



Political and economic uncertainty and its impact on oil prices

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Received:25/01/2024

Accepted:24/02/2024

Abstract

Political and economic uncertainty can have a significant impact on oil prices. This essay/report will analyze the various factors that contribute to political and economic uncertainty and how they affect oil prices. It will explore the effects of geopolitical events and government policies on oil production, transportation, and demand.

The document will also examine the relationship between uncertainty and supply disruptions, as well as the reluctance of investors and businesses to make long-term decisions. By understanding these dynamics, we can gain insights into the volatility of oil prices and its implications for the global economy.

✓ political. Economic uncertainty. prices.oil.

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1. INTRODUCTION

The surge in oil prices isn't just a simple increase, but rather a heightened volatility that is more pronounced than in the 1990s, leading to unpredictable outcomes. Oil holds a crucial position as a macroeconomic factor in the global economy, and its market is the largest commodity market worldwide. What makes changes in oil prices even more intriguing is not only their direct impact on economic activity, but also the potential for them to reflect or even predict changes in global stability. Unlike other commodities, oil is one of the few or possibly the only production input that can both positively and negatively influence economic growth, to the extent of potentially causing a recession. The volatility of oil prices hinders growth through various channels, from increased production costs to inflation expectations. Overall, an increase in oil prices results in a wealth transfer from importing to exporting countries through a shift in trade terms. The magnitude of the direct impact of a given price increase depends on the share of oil costs in national income, reliance on imported oil, and the ability of end-users to reduce consumption and transition away from oil.

The relationship between oil performance and macroeconomics has long been a focus in economic literature. This issue gained attention as far back as the 1970s when sharp spikes in oil prices led to negative supply shocks and macroeconomic fluctuations. In recent years, most financial assets including oil have shown volatility clustering and significant jumps due to important and surprising news. This has sparked a debate about potential factors explaining crude oil price developments, particularly these sudden jumps.

Changes in both fundamental and non-fundamental factors result in shifts in oil prices, with geopolitical events, government policies, stock market activities, and global demand for industrial commodities all playing significant roles. The rise or fall of these prices carries significant implications for the economies of both importing and exporting countries.

In conclusion, fluctuations in oil prices have diverse effects across various sectors such as transportation costs, production expenses, inflation rates, effectiveness of monetary policy, exchange rates, unemployment rates, among others. Understanding these impacts is essential for evaluating how different economies respond to political and economic uncertainties.

2. Factors contributing to political and economic uncertainty

2.1. Geopolitical events

Geopolitical events play a pivotal role in the unpredictability and volatility of worldwide oil prices. The Middle East, being one of the largest regions for oil production and export, has been at the epicenter of numerous geopolitical tensions and conflicts that directly affect oil prices. For instance, tensions between the United States and Iran, as well as conflicts in countries like Syria, have resulted in disruptions in supply and increased uncertainty in the oil market. (Rezeaian et al, 2021)

