

# Economic Narratives and Realities of Geopolitical Risk\*

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\*This work reflects the authors' views, which may not coincide with those of the BIS, Deutsche Bundesbank or the ECB.

## MOTIVATION

Growing importance of **Geopolitical risk (GPR)**: 'threat to, or outright disruption in, the relation between countries'.

- GPR shocks are contractionary (Caldara and Iacoviello, 2022)
- Overall, GPR shocks are inflationary (Caldara et al., 2026; Bondarenko et al., 2024); however, effects on inflation are event-specific
- Central banks need guidance how to respond to geopolitical events

## Research Question

- When do geopolitical risk shocks manifest as adverse supply shocks, raising inflation? When do they propagate as adverse demand shocks, lowering inflation? Can we tell (in real time)?

## GEOPOLITICAL RISK SHOCKS: MAIN TRANSMISSION CHANNELS

**Negative supply channel:**  $Y \downarrow, P \uparrow$

- Disruption of supply chains, diversion of international trade  $\Rightarrow$  production and transportation costs  $\uparrow$
- Cyber attacks and destruction of infrastructure capital disrupt economic activity and raise production costs

**Negative demand channel:**  $Y \downarrow, P \downarrow$

- Consumer and investor confidence  $\downarrow \Rightarrow$  aggregate demand  $\downarrow$
- Financial accelerator: net worth  $\downarrow \Rightarrow$  borrowers' default probability  $\uparrow$
- Safe-haven flows  $\Rightarrow$  US \$ appreciates  $\Rightarrow$  demand for US goods  $\downarrow$

## IDENTIFYING DEMAND AND SUPPLY NARRATIVES OF GPR

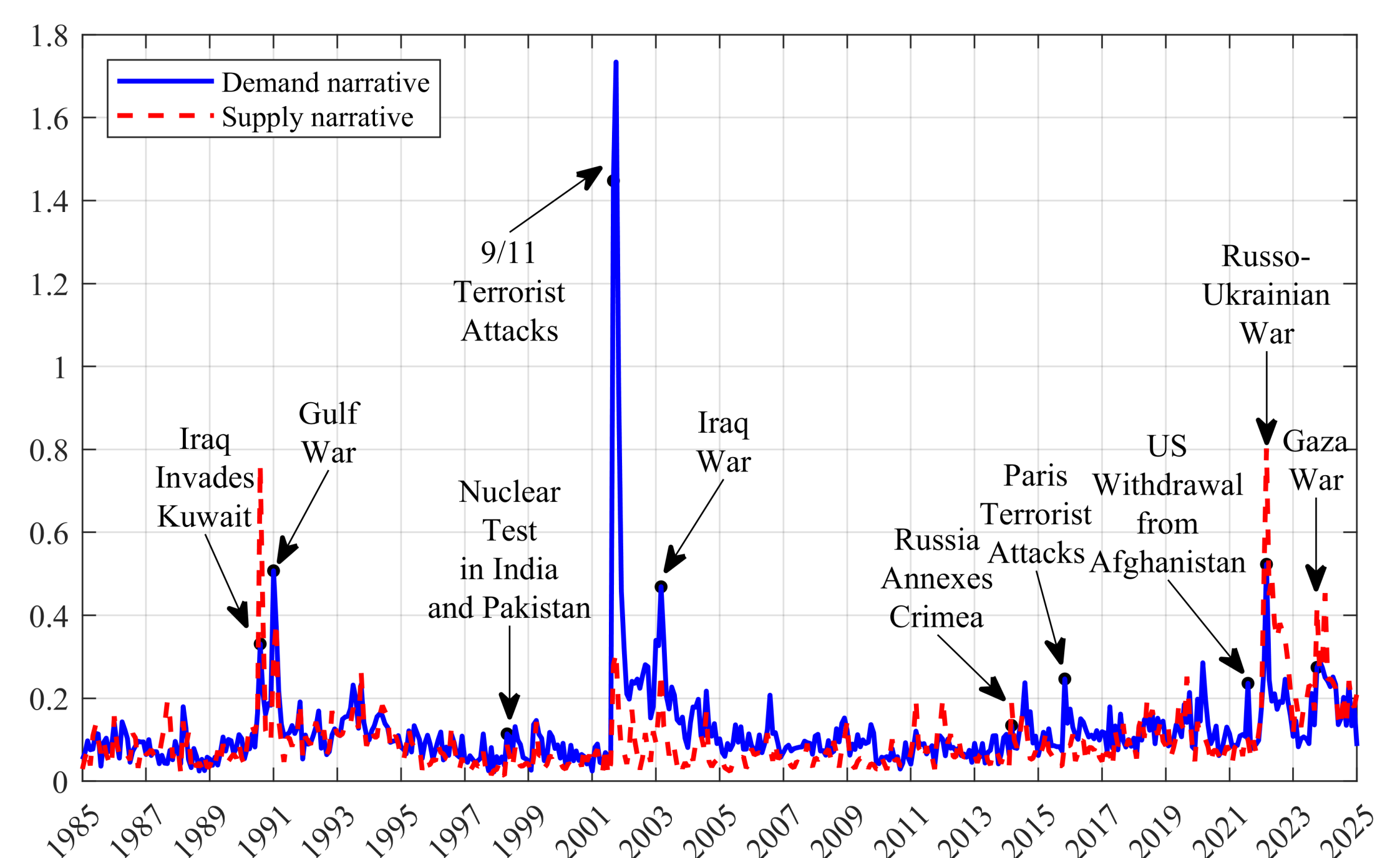
Search query for GPR articles as in Caldara and Iacoviello (2022)

