

ANALYSIS OF THE EFFECTS OF MIDDLE EAST CONFLICTS ON THE FINANCIAL AND ENERGY MARKETS

The new geopolitical tensions caused by Hamas' attack on Israel on 7 October may have a significant impact on the world economy, manifesting itself through various trade and financial channels. The effect on the oil and gas energy markets would be particularly noteworthy, as different historical episodes since the mid-20th century illustrate. The more the conflict expands, the more disruptive will these effects be, particularly if other energy-commodity exporting countries in the region become involved or if severe disruptions in the main distribution routes arise.

Energy markets channel

The impact of a geopolitical event of this kind on oil and gas prices depends on the production volume that is ultimately affected and the duration of the event. Based on these variables, the main events of this kind which have occurred in the Middle East since the 1973 oil crisis have had an uneven effect on oil prices (see Chart 1).¹ Some of these events, such as the 1970s crisis, had more persistent effects, while other more recent ones were more temporary – which also depends on the effect of mitigating factors. These include the spare capacity of other producer countries or the use of inventories and strategic reserves.

For now, the current Middle Eastern tensions have not affected oil production and have hardly affected that of gas,² so the immediate impact on their prices has been relatively limited (around \$6 per barrel of Brent oil and around €10/MWh of gas in Europe). However, the expansion of the conflict to other countries in the region, some of which are among the main world producers of energy commodities (such as Saudi Arabia, Iran, Iraq and Qatar), could have more significant effects.

A particularly severe scenario would be the blockade of strategic corridors, such as the Strait of Hormuz, through which around 20% of the global oil supply (see Chart 2) and 25% of that of liquefied natural gas flow, according to International Energy Agency data.

This would have a direct impact on the European Union's and Spain's energy imports from the Middle East, which account for around 10% of the total (see Chart 3).³ Even if it were possible to import these products from other countries, the prices of these energy commodities, particularly oil,⁴ which has a more globally integrated market, would rise.

Such an increase in energy prices would trigger another shock for the world economy, in the wake of the shocks in recent years, with additional adverse consequences in terms of activity and further rising inflation, which could lead to a more restrictive monetary policy stance.

Confidence and financial markets channel

The adverse effects of the energy shock would be compounded by other possible impact channels, such as those deriving from heightened uncertainty and geopolitical instability, potentially affecting households' and firms' confidence and expenditure decisions, or from a higher level of risk aversion in the financial markets.

In this connection, the international financial markets have reacted in a much more subdued manner in the ten days since the Israel-Hamas conflict erupted than in the same period after Russia's invasion of Ukraine. The latter conflict had a more widespread and pronounced impact which persisted beyond the first ten days of analysis, especially in the European markets.

The fact that energy price hikes have been moderate, as noted earlier, and, in particular, lower than those seen after the Russia-Ukraine conflict started, has contributed to this (see Chart 4). That said, it is true that a larger increase in natural gas prices has been observed.

The ten-year sovereign bond yields in the United States, Germany and Spain fell during the first few days of the Israel-Hamas conflict, although much of these falls reversed in the same period, mainly in the United States

1 See James D. Hamilton (2011), "Historical oil shocks", National Bureau of Economic Research, NBER Working Papers, 16790.

2 A small gas field in Israel has been shut down.

3 The EU's and Spain's trade exposures to the Middle East are mainly confined to energy product imports, while the volume of exports and imports of other items account for around 2% of the total.

4 See Banco de España (2020), "Geopolitical tensions and oil prices", Quarterly Report on the Spanish Economy, Box 2, Economic Bulletin 1/2020.

