## Affirmative Answers

### Non-unique – Business confidence low

#### Small business confidence is lowest it’s been since peak pandemic – pessimism is at all time high

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Confidence among small-business owners in the U.S. flatlined in May for a second consecutive month, but expectations for future business conditions continued to deteriorate amid persisting inflation and supply shortages. The NFIB Small Business Optimism Index decreased marginally to 93.1 in May from 93.2 in April, the lowest level since April 2020, according to data released Tuesday by the National Federation of Independent Business. The reading is broadly in line with economists’ expectations in a poll by The Wall Street Journal. “Small-business owners remain very pessimistic about the second half of the year as supply-chain disruptions, inflation and the labor shortage are not easing,” NFIB Chief Economist Bill Dunkelberg said. The number of small-business owners who expect better business conditions in the next six months declined further in May, reaching a fresh new low in the near-five-decade survey’s history. Respondents also became more downbeat when assessing their projections for short-term sales.

#### Large Business isn’t doing better – CEO’s are terrified about the next 12 months

Melanie C. Nolen, 6-13 (Melanie C. Nolen, 6-13-2022, ChiefExecutive.net, CEO Confidence Falls To Decade Low, But Few Predict Recession, https://chiefexecutive.net/ceo-confidence-falls-to-decade-low-but-few-predict-recession/, 6-15-2022) SCade

Nearly 300 U.S. CEOs participated in Chief Executive’s CEO Confidence Index poll in June, sharing their prospect of the U.S. economy and business landscape. While their ratings of current business conditions remained flat month-over-month, at 6.4 out of 10, their forecast for business 12 months from now dropped another 6 percent, down to 5.6/10 from 5.9/10 in May. That reading is now 20 percent off where it was at the beginning of the year, before Russia’s invasion of Ukraine, when CEOs told us they were increasingly hopeful that persistent issues in the supply chain and growing inflation—and even Covid-19—would wind down this year. It is the lowest level it’s been since January 2013, on the heels of the “Fiscal Cliff” drama in Washington and ahead of further debt ceiling negotiations. CEOs say it’s the uncertainty of the situation more than specific issues that is driving their forecast down, although the list of concerns they shared continues to grow each month. Among those: market volatility, a chaotic geopolitical scene, uncontrolled inflation, record-high oil prices, and continued labor and supply chain shortages are all adding to the mix fueling doubts over the future. “The economy runs on oil, and until we get more, things are not getting better,” said Darrel Box, CEO at Lafayette Regional Health Center in Lexington, Missouri, who also lists labor and supply costs and shortages as reasons for his 4 out of 10 rating of business conditions 12 months from now (considered “Weak” according to our 10-point scale points). “Supply chain issues remain and do not seem to be getting any better,” said the CEO of an electronic component manufacturer participating in the poll. “Finding people is another major problem, so even if we find the parts, we will still have issues executing.”

#### Small business confidence collapsed now – inflation, supply chain disruptions, lack of workers

SARAH EWALL-WICE (CBS News) “As inflation soars, major corporations are posting record profits. But small businesses are feeling the squeeze” April 25, 2022 https://www.cbsnews.com/news/inflation-profits-corporate-small-business/

80% of small-business owners say their business' financial health has suffered due to inflation over the past six months, a new Goldman Sachs 10,000 Small Businesses Voices survey found. Of those, 67% have increased wages to retain employees, and 61% have increased wages to attract new employees. Meanwhile, 60% said they've offset their cost increases by passing it off to consumers by raising prices. Increasing energy costs – up 32% overall over the past year – are having a negative impact on bottom lines, 73% of small-business owners said. Overall, 91% of small-business owners say broader economic trends, such as inflation, supply chain issues and workforce challenges are hurting their businesses. And while the U.S. economy is considered strong by multiple measurements, 56% of small-business owners say the economy has worsened since January this year. As small businesses grapple with inflation – it's adding to other challenges they're already facing. At the top of the list, hiring and retaining qualified workers remains the top challenge cited by small-business owners, the survey found, as job openings remain near a record high with more than 11 million as of the end of February

#### crushed now---Supply chain weaknesses and pandemic

Crush 10/28[Peter Crush, "Business leaders admit over confidence in dealing with disruptions", 10/28/21, https://www.cips.org/supply-management/news/2021/october/business-leaders-admit-over-confidence-in-dealing-with-supply-chain-challenges/]

