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INTERNATIONAL NETWORK FOR ECONOMIC RESEARCH

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INTERNATIONAL NETWORK FOR ECONOMIC RESEARCH

No. 7 | 2023

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How Political Tensions and Geopolitical Risks Impact Oil Prices?*

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Abstract

This paper assesses the effect of US-China political relationships and geopolitical risks on oil prices. To this end, we consider two quantitative measures — the Political Relationship Index (PRI) and the Geopolitical Risk Index (GPR) — and rely on structural VAR and local projections methodologies. We expand the literature on the macroeconomic consequences of geopolitical risks by considering bilateral political relationships. The bilateral GPR does not focus on the relation between the US and China; rather, it provides an overall picture of the geopolitical uncertainty for China on a multilateral basis. Our empirical investigation shows that improved US-China relationships, as well as higher geopolitical risks, drive up the price of oil. Indeed, unexpected shocks in the political relationship index are associated with optimistic expectations about economic activity, whereas unexpected shocks in the geopolitical risk index reflect fears of supply disruption. Political tensions and geopolitical risks are thus complementary causal drivers of oil prices, the former being linked to the demand side and the latter to the supply side.

Keywords: Oil prices, political relationships, geopolitical risk, China.
JEL: Q4, F51, C32

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Preprint *July 23, 2023*

1. Introduction

The last two decades have been characterized by impressive changes in the oil market at the global level. Although the role of the Chinese economy in the oil market was negligible before China's entrance into the WTO, the situation dramatically evolved afterward. Indeed, China has become a significant player in the oil market, with 16.4% of global consumption in 2021.[1] Turning to the US, it is the first largest consumer (19.9% of world oil consumption) and producer (16.8% of world oil production). Given the weight of these two countries, the evolution of their political relationships could thus strongly affect the dynamics of oil prices, in addition to geopolitical risks.

This paper tackles this issue by investigating the impact of political tensions and geopolitical risks on oil prices. Whereas various articles have tried to capture these effects using proxy variables (Chen et al., 2016; Lee et al., 2017; Miao et al., 2017; Perifanis and Dagoumas, 2019; Abdel-Latif and El-Gamal, 2020; Qin et al., 2020; Caldara and Iacoviello, 2018), Cai et al. (2022) is the first study that relies on a quantitative measure of political relations to investigate their possible impacts on oil prices.

In the present paper, we go further than the previous literature by relying on two complementary quantitative measures. First, we use an index built by the Institute of International Relations at Tsinghua University to measure political relationships for China and its major trade partners (see Yan (2010) for a discussion). This Political Relationship Index (hereafter PRI), ranging between -9 and 9, indicates whether the countries are rivals (between -9 and -6), in a tense relation (between -6 and -3), in a bad relation (between -3 and 0), in a normal relation (between 0 and 3), in good relation (between 3 and 6), and friends (between 6 and 9). PRI fluctuates according to a scale similar to the Goldstein scale (Goldstein, 1992). Each month, bad or good events appearing in People's Daily and on the Chinese Ministry of Foreign Affairs website are included to update the index.[2] As shown in Figure 1, the US-China political relationships dramatically deteriorated after the beginning of Trump's trade war.

Second, we use the bilateral version specific to China of the Geopolitical Risk Index (hereafter GPR) introduced by Caldara and Iacoviello (2018). GPR is a monthly index obtained by running automated text searches on the electronic archives of 11 newspapers that counts the percentage of articles related to adverse geopolitical events (wars, terrorist attacks, tensions between countries, etc.). The bilateral version of GPR refers to the percentage of articles in US newspapers dealing with adverse geopolitical events that concern one specific country, namely China in our case. This bilateral index uses three US newspapers: The New York Times, Chicago Tribune, and The Washington Post. As shown in Figure 1, the percentage of articles associated with China increased substantially after Trump's trade war began.

[1] Source: BP Statistical Review of World Energy 2022.
[2] See section 2.

Figure 1: Political Relationship Index (left-hand scale) and Geopolitical Risk Index (right-hand scale)

Notes: PRI (in blue) can be downloaded at: http://www.tuiir.tsinghua.edu.cn/imiren/info/1091/1320.htm, and the bilateral GPR (in red) at: https://www.matteoiacoviello.com/gpr_country.htm. PRI is expressed as $\text{sgn}(x) * ln(|x|+1)$ and ranges between -2.30 and 2.30: rival countries between -2.30 and -1.95, in a tense relation between -1.95 and -1.39, in a bad relation between -1.39 and 0, in a normal relation between 0 and 1.39, in good relation between 1.39 and 1.95, and friends between 1.95 and 2.30. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

In order to analyze the impact of the US-China political relations on the oil market, the bilateral GPR index specific to China and the PRI index can be seen as complement. Indeed, the bilateral GPR does not focus on the relation between the US and China, rather it provides an overall picture of the geopolitical uncertainty for China. For example, the Sino-Japanese dispute over the Diaoyu/Senkaku Islands could be included in the GPR index specific for China, but it will be included in the Sino-Japanese PRI, not in the PRI for the relation between US and China. The PRI for the US and China is focused on the bilateral relationship. In this respect, we contribute to the literature on the macroeconomic consequences of geopolitical risk (see Caldara and Iacoviello 2022) by considering the bilateral political relationships between the US and China. We analyze the possible complementarities between the PRI and the GPR index.

