CEPII

Not all political relation shocks are alike: Assessing the impacts of US-China tensions on the oil market

Yifei Cai, Valérie Mignon & Jamel Saadaoui

Highlights

▮ The paper assesses the effects of US-China political tensions on the oil market.

▮ Trade tensions between the two countries threaten world economic growth, pulling down oil demand.

▮ Conflicting relationships between these two major players in the oil market may lead to the development of new strategic partnerships.

RESEARCH AND EXPERTISE
ON THE WORLD ECONOMY

▌ Abstract

This paper assesses the effects of US-China political tensions on the oil market. Relying on a quantitative measure of these relationships, we investigate how their dynamics impact oil demand, supply, and prices over various periods, starting from 1971 to 2019. To this end, we estimate a structural vector autoregressive model as well as local projections and show that political tensions between the two countries pull down oil demand and raise supply at medium- and long-run horizons. Overall, our findings show that conflicting relationships between these two major players in the oil market may have crucial impacts, such as the development of new strategic partnerships.

▌ Keywords

China, Oil market, Political relations.

▌ JEL

Q4, F51, C32.

Not all political relation shocks are alike:
Assessing the impacts of US-China tensions on the oil market[★]

Yifei Cai[a]
Valérie Mignon[b]
Jamel Saadaoui[c]

1. Introduction

China and the United States being the world's two largest oil consumers, and the US the largest producer, both countries are expected to play a key role in the oil market.[1] The recent trade war between the two nations provides a particularly appealing illustration. Political tensions began in March 2018 when Donald Trump imposed an increase in tariffs of around $60 billion on imported Chinese goods to fight against the US trade deficit with China. In return, China announced a rise in tariffs on a list of several imported US products. These measures have provoked a decrease in Chinese production since they have affected Chinese producers of the goods concerned by the tariffs as well as the producers who use those goods as intermediate inputs.[2] Given China's key role in the oil market, this reduction in production translated into a decline in Chinese consumption and demand for crude oil. Combined with an excess supply, this drop in oil demand has caused significant volatility in crude oil prices. This episode is far from being unique, and there are many other examples showing that the nature of the political relationships between the two countries is affecting the oil market significantly.

This paper tackles this issue by investigating the impact of US-China political relation shocks on the oil market. As stated above, the trade war between the US and China has spread over time since 2018, with a succession of multiple measures taking the form of threats and tariffs. Regarding the oil market, in August 2019, China announced that it would impose tariffs on US crude oil imports for the first time, leading to a severe drop in the prices. Such plunges in oil prices

---

[a]Teesside University, International Business School, UK. Email address: Y.Cai@tees.ac.uk

[b]EconomiX-CNRS, University of Paris Nanterre, and CEPII, Paris, France. Email address: valerie.mignon@parisnanterre.fr

[c]University of Strasbourg, University of Lorraine, BETA, CNRS, 67000, Strasbourg, France. Email address: saadaoui@unistra.fr

[1]According to BP Statistical Review of World Energy 2021, the US and the Chinese economies are the largest consumers of oil (around 20% and 16% of the world consumption, respectively).

[2]See, e.g., Chor and Li (2021).

come from worries about a slowdown in world economic growth and, in turn, global oil demand. This uncertainty surrounding oil demand, fueled by the escalating political tensions between the two countries, pulls prices down.

In addition to the threat of an economic downturn affecting the demand side, US-China political relations may also impact the oil market in various other ways. A typical illustration is provided by Iran, which faced severe dwindling demand—and, therefore, a decline in its oil exports—due to US sanctions since 2018. To defy US sanctions, China started to import Iranian oil, with a noticeable increase in 2020-2021. Since China is a non-negligible market for US oil exports,[3] this move toward Iran obviously affects the US oil industry and, in turn, the global oil demand and supply.[4] Regarding the supply side, another mechanism could also be at play due to the nature of the oil industry. The latter is capital intensive, and a significant part of such capital equipment and raw materials necessary to produce it comes from China. As it is well known, pipelines are mainly composed of steel. Chinese steel being cheaper than the US one, if a pipeline company is forced to buy—more expensive—steel in the US, it will impact its capital budgets and result in fewer projects, thus affecting the oil supply in the medium to long run. Finally, the escalating trade war between China and the US may also encourage oil demand for precautionary reasons.

