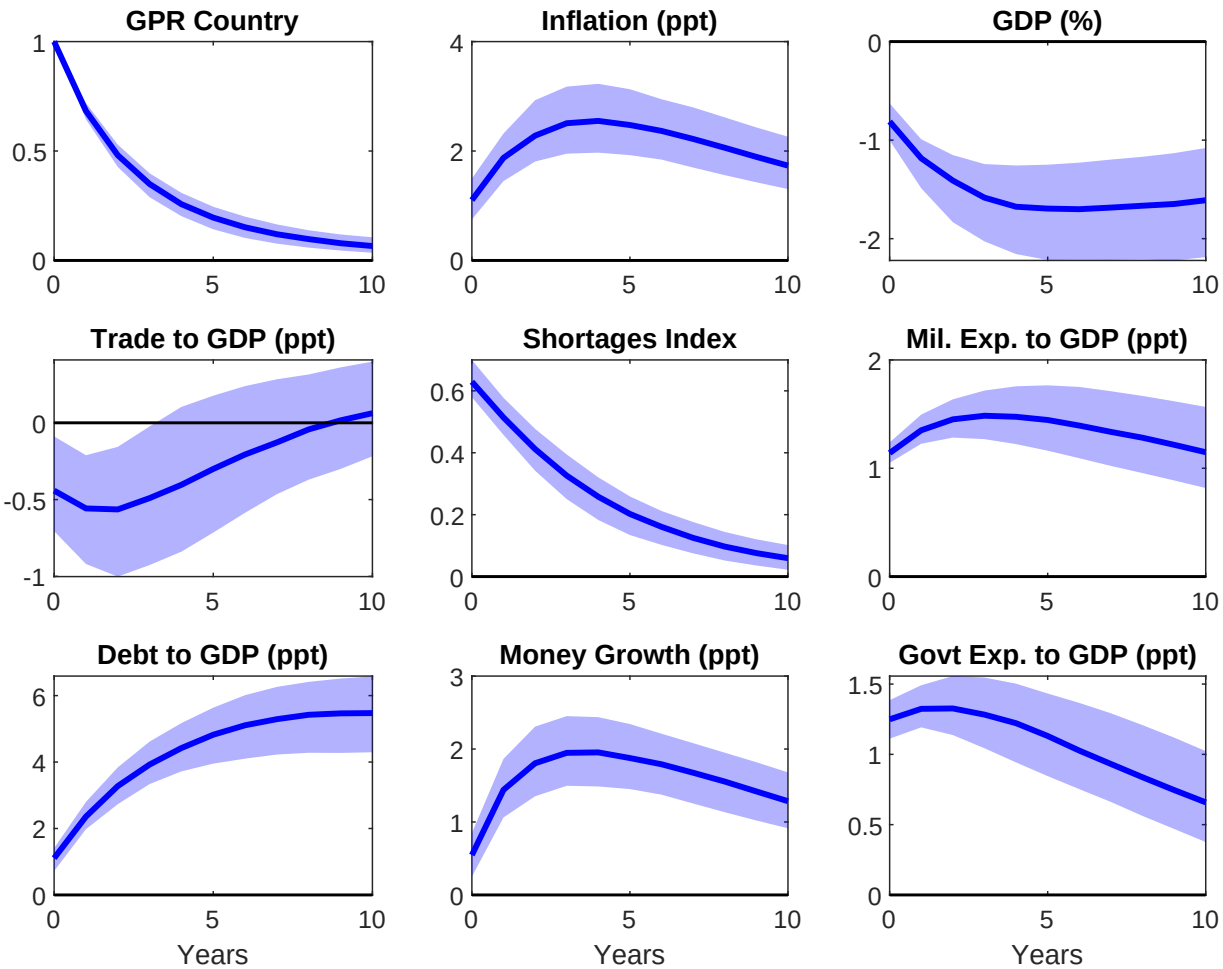
Result: Increases in GPR raise inflation