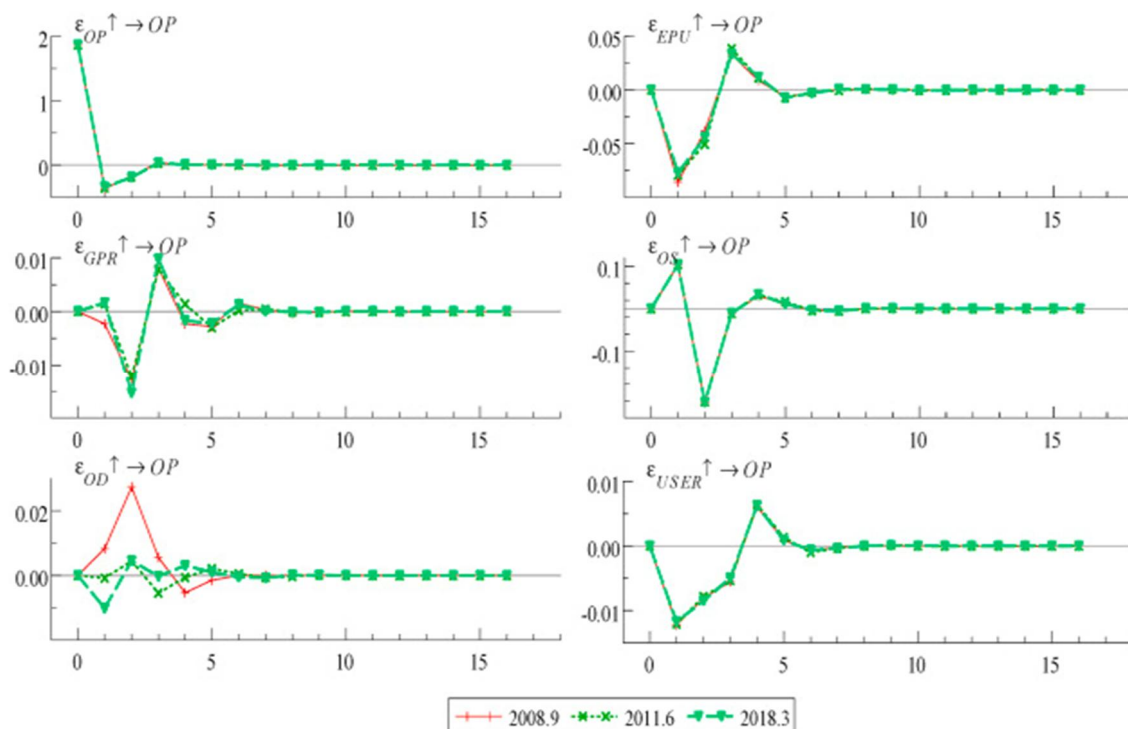
Geopolitical risks in these regions not only impact oil supply but also create uncertainty regarding future production levels and export capacities. The potential for conflict or instability in these areas can lead to fluctuations in global oil prices as market participants respond to perceived risks and uncertainties. Moreover, geopolitical events can also influence oil demand, with countries seeking to secure strategic reserves or increase stockpiles as a precautionary measure during times of heightened tensions.

Trade disputes between nations also contribute to political and economic uncertainty, further impacting oil prices. For example, the ongoing trade disputes between the US and China have created significant uncertainty in global markets, leading to fluctuations in demand for commodities like oil. The implementation of tariffs and trade restrictions can disrupt supply chains and affect economic growth, ultimately influencing the demand for oil. (song & wang, 2022)

The complexity of geopolitical events combined with ongoing trade disputes underscores the interconnected nature of political and economic factors on global oil prices. These uncertainties have consequences for both supply disruptions and changes in demand patterns, contributing to volatility in oil prices. (Baffes et al, 2016)