To decipher the differences between the impact of political tensions and geopolitical risks — two concepts that are related to each other but are not entirely substitutable — on oil prices, we use structural vector autoregressions (SVAR) and Local Projections (LP). Our findings show that improved US-China political relationships, as well as an amelioration of geopolitical risks, drive up the price of oil[3].

The rest of the paper is organized as follows. Section 2 presents the data and methodology. Section 3 reports our empirical results. Section 4 concludes.

[3]Castillo et al. (2020) show that higher oil price volatility induces higher levels of average inflation. Thus, our results have some implications in terms of monetary policy.

2. Data and Methodology

Using monthly data from January 2000 to December 2019, we run SVAR and LP analyses (Jordà, 2005) to evaluate how oil prices react to shocks on PRI and on the bilateral GPR index. We consider the following variables in the SVAR model: bilateral GPR for China (*gpr_cn*), oil supply (global oil production, million barrels/day, *lpro*), oil demand (OECD and six major non-member economies (Brazil, China, India, Indonesia, the Russian Federation, and South Africa) industrial production, *ldem*), oil prices (real WTI spot price, *lrpo*), and PRI between China and the US (*lpri_us*), respectively.[4] These oil-related variables are transformed into natural logs. For PRI, we use the log-modulus transformation, which is defined for zero and negative values.

As previously mentioned, PRI is updated using the news published in People's Daily and on the Chinese Ministry of Foreign Affairs website. Specifically, the formula used to update PRI is given by:

$$PRI_t = \frac{\left(\frac{N-PRI_{t-1}}{N} EV^+ + \frac{N+PRI_{t-1}}{N} EV^-\right)}{5} + PRI_{t-1} \tag{1}$$

where N denotes the half of the range of the PRI index, EV^+ is the level of good events, and EV^- is the level of bad events during the current month, respectively.[5] The first term after the equal sign is rounded to the smallest increment 0.1.

Following Lütkepohl (2005), the SVAR specification is given by:

$$\mathbf{A}\mathbf{y}_t = \mathbf{A}_1\mathbf{y}_{t-1} + \mathbf{A}_2\mathbf{y}_{t-2} + \cdots + \mathbf{A}_p\mathbf{y}_{t-p} + \mathbf{B}\varepsilon_t \tag{2}$$

where $\mathbf{y}_t$ is the vector of endogenous variables, $\mathbf{A}, \mathbf{A}_1, \mathbf{A}_2, \cdots, \mathbf{A}_p$ denote the structural coefficients, and ε_t are the orthonormal unobserved structural innovations, $\varepsilon_t \sim (0, I_K)$. We can rewrite equation 2 as follows:

$$\mathbf{y}_t = \mathbf{C}_1\mathbf{y}_{t-1} + \mathbf{C}_2\mathbf{y}_{t-2} + \cdots + \mathbf{C}_p\mathbf{y}_{t-p} + u_t \tag{3}$$

where $\mathbf{C}_\mathrm{i} := \mathbf{A}^{-1}\mathbf{A}_\mathbf{i} \quad (i = 1, 2, \ldots, p)$.

The reduced-form error u_t can be expressed by:

$$\mathbf{A}u_t = \mathbf{B}\varepsilon_t \tag{4}$$

$$u_t = \mathbf{A}^{-1}\mathbf{B}\varepsilon_t = \mathbf{S}\varepsilon_t \tag{5}$$

$$\mathbf{E}\left(u_t u_t'\right) = \Sigma_u = \mathbf{A}^{-1}\mathbf{B}\mathbf{B}'\mathbf{A}^{-1'} = \mathbf{S}\mathbf{S}' \tag{6}$$

with $\mathbf{S} = \mathbf{A}^{-1}\mathbf{B}$. To recover $\mathbf{S}$, we rely on the recursive identification scheme by using Cholesky decomposition to obtain a lower-triangular matrix. In line with the recent literature (Caldara and Iacoviello, 2022), the identified shocks of PRI for the US or GPR for China contemporaneously impact oil-related variables, but the reverse effects of other oil shocks take time.

[4] All the oil-related variables are taken from: https://sites.google.com/site/cjsbaumeister/. More details can be found in Baumeister and Hamilton (2019).

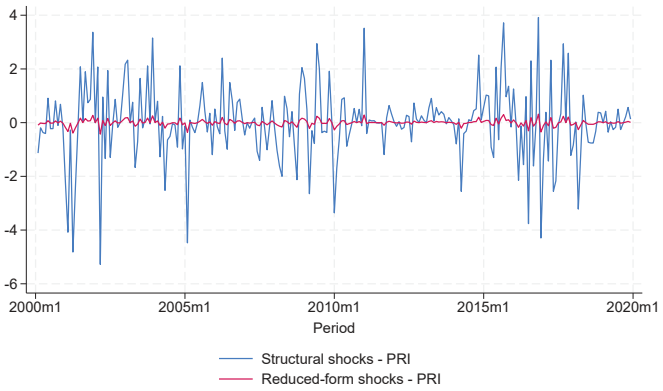
[5] The formula used to update PRI gives less weight (i) to bad events when the relation deteriorates, and (ii) to good events when the relationship is good.