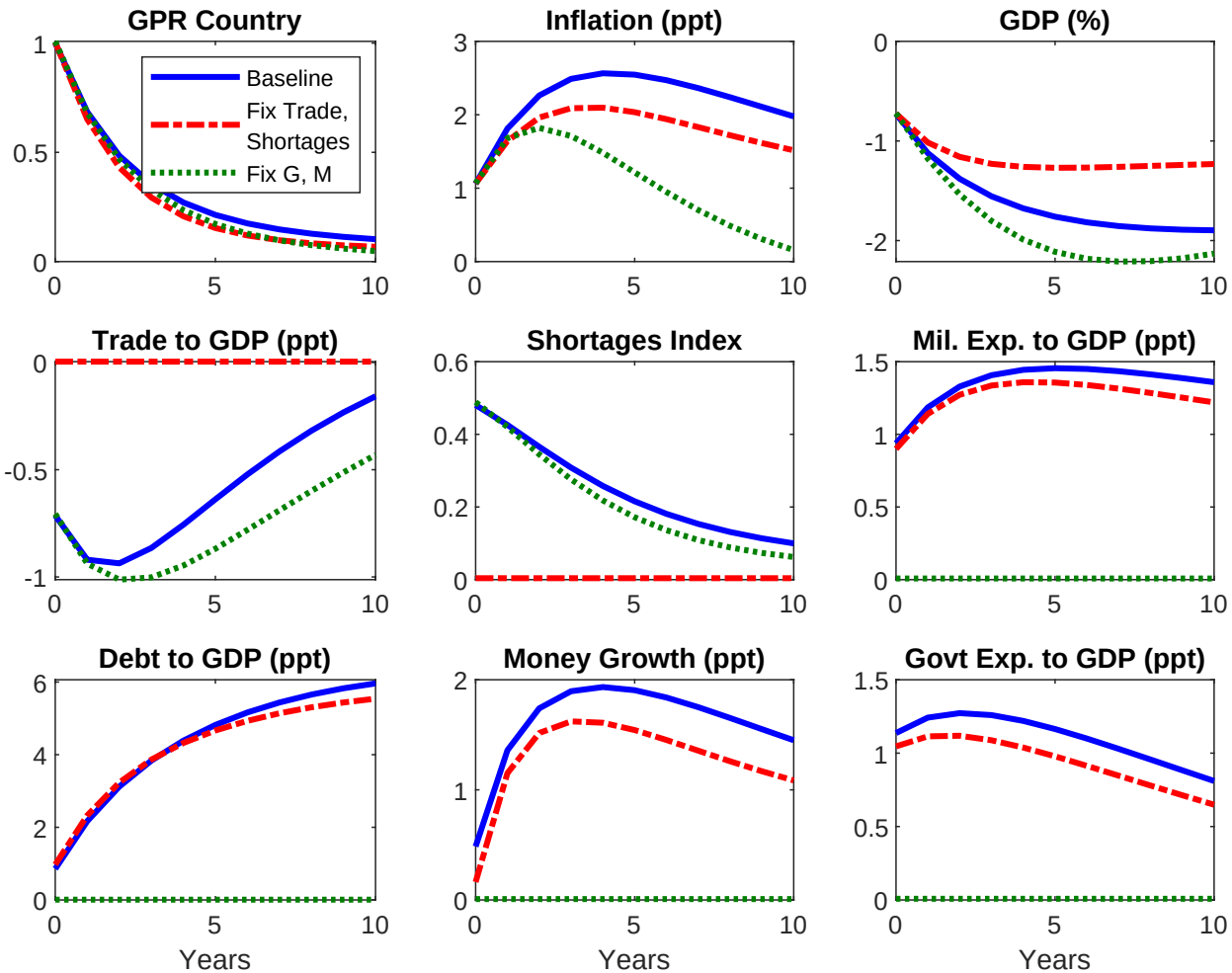
9-variable Panel VAR: Inspecting Transmission

- Following increase in country-specific GPR...
- ... Decline in international trade, supply disruptions
- ... Public spending, debt and money supply increase



Panel VAR: Counterfactual

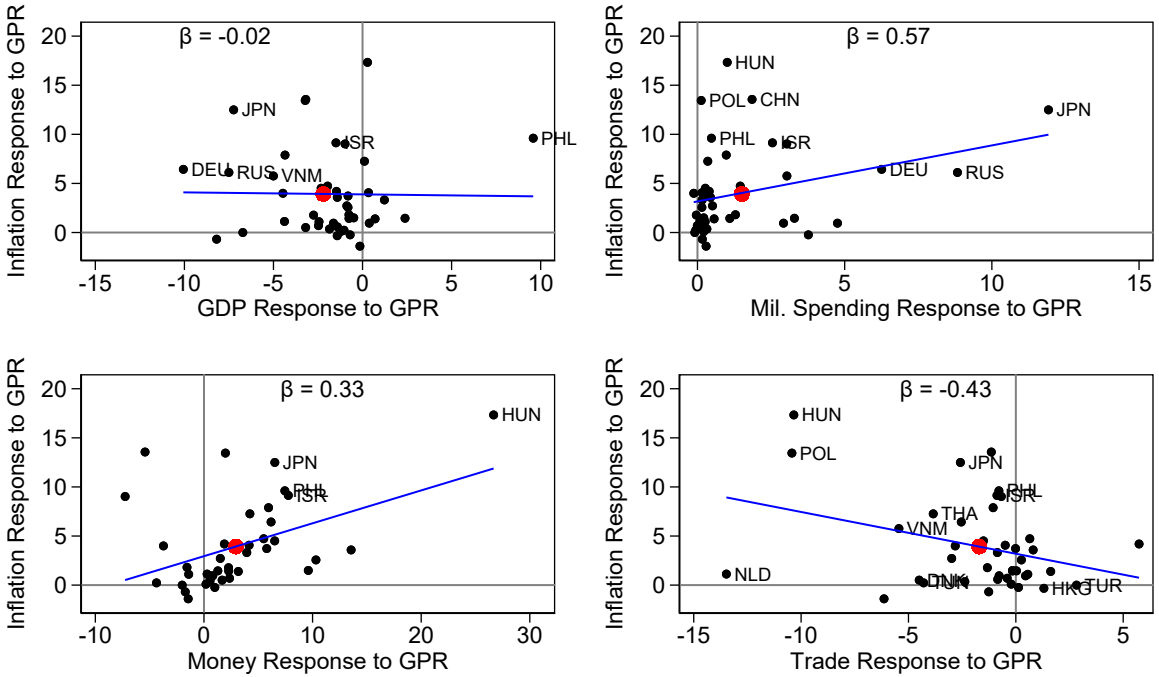
- Does inflation rise because of demand or supply forces?
- Keeping shortages and trade unchanged, smaller inflation rise.
- Absent higher spending, smaller inflation rise, and larger activity drop.