**Business heads have admitted being over confident about their ability to deal with supply chain disruptions**, according to a new report The research, by DuPont Sustainable Solutions, surveyed attitudes to managing unexpected supply chain events before and after the Covid-19 pandemic. It revealed **more than eight in 10 of the 203 leaders surveyed in 2019 thought they had a plan capable of addressing any unexpected business disruption**. However, this **level of confidence fell dramatically when they were asked again in 2021, with just 43% of those polled claiming they were prepared**. According to the survey, **77% of those questioned now feel risks to their business have increased since the pandemic began** (just 5% thought they had decreased), with 18% saying it is the same. Although the survey reveals **leaders were overly bullish about their ability to respond to sudden events**, the data did, however, reveal learnings had been made. Some 70% of leaders questioned said the pandemic had a positive impact on their digital strategies; more than 50% said communication had improved, and nearly 60% agreed their attitude to risk management had been positively impacted. Commenting on the research, CEO of DuPont Sustainable Solutions, Davide Vassallo, said: “By placing a premium on achieving cost efficiencies by minimising inventories, streamlining supply chains, sourcing from low-cost labour markets, and implementing just-in-time manufacturing, it left companies with little flexibility to absorb the supply, sourcing, operating, and commercial shocks caused by the pandemic.” According to the report, **some 64% of respondents said the pandemic had negatively impacted their supply chain, with 36% saying it had negatively impacted operations**.

### Thumpers

#### Laundry list of issues and uncertainty which destroyed bizcon

Melanie C. Nolen, 6-13 (Melanie C. Nolen, 6-13-2022, ChiefExecutive.net, CEO Confidence Falls To Decade Low, But Few Predict Recession, https://chiefexecutive.net/ceo-confidence-falls-to-decade-low-but-few-predict-recession/, 6-15-2022) SCade

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#### The Ukraine conflict has tanked business outlook across the G4 economies

IHS Markit 3/29, (IHS Markit (Nasdaq: INFO) is a world leader in critical information, analytics and solutions for the major industries and markets that drive economies worldwide, 3-29-2022, 3-29-2022, < https://seekingalpha.com/article/4498323-ukraine-war-hits-business-confidence-drives-price-pressures-to-new-highs > Blucas

While Russia's invasion of Ukraine had only a minor adverse impact on business output across the four largest developed economies in March, its impact was more evident on business confidence. Across the G4, business expectations of output in the coming 12 months slumped to the lowest since December 2020, sliding in all four economies but most notably in the eurozone. Future expectations hit 17-month lows in both the eurozone and UK, with 14- and five-month lows recorded in Japan and the US respectively. Anecdotal evidence from the surveys revealed that the invasion had exacerbated existing concerns over supply chains, prices and a potential slowing of economic growth as the pandemic rebound faded.

Ukraine war crushes business confidence

Roubini February 25 2022 (Nouriel Roubini, Professor Emeritus of Economics at New York University's Stern School of Business, 2-25-2022, Putin's war promises to crush the global economy with inflation and much slower growth, MarketWatch, https://www.marketwatch.com/story/putins-war-promises-to-crush-the-global-economy-with-inflation-and-much-slower-growth-11645803074)

The economic and financial fallout from the war, and the resulting stagflationary shock, will of course be largest in Russia and Ukraine, followed by the European Union, owing to its heavy dependence on Russian gas. But the U.S. will suffer, too. Because world energy markets are so deeply integrated, a spike in global oil prices—represented by the Brent BRN00, +0.47% benchmark—will strongly affect U.S. crude oil (West Texas Intermediate) prices. Yes, the U.S. is now a minor net energy exporter; however, the macro-distribution of the shock will be negative. While a small cohort of energy firms will reap higher profits, households and businesses will experience a massive price shock, leading them to reduce spending. Given these dynamics, even an otherwise strong U.S. economy will suffer a sharp slowdown, tilting toward a stagflationary growth recession. Tighter financial conditions and the resulting effects on business, consumer, and investor confidence will exacerbate the negative macro consequences of Russia’s invasion, both in the U.S. and globally. Likewise, the coming sanctions against Russia—however large or limited they turn out to be, and however necessary they are for future deterrence—inevitably will hurt not only Russia but also the U.S., the West, and emerging markets.

### BizCon not key

#### Not key to growth

Cameron Bagrie 18, Managing Director of Bagrie Economics, “Business confidence is a hopeless indicator. But that doesn't mean the economy isn't in trouble,” Spinoff, 8-9-2018, https://thespinoff.co.nz/business/09-08-2018/business-confidence-is-bullshit-but-that-doesnt-mean-the-economy-isnt-in-trouble/

The good news is that business confidence is hopeless as an economic indicator. The correlation with economic growth is poor and I largely ignore business confidence readings. Changes in direction can provide some insightful information – whether things are picking up or slowing down, but not the levels.