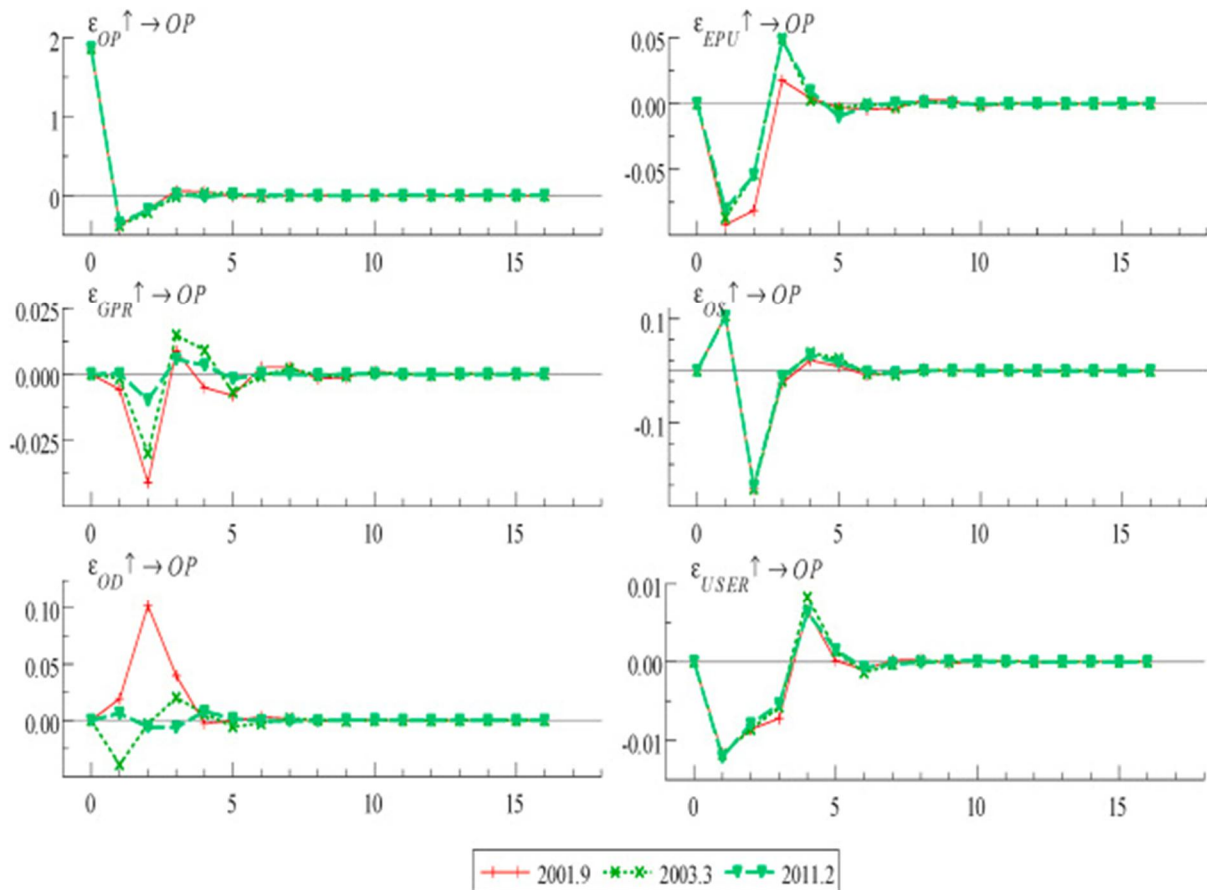
In summary, conflicts in the Middle East and trade disputes between nations directly impact political and economic uncertainty, which consequently influences global oil prices. Understanding the intricate relationship between these factors is essential for stakeholders involved in the international oil market.

Figure 1: Impulse response at different time points (economic events)



source: (song & wang, 2022)

Figure 2: Impulse response at different time points (political events)



Source : (song & wang, 2022)

2.2. Government policy

Government policy holds a critical position in shaping the oil market and exerting influence over oil prices. One of the main factors that can affect oil prices is alterations in taxation policies. Taxation policies have the potential to substantially impact the cost of oil production and transportation, which in turn can sway the overall supply and demand dynamics of the market. For instance, an increase in taxes on oil production can result in higher production costs for oil companies, potentially leading to reduced supply and higher prices for consumers. Conversely, a reduction in taxes can make production more cost-effective and lead to increased supply.

Apart from taxation policies, regulations on oil production and transportation also play a crucial role in shaping the oil market. Government regulations can influence the ease with which companies can explore, extract, and transport oil. Stringent

regulations on environmental protection may lead to increased compliance costs for oil companies, potentially reducing their profitability and impacting supply.

Furthermore, government policies also impact investment decisions in the oil industry. Uncertainty stemming from changes in government policy can lead to reluctance among investors to commit capital to long-term projects such as exploration and development of new oil fields or construction of new infrastructure for transportation. This hesitance to invest can significantly impact future supply levels in the market.

It is important to acknowledge that changes in government policy are often driven by broader economic and geopolitical factors, which are themselves sources of uncertainty. Political instability or shifts in power within governments can lead to sudden changes in energy policies, further complicating investment decisions within the industry. (song & wang, 2022)

To sum up, government policy holds significant sway over the functioning of the global oil market and plays a pivotal role in determining oil prices through its influence on taxation policies, regulations on production and transportation activities, and investment decisions within the sector.

