
Introduction: Geopolitics for Investors

Geopolitics is ultimately the study of the balance between options and limitations. A country's geography determines in large part what vulnerabilities it faces and what tools it holds.

—Peter Zeihan, *The Absent Superpower*

Narratives or Fairy Tales?

On 7 January 2017, Robert Shiller gave the presidential speech at the annual meeting of the American Economic Association.¹ The topic he chose was unusual. He titled his speech “Narrative Economics” and discussed the fact that economics (and, by extension, finance) has focused too much on quantitative methods and forgotten something important in the process: We humans have evolved to be storytellers. The stories we tell each other bind us together as families, communities, nations, and religions. These narratives define what it means to be a mother, a German, or a Jewish person.

And because we are natural storytellers, we also tell stories in economics and finance. Yet in economics and finance, we have been trained to ignore stories and narratives and to instead look at hard facts and data. On the one hand, some quantitative investors might even consider the narratives “fairy tales” because although the stories can contain a grain of truth, they are largely considered justifications for investors who cannot do the required math. Such critics often claim that economic narratives are for laypeople and are not a proper subject for economic analysis.

Shiller, on the other hand, laments that we might overlook a crucial driver of financial markets if we ignore the stories and narratives because, to quote the sociologist William Bruce Cameron, “Not everything that can be counted counts, and not everything that counts can be counted” (1963, p. 13). Luckily, thanks to technological advances, such as textual analysis software, we can increasingly bridge the gap between the things that can be counted and the things that count.

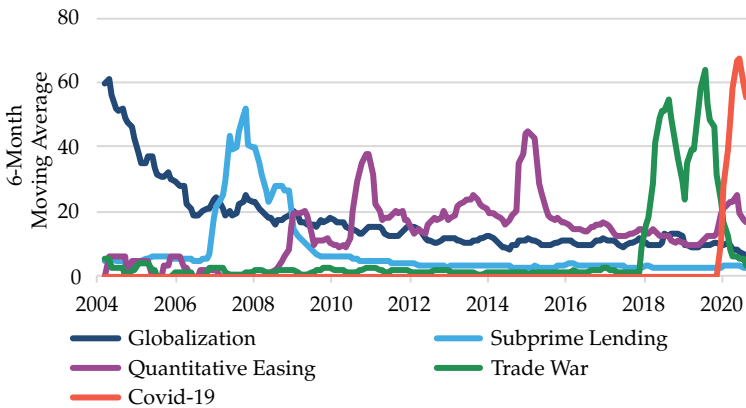
¹See Shiller (2017). Robert J. Shiller, a Yale professor, won the 2013 Nobel Prize in Economic Sciences, which he shared with Eugene F. Fama and Lars Peter Hansen.

This chapter is from the book *Geo-Economics: The Interplay between Geopolitics, Economics, and Investments* by Joachim Klement, CFA. For more chapters, go to <https://www.cfainstitute.org/en/research/foundation/2021/geo-economics>.

Exhibit 1 shows the results of a Google Trends search of different words and phrases (or narratives) on financial sites on the internet. The early years of the 21st century were dominated by the topic of globalization. China was emerging as an economic superpower, and other emerging markets, most notably the former communist countries in Eastern Europe, were opening up their economies and expanding the opportunity set for investors. But investor interest in these markets (as reflected in search volumes) was already in decline early in the century. Other narratives, such as the housing boom in the United States, were capturing investors' attention. Of course, that boom ended in tears, and between 2006 and 2008, investors around the world had to become experts in subprime mortgages, collateralized debt obligations, and other arcane financial innovations that had led the global economy to the brink of collapse.

The central banks of the world had to step in to rescue the global economy. In the years after the global financial crisis of 2006–2008, central banks and their unconventional monetary policy measures, such as quantitative easing, were the main drivers of financial markets. Even the near default of some eurozone countries did not derail global equity markets, nor did the technical default of the United States that was missed by a heartbeat in 2011. All that mattered were the actions of the Federal Reserve Board, the European Central Bank, and other central banks. This devotion of investors to the power of monetary policy lasted for many years, but recently, politics has taken center stage again.

Exhibit 1. Google Trends in Investment Narratives of the 21st Century



Source: Google Trends.

The election of Donald Trump as president of the United States led to a sudden and significant change in both foreign and domestic US policies. The trade war between the United States and China is probably the most prominent example of this renewed importance of politics in recent years, until the Covid-19 pandemic became the all-encompassing narrative of 2020.

