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The Damocles sword of lingering conflicts

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Geopolitics will remain a threat to the world economy

Capital markets remain relaxed

These days, good economists don't just have to be good, well, economists. With all the simmering, sometimes blazing conflicts around the world, our profession also needs a crash course in geopolitics. At first glance, you might think: why? After all, the capital markets don't really seem to be rattled by the wars in Ukraine and the Middle East. Leading share indices are at roughly the same level today as they were on the eve of Hamas' brutal terrorist attack and the subsequent war in the Gaza Strip. And Russia's attack on Ukraine has not shaken the markets in the long term either. So not all that bad? Why bother?

The worst fears did so far not come true

In Ukraine, the troops on the front line have become bogged down, gains in territory on either side are negligible. Fears that the situation could escalate, for example through weapons of mass destruction, have dwindled. And the war between Israel and Hamas has so far remained regionally limited. Fears that Iran could close the Strait of Hormuz, through which a fifth of the world's oil is transported, are diminishing. The oil price is already below its level directly before Hamas' campaign of terror.

The respective catastrophic scenarios have not (yet?) materialized. Nevertheless, the geopolitical risks remain a threat to the stability and growth of the global economy.

The rivalry between the USA and China as a top risk

And you don't have to think only about all-out war. The conflict with the most powerful potential to hurt the global economy is unlikely to be a direct military conflict. I am of course referring to the growing antagonism between the USA and China. Nothing unites the Republicans and Democrats, who are otherwise at loggerheads on almost everything, like their mistrust of China (see illustration). And the fact that China has gone from partner to rival under Xi Jinping was not only demonstrated by Beijing's lenient stance on Russia's aggression.

If Donald Trump returns to the White House in early 2025, the trade war with China will almost certainly escalate and the geopolitical conflicts will intensify. US support for Ukraine will be curtailed. A less balanced position is to be expected in the Middle East conflict. Prospects for de-escalation would fade further.

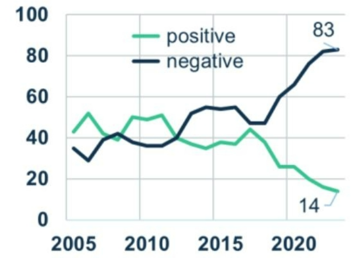
Taiwan as the worst-case scenario

Even so, Taiwan remains the biggest geopolitical risk. Xi Jinping has made it clear that he wants Taiwan to be reunited with the People's Republic. A forced marriage at gunpoint would have catastrophic economic consequences. Taiwan is the equivalent of OPEC for the global semiconductor industry. Supply disruptions would cause a deep global recession.

Personally, I do not believe that a Taiwan crisis is imminent. However, it could become critical if resentment were to spread among the Chinese population if and when the communist party, confronted with a slowing economy, can no longer fulfil its promise of the implicit social contract "political control and acquiescence in exchange for increasing prosperity". In such situations, authoritarian rulers like to play nationalist card in order to rally the population behind the leadership. The most recent demonstration of this pattern was Azerbaijan's President Ilham Aliyev’s decision to invade the contested region of Nagorno-Karabakh and send the resident Armenian population packing.

Economics and geopolitics will remain Siamese twins for the foreseeable future. Economist must now not only read Keynes, but keep their Clausewitz nearby as well.

USA: Public opinion on China



Source: Pew Research Center, LBBW Research

Economy and geopolitics are Siamese twins