3. Impact of uncertainty on oil prices

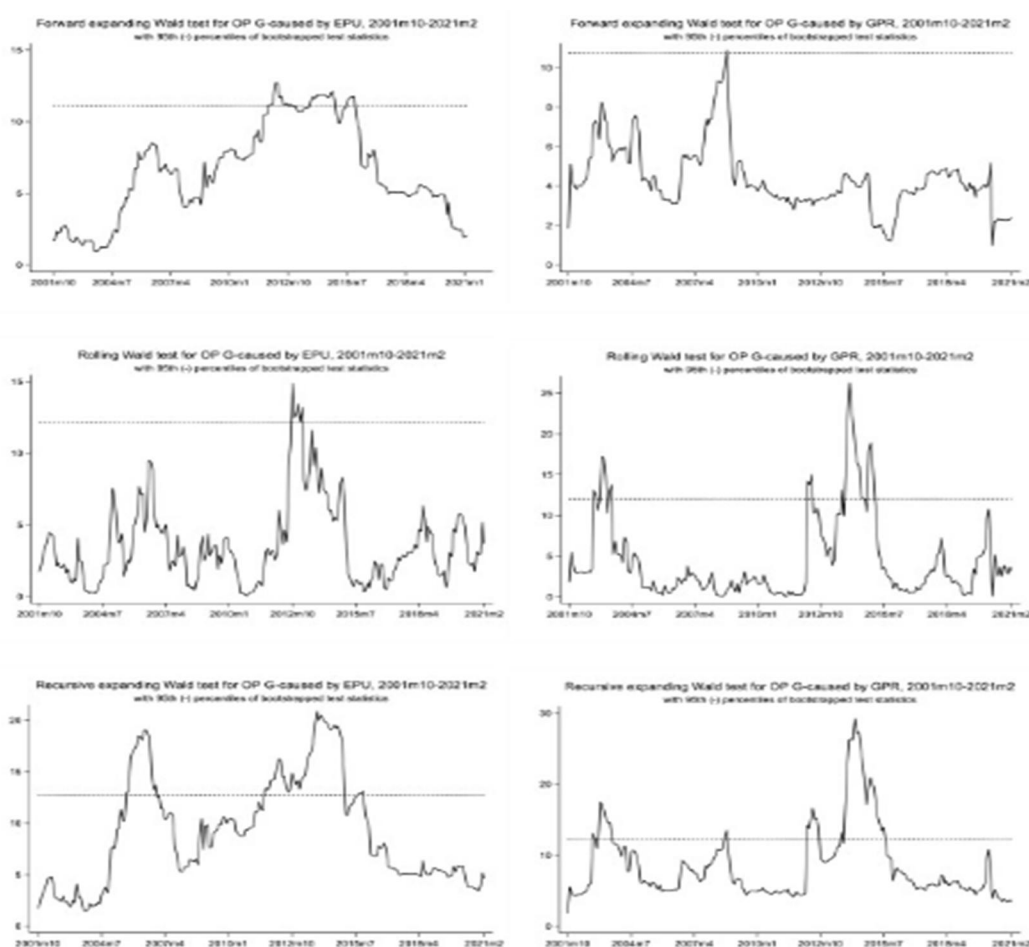
3.1. Supply disruptions

The oil market is greatly affected by political and economic uncertainty, which can cause significant fluctuations in oil prices through a variety of channels, including supply disruptions. Natural disasters such as hurricanes, earthquakes, and other calamities can damage oil production facilities, leading to a decrease in oil supply and resulting in a surge in oil prices. These events not only impact immediate supply but also create uncertainty about future production capacity, contributing to price volatility. (song & wang, 2022)

Moreover, political unrest can lead to shutdowns of oil fields, as seen in the case of Venezuela where political instability has caused a considerable decline in oil production. The country's economic crisis and political conflicts have disrupted its oil industry, adding to global supply uncertainty. Similarly, trade disputes between major economies like the US and China can create geopolitical tensions that disrupt supply chains and trade relationships, ultimately impacting global oil prices. (Baffes et al, 2016)

These examples clearly demonstrate how both natural disasters and political unrest can lead to supply disruptions that influence global oil prices. It is crucial for policymakers and industry stakeholders to take these factors into consideration when analyzing the impact of political and economic uncertainty on the oil market.

Figure 3: Tests for Granger causality running from the uncertainty risk to oil



prices.

source: (song & wang, 2022)

3.2. Reluctance to invest

The oil market is greatly affected by uncertainties in the political and economic landscape, which can have a significant impact on oil exploration and production investments. Uncertainty risk in oil-producing countries can disrupt oil supplies, while in non-oil-producing countries, it can hinder economic development and reduce demand. This directly affects global oil prices as uncertainty risk impacts both the supply and demand dynamics of the oil market.