Note in Exhibit 1 that two of the major investment narratives of the past 20 years (globalization and the trade war) were “geopolitical” in nature. Both globalization and the rise of populist policies that led to the trade war are political and driven by nations’ strategic goals. As China has evolved from the workshop of the world to a country with an economy that rivals that of the United States, it has become more assertive on the global stage and thereby introduces some new political challenges for developed and developing countries. Meanwhile, the Covid-19 pandemic has upended the world in 2020.

To be clear, a pandemic is not, by definition, a geopolitical event. As we have seen with the intensifying tensions between the United States and China, however, the pandemic has accelerated existing geopolitical tensions. The trade war between the United States and China is on hold for now, thanks to the Phase 1 deal established in early 2020, but the political and economic relationship between the two countries is arguably worse today than it has been in the past 40 years.

Thus, today’s investors need to understand geopolitical trends as a main driving force of markets. This book provides just that: an understanding of the interplay between geopolitics and economics and of the impact of that dynamic on financial markets. To that end, this introductory chapter will first briefly introduce geopolitics and the aspects of geopolitical research that are relevant for investors and then provide an overview of the individual chapters in the book.

I invite readers to read the entire book from front to back, but I would like to emphasize to the time-pressed reader that each chapter in this book can be read on its own because I have tried to put little nuggets of wisdom and lesser-known research findings in each chapter. Thus, even experienced investors and economists will find something in each chapter that they did not already know. So, sit back, relax, let the markets crash and the children scream—and enjoy this book.

What Is Geopolitics?

Traditionally, geopolitics was understood to be the study of how geography (the “geo” in geopolitics) influences the international policies of nations and societies (the “politics”). Flint (2006) thus defined geopolitics as a component of both human geography and international affairs.

Classical geopolitics can be traced back to Aristotle, who derived the political systems of Greek city-states from their climatic and geographical conditions. But the most common starting point for classical geopolitics is provided by Swedish geographer Rudolf Kjellén, who first used the term “geopolitics” in 1916, and by German geographer Friedrich Ratzel, who wrote in 1897 about how states receive their power as nations from the territory they occupy. Unfortunately, Ratzel combined his theory of geopolitics with elements of social Darwinism and postulated that every people strives to expand what he called *Lebensraum* (“living space”), the space occupied by a culture and civilization. He believed that different cultures and races had different levels of fitness; hence, higher cultures would rightfully replace lower cultures from their homelands. This concept of *Lebensraum* became an integral part of the ideology of Adolf Hitler and the Nazis and led straight to the gas chambers of Auschwitz.

Whereas the German school of classical geopolitics descended into one of the worst theories ever invented, the Anglo-American school focused on how geography determines a nation’s military security and its options to project power. This school of thought was thus more about politics and identifying beneficial paths for international political action than was the European view. It came to prominence with the advent of the Cold War, when the United States and the Soviet Union were in a constant struggle to enhance their international influence. Combined with an invention from mathematics—game theory—geopolitics and the simulation of geopolitical scenarios with the help of war games became an indispensable tool for political and military decision makers.

Classical geopolitics was rather rigid, however, in its assumptions about the limiting factor posed by geography. A core assumption of many classical geopolitical studies was that geography is immutable and cannot be overcome. Hence, if a country occupies certain strategic territories or has access to crucial chokepoints in international waters, it will always be able to dictate its will to other nations and have a permanent political advantage. Halford Mackinder (1919) claimed, “Who rules East Europe commands the [Eurasian] Heartland; who rules the Heartland commands the World-Island; who rules the World-Island commands the world.” If that were true, the Soviet Union—as the country that ruled Eastern Europe and the Eurasian heartland—should have won the Cold War.

Modern geopolitics does not see geography as immutable destiny but as a set of limitations and opportunities that influence the space of possibilities for decision makers. This geographical factor, together with the political options chosen, can lead to very different outcomes from region to region. Cohen

(1991), for example, differentiated between “gateways” and “shatterbelts.” Gateways are regions where various societies and countries foster international cooperation and economic growth. Classic examples of a gateway are the European Union and the countries participating in China’s Belt and Road Initiative. Shatterbelts are regions dominated by interregional conflicts and the rivalry of external powers for influence, something we observe in the Middle East.