Businesses tend to be more upbeat regarding general confidence about the economy under a blue flag as opposed to a red one. Business confidence averaged minus 18 between 2000 and 2007. The economy (measured by real gross domestic product) grew on average by more than 3.5% per year. Yep, confidence was negative, but growth was positive. So, we ignore business confidence as an economic indicator. This is nothing new. It’s surprising headline business confidence figures receive so much attention’

#### “Shocks” are inevitable and have no impact.

Bagrie ’18 [Cameron; 8/9/18; Managing Director @ Bagrie Economics; “Business Confidence Is a Hopeless Indicator. But That Doesn’t Mean the Economy Isn’t in Trouble”; https://thespinoff.co.nz/business/09-08-2018/business-confidence-is-bullshit-but-that-doesnt-mean-the-economy-isnt-in-trouble]

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Commentators make the constant mistake of saying the ANZ survey is a business confidence survey. The same applies to the NZIER’s QSBO. They are surveys of business views across an array of key indicators including prospects for growth, hiring, whether firms are planning to invest and experiences with inflation / costs. These indicators matter. Business confidence is one question.

The so-called “soft” or “perception” indicators are the hard data of tomorrow. They are estimates and view based but you can’t ignore them. They are well correlated with growth.

In a perfect world we’d have timely “hard” official data and statistics. We don’t. Official data comes with a lag. So, we need to rely on sentiment-based indicators if we want timely readings on the economy and a guide as to the year ahead.

The likes of the ANZ survey are showing a sombre mood when it comes to indicators that matter. The ANZ survey asks key questions about activity, employment, investment and profitability. When these indicators head to zero, which they have done now, growth can do the same. Those indicators were weak in 2000 during the so-called winter of discontent – and growth slowed to 0.9% year on year.

Growth did rebound. But back then the economy was early in the economic expansion. The economy is late in the business cycle this time around. The economy has tended to go through a ten-year cycle, so businesses are naturally looking more nervously over their shoulders at present. The economy is going through substantial economic change too and businesses are wary. There is little argument over the need to change the economy. However, there are serious questions about the actual economic plan and what the new economy looks like. That is a key issue that needs addressed.

Some of the weakness in survey measures could be put down to the way survey questions are phrased. Firms are asked their view and given three options; will conditions improve, stay the same, or worsen. For a lot of firms’ things are damned good. It’s telling that finding skilled staff is the biggest problem firms are facing. Businesses are facing capacity constraints. So, zero readings may reflect a levelling out at a high base.

### Econ defense

#### No Econ Impact

Walt 20 – Stephen M, the Robert and Renée Belfer professor of international relations at Harvard University. “Will a Global Depression Trigger Another World War?”, Foreign Policy, <https://foreignpolicy.com/2020/05/13/coronavirus-pandemic-depression-economy-world-war/>, 05-13-2020