3. Empirical evidence

3.1. Baseline results

Figures 2 and 3 report the reduced-form and structural shocks for PRI for the US and GPR for China, respectively. Figure 2 shows that unanticipated negative shocks (deterioration of political relations) are more frequent during Trump's trade war. Similarly, Figure 3 reveals a rise in the frequency of unexpected positive shocks (an increase in articles related to China in US newspapers) during the same trade war period.

Figure 2: Structural and Reduced-form Shocks for PRI



Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

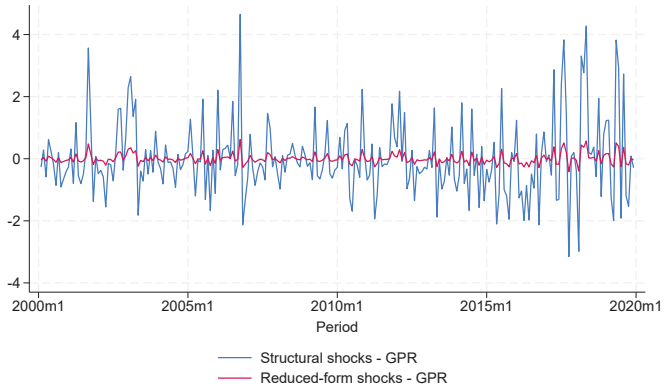
To compare the results of VAR and LP, we present the dynamic multipliers in Figures 4 and 5. Dynamic multipliers measure the impact of a unit increase in an exogenous variable on endogenous variables over time. The contemporaneous effect of the exogenous variable (the structural shocks on PRI for the US and on GPR for China) is not constrained to 1. A regression of the endogenous variables at time $t + h$, $\mathbf{y}_{t+h}$, on the exogenous variable today, $\mathbf{x}_t$, gives the dynamic multiplier at horizon h:

$$\mathbf{y}_{t+h} = \mathbf{D}^h \mathbf{x}_t + u_{t+h} \tag{7}$$

Matrix $\mathbf{D}^h$ contains the dynamic multipliers at horizon h. For the exogenous variables, $\mathbf{x}_t$, we focus on the structural shocks, ε_t, identified in the SVAR for PRI and GPR variables, respectively. Finally, we focus on the real price of oil for the endogenous variables, $\mathbf{y}_{t+h}$.

In Figure 4, the LP's dynamic multipliers show that improving political relations positively affects the real price of oil after 13 months; this positive effect lasting about 10 months. Turning to the VAR's dynamic multipliers, we observe (i) an initial drop that is not significant in LP, and (ii)

Figure 3: Structural and Reduced-form Shocks for GPR



Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

the absence of a significant positive effect. Overall, LP seems to capture the short-run dynamics. These results are rather intuitive. An unanticipated improvement in PRI for the US means a better relationship between the two major players in the world economy and in the oil market. Positive shocks on PRI are thus linked to the demand side and are associated with optimistic expectations regarding future economic activity, driving up oil prices.

In Figure 5, we consider the structural shocks in GPR for China. The LP's dynamic multipliers results are very similar to those related to PRI for the US. Indeed, we observe a rise in the real price of oil after 8 months. This increase lasts around 18 months and is of higher magnitude than the shocks on PRI for the US. Regarding the VAR's dynamic multipliers, the increase is not significant, as in Figure 4. Our result that higher geopolitical risks drive up oil prices persistently is in line with the fact that there is a tendency to confound all geopolitical tensions with oil supply shocks provoked by geopolitical tensions in the Middle East (Caldara and Iacoviello, 2022). Positive shocks on GPR are thus linked to the supply side and reflect fears of oil supply disruption, pulling up oil prices.

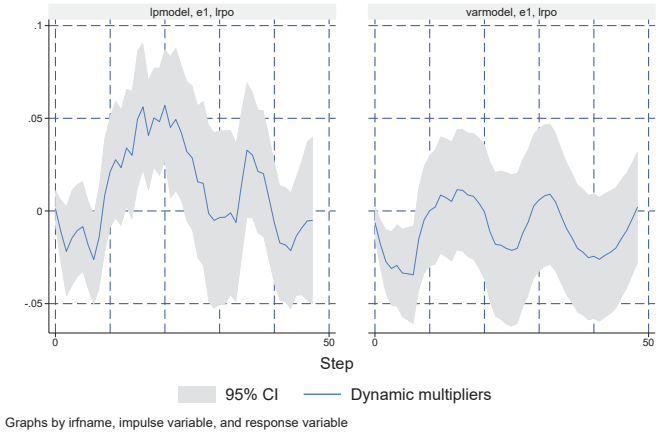
Finally, to assess the robustness of our findings to the proxy retained for oil demand, we rely on the index of global real economic activity in industrial commodity markets, as Kilian (2009, 2019) and Kilian and Zhou (2018) proposed. As shown in Appendix C and Appendix D, our findings remain similar, illustrating the robustness of our conclusions.