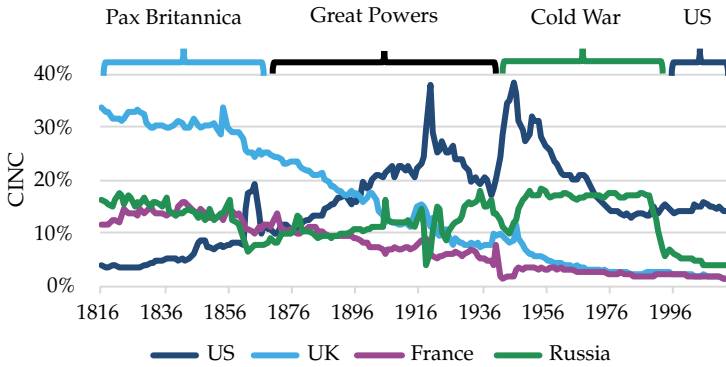
Hence, Scholvin (2016) defined the three pillars of the modern geopolitical approach as follows:

- Geographical factors must not be seen as irreversible fate. They provide both opportunities and constraints, but these opportunities and constraints are not static.
- General patterns and long-term processes are substantially influenced by geographical factors, but understanding specific developments in international affairs requires taking into account nongeographical factors.
- For geopolitical scientists, revealing causal mechanisms and concentrating on the role of geography therein are helpful.

Bergesen and Suter (2018) provided an instructive example of this thinking when they argued that geopolitics follows long-term cycles in which periods of globalization and the removal of borders and geographical barriers alternate with periods of rising nationalism and the erection of (new) borders. **Exhibit 2** shows the Composite Index of National Capability (CINC) as calculated by the Correlates of War project for four major countries back to 1816.² The CINC is a combination of several factors—such as the share of the global population in a country, the size of a country’s military, the military expenses of a country, and the energy consumption of a country. As such, it is not an economic measure but a measure of military power relative to that of other nations. The CINC is expressed as a country’s share of global military capabilities.

As Exhibit 2 shows, the early to mid-19th century was a period of great globalization with a single hegemon—the British Empire. Within the British Empire, trade prospered, and borders were torn down. As the British Empire declined in the second half of the 19th century, it was increasingly challenged by rising powers in Europe and North America. This confrontation led to the era of “Great Power competition,” wherein each of the rising powers expanded its colonies and tried to gain access to vital resources around

²Correlates of War is a research project by several US universities under the leadership of the University of California, Davis, and Penn State University that collects quantitative data on international relations and conflicts.

Exhibit 2. Composite Index of National Capability, 1816–2012

Source: Correlates of War.

the globe. The competition among the great European powers of the United Kingdom, France, Germany, Austria-Hungary, and Russia eventually led to the outbreak of the First and Second World Wars, which from a geopolitical perspective can be understood as one long, 30-year war.

At the end of the Second World War, the United States emerged as the sole global hegemon. It was (at least economically) challenged only by the Soviet Union during the Cold War. With the dissolution of the Soviet Union in 1991, the United States finally occupied a position similar to that of the British Empire in the first half of the 19th century, and a renewed period of globalization and the removal of national borders occurred.

Throughout these periods of globalization and Great Power competition, geographical factors such as access to natural resources played a key role in establishing and defending power. But as technology advanced over time—as coal was replaced by oil, for example—the benefits of access to some natural resources declined, allowing other countries to challenge the hegemon of the past. Today, technological progress seemingly makes geography irrelevant in many cases (think of the internet) but, as the reader will see, this situation does not herald the end of geopolitics. It simply shifts the power balance and benefits to some countries while leading to the relative decline of others.

From Geopolitics to Geo-Economics

This book is not about military power and political strategy, however, but about economics and investments. In an age of nuclear weapons and the possibility of destroying all of human civilization in a potential third world war,

the projection of military power has to be limited. Instead, geopolitics increasingly uses economic means to project power. Luttwak (1990) coined the term “geo-economics” when he argued that power comes from “disposable capital in lieu of firepower, civilian innovation in lieu of military-technical advancement, and market penetration in lieu of garrisons and bases” (p. 17).

Scholvin and Wigell (2018) defined geo-economics as the application of economic means of power to achieve strategic objectives. And in this book, we adopt a similar definition. To me, geo-economics is the study of how geopolitics and economics interact in international relations.

A good example is the role Germany has played in international politics since the end of the Second World War. Germany, for understandable reasons, has been reluctant to use military force and, instead, uses its economic might to impose its preferences on other nations. When the eurozone faced an existential crisis in 2011 and 2012 with the near collapse of Greece and the potential spread of the eurozone debt crisis to Italy and other large economies, Germany was the leading advocate for the austerity measures imposed on Greece and other countries. Effectively, Germany promised to help bail out the weaker countries in the eurozone if they committed to strict fiscal discipline in the years to come.