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Chart 1
Geopolitical tensions and oil price



Chart 2
Oil exports through the Strait of Hormuz

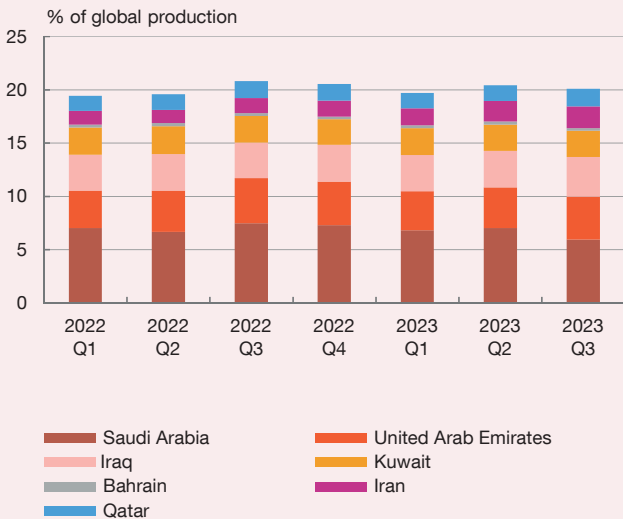
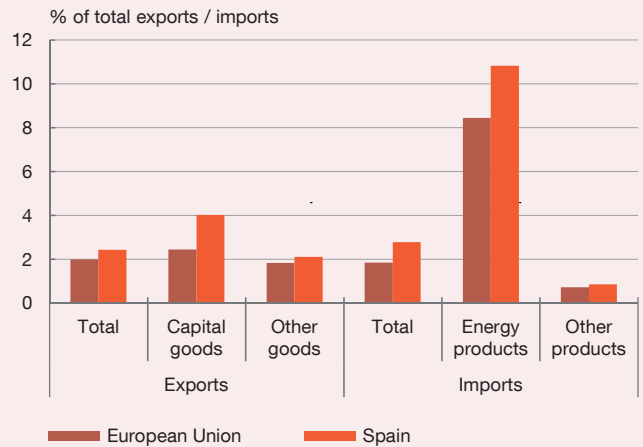


Chart 3
Trade with Middle Eastern countries (2022) (b)



SOURCES: Eurostat, International Energy Agency, Refinitiv and Banco de España.

a Prompted by the Yom Kippur War.

b Saudi Arabia, Bahrain, United Arab Emirates, Iran, Iraq, Israel, Jordan, West Bank, Kuwait, Lebanon, Oman, Qatar, Syria and Yemen.

(see Chart 5).⁵ This means that investors have not significantly revised their expectations on the future path of interest rates nor sought safe-haven assets intensely since the outbreak of the conflict.

The EURO STOXX 50, the IBEX 35 and the S&P 500 have proved resilient to the Israel-Hamas conflict as at the cut-off date for this analysis. This is in stark contrast to the invasion of Ukraine, which had a highly adverse effect on

⁵ The decrease in sovereign bond yields could have been due not only to the search for a safe-haven asset, but also to the effect of certain Federal Reserve System members' statements opposing further monetary policy tightening.

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Chart 4
Energy prices

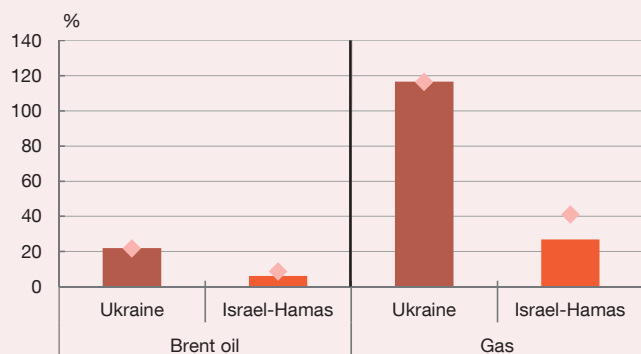


Chart 5
Fixed income (ten-year government bond yields)



Chart 6
Equity (stock market indices)