One familiar argument is the so-called diversionary (or “scapegoat”) theory of war. It suggests that leaders who are worried about their popularity at home will try to divert attention from their failures by provoking a crisis with a foreign power and maybe even using force against it. Drawing on this logic, some Americans now worry that President Donald Trump will decide to attack a country like Iran or Venezuela in the run-up to the presidential election and especially if he thinks he’s likely to lose. This outcome strikes me as unlikely, even if one ignores the logical and empirical flaws in the theory itself. War is always a gamble, and should things go badly—even a little bit—it would hammer the last nail in the coffin of Trump’s declining fortunes. Moreover, none of the countries Trump might consider going after pose an imminent threat to U.S. security, and even his staunchest supporters may wonder why he is wasting time and money going after Iran or Venezuela at a moment when thousands of Americans are dying preventable deaths at home. Even a successful military action won’t put Americans back to work, create the sort of testing-and-tracing regime that competent governments around the world have been able to implement already, or hasten the development of a vaccine. The same logic is likely to guide the decisions of other world leaders too. Another familiar folk theory is “military Keynesianism.” War generates a lot of economic demand, and it can sometimes lift depressed economies out of the doldrums and back toward prosperity and full employment. The obvious case in point here is World War II, which did help the U.S economy finally escape the quicksand of the Great Depression. Those who are convinced that great powers go to war primarily to keep Big Business (or the arms industry) happy are naturally drawn to this sort of argument, and they might worry that governments looking at bleak economic forecasts will try to restart their economies through some sort of military adventure. I doubt it. It takes a really big war to generate a significant stimulus, and it is hard to imagine any country launching a large-scale war—with all its attendant risks—at a moment when debt levels are already soaring. More importantly, there are lots of easier and more direct ways to stimulate the economy—infrastructure spending, unemployment insurance, even “helicopter payments”—and launching a war has to be one of the least efficient methods available. The threat of war usually spooks investors too, which any politician with their eye on the stock market would be loath to do. Economic downturns can encourage war in some special circumstances, especially when a war would enable a country facing severe hardships to capture something of immediate and significant value. Saddam Hussein’s decision to seize Kuwait in 1990 fits this model perfectly: The Iraqi economy was in terrible shape after its long war with Iran; unemployment was threatening Saddam’s domestic position; Kuwait’s vast oil riches were a considerable prize; and seizing the lightly armed emirate was exceedingly easy to do. Iraq also owed Kuwait a lot of money, and a hostile takeover by Baghdad would wipe those debts off the books overnight. In this case, Iraq’s parlous economic condition clearly made war more likely. Yet I cannot think of any country in similar circumstances today. Now is hardly the time for Russia to try to grab more of Ukraine—if it even wanted to—or for China to make a play for Taiwan, because the costs of doing so would clearly outweigh the economic benefits. Even conquering an oil-rich country—the sort of greedy acquisitiveness that Trump occasionally hints at—doesn’t look attractive when there’s a vast glut on the market. I might be worried if some weak and defenseless country somehow came to possess the entire global stock of a successful coronavirus vaccine, but that scenario is not even remotely possible. If one takes a longer-term perspective, however, a sustained economic depression could make war more likely by strengthening fascist or xenophobic political movements, fueling protectionism and hypernationalism, and making it more difficult for countries to reach mutually acceptable bargains with each other. The history of the 1930s shows where such trends can lead, although the economic effects of the Depression are hardly the only reason world politics took such a deadly turn in the 1930s. Nationalism, xenophobia, and authoritarian rule were making a comeback well before COVID-19 struck, but the economic misery now occurring in every corner of the world could intensify these trends and leave us in a more war-prone condition when fear of the virus has diminished. On balance, however, I do not think that even the extraordinary economic conditions we are witnessing today are going to have much impact on the likelihood of war. Why? First of all, if depressions were a powerful cause of war, there would be a lot more of the latter. To take one example, the United States has suffered 40 or more recessions since the country was founded, yet it has fought perhaps 20 interstate wars, most of them unrelated to the state of the economy. To paraphrase the economist Paul Samuelson’s famous quip about the stock market, if recessions were a powerful cause of war, they would have predicted “nine out of the last five (or fewer).” Second, states do not start wars unless they believe they will win a quick and relatively cheap victory. As John Mearsheimer showed in his classic book Conventional Deterrence, national leaders avoid war when they are convinced it will be long, bloody, costly, and uncertain. To choose war, political leaders have to convince themselves they can either win a quick, cheap, and decisive victory or achieve some limited objective at low cost. Europe went to war in 1914 with each side believing it would win a rapid and easy victory, and Nazi Germany developed the strategy of blitzkrieg in order to subdue its foes as quickly and cheaply as possible. Iraq attacked Iran in 1980 because Saddam believed the Islamic Republic was in disarray and would be easy to defeat, and George W. Bush invaded Iraq in 2003 convinced the war would be short, successful, and pay for itself.The fact that each of these leaders miscalculated badly does not alter the main point: No matter what a country’s economic condition might be, its leaders will not go to war unless they think they can do so quickly, cheaply, and with a reasonable probability of success. Third, and most important, the primary motivation for most wars is the desire for security, not economic gain. For this reason, the odds of war increase when states believe the long-term balance of power may be shifting against them, when they are convinced that adversaries are unalterably hostile and cannot be accommodated, and when they are confident they can reverse the unfavorable trends and establish a secure position if they act now. The historian A.J.P. Taylor once observed that “every war between Great Powers [between 1848 and 1918] … started as a preventive war, not as a war of conquest,” and that remains true of most wars fought since then. The bottom line: Economic conditions (i.e., a depression) may affect the broader political environment in which decisions for war or peace are made, but they are only one factor among many and rarely the most significant. Even if the COVID-19 pandemic has large, lasting, and negative effects on the world economy—as seems quite likely—it is not likely to affect the probability of war very much, especially in the short term. To be sure, I can’t rule out another powerful cause of war—stupidity—especially when it is so much in evidence in some quarters these days. So there is no guarantee that we won’t see misguided leaders stumbling into another foolish bloodletting. But given that it’s hard to find any rays of sunshine at this particular moment in history, I’m going to hope I’m right about this one.

**--War can’t be attributed to recessions**

**Liao 19** – Jianan, Shenzhen Nanshan Foreign Language School, China. “Business Cycle and War: A Literature Review and Evaluation”, Advances in Economics, Business and Management Research, International Symposium on Social Science and Management Innovation, Vol. 68, <https://www.atlantis-press.com/proceedings/ssmi-18/55913122>, 02-xx-2019

Academic researches on the relationship between business cycle and war are particularly rich, all of which can be divided into two major categories. One is the relationship between economic **rise** and **war**, and the other is the relationship between economic **recession** and war. Through the simple description and comparison of the two types of standpoints, the author divides economic upturn into recovery phase and expansion phase, and economic recession into recession phase and crisis phase, **all of which** have motivations as well as conditions enabling wars to break out. Therefore, the **outbreak of war** shall **never** be **simply attributed** to **either economic rise or recession**.