Another example of geo-economics is the use of economic power by both China and the United States to impose international rules and standards on other nations. The International Monetary Fund (IMF), the World Bank, and the World Trade Organization are all institutions that were shaped largely by US economic preferences, and they have influenced global trade and global finance for the past seven decades. Meanwhile, China, with its Belt and Road Initiative and its Asian Infrastructure Investment Bank, is trying to project its own economic preferences globally. These topics will be covered in separate chapters in this book.

Today, the era of globalization of the past 30 years seems to be coming to an end. Nationalism is on the rise, and geopolitical and geo-economic risks increasingly take center stage. **Exhibit 3** shows the top five risks identified by global business leaders each year at the World Economic Forum (WEF). I have marked geo-economic risks in gray boxes and other risks in white boxes. Five to ten years ago, the risks perceived as most likely to come true were predominantly economic or social in nature—another financial crisis, a slowdown of the Chinese economy, rising unemployment, or inequality. The geo-economic risks that will be discussed in this book have dominated the list in recent years—from global terrorism, cyber attacks, and data fraud to natural disasters and extreme weather triggered by climate change.

Exhibit 3. Top Five Risks in Terms of Likelihood

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
1st	Market Crash	Storms	Inequality	Inequality	Inequality	War	Migration	Extreme weather	Extreme weather	Extreme weather
2nd	China slows	Floods	Fiscal crisis	Fiscal crisis	Extreme weather	Extreme weather	Extreme weather	Migration	Natural disaster	Climate change
3rd	Pandemic	Corruption	Climate change	Climate change	Unemployment	Governance failure	Climate change	Natural disaster	Cyber attacks	Natural disaster
4th	Fiscal crisis	Biodiversity loss	Cyber attacks	Water	Climate change	State collapse	War	Terrorism	Data fraud	Data fraud
5th	Governance failure	Climate change	Water	Demographics	Cyber attacks	Unemployment	Natural disaster	Governance failure	Climate change	Cyber attacks

Note: Gray boxes indicate geo-economic events.
Source: WEF (2019).

The Things to Come

Plenty of books on geopolitics have been written by eminent experts in politics and international affairs. This book is not one of them.

First, I am neither a political scientist nor an expert in international affairs. I am an economist and an investment strategist who has been fascinated by geopolitics for many years. And this fascination has led me to the realization that almost all books and articles written on geopolitics are useless for investors. Political scientists are not trained to think like investors, and they are not typically trained in quantitative methods. Instead, they engage in developing narratives for geopolitical events and processes that pose risks and opportunities for investors.

My main problem with these narratives is that they usually do not pass the “so what?” test. Geopolitical risks are important, but how am I to assess which risks are important for my portfolio and which ones are simply noise? Because geopolitics experts focus on politics, they do not provide an answer to this crucial question for investors. What could be important for a geopolitics expert and for global politics could be totally irrelevant for investors. For example, the US wars in Iraq and Afghanistan have been going on for almost two decades now and have been an important influence on the political discussion in the United States. But for investors, the war in Afghanistan was a total nonevent, and the war in Iraq had only a fleeting influence, when it started in 2003.

Geopolitics experts cannot answer the question of which geopolitical events matter for investors and which do not. Unfortunately, some experts thus claim that all geopolitical risks matter and that these risks cannot be quantified but only assessed qualitatively. Nothing could be further from the truth. In the chapters that follow, I discuss geopolitical and geo-economic events from the viewpoint of an investor and show that they can be quantified and introduced as part of a traditional risk management process. I do this in two parts.

Part I: Reviewing How Geopolitics Influences Investments. The first part of this book focuses on geopolitics that matters to investors. It reviews the literature on a range of geopolitical events and shows which events have a material economic effect and which do not. To do so, **Chapter 1** briefly discusses how geopolitics can affect the economy and investments. As the reader will see, some geopolitical events have only a fleeting, short-term impact (or none at all), whereas others have a long-lasting impact that might be felt for years—if not decades. The impact depends on the economic variables that are affected by the geopolitical event.

Chapter 2 examines the types of events that probably first come to mind when we talk about geopolitics: wars and international conflict. Unfortunately, in many cases, wars do not really matter all that much for investors, but in some circumstances, wars can and do have a material influence on financial markets. This chapter will enable readers to differentiate between the two types and provides examples of how big the impact of international conflict has been on markets historically. Because the face of international conflict is also changing, this chapter covers not only traditional wars between nation-states but also the impact of international terrorism on the economy and financial markets.