Additionally, volatile prices lead to cautious decision-making by businesses. Economic policy uncertainty, as a guideline for a country's development, is formulated with a long-term perspective, with relatively small short-term fluctuations. However, its impact on oil prices is more profound than geopolitical risks. This uncertainty over economic policies can hinder the production and investment decisions of enterprises and investors.

Frequent policy fluctuations could hinder the production and investment decisions of enterprises; furthermore, it reduces the effectiveness of economic policies due to uncertainty. The fluctuation also affects the ability of businesses to make long-term investment decisions in the oil exploration and production sector.

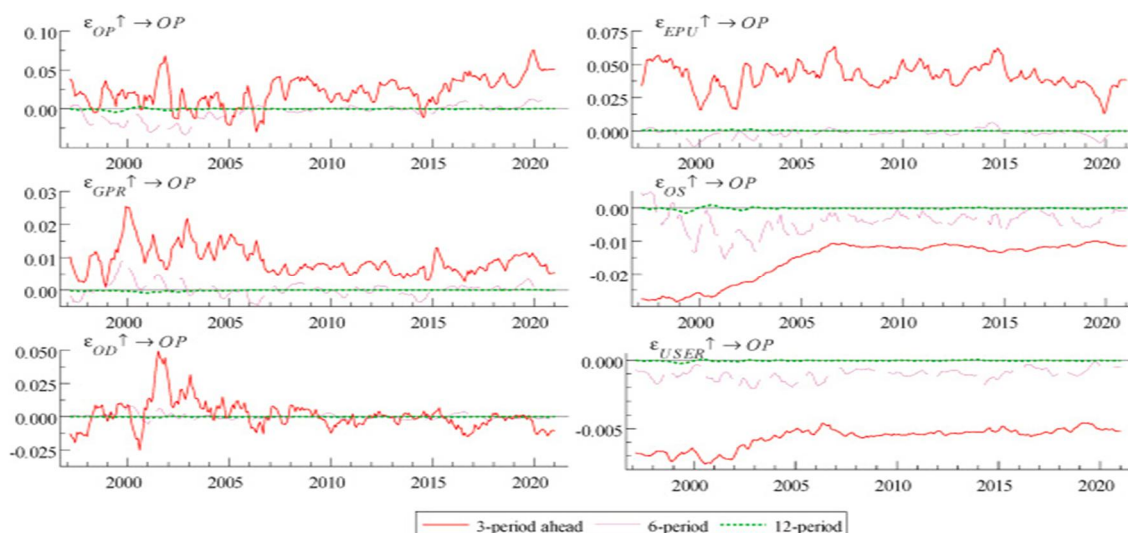
Furthermore, volatile prices cause businesses to be more cautious about their investments as they seek to avoid risks. Recent uncertainty risks have stimulated investors to use hedging tools to avoid risks, making oil prices less sensitive to changes in demand and supply. This cautious decision-making by businesses has a direct impact on how they approach investments in oil exploration and production.

The intricate interaction between economic policy uncertainty and geopolitical risks creates an environment where businesses are hesitant to invest confidently in the oil market due to concerns about future price movements and regulatory changes. The influence of these uncertainties on investment decisions highlights the importance of

considering nonconstant parameters when analyzing their impact on the oil market. (song & wang, 2022).

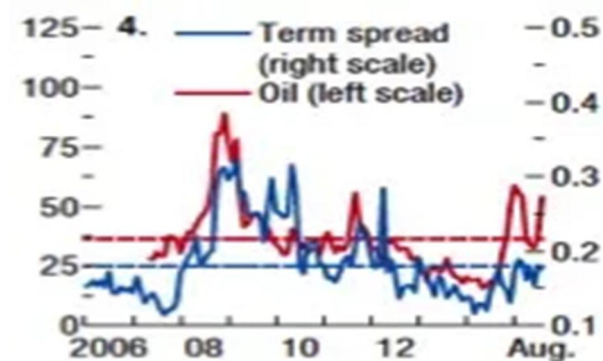
In summary, political and economic uncertainty significantly impacts business decision-making regarding investments in oil exploration and production. Volatile prices contribute to cautious decision-making by businesses seeking to mitigate risks associated with uncertain future developments. These factors combine to create an environment where investments are discouraged due to concerns about future price movements and regulatory changes.