#### --They’re exogenous

Caldara and Lacoviello 18 – Dario, Federal Reserve Board of Governors. Matteo, Federal Reserve Board of Governors. “Measuring Geopolitical Risk”, International Finance Discussions Papers, <https://www.federalreserve.gov/econres/ifdp/files/ifdp1222.pdf>, 02-xx-2018

**We identify** the **structural shocks** **by using a Cholesky decomposition of the covariance matrix of the VAR reduced-form residuals**, ordering the GPR index first. **The ordering implies that the GPR index reacts contemporaneously only to its own shock.** Hence, **any contemporaneous correlation between the macro variables and the GPR index reflects the effect of the GPR index on the macro variables**. The characteristics of the GPR index discussed in Section 2—as well as the comparison to the EPU index in Section 3—lend support to this assumption. For instance, **Jackson and Morelli** (2011) **list religion, revenge, ethnic cleansing, and bargaining failure** over resources **as** **the** **main reasons for armed conflicts. Although recessions, lower** **commodity** prices**, or dismal economic performance might in some cases** **have** **exacerbated existing** **geopolitical** **tensions**, **it seems reasonable to assume that** **movements in economic variables** within a month **have little bearing on geopolitical risks**. Nonetheless, in Section A.4 in the Appendix we explore robustness to an alternative Cholesky ordering, as well as to alternative specifications of the baseline VAR model.

The solid lines in Figure 9 show the median impulse responses to an exogenous increase in the GPR index of 167 points, while the light- and dark-shaded areas represent the corresponding 68 percent and 90 percent pointwise credible bands, respectively. The size of the shock equals the average change in the index following the nine episodes of largest increases in the GPR index.29 The rise in the GPR index induces a small and short-lived increase in the EPU index and a decline in consumer sentiment. Intuitively, geopolitical risk can induce some economic policy uncertainty on items such as national security and the fiscal budget and negatively weigh on consumer sentiment. On the real side, IP declines quickly, bottoming out at negative 0.9 percent after about 6 months, before reverting back to trend. The deterioration in labor market conditions is substantial but more gradual, with payroll employment reaching a trough of negative 0.4 percent a year after the shock. Gross trade also drops, with U.S. imports and exports falling nearly 2 percent relative to the baseline. Figure A.7 in the Appendix plots the response of private investment to a GPR shock, based on an extension of the baseline model estimated on quarterly data. The economically significant decline in investment following a GPR shock, together with the decline in employment, is consistent with models of investment under uncertainty a la Dixit and Pindyck (1994).30

On the financial side, the response of the stock market is economically and statistically significant. Stock prices drop by almost 3 percent on impact and remain below baseline for a little over three months. The increase in the GPR leads to a decrease in oil prices, which bottom out at 7 percent below baseline after three months. This result stands in contrast with much of the conventionally held view that higher geopolitical risk drives up oil prices persistently—a view that might reflect a selective memory that confounds all geopolitical tensions with oil supply shocks driven by geopolitical tensions in the Middle East. Finally, the yield on two-year Treasuries declines by about 20 basis points, indicating both a worsening of the macroeconomic outlook and a loosening of the monetary policy stance.

One useful way to assess the exposure to GPR of various sectors of the U.S. economy is depicted in Figure 10. We add to the VAR model the cumulative excess return of firms in given industries relative to the S&P 500.n The solid lines show the excess return for 6 industries. The defense industry, which is perhaps directly exposed to geopolitical risk, records a positive but short-lived excess return; by contrast, industries that are exposed to the overall U.S. economy—such as aircraft, steelworks, and mining—display somewhat persistent negative returns. The oil industry, which some commentators argued could benefit from wars, especially in the Middle East, displays an initial positive excess return followed by a persistent decline, a response that mimics the path of oil prices. Finally, the insurance industry moves in sync with the overall U.S. stock market.

4.2 Threats versus Acts

Next, we evaluate the difference between innovations in the two broad components of the GPR index, the GPA geopolitical acts index and the GPT geopolitical threats index, by replacing the GPR index with the GPA and GPT indexes in the benchmark VAR. To achieve identification, we use a Cholesky ordering, with the GPA index ordered first and the GPT index ordered second. We interpret the first shock the GPA shock -as the realization of some adverse geopolitical events that could induce an increase in geopolitical threats; we interpret the second shock the GPT shock -as capturing geopolitical threats that are not contemporaneously associated with geopolitical acts, such as tensions building up before wars or after terrorist attacks.