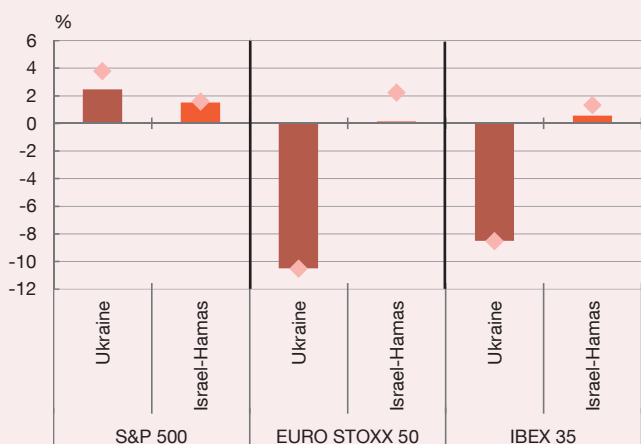
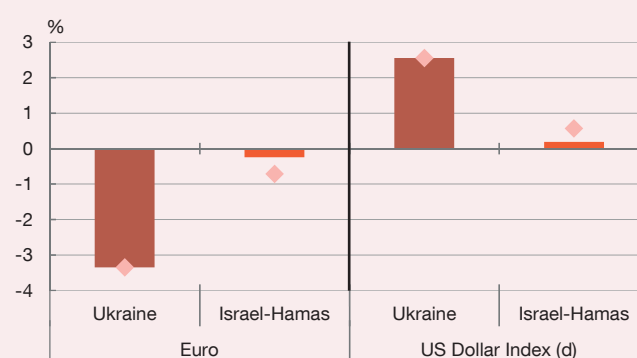


Chart 7
Exchange rates



■ Cumulative change in the first 10 days of the Ukraine War (a)
■ Cumulative change in the first 10 days of the Israel-Hamas conflict (b)
◆ Maximum cumulative daily change in the first 10 days (c)

SOURCE: Bloomberg.

- a Change calculated from the day before the start of the Ukraine War (i.e. from 23 February 2022).
- b Change calculated from the day before the start of the Israel-Hamas conflict (i.e. 6 October 2023).
- c The highest cumulative daily change within the same ten-day period is shown.
- d The US Dollar Index measures the US dollar's performance relative to a basket of six major currencies (euro, yen, pound sterling, Canadian dollar, Swedish krona and Swiss franc).

the European stock markets (see Chart 6). Lastly, the dollar's initial appreciation against other advanced economy currencies, including the euro, is now partially reversing, contrary to events following Ukraine's invasion, when the dollar index rose by 2.5% and the euro lost more than 3% against the dollar, with these movements persisting over time (see Chart 7).

Historical experience on global energy and financial market trends following the outbreak of conflicts in the Middle East

There is much uncertainty regarding the outcome of the Israel-Hamas conflict, its possible expansion across the region and the degree to which the different global

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geopolitical actors may become involved. Against this backdrop, it is useful to measure developments in the energy and financial markets during the months following the outbreak of previous armed conflicts in the Middle East. Despite certain limitations, this exercise provides a useful historical reference to assess the current uncertain environment.

More specifically, the exercise analyses the change in financial variables (the ten-year US bond yield and the S&P 500 and MSCI Europe indices) and the oil price (the price of a barrel of Brent oil), using a list of dates on which the main armed regional conflicts began as the starting point, from Black September (the Jordanian civil war, 6 September 1970) to the Yemeni civil war (using the Saudi-led intervention on 25 March 2015 as the reference date).⁶

For each conflict, the last trading day prior to the referenced date is determined and the change in each variable is calculated (differences in bond yields and cumulative growth relative to the start date for stock market indices and oil prices) for the next six months (the most relevant risk horizon for the purpose of the Financial Stability Report).

After that, the 15th, 50th (median) and 85th percentiles are calculated for each date for each variable and for the aggregate six-month trends under consideration for each conflict. This provides a central trend (the median) as well as a measure of uncertainty for the potential impact of the armed conflicts on the selected variables over each time horizon. In addition, the charts show the minimum and maximum impact of the armed conflicts. They also show the average impact of six conflicts that are particularly significant in terms of both their regional

scale and loss of life, the uncertainty surrounding their consequences⁷ and the current episode of the Hamas-Israel conflict.

Among the limitations of this analysis, it is worth noting that other macro-financial events or shocks may occur in the six-month time frame following each conflict and influence these variables.⁸ However, the set of historical conflicts under consideration is broad and representative, which means it is possible to estimate a general distribution of the upside and downside risks over the six-month time frame linked to the current Hamas-Israel conflict.