Figure 4: Impulse responses at different horizons.



source: (song & wang, 2022)

Figure 5: Volatility in Oil Prices in the Past and in the Future



source: (Admin, 2019)

3.3. Lower demand

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[Figure 6](#): Price Level vs. Price Variability



source: (Admin, 2019)

4. Case studies and examples

4.1. Effects of political unrest in Venezuela on oil production

The turmoil in Venezuela has caused significant disruptions in global oil prices, impacting the stability of the energy market. Venezuela's long-standing role as a major player in the global oil market has been compromised by ongoing political unrest and economic uncertainty within the country. The resulting supply disruptions and reluctance to invest in new oil fields have created volatility and uncertainty in global oil prices.

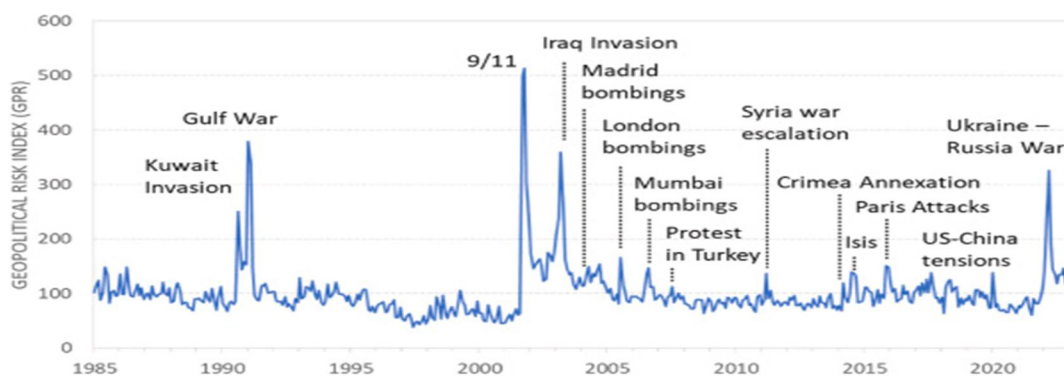
The political instability and economic uncertainty in Venezuela have led to fluctuations in global oil prices, driven by disruptions in oil production. Civil unrest and government instability have affected the operations of oil facilities, further contributing to the imbalance in global oil supply. This has put additional pressure on

global oil prices, underscoring the profound impact of geopolitical events on energy markets.

The uncertain political climate in Venezuela has also deterred investment in its oil sector, hindering its potential for economic recovery and contributing to lower supply levels on the global market. This reduction in supply has added to the volatility of global oil prices, highlighting the interconnectedness of geopolitical events and energy markets. (Ryan & berg, 2021)

In summary, the political unrest and economic uncertainty in Venezuela have significantly impacted global oil prices, creating volatility and uncertainty in the energy market. The disruptions in supply and reluctance to invest emphasize the far-reaching consequences of geopolitical events on the stability of global oil prices, underlining the need for a deeper understanding of how political and economic factors intersect with energy markets.

Figure 7: The geopolitical risk index (from 1985 to 2022)



Source: (Monge, García-Herrero, & Sanchis-Guallart, 2023)

4.2. Impact of trade disputes between the US and China on global oil prices

The ongoing trade disputes between the US and China have caused significant upheaval in global oil prices. The uncertainty surrounding these disagreements has led to fluctuations in oil prices, impacting both supply and demand. As tensions between the two economic giants have intensified, there has been a hesitance to invest in the oil market due to the unpredictable nature of the trade disputes. This has

resulted in a decrease in investment in oil production and infrastructure, contributing to supply disruptions.

In addition, the trade disputes have also impacted oil demand. The uncertainty surrounding global trade relations has led to reduced demand for oil, as businesses and consumers are hesitant to make long-term commitments amid geopolitical uncertainty. This has led to an overall decrease in oil demand, further pressuring prices downward. (song & wang, 2022).