The impulse responses to the GPA and GPT shocks are shown for selected variables in Figure 11. In presenting the results, we adopt the following exposition scheme, which is best viewed in color. Specifically, the responses to the GPA shock are plotted using a green-based color motif, while the responses to the GPT shock are plotted using a red-based color motif.

Starting from the responses of the three uncertainty proxies, a GPA shock of size 288—a shock sized to be equal to the 7 largest spikes in GPA, shown in panel (a)—induces an initial increase in the GPT and EPU indexes, followed by a period of below-average GPT and EPU that lasts for about a year. Thus, these responses are consistent with the realization of acts leading to the resolution of threats and uncertainty. By contrast, a GPT shock—shown in panel (b)—leads to a persistent increase in GPT which remains elevated for over a year- and in EPU. The GPA index, which by assumption does not move on impact, increases for about one year, as in our sample many geopolitical threats precede geopolitical acts.

The responses of activity, trade, and the stock market show that the GPA and GPT shocks have asymmetric effects on the U.S. economy. A shock to the GPA leads to a small but short-lived decline in economic activity and trade, whereas the stock market rises sharply one month after the shock. By contrast, a shock to the GPT induces large and protracted recessionary effects, as well as a decline in stock prices. Incidentally, the response of the stock market lends support to the old idea, attributed to London financier Nathan Rothschild, that one should buy stocks “on cannons,” and sell them “on trumpets.”

Figure 12 further elaborates on the asymmetric response of the stock market by depicting the response of cumulative excess returns in six industries to GPA and GPT shocks. Excess returns in all industries feature an asymmetric response, albeit to a various degree. The defense industry features the largest asymmetry: defense companies, on average, earn an excess return of about 5 percent for more than two years following a GPA shock, while they earn only a modest and shortlived excess return following a GPT shock. Excess returns in the steel and mining industries are also asymmetric—positive when geopolitical acts materialize and negative when threats are high. By contrast, the asymmetry in excess returns for insurance companies is economically modest.

One possible interpretation of the asymmetric effects of shocks to acts and threats is that the act component of GPR leads to a resolution of the uncertainty around a particular set of events, as well as to a coordinated policy response that ends up giving protection on the worst possible outcomes. By contrast, threat shocks depress asset prices and economic activity because they increase uncertainty and send signals about future adverse events. 2 The finding that the realization of the event has only modest economic consequences compared to the threat echoes the findings of theoretical models where agents form expectations using a worst case probability, as for instance in lint and Schneider (2014).

5 International Effects of Higher Geopolitical Risk

This section characterizes the international effects of rising geopolitical tensions. We first estimate a battery of structural VAR models, which we use to track the macroeconomic implications of an exogenous rise in geopolitical risk on real activity. We then test whether global stock market returns depend on geopolitical risk. Finally, we estimate panel regressions to unveil whether geopolitical risk affects international capital flows.

5.1 Geopolitical Risk and Real Activity

We first study whether GPR shocks have adverse consequences on the real economy outside the United States. We start by looking at the response of world IP and IP in advanced and emerging economies. Importantly, the emerging economies’ IP index includes mostly Asian, European, and Latin American countries. Reliable data on IP in major oil producing countries—which are likely to be highly exposed to the geopolitical risks captured by our index—are not available. We then estimate the response of real activity in three countries: Canada and the United Kingdom—as we used newspapers from these two countries in the construction of the index—and Mexico, an emerging economy selected for its large exposure to the U.S. economy.

We estimate a battery of VAR models consisting of the GPR index, the EPU index for the United States, and IP.'14 As for the U.S. model, we identify a GPR shock ordering the GPR index first in a Cholesky decomposition of the covariance matrix of the VAR residuals. The black lines in Figure 13 depict the median responses of IP for the six countries and regions listed above. These impulse responses suggest that a GPR shock has global consequences—world IP declines by about 0.5 percent one year after the shock—but its effects are mostly concentrated in advanced economies. By contrast, the emerging economies included in our index, on average, do not respond to geopolitical risks. Yet, Mexico—possibly through its large exposure to U.S. trade—experiences a modest but persistent decline in real activity.   
5.2 Geopolitical Risk and Stock Returns

We now turn to examining the reaction of stock market returns to changes in geopolitical risk. We do so both for the sample covered by the historical GPR index and for the sample covered by the benchmark GPR index.

The baseline econometric specification echoes the work of Berkman, Jacobsen, and Lee (2011). These authors find that disaster risk depresses stock returns. They measure disaster risk by counting the number of active crises recorded in the International Crisis Database discussed in Section 3 and plotted in Figure 7. Since their measure of disaster risk is tightly linked to geopolitical events, in this section we ask if our proxy, which displays only a weak correlation with their crisis index, can help us uncover a significant relationship between geopolitical risk and stock returns.