Allowing for Country Heterogeneity

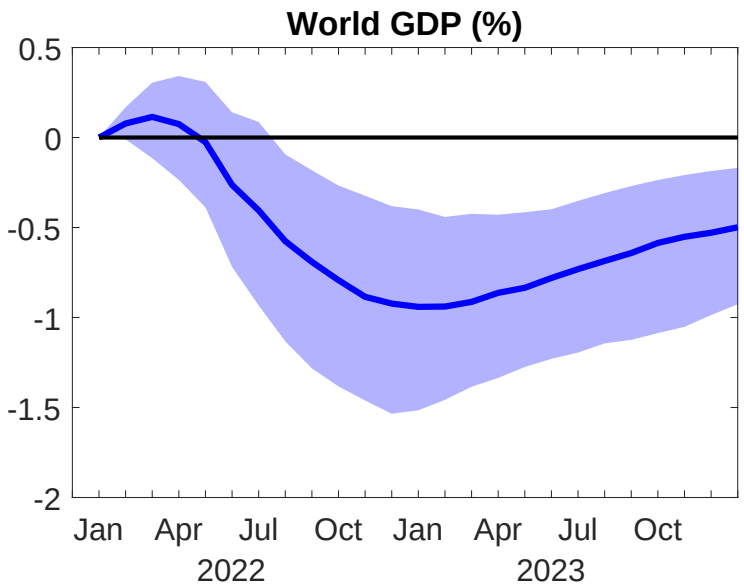
Predictive regressions allowing for heterogeneous country responses.

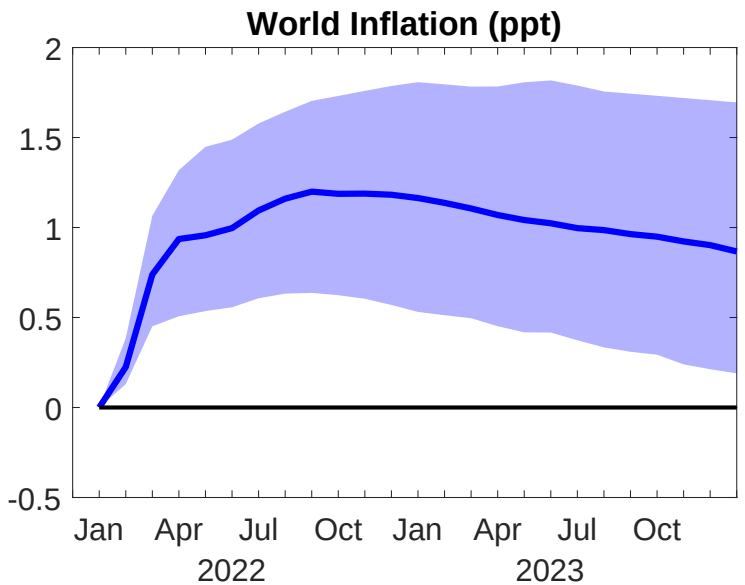
- Response of π varies across countries: mostly positive.
- Response of π lines up in the cross-section with responses of GDP(-), mil. spending (+), money (+), trade (-).