- USA Today, Chicago Tribune, The Globe and Mail, The Daily Telegraph, The Guardian, The Wall Street Journal, The Washington Post

## Identifying GPR narratives using AI

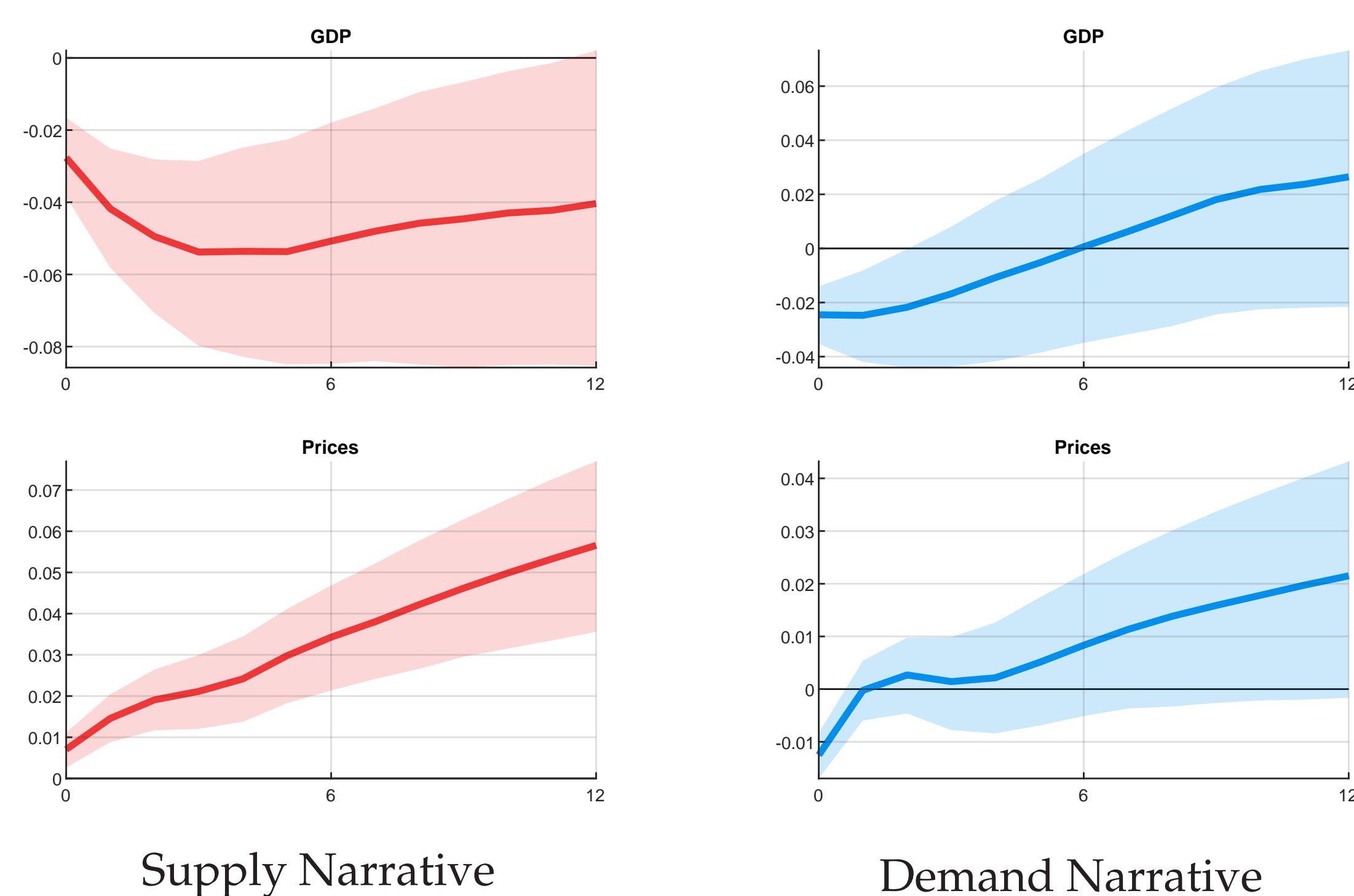
- Design prompt mimicking a questionnaire; questions formulated so as to uncover supply and demand GPR narratives
- Classify articles using a large language model (similar to Kwon et al. (2025)); article may transport both narratives
- Construct two geopolitical narrative indices as a share of total (not only GPR) articles