The focus of **Chapter 3** is on one of the most important topics of geopolitics—namely, access to natural resources, such as oil and minerals. Crude oil is the lifeblood of the modern economy; thus, access to crude oil at affordable prices is of vital interest to any modern economy. A material disruption in the supply of natural resources has the potential to significantly slow economic growth and trigger inflationary spikes. How big these disruptions have to be before they have a material impact on the economy and an investment portfolio is the central topic of this chapter. The chapter also tries to help investors identify ways to hedge the geopolitical risks caused by a disruption in the access to natural resources.

Chapter 4 focuses on the opportunities created by geopolitical events, and in it, I note the benefits of globalization, free trade, and related processes for the global economy and financial markets. Globalization and free trade have received a lot of bad press in recent years, and some of this criticism is justified. Although globalization has provided many benefits, it has also had unintended consequences that have caused a political backlash. Rising inequality in developed countries and criticism of some of the policies the IMF has imposed on emerging economies are just two examples that are critically examined in this chapter.

Part II: Evaluating Current Geopolitical Trends. The first four chapters of this book consider geopolitical aspects that matter for finance and investment. The second part of this book puts the insights from those first chapters into practice by applying them to current geopolitical trends. In this second part, I stick my head out and examine the impact the geopolitical trends have on the economy and financial markets today and their likely development in the coming years.

Forecasting the future is difficult, however, especially with respect to geopolitical and geo-economic developments, which are subject to large errors. Hence, **Chapter 5** introduces the rules of forecasting that I have developed

during my career and that provide guidelines for the subsequent chapters in this part of the book.

Chapter 6 focuses on the dominant geopolitical topic of our time—namely, the economic and political rivalry between the United States and China. As China has grown to be an economy similar in size to that of the United States, the country has become increasingly assertive on the global stage—for example, demanding more influence in existing international organizations such as the IMF and the World Bank. China is also in the process of upgrading its economy from a manufacturing base for low-tech products to a high-tech economy similar to that of Japan or South Korea.

Of course, the changes in China provide a direct challenge to the global economic influence of developed countries and have caused a lot of irritation in some places. An example reaction to China's demands for its rightful place at the table of great economic powers is the trade war initiated by the United States, but other, more subtle developments are taking shape today. How the trade war and the geo-economic competition between China and the rich countries of the West might develop is the focus of Chapter 6.

As noted in this introductory chapter, geography itself is not a permanent obstacle to the rise and fall of economies. Today, geopolitical and geo-economic rivalry is based less on access to natural resources (which is clearly dominated by geographical factors) and more on access to data (which is not). Data have often been dubbed the oil of the 21st century, and access to data is not always pursued by legal means. Cyber warfare and cyber terrorism have become tools that complement traditional warfare and terrorism. In our connected economies, the economic damage caused by successful cyber attacks can be tremendous, so **Chapter 7** focuses on the potential impact of a large-scale cyber attack. Could a successful cyber attack cause a prolonged blackout of a major city or even trigger another financial crisis? If so, how bad would it be? These are the questions I address in this chapter.

Chapter 8 shifts the focus to an emerging form of resource competition. As renewable energy is becoming an increasingly important part of our energy supply, access to the minerals used in batteries and solar cells, as well as the technology to build modern renewable energy applications, is becoming vital. The shift to renewable energy might also have some destabilizing economic effects on countries that rely heavily on the export of crude oil and other fossil fuels, triggering new geo-economic developments. How both oil exporters and oil importers can prepare for the rise of renewable energy and benefit from its opportunities is the focus of this chapter.

Chapter 9, the final chapter of the book, focuses on one of the most pressing global challenges for politics and humankind alike: climate change.

Climate change is already triggering more intense and more frequent extreme weather events—cyclones, floods, and droughts—than in the past. And these extreme weather events have a rapidly rising impact on the economy of the affected regions. As climate change progresses, investors need to deal with two major geo-economic developments: the likely economic impact of climate change and the societal consequences of climate change, such as famine, mass migration, and civil strife.

As I noted, each chapter can be read on its own, but the introductory chapters in each part (Chapters 1 and 5) provide a mental model for the reader that creates a guiding theme for each of the subsequent chapters. Of course, what will provide the most coherent economic narrative is to read all the chapters in order, which I invite the reader to do.

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