Russia-Ukraine War Scenario: Global Effects

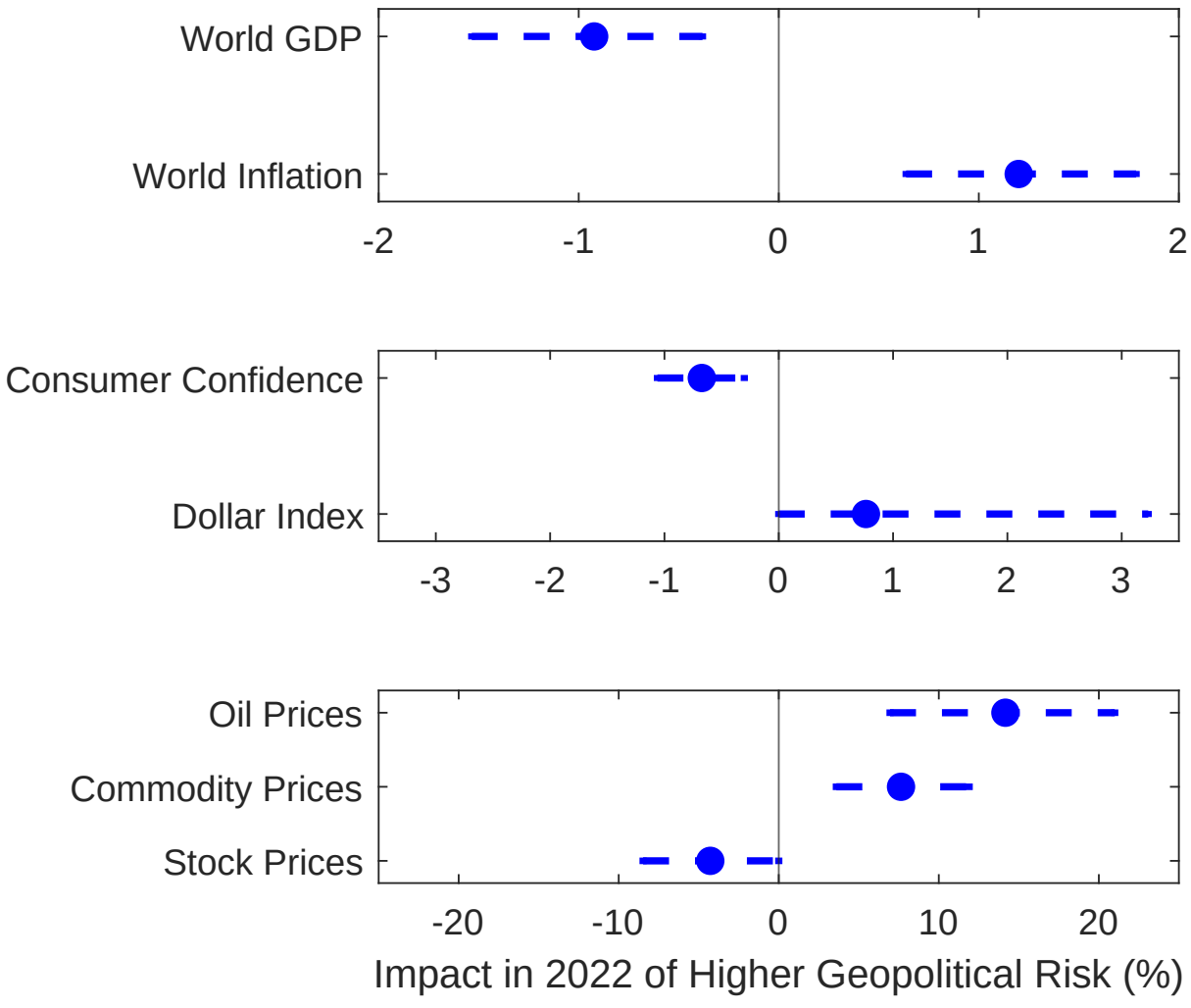
Geopolitical Shocks Observed between Jan and Apr '22





Russia-Ukraine War Scenario: Transmission

Geopolitical Shocks Observed between Jan and Apr '22



Our Research Agenda

- Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino and Andrea Raffo (2020), "The Economic Effects of Trade Policy Uncertainty," Journal of Monetary Economics, vol. 103, pp. 38-59.
- Caldara, Dario, and Matteo Iacoviello (2022), "Measuring Geopolitical Risk," American Economic Review, vol. 112 (April), pp. 1194–225.
- Caldara, Dario, Sarah Conlisk, Matteo Iacoviello, and Maddie Penn (2022), "The Effect of the War in Ukraine on Global Activity and Inflation," FEDS Notes, May 27, 2022.
- Caldara, Dario, Sarah Conlisk, Matteo Iacoviello, and Maddie Penn (2023), " Do Geopolitical Risks Raise or Lower Inflation?," Federal Reserve Board.
- Caldara, Dario, Matteo Iacoviello, and David Yu (2024), "Measuring Shortages since 1900," Federal Reserve Board