3.2. Sub-sample analyses and case studies

3.2.1. US bombing of the Chinese embassy in Belgrade

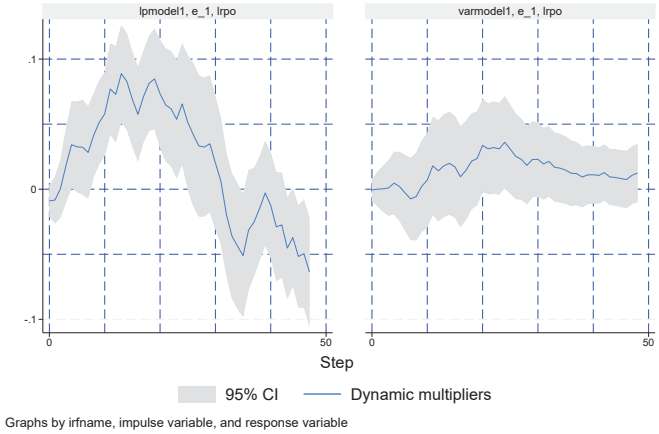
In the following, we will run the same analyses with samples from February 1990 after the 1989 Tiananmen Square Events, and from February 1985 where the recent GPR index is available. The

Figure 4: Dynamic Multipliers for the Real Price of Oil (Shock on PRI for the US)



Notes: Left graph: LP, right graph: SVAR. As shown by Cai et al. (2022), the results are robust to different orderings. The real price of oil and the series of structural shocks on PRI for the US are uncorrelated (see Appendix A). PRI, Political Relationship Index.

Figure 5: Dynamic Multipliers for the Real Price of Oil (Shocks on GPR for China)

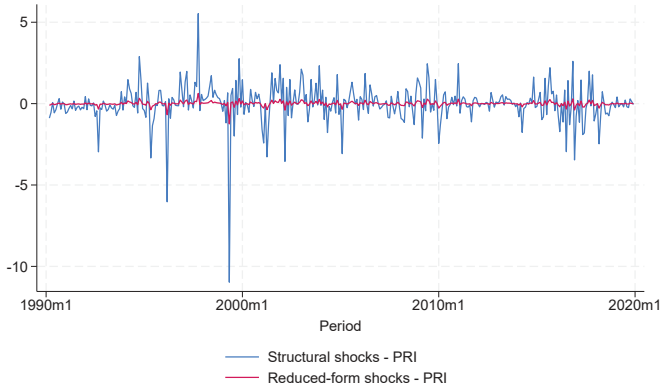


Notes: Left graph: LP, right graph: SVAR. As shown by Cai et al. (2022), the results are robust to different orderings. The real price of oil and the series of structural shocks on PRI for the US are uncorrelated (see Appendix B). GPR, Geopolitical Risk Index.

results are largely similar, but they offer some evidence about the complementarity between the GPR and PRI index in the understanding of the macroeconomic consequences of geopolitical risk. We start with the sample after the 1989 Tiananmen Square Events. The sample starts now from January 1990. We will focus on a specific event that has not been reported and perceived in the same in the US and in China. Indeed, on May 7, 1999, the Chinese embassy in Belgrade was bombed by the US during the NATO bombing of Ex-Yugoslavia, as reported by Ponniah and Marinkovic (2019). As shown by Bondarenko et al. (2023), geopolitical risk cannot be universally measured. In a case study on Russia, they show that geopolitical risk shocks identified from English-language news sources do not have any impact on the Russian economy, whereas Russian-language news sources do have an impact on the Russian economy.

As you can see in the following Figures 6 and 7, this huge negative shock can only be seen in the PRI index (Figure 6). This important negative event has not been reported in the same way in the US press (Parsons and Xiaoge, 2001) and, thus, stay invisible in the GPR index (Figure 7). The results are largely similar, as you can see in Figures 8 and 9. In the LP's dynamic multipliers for the PRI, the increase in the oil price comes a little bit later, after 22 months, and lasts 10 months as in the baseline results. The VAR's dynamic multipliers for the PRI provide a similar dynamics. Besides, the results are very similar for the GPR index.

Figure 6: Structural and Reduced-form Shocks for PRI after the 1989 Tiananmen Square Events

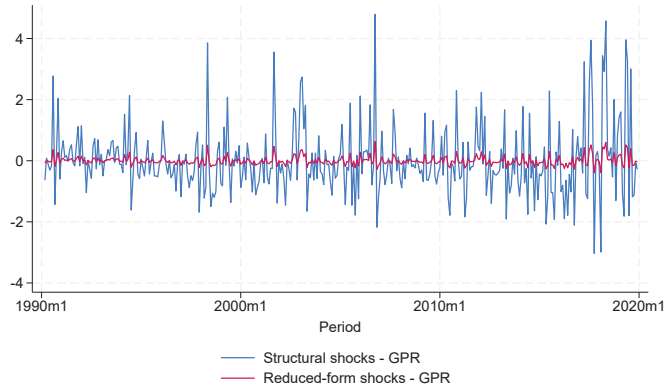


Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

3.2.2. 1989 Tiananmen Square events

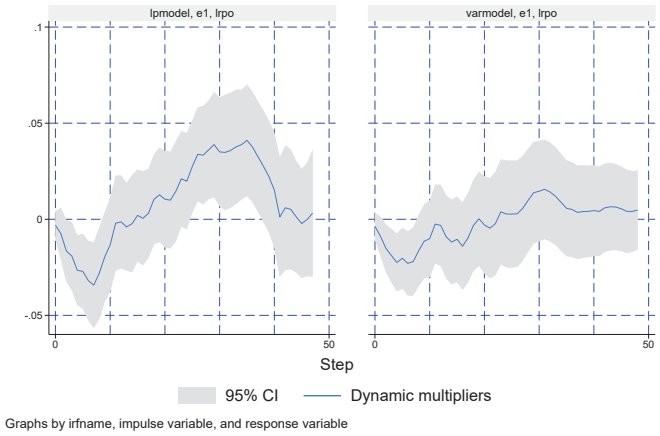
Now, we start the sample for January 1985 where the GPR index is available. We will focus on the 1989 Tiananmen Square events that took place between 15 April and 4 June 1989. In Figure 10 and 11, we cannot observe the same discrepancy between the bilateral GPR and the PRI for the

