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## Editorial

## Geopolitical Risks, Political Tensions and the European Economy



In an era of shifting alliances and global uncertainty, understanding the multifaceted nature of political risk is paramount, particularly in the European context. In these 10 articles, this special issue of the European Journal of Political Economy explores this crucial issue by examining how different forms of political risk shape economic outcomes across the continent. The research presented here offers a comprehensive look at the interplay between geopolitics, financial markets, media narratives and political sentiment, providing valuable insights for policymakers and investors alike.

Aiyar et al. (2024) provide an important starting point by highlighting how geopolitical alignment is increasingly influencing foreign direct investment (FDI) flows. Using project-level data on greenfield FDI between 2003 and 2022 and voting patterns in the United Nations General Assembly (UNGA) to measure geopolitical alignment, their analysis shows that countries are not only driven by economic incentives, but also prioritise strategic partnerships with nations that share similar political views. This suggests a fundamental shift in investment strategies, where political considerations are on a par with economic benefits. In addition to geographic distance, geopolitical distance also plays a role in firms' FDI location decisions. This sets the stage for understanding the complex relationship between political and economic factors.

To analyse this relationship effectively, a robust measurement tool is essential, and the Geopolitical Risk (GPR) index developed by Caldara and Iacoviello (2022) plays a central role in several of the studies presented in this issue. This news-based index, which quantifies global geopolitical risk by counting articles on relevant events in major newspapers, is used to assess the economic impact of such risks. Compared to the dummies often used in event studies, these GPR indices add a measure of the intensity of events. An important distinction between GPR threats and acts suggests that household and business expectations are important channels through which GPRs affect the economy.

One of the most consistent findings across several studies is the negative impact of geopolitical risk on financial markets. Yilmazkuday (2024) finds a clear negative correlation between global geopolitical risk and stock prices across 29 economies, using a local projection method on monthly stock price data from the OECD and GPR data from Caldara and Iacoviello (2022). They find that rising geopolitical tensions reduce investor confidence. This finding is corroborated by Salachas et al. (2024), who show that geopolitical risks increase risk aversion and stock market volatility using a fixed effects panel data analysis for 35 countries, using the GPR index and data from Thomson Reuters EIKON. In addition, Baur and Smales (2020) use OLS regressions with the GPR index and data on stock, bond and metal markets to examine how precious metals such as gold can act as a hedge against geopolitical risk due to their negative correlation with stock prices, making them a safe haven in times of uncertainty.

Moving away from general geopolitical risks, the analysis of Hoffmann et al. (2025) examines the specific impact of military conflicts; their study of 17 invasions provides a nuanced view of how stock markets react negatively to war, as measured by abnormal returns. This is achieved by using an event study methodology with an estimation window of 250 days using data from the MSCI World Index. This highlights the severe impact of armed conflict on market sentiment and investor behaviour.

Afonso et al. (2024) further highlight the economic impact of geopolitical tensions by showing that sovereign debt risk is significantly affected by tensions between neighbouring countries. This study uses a GMM methodology, using sovereign credit default swap (CDS) data from Bloomberg, AMECO and Thomson Reuters Datastream, together with the Geopolitical Risk Index (GPR), to examine the impact of geopolitical risk on sovereign risk. This demonstrates the interconnectedness of regional economies and how political instability in one country can quickly affect the financial health of its neighbours.

Sectoral analysis of the impact of geopolitical tensions can also provide interesting insights. In an innovative study, Aizenman et al. (2024) examine the impact of the Russian invasion of Ukraine on agricultural and energy commodities. Using daily data from LSEG Workspace from January 2022 to March 2024, they test the impact of event days versus non-event days on future commodity prices

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using a heteroskedasticity-based SVAR (Rigobon, 2003). Geopolitical risks from this invasion have heterogeneous effects on commodity prices. In particular, the European natural gas market is more affected than the US and Asian markets.

These sectoral effects are further explored in Jawadi et al. (2024). To investigate the effects of geopolitical tensions, they use monthly data over the last 20 years and several proxies for the real, financial and energy sectors. In line with previous literature (Caldara and Iacoviello, 2022), European economies are more sensitive to geopolitical threats than to geopolitical actions through the investment and consumption channels. In particular, geopolitical tensions generate more oil inflation than gas inflation.

The role of the media in shaping economic perceptions is a critical aspect of political risk that cannot be ignored. Beckmann et al. (2024) clearly show how media coverage of trade disputes influences both economic expectations and market reactions in Europe. This is done using a local projection method with news-based measures of trade war sentiment, survey data and macroeconomic data from Thomson Reuters Datastream. The results suggest that media sentiment can be a powerful force influencing economic forecasts and market behaviour, and that media narratives need to be considered as part of the economic and political landscape.

In addition to traditional media, the rise of social media plays a crucial role in shaping political opinion. The study by Mutascu et al. (2024) demonstrates how platforms such as Facebook and LinkedIn can influence populist voting patterns in Europe, using an ordered probit model on a panel dataset covering the EU-27 countries, showing a direct link between social media and political behaviour. This highlights the importance of understanding the digital landscape and its impact on political outcomes.

Finally, the importance of political and military alliances is examined by Jackson and Shepotylo (2024), who show that membership in military alliances such as NATO can significantly boost trade flows between member countries. The study uses a structural gravity model and panel data for 160 countries, using trade data from the IMF's Directions of Trade Statistics (DOTS) and military alliance data from the Correlates of War (COW) dataset. It highlights the clear economic benefits of political alliances and shows the impact of these agreements on trade and economic cooperation.

In conclusion, this special issue highlights the complex and interdependent relationships between political events, economic outcomes and market behaviour in Europe. The findings underline that political risk is a multifaceted challenge that requires a comprehensive approach that includes geopolitical factors, financial market reactions, media influences and social media trends. By understanding these dynamics, policymakers, investors and other stakeholders can make more informed decisions in this increasingly uncertain world. Geopolitical risk is not just a political phenomenon, but a fundamental force that shapes economic outcomes, market behaviour and societal trends. Future research should seek to develop more integrated, dynamic and ethically informed frameworks that recognise this complex interconnectedness. This will ultimately be essential for navigating a world increasingly characterised by uncertainty and rapid change.

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