In the case of the Brent oil price, it is striking that, although half of the conflicts entail an increase in oil prices, the other half have the opposite impact, leading to the median effect being negligible. However, the distribution of impacts covers highly adverse scenarios, with steep jumps in oil prices such as, for example, those seen during the Yom Kippur War or the Iraqi invasion of Kuwait in 1990, which is consistent with the leading role played by Middle Eastern countries in global oil supply (see Chart 8).⁹

For ten-year US bond yields, Chart 9 shows that, while there is a slight negative trend, consistent with the role played by US bonds as a safe-haven asset in such scenarios, there is also historical evidence of increase in the yields on these bonds. This could possibly be explained by the fact that some of these armed conflicts (such as for example, the Yom Kippur War or the Iran-Iraq War) can also create significant inflationary pressures, raising expectations for future interest rates.

Regarding the S&P 500, a general upward trend is visible despite conflicts breaking out in the Middle East. However,

6 The list of conflicts considered includes: Black September, Jordanian civil war (06/09/1970); the Yom Kippur War (06/10/1973); the Turkish invasion of Cyprus (20/07/1974); the Lebanese civil war (13/04/1975); the outbreak of the Kurdish-Turkish conflict (27/11/1978); the Iranian Revolution (16/01/1979); the uprising in Syria (31/05/1979); the Iran-Iraq War (22/09/1980); the 1982 Israel-Lebanon War (06/06/1982); the First Intifada (08/12/1987); the Gulf War: the Iraqi invasion of Kuwait (02/08/1990); the Gulf War: Operation Desert Storm (17/01/1991); the Second Intifada (28/09/2000); Israel's Operation Defensive Shield (29/03/2002); the Iraq War (20/03/2003); the Israel-Hezbollah War (12/07/2006); the start of Israel's Operation Cast Lead in the Gaza War (27/12/2008); the 2011 Egyptian Revolution (25/01/2011); the Syrian civil war (15/03/2011); the Iraqi Insurgency (30/12/2013); Israel's Operation Protective Edge in the Gaza War (08/07/2014); the Saudi-led intervention in the Yemeni civil war (25/03/2015). Some of these conflicts took place over a long period of time and span other significant events happening at the same time as those listed, which, nevertheless, cover a wide range of conflicts in the region since 1970.

7 These are the Yom Kippur War, the Iranian Revolution, the Iran-Iraq War, the Gulf War: the Iraqi invasion of Kuwait, the Gulf War: Operation Desert Storm and the 2011 Egyptian Revolution.

8 An additional limitation is posed by the fact that the political and economic structures in place in decades long past are not perfectly comparable.

9 Note that although Brent oil is not the type of oil produced by Middle Eastern countries, this commodity's price has historically closely tracked that of its main counterparts around the world.

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Chart 8
Brent oil price (a)

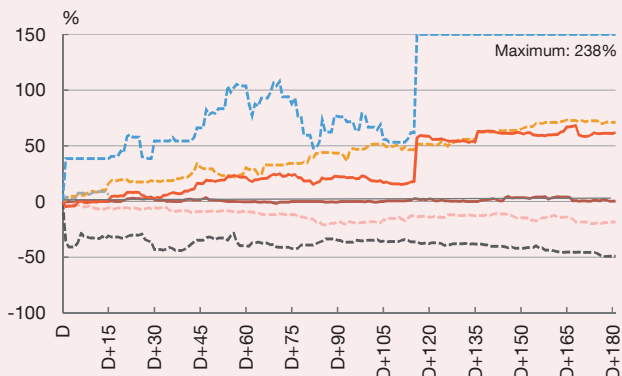


Chart 9
US 10-year sovereign bond (a)