Figure 7: Structural and Reduced-form Shocks for GPR after the 1989 Tiananmen Square Events



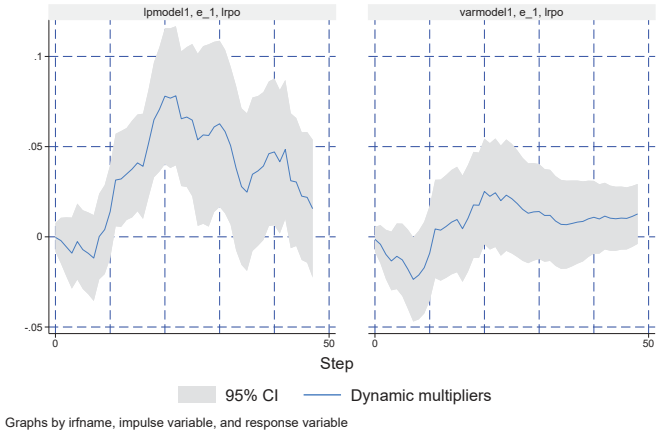
Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

Figure 8: Dynamic Multipliers for the Real Price of Oil (Shock on PRI for the US) after the 1989 Tiananmen Square Events



Notes: Left graph: LP, right graph: SVAR. As shown by Cai et al. (2022), the results are robust to different orderings. The real price of oil and the series of structural shocks on PRI for the US are uncorrelated. PRI, Political Relationship Index.

Figure 9: Dynamic Multipliers for the Real Price of Oil (Shocks on GPR for China) after the 1989 Tiananmen Square Events



Notes: Left graph: LP, right graph: SVAR. As shown by Cai et al. (2022), the results are robust to different orderings. The real price of oil and the series of structural shocks on PRI for the US are uncorrelated. GPR, Geopolitical Risk Index.

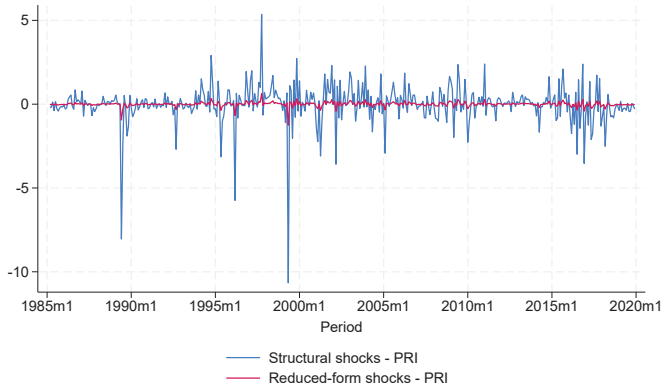
relationship between US and China, that we observe for the United States bombing of the Chinese embassy in Belgrade. The rationale behind these results is simple. Indeed, the international media coverage of the Tiananmen Square events is in line with the perceived deterioration in China of the relation with the US.

The results of the dynamic multipliers are qualitatively similar, as you can see in Figures 12 and 13. As the estimation period is longer, we can note some differences in the LP's and VAR's dynamic multipliers for the real price of oil for the PRI. In Figure 12, the increase in the oil price is obtained after 28 months and is shorter than in the baseline. This last result is interesting, as before the 1990s, the Chinese economy has not a large influence on the world economy. Besides, in Figure 13 the results for the GPR are very similar to the baseline results. After the shock, the increase in the real price of oil comes a little bit later (10 months after the shock versus 8 months in the baseline) and lasts longer (22 months against 18 months in the baseline).

3.2.3. Considering the COVID pandemic

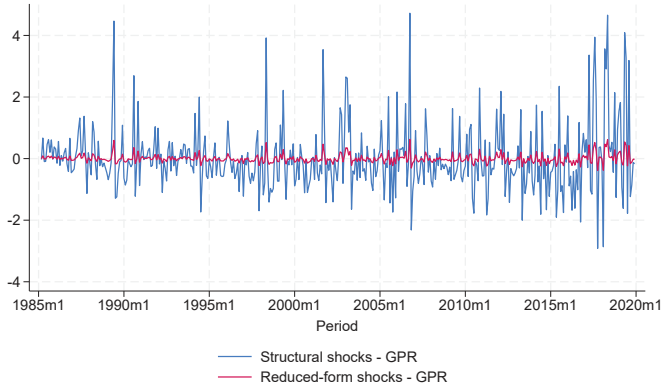
Now, we will consider the effect of the COVID pandemic by expanding our sample to January 2022. We stop our sample in January 2022, before the start of the war in Ukraine. Of course, the results of this peculiar sub-sample analysis should be taken with a grain of salt, as the COVID outbreak constitute a huge, and short-lived, structural break in many macroeconomic time-series. However, it could be interesting to investigate how the model behaves when we include the COVID period.