## NARRATIVE SUPPLY AND DEMAND GEOPOLITICAL RISK INDICES

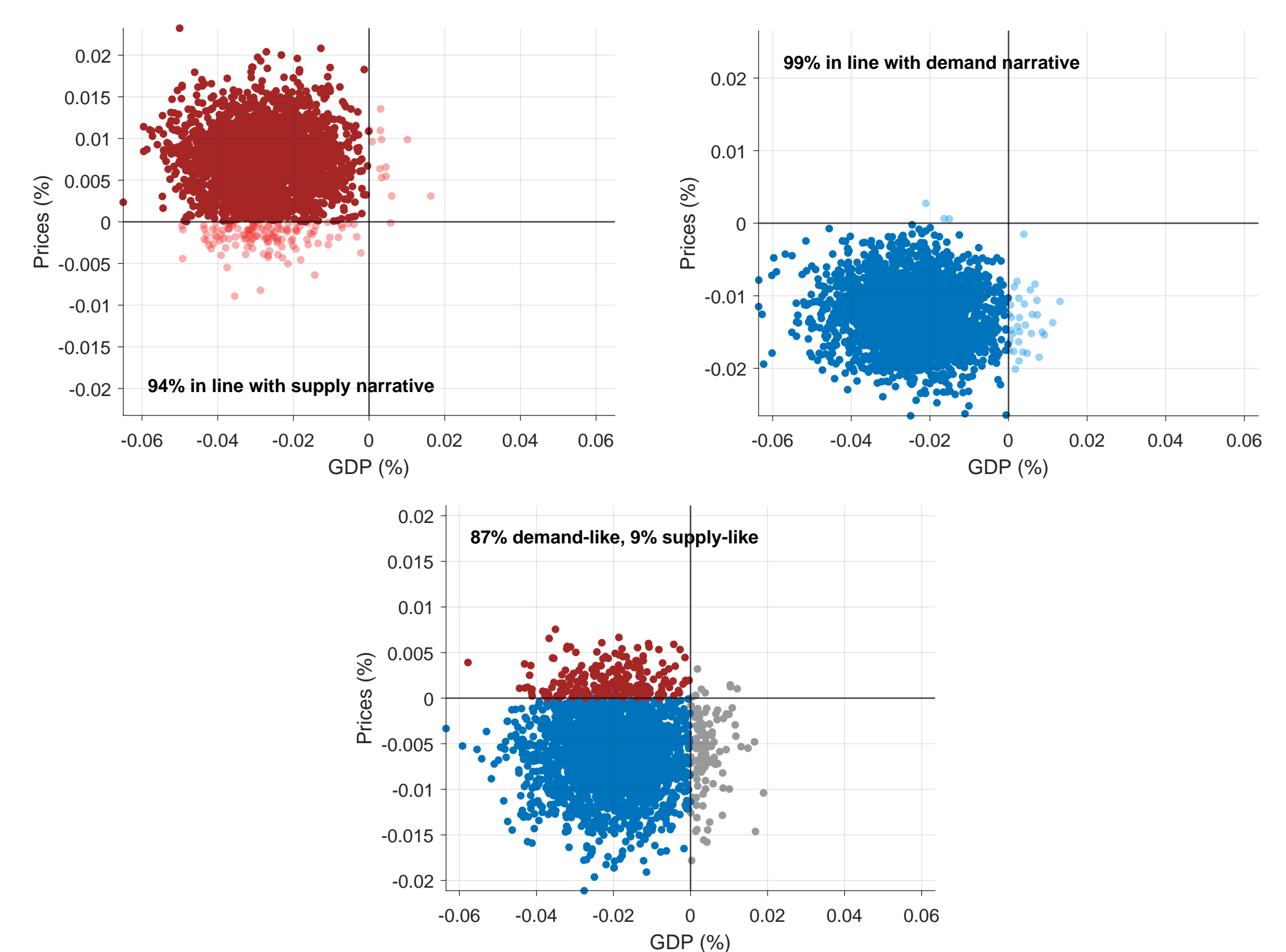


## VALIDATION 1: IMPULSE RESPONSES TO NARRATIVE GPR SHOCKS

On impact, GDP and prices respond as predicted by the theory



## VALIDATION 2: POSTERIOR DRAWS OF GDP AND PRICE RESPONSES



## CONCLUSION

- We construct novel indicators of supply and demand geopolitical risk (GPR) narratives identified in newspaper text using AI methods
- We validate our narrative GPR indices and show that broad GPR measures mix up the two transmission channels
- Structural VAR analysis shows that narrative supply shocks have stronger and longer lasting effects on GDP than narrative demand shocks

## REFERENCES

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