The literature on the effects of US-China political tensions and trade war on the oil market is inexistent. As noticed by Bouoiyour et al. (2019), most studies dealing with political tensions and events concern their impact on stock returns and their volatility, not the oil market (see, e.g., Carlomagno and Albagli (2022) for a recent illustration). However, there are some rare papers (see Section 2) related to the oil market, but they mainly focus on the impact of tensions in the Middle East (see, e.g., Alhajji and Huettner, 2000; Coleman, 2012; Chen et al., 2016). Thus, to the best of our knowledge, our paper is the first to assess the effects of political relation shocks between China and the US—two key actors in the oil market—on oil demand, supply, and prices.

More generally, investigating the impacts of geopolitical risks and political tensions on financial and macroeconomic variables has not been the subject of many empirical studies due to the lack of a relevant measure to proxy such phenomena. We fill this gap in the present paper by relying on a quantitative measure of political relations between China and the US, allowing us to have a detailed—quantitative—view of the evolution of the tensions between the two countries over time. We analyze the degree to which the dynamics of these relations impact the oil market by investigating the effects on demand, supply, and prices over various periods, starting from 1971 to 2019. Although the role of China as an international key player mainly starts in the 2000s, working on such a long horizon allows us to highlight China's growing influence on the international scene and, in particular, on the oil market. From a methodological viewpoint, we estimate a structural vector autoregressive (SVAR) model, which we complement with several robustness checks—including the estimation of local projections.

Our main findings are that the threat of worsened relations impacts the oil market. Specifically, the climate of uncertainty created by these tensions between the two countries deteriorates oil demand, reflecting threats of a global economic downturn.[5] Since the Organization of the Petroleum

---

[3]In 2019, around 13.5% of US oil exports went to China (source: BP Statistical Review of World Energy).

[4]It is worth mentioning that the global oil demand is affected as Iran is under a sanctions regime by the US.

[5]From a general viewpoint, it is worth recalling that a rise in oil prices constitutes an inflationary shock. For

Exporting Countries (OPEC) has no control over prices in that case, it is not inclined to reduce its production. The sub-sample estimations corroborate our key findings, highlighting different impulse response patterns depending on the nature of the bilateral relation—repaired, fluctuating, common, and deteriorating.

The rest of the paper is organized as follows. Section 2 reviews the literature related to the impact of political events on the oil market. Section 3 presents the methodology and data. Section 4 displays the SVAR estimation results. It also includes a detailed sub-period analysis and a counterfactual investigation. Section 5 provides several robustness checks, including the estimation of local projections. Finally, Section 6 concludes the paper.

2. Literature review

Baumeister and Kilian (2016) describe several historical episodes of major fluctuations in the real price of oil, and underline that the literature on their causes has largely evolved since the 1980s. Although exogenous political events and revolutions in OPEC member countries were initially considered the main drivers of fluctuations in oil prices (Hamilton, 2003, 2009), various studies further argue that they are only one possible explanatory factor (Bodenstein et al., 2012; Lippi and Nobili, 2012; Baumeister and Peersman, 2013; Kilian and Hicks, 2013; Kilian and Lee, 2014; Kilian and Murphy, 2014).

As an example, Hamilton (2003) argues that the 1973 oil price shock corresponds to a negative supply shock, as the supply fell and the prices soared, and results from a political conflict in the Middle East. In contrast, Kilian (2008) found empirical evidence that only 25 percent of the 1973 oil price increase is due to exogenous supply shocks; the other factors that play a key role being exogenous events in OPEC countries such as the Persian Gulf war or the Iranian revolution which may also include exogenous oil demand shocks.

More generally, at the global level, market forces and, especially, the demand for crude oil play a key role. As it is well known, when the global economy expands, the demand for raw materials (including crude oil) increases, inducing a rise in oil prices.

Disentangling the respective contributions of exogenous political events/tensions and market forces (demand, supply, inventories) in oil price fluctuations is a rather difficult task. Indeed, the causal structure and interactions between political tensions, oil demand, oil supply, oil inventories, and oil prices are not straightforward. It is worth mentioning that the evolution of oil prices could impact global supply, as OPEC members could find it interesting to produce more when prices are high. Besides, political tensions could affect the global cycle, lowering oil demand and, finally, oil prices.