Figure 10: Structural and Reduced-form Shocks for PRI before the 1989 Tiananmen Square Events



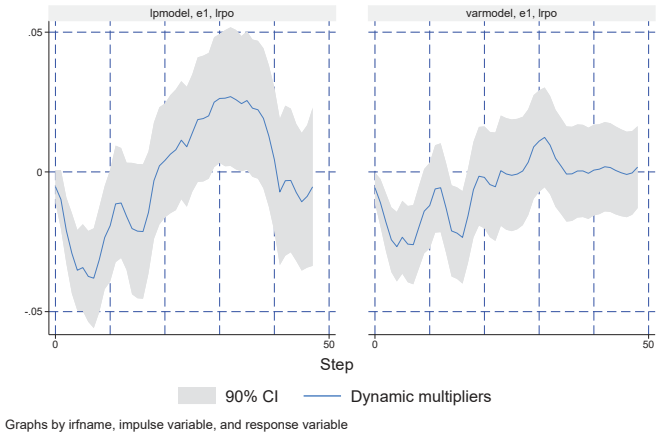
Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

Figure 11: Structural and Reduced-form Shocks for GPR before the 1989 Tiananmen Square Events



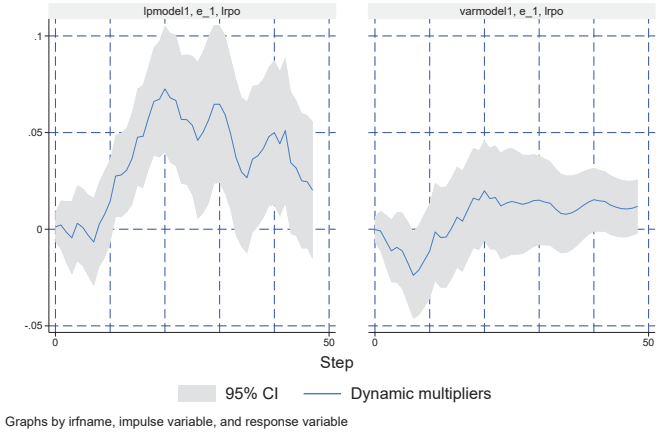
Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

Figure 12: Dynamic Multipliers for the Real Price of Oil (Shock on PRI for the US) before the 1989 Tiananmen Square Events



Notes: Left graph: LP, right graph: SVAR. As shown by Cai et al. (2022), the results are robust to different orderings. The real price of oil and the series of structural shocks on PRI for the US are uncorrelated. PRI, Political Relationship Index.

Figure 13: Dynamic Multipliers for the Real Price of Oil (Shocks on GPR for China) after the 1989 Tiananmen Square Events



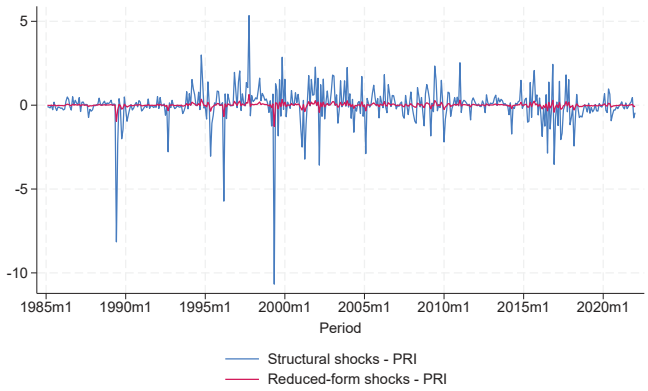
Notes: Left graph: LP, right graph: SVAR. As shown by Cai et al. (2022), the results are robust to different orderings. The real price of oil and the series of structural shocks on PRI for the US are uncorrelated. GPR, Geopolitical Risk Index.

In Figure 14 and 15, we can observe that the PRI index between the US and China has not known any major shock during the COVID. The relation was in rival state and remained stable (Figure 14). On the contrary, the GPR index has known several shocks (Figure 15). This gap is explained by the more general nature of the GPR index. As mentioned before, the GPR index captures the mention of the geopolitical risk relative to China, but is not focused on the bilateral relation between China and the US. In the Figure 16 and 17, we can see that the effects on the oil price dynamics are qualitatively similar.

The results are very similar to those in with the sample that starts from January 1985 and stops in December 2019. In Figure 16, the increase in the oil price is obtained after 28 months and is shorter than in the baseline. Besides, in Figure 17, the results are in line with baseline in Figure 5. The increase in the real price of oil lasts even longer (22 months against 18 months in the baseline).