Moreover, the trade disputes have also had broader implications for the global economy. Fluctuating oil prices resulting from these disputes have affected inflation rates, as changes in oil prices can directly impact production and transportation costs for goods and services. This can lead to higher consumer prices and overall inflationary pressures within economies. (Monge, García-Herrero, & Sanchis-Guallart, 2023).

Furthermore, countries heavily reliant on oil exports have keenly felt the repercussions of these trade disputes. The uncertainty surrounding global trade relations has made it challenging for these countries to forecast future demand for their exports, leading to economic instability and potential revenue losses. (Baffes et al, 2016)

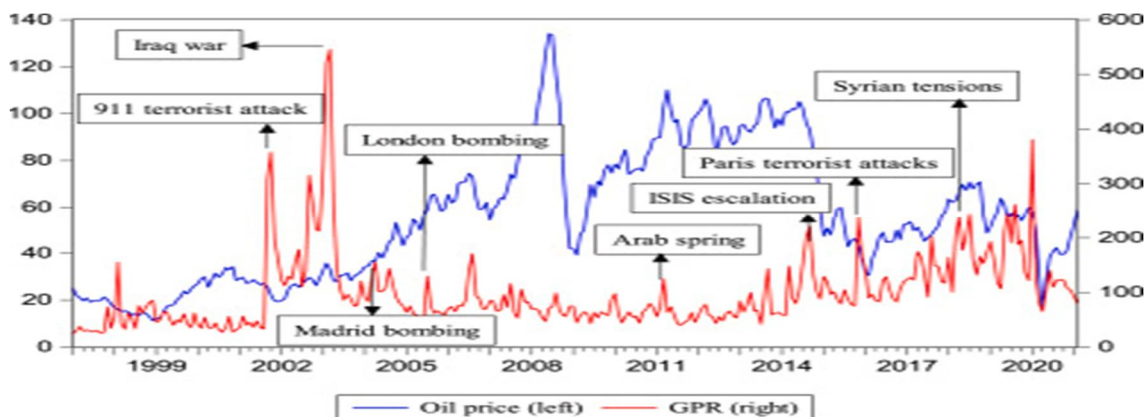
In conclusion, it is clear that political and economic uncertainty stemming from trade disputes between major economic powers like the US and China can have profound implications for global oil prices. The reluctance to invest, supply disruptions, lower demand, and effects on inflation rates and countries heavily reliant on oil exports all underscore the importance of understanding how geopolitical events impact the international oil market.

Figure 8: The trend of oil price and economic policy uncertainty (EPU).



source: (song & wang, 2022)

Figure 9: The trend of oil price and geopolitical risk (GPR).



source: (song & wang, 2022).

5. Implications for the global economy

5.1. Effects of fluctuating oil prices on inflation rates

The influence of variable oil prices on inflation rates is a crucial element of the global economy. As demonstrated in the information obtained in the context of Oil Price Volatility and Political Unrest, it is clear that surges in oil prices have a detrimental impact on importing economies, leading to an increase in inflation. This can be explained by classic economic supply theory, as the cost of an input good rises, aggregate output and productivity decrease, resulting in lower real GDP and causing inflation. The decrease in output and productivity also contributes to

unemployment. The effects of an oil price shock on economic growth are uneven, with price surges having a more significant negative impact than price drops. (Esfandiari, Marziyeh, & Parvaneh Pordel, 2022)

In addition to affecting economic growth and employment levels, fluctuating oil prices also influence consumer demand. The prices of durable goods, heating, and food are heavily reliant on oil prices. When oil prices rise, these changes are more easily transmitted for oil-based products than most other raw materials, reducing consumer demand in oil-importing states. (Wang, Wei, Bashir, & Zhou, 2022).