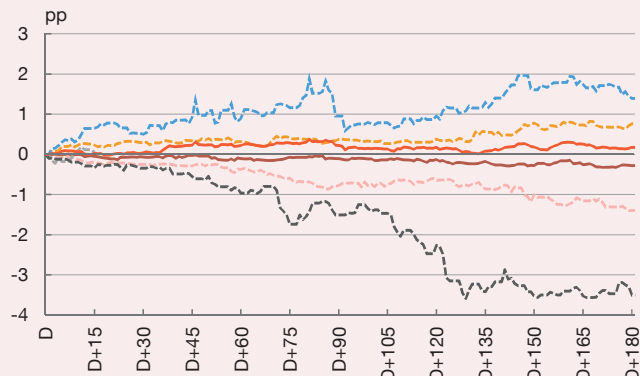


Chart 10
S&P 500 Index (a)

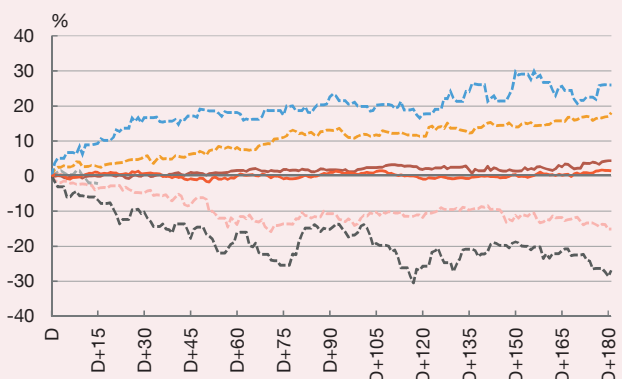
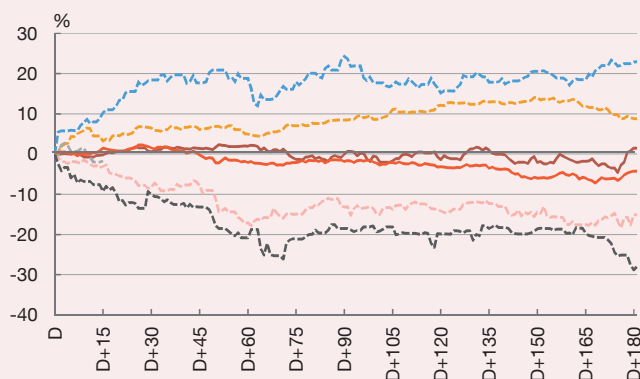


Chart 11
MSCI Europe Index (a)



- - - 15th percentile
- - - 85th percentile
- - - Minimum
— Major conflicts (b)

— Median
- - - Current episode
- - - Maximum

SOURCES: Datastream, Thomson Reuters and Banco de España.

- a D denotes the day before the start of each conflict. For each day in the period between D and D+180 days (six months), the following are measured relative to D: the change (in the case of US government bond yields) and cumulative growth (in the case of stock market indices and oil prices).
- b For the purposes of this chart, the major conflicts are the Yom Kippur War (06/10/1973), the Iranian Revolution (16/01/1979), the Iran-Iraq War (22/09/1980), the Gulf War: the Iraqi invasion of Kuwait (02/08/1990), the Gulf War: Operation Desert Storm (17/01/1991) and the 2011 Egyptian Revolution (25/01/2011).

some conflicts with more uncertain global consequences, such as the Yom Kippur War, can put clear downward pressure on share prices, as revealed by the most hard-hit percentiles (see Chart 10).

Turning to the MSCI Europe, a nearly-zero median impact can be observed alongside, once again, a broad spectrum of changes, both positive and negative. In any case, the

existence of possible historic trends with steep drops can be seen in the prices of equity securities in Europe (see Chart 11).

In general, the historical analysis set out here enjoys a certain degree of caution in assessing the potential economic and financial impact of the current conflict between Israel and Hamas in the short term. There are

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scenarios entailing little to no impact – the outbreak of a conflict in the Middle East does not, on its own, provide certainty with regard to changes in the prices of energy or financial assets. For example, there are various historical examples of outbreaks of conflict that have not stopped oil prices from dropping in subsequent months. However,

this past experience also suggests that, depending on the potential escalation, there may be severe shocks in the prices of financial assets and oil. Such disruptions appear to be linked to conflicts that stand out owing to the intense uncertainty they occasion for international geopolitical equilibria.