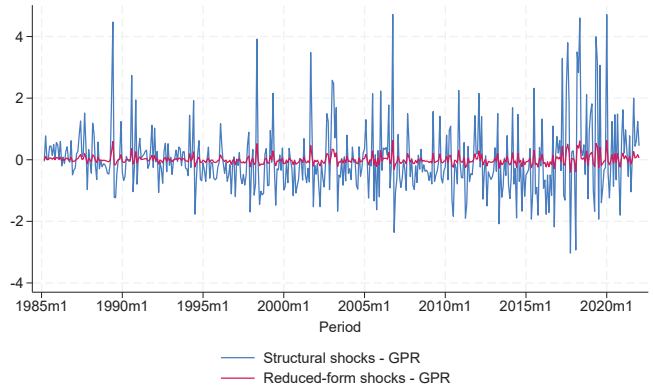
Overall, our results are robust to various subsamples periods. Besides, they are robust to other proxy for the world demand for oil. The results converge toward a positive causal influence of political relation and geopolitical risk over the short to medium run. However, these two quantitative measures are not fully substitutable, as they measure different dimensions of geopolitical relationships. As noted by Bondarenko et al. (2023), the perception of geopolitical risk in each country may matter to measure the influence of these risks on the economy. This last point has been illustrated with the US bombing of the Chinese embassy in Belgrade. Besides, the PRI is more focused on the bilateral relation between China and the US and reflects expectations on the world demand for oil. The GPR index for China is more general and reflects fears of supply disruptions.

Figure 14: Structural and Reduced-form Shocks for PRI with the COVID pandemic



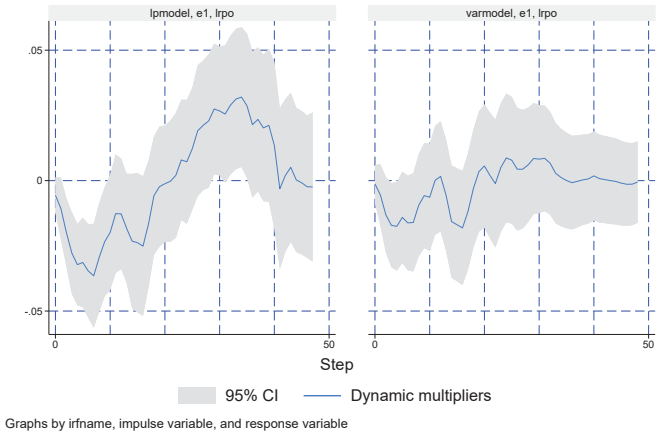
Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

Figure 15: Structural and Reduced-form Shocks for GPR with the COVID pandemic



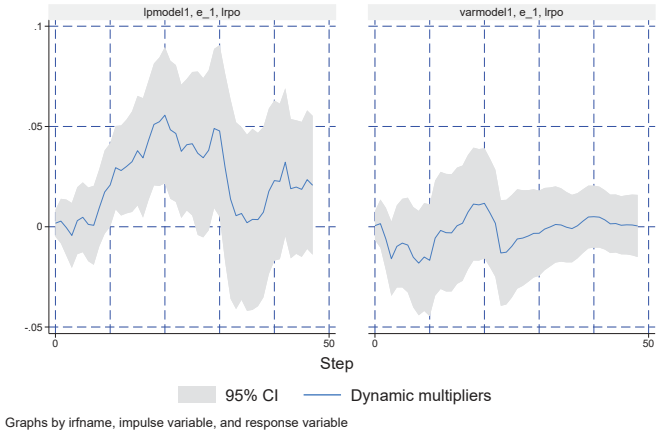
Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index; GPR, Geopolitical Risk Index.

Figure 16: Dynamic Multipliers for the Real Price of Oil (Shock on PRI for the US) with the COVID pandemic



Notes: Left graph: LP, right graph: SVAR. As shown by Cai et al. (2022), the results are robust to different orderings. The real price of oil and the series of structural shocks on PRI for the US are uncorrelated. PRI, Political Relationship Index.

Figure 17: Dynamic Multipliers for the Real Price of Oil (Shocks on GPR for China) with the COVID pandemic



Notes: Left graph: LP, right graph: SVAR. As shown by Cai et al. (2022), the results are robust to different orderings. The real price of oil and the series of structural shocks on PRI for the US are uncorrelated. GPR, Geopolitical Risk Index.

4. Conclusion

This paper presents new evidence on the impact of US-China political relationships and geopolitical risks on the oil market. Our findings show that an improvement in the US-China political relationships positively affects the oil market: positive shocks on PRI are associated with optimistic expectations regarding future economic activity, driving up oil prices. Similarly, we find that higher geopolitical risks drive up oil prices, as positive shocks on GPR reflect fears of oil supply disruption, pulling up oil prices.

Overall, our findings show that political tensions and geopolitical risks play a crucial role, illustrating that they are complementary rather than substitute factors in explaining oil price dynamics. These findings could help policymakers to understand the macroeconomic consequences of geopolitical risks by considering bilateral political relationships. In this perspective, considering bilateral political relations and geopolitical risk perceptions in the recent surge of inflation after the COVID pandemic and the subsequent monetary developments would be an interesting avenue for future research, as witnessed by the recent empirical investigation of Caldara et al. (2023).