Another study obtained from the context of Geopolitical risk and economic policy uncertainty further emphasizes this point by addressing how changes in oil prices and economic policy uncertainty impact stock returns. Oil demand-side shocks have a positive effect on stock returns of oil and gas companies, while the impact of policy uncertainty on earnings is negative. This suggests that uncertainty surrounding economic policies can worsen the impact of oil shocks on stock returns. (Vega-Muñoz, Han, Iqba, Ahmad, & Ariza-Montes, 2022)

The data obtained from Macroeconomic effects of crude oil shocks: Evidence from South Asian countries reinforces these findings by indicating that an increase in oil prices has a significant and long-term influence on the inflation rate. Variance decomposition results revealed that an increase in oil prices accounts for a change in the inflation rate in the long term. (Vadlamannati, 2019)

Furthermore, Changes in oil price and economic policy uncertainty and the G7 stock returns: evidence from asymmetric quantile regression analysis highlights how changes in oil price and EPU may affect stock returns throughout different market conditions. Economic policy uncertainty can have significant impacts on inflation rates, real interest rates, investment, and ultimately stock prices and stock returns. (Salah , Nusair , Jamal , & Al-Khasawneh, 2023, pp. 1849-1893)

In conclusion, it is evident from these studies that fluctuating oil prices have a substantial impact on inflation rates. The connection between changes in oil prices and economic policy uncertainty affects not only consumer demand but also has implications for investment decisions, employment levels, and overall economic growth.

5.2. Consequences for countries heavily reliant on oil exports

Nations that heavily depend on oil exports are particularly susceptible to political and economic uncertainty, as fluctuations in oil prices can have substantial impacts on their economic stability. A decrease in oil prices, as predicted for the annual average of 2015, can lead to adverse effects on oil-exporting economies, resulting in significant losses in export and fiscal revenues. This can then lead to reduced growth and worsened external and fiscal balances, increasing macroeconomic vulnerabilities. Conversely, in developing economies that import oil, the decline in oil prices can support stronger growth, lower inflation, and improve external and fiscal balances, thereby reducing macroeconomic vulnerabilities. (Monge, García-Herrero, & Sanchis-Guallart, 2023)

Venezuela serves as a prime example of the repercussions of political unrest on oil-exporting countries. The country has faced significant reductions in oil production due to political instability, leading to severe economic hardships. Similarly, trade disputes between major oil-consuming countries such as the US and China have had a global impact on oil prices. The implementation of tariffs and other trade barriers has caused fluctuations in global oil prices, affecting both exporting and importing nations. (John, Ayhan Kose, Franziska , & Marc, 2016)

The fluctuation of oil prices also has implications for global inflation rates. Lower oil prices may result in decreased inflation rates due to lower production costs for businesses. However, this may not necessarily benefit all countries equally. Nations heavily reliant on oil exports may face economic downturns due to decreased export

revenues, while others may benefit from reduced production costs. (Salah , Nusair , Jamal , & Al-Khasawneh, 2023)

In conclusion, the effects of political and economic uncertainty on nations heavily dependent on oil exports are multi-faceted. While lower oil prices may benefit importing economies by reducing inflation and improving external balances, they can significantly harm exporting economies by causing losses in export revenues and fiscal balances. (Bank, 2010)

6. Conclusion

In conclusion, the influence of political and economic uncertainty on oil prices is undeniable. Geopolitical events, government policies, and economic policy uncertainty all contribute to the volatility of the oil market. Economic policy uncertainty, in particular, leads to higher oil prices due to its systemic risk factor, resulting in increased demand for hedging and speculation. Additionally, geopolitical risks also play a role in reducing oil supply and increasing demand, thereby driving up oil prices. The impact of economic policy uncertainty on the oil market surpasses that of geopolitical risks, emphasizing its significance in the international oil market.

Case studies and examples further demonstrate the effects of political unrest in Venezuela on oil production and the impact of trade disputes between the US and China on global oil prices. These events illustrate how uncertainty can disrupt supply chains and lead to fluctuating oil prices.

The implications for the global economy are substantial, as fluctuating oil prices can affect inflation rates and have consequences for countries heavily reliant on oil exports. Lower demand due to economic uncertainties can weaken fiscal and external positions, while sharply lower oil prices can undermine economies that depend on oil exports.

Overall, it is evident that political and economic uncertainty profoundly influences global oil prices. Understanding these factors is crucial for policymakers, investors,

and countries heavily reliant on the export of this valuable commodity. Therefore, future research should consider more sources of risk and study the impact of uncertainty risk on different types of assets or asset portfolios.

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