We obtain data on monthly stock returns based on general market price indexes from Global Financial Data. Our sample ranges from 1900 to 2016, although data availability varies by country, and the world stock price index is available starting in 1919. We select 17 countries—all countries that are currently classified as advanced economies, with the exception of India, Peru, and South Africa—for which data before World War II are available. The world stock price index is the Morgan Stanley Capital International (MSCI) index from 1970. Prior to 1970, world returns are calculated using the weighted average of country-specific returns. Nine countries have data starting before World War I. Many countries included in our regressions have gaps in the coverage that range from one month to over a year. Since these gaps partly coincide with World War II—as some stock markets did not operate in those years—we follow Berkman, Jacobsen, and Lee (2011) and use all available information.

We start by estimating the following regression:

rwtd,t — fa + otwidQPRSHOCKt + PnijCRISESt + £wid,t>

where rw[jt is the world stock market return in month t, GPRSHOCKt is the residual of an autoregressive process of order one estimated for the GPR index, and CRISESt is the crisis index constructed by Berkman, Jacobsen, and Lee (2011). In columns (1) and (3) of Table 2 we report results for two samples, starting in 1919 and 1985, respectively. To compare the impact on the GPR and on the crisis index, the coefficients measure the impact on stock returns of a one standard deviation shock in the GPR, and of having 2.41 active crises per month, the average number of crises over our sample.

For the historical sample, we find that a 1 standard deviation increase in the GPR induces a statistically significant decline in monthly stock returns of 0.5 percent. The sensitivity of world stock returns to geopolitical risk is larger after 1985, with an estimated drop of 0.75 percent. Interestingly, the coefficient on the crisis variable is negative for the historical sample—albeit not statistically significant—and becomes positive and not significant in the post-1985 sample. Thus, the GPR index correlates with negative stock returns controlling for the realizations of international crises. Moreover, the result over the post-1985 sample suggests that an advantage of the GPR index over the crisis index is that, having substantially more time variation, allows for the estimation of the impact of geopolitical events on stock returns over relatively short samples.

World stock returns react more to threats about geopolitical events than their realizations. This result is based on a modified version of equation (1), where we replace GPRSHOCKt with the residuals of AR(1) processes estimated for the GPR acts and threats indexes. As tabulated in column (2) of Table 2, for the historical sample, world stock returns decline in response to both GPA and GPT shocks, but the response to the former is small and not statistically significant. By contrast, in the post-1985 sample, stock returns rise in response to a positive GPA shock, while they experience a large and statistically significant decline in response to a GPT shock. Thus, as in the United States, world stock returns respond asymmetrically to the threats and realizations of geopolitical events.

We also estimate the following regression on country stock returns data:

rM = p, + aMGPRSHOCKt + eM,

where ri t is the stock market return in country i and month t. We exclude the crisis index from the country regressions because for the 11 countries we have stock returns data starting prior to 1919, the first year the crisis index is available. Table 3 tabulates the results for the historical and the post-1985 samples.

Three results emerge from this exercise. First, both in the historical and post-1985 sample, geopolitical risk depresses stock returns in all but one of the countries included in our regressions— the only positive coefficient is estimated for Japan and is close to zero. Second, on average, the sensitivity of stock returns to geopolitical risk is larger in the post-1985 sample relative to the historical sample, with countries like the Netherlands, Portugal, and Spain having a coefficient about 3 times larger in the short sample. Third, the response of stock returns varies substantially across countries. For the historical sample, the response ranges from about negative 0.9 for Italy and South Africa, to 0 for countries like Japan and Germany. Similarly, for the post-1985 sample, coefficients range from negative 1.50 for Italy and Germany, to negative 0.3 for Australia and Japan. Furthermore, while stock returns in some countries have remained particularly responsive (such as Italy or South Africa) or unresponsive (such as Japan) over time, stock returns have become more sensitive in others most notably in Germany.