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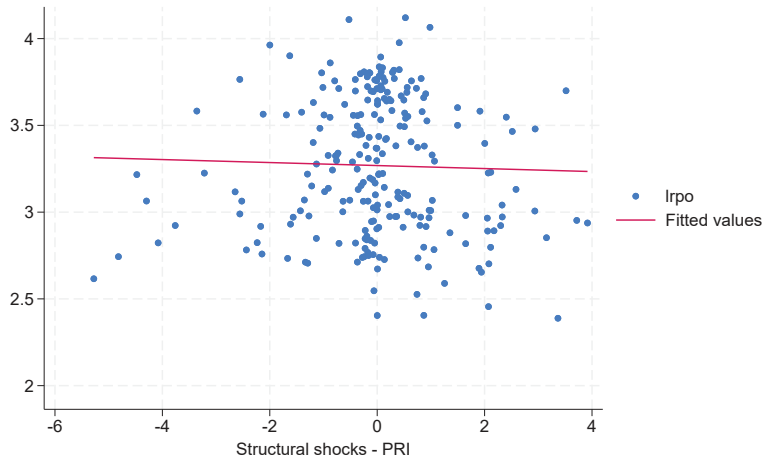
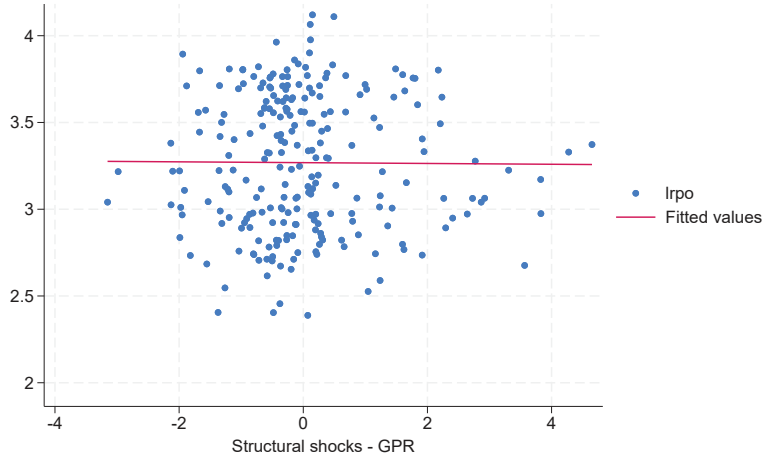
Appendix A. Correlation between structural shocks on PRI for the US and the real price of oil



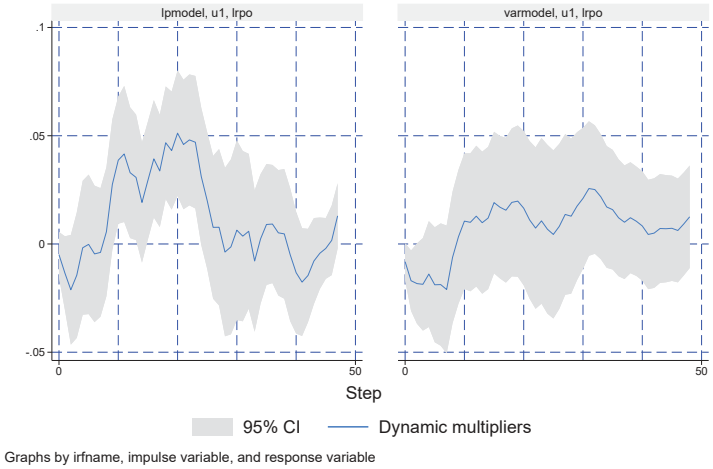
Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. PRI, Political Relationship Index.

Appendix B. Correlation between structural shocks on GPR for China and the real price of oil



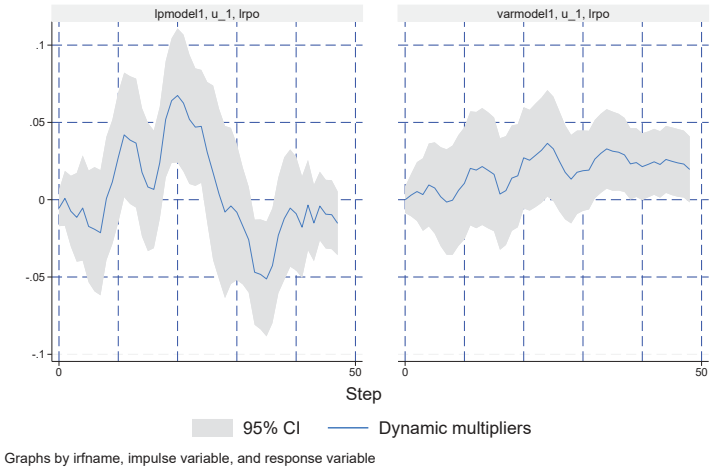
Notes: Structural shocks are obtained in the following way: $\mathbf{B}^{-1}\mathbf{A}u_t = \varepsilon_t$. GPR, Geopolitical Risk Index.

Appendix C. Robustness for the dynamic multipliers (Shock on PRI for the US)



Notes: Left graph: LP, right graph: SVAR. In this robustness exercise, we use an alternative proxy for oil demand introduced by Kilian and Zhou (2018): https://www.dallasfed.org/research/igrea. PRI, Political Relationship Index.

Appendix D. Robustness for the dynamic multipliers (Shock on GPR for China)



Notes: Left graph: LP, right graph: SVAR. In this robustness exercise, we use an alternative proxy for oil demand introduced by Kilian and Zhou (2018): https://www.dallasfed.org/research/igrea. GPR, Geopolitical Risk Index.