5.3 Geopolitical Risk and Capital Flows

Finally, we present additional evidence on the global economic consequences of changes in geopolitical risk by showing how geopolitical risk affects capital inflows in a sample of advanced and emerging economies. The procyclical and volatile nature of capital flows makes them a leading policy concern, especially in economies that rely heavily on foreign sources of financing. We use country-level, quarterly data on capital inflows from the IMF’s Balance of Payments Statistics database. Our sample consists of 22 advanced economies, 23 emerging economies, and the United States, and covers the period from 1986:Q1 through 2015:Q4.36

Our baseline specification tests whether movements in geopolitical risk have explanatory power for gross capital inflows. We choose gross inflows—net purchases of domestic assets by foreign residents excluding official reserves—in line with a large and growing body of empirical evidence that shows that gross capital flows respond systematically to changes in global conditions, and in line with the notion that our measure of geopolitical risk is more likely to matter for the economic-decisions of global investors on where to allocate capital across countries. \*7

Our regression takes the form:

Vi,t — ai + PDi.t-i + PGP Rt + rXt + Uit,

where yi t — inflowsi t/GDP,t are gross capital inflows divided by annualized GDP, a, are country fixed effects, GPRt is our geopolitical risk index, and Xt is a vector of control variables. We estimate equation (3) separately for emerging economies, for advanced economies excluding the United States, and for the United States. Throughout, we assume that the effect of the GPR index on capital inflows is equal within each group of countries. Following the work of Ahmed and Zlate (2014), our model specification includes the VIX to control for global economic risk, lagged capital flows to control for persistence in capital flows, as well as country-specific GDP growth to capture demand-side factors that could drive capital flows towards one country.

Table 4 reports regressions coefficients scaled to denote the impact of a 1 standard deviation increase in the GPR index and the VIX. Comparing columns (1) and (2) of the table, an increase in GPR produces different effects on capital inflows in emerging versus advanced economies. In emerging economies, high GPR reduces capital inflows by 0.23 percentage points, while an equally sized increase in the VIX reduces capital inflows by more than one percentage point. By contrast, in advanced economies, increases in GPR lead to a sizable increase in capital inflows— about one percentage point—whereas increases in the VIX reduces capital inflows by 1.5 percentage points. GPR and VIX also have opposite effects on inflows for the United States: as tabulated in column (3), the effect of an increase in geopolitical risk is negative (albeit the coefficient is not statistically different from zero) while the effect of an increase in the VIX is positive and statistically significant. In all specifications, the coefficient on lagged GDP growth is positive, confirming the findings in Broner, Didier, Erce, and Schmukler (2013) that a better investment climate (as proxied by GDP growth) leads to larger inflows in both advanced and emerging economies.

In additional regressions results, we have verified that the asymmetric effect of geopolitical risk on capital inflows for emerging and advanced economies is present for all three subcomponents of capital inflows: portfolio flows, foreign direct investment, and other investments.38 However, such effects are especially pronounced for portfolio flows and other investments compared to foreign direct investment.

All told, the results suggest a marked difference between the effects on capital flows of global economic risk (as measured by the VIX) and geopolitical risk. While higher economic uncertainty leads to a repatriation of foreign capital across the board, increases in geopolitical risk appear to shift purchases of foreign capital away from emerging and toward advanced economies, consistent with a flight-to-safety hypothesis.311 However, the relatively small estimate of the effect of GPR on emerging economies' inflows suggests that adverse geopolitical events fall short of causing full-blown sudden stops in these economies. This finding mirrors our international VAR evidence showing little effects of higher geopolitical risk on activity in emerging economies.

6 Conclusions

**We construct an index of geopolitical risk and examine** **its evolution and** **its effects over** **the past** **120 years. This index captures** **an important dimension of uncertainty: the** **risk of events that disrupt** **the normal**, democratic, and **peaceful course of relations across states**, populations, and territories. **Compared to existing proxies for macroeconomic uncertainty**, **we argue that our index can be used to isolate risks -such as risks of wars** and terrorist attacks—**that are more likely** to be **exogenous to economic developments in the U**nited **S**tates **and other** advanced **economies.**

#### Economic downturns don’t cause conflict

Clary 15 (Ph.D. in Political Science from MIT, Postdoctoral Fellow, Watson Institute for International Studies, Brown University, “Economic Stress and International Cooperation: Evidence from International Rivalries,” April 22, 2015, http://papers.ssrn.com/sol3/papers.cfm?abstract\_id=2597712)

Do economic downturns generate pressure for diversionary conflict? Or might downturns encourage austerity and economizing behavior in foreign policy? This paper provides new evidence that economic stress is associated with conciliatory policies between strategic rivals. For states that view each other as military threats, the biggest step possible toward bilateral cooperation is to terminate the rivalry by taking political steps to manage the competition. Drawing on data from 109 distinct rival dyads since 1950, 67 of which terminated, the evidence suggests rivalries were approximately twice as likely to terminate during economic downturns than they were during periods of economic normalcy. This is true controlling for all of the main alternative explanations for peaceful relations between foes (democratic status, nuclear weapons possession, capability imbalance, common enemies, and international systemic changes), as well as many other possible confounding variables. This research questions existing theories claiming that economic downturns are associated with diversionary war, and instead argues that in certain circumstances peace may result from economic troubles.