With this general background in mind, we survey some recent studies that estimate the impact of exogenous political events, thanks to a quantitative measure of political tensions. Although the narrative—i.e., historical—approach is helpful to examine specific historical episodes, the quantitative approach is precious to discover more systematic evidence. Besides, we focus on studies that aim at (i) deciphering the complex structural interactions between political tensions,

---

instance, Choi et al. (2018) empirically show that a 10% increase in oil prices leads to a rise in domestic inflation by 0.4 percentage points in the short run.

market forces, and oil price movements; and (ii) determining the relative contributions of political tensions and market forces to the oil price dynamics.

Chen et al. (2016) investigate the impact of OPEC's political risk on oil prices thanks to estimating an SVAR specification. They aim to shed light on two questions: how do international oil prices respond to shocks of political risk events? What is the relative contribution of those shocks in explaining changes in oil prices? To answer these questions, Chen et al. (2016) consider five variables in the SVAR, namely the political risk of OPEC countries, oil supply, oil demand, speculation, and crude oil prices. OPEC countries' political risk is measured by a transformation of the well-known International Country Risk Guide index (hereafter the ICRG index). Using monthly data from January 1998 to September 2014, they find that the two main contributors to oil price fluctuations are political risk shocks (for 34.6%), and demand shocks (for 17.6%). Specifically, OPEC's political risk shocks positively influence oil prices after 17 months; this positive effect lasting for 10 months, indicating delayed significant impacts over the examined period. Consistent with Kilian (2008, 2009) and Kilian and Murphy (2014), oil demand shocks positively impact oil prices for 20 months, whereas supply shocks do not exert a significant effect as they contribute only to 5.9% of the oil price fluctuations. Turning to financial speculation shocks, they positively affect oil prices, as in Morana (2013) and Dvir and Rogoff (2014).

Interestingly, through the impulse-response functions (IRF)' analysis, Chen et al. (2016) also find that political risk shocks in the Middle East positively affect oil prices, while political risk shocks in North Africa and South America have no significant effect.[6] Consequently, political tensions between strategic partners may impact the oil price dynamics, even if they do not find a significant effect of external conflicts for the studied sample and countries (OPEC).

Along with the empirical investigation of Chen et al. (2016), several papers aimed at estimating the quantitative impact of political risk on the oil price dynamics (Lee et al., 2017; Miao et al., 2017; Perifanis and Dagoumas, 2019; Abdel-Latif and El-Gamal, 2020; Qin et al., 2020; Caldara and Iacoviello, 2022). Alhajji and Huettner (2000) can be considered the first attempt to assess the quantitative impact of political risk shocks on oil price fluctuations, being the sole study that incorporates quantitative measures of political tensions—security cost per barrel (i.e., the increase of military spending for each OPEC country relative to Venezuela)—in a model of oil prices during the 2000s (Coleman, 2012).

In his work, Coleman (2012) aims at explaining crude oil prices with fundamental measures, including two variables for proxying political factors: the number of US troops deployed in the Middle East (expressed in logarithm), and the terrorist attacks with fatalities in the Middle East. According to him, these two variables provide a consistent measure of regional instability and the threat of war. Using monthly data over the 1984-2007 period, he confirms the traditional role played by market forces, and shows that fatal attacks in the Middle East and US troops deployed in the region have a positive impact on oil price fluctuations. A one-standard-deviation change in fatal attacks and in the log of US troops increases oil prices respectively by $4 and $1. Despite its interest, it is worth mentioning that this study does not control for reverse causality running from oil prices to the explanatory variables.

---

[6]Political risk shocks in the Middle East have more impact due to the larger share of oil production and the higher occurrence of geopolitical events.

Lee et al. (2017) expand Chen et al. (2016)'s investigation and estimate an SVAR model including the following variables: world oil production, real global economic activity index (Kilian, 2009), oil prices (Brent), and country risk rating for each G7 member (ICRG index). Using monthly data over the 1994-mid-2015 period for the G7 countries, they highlight different results between oil-exporting (the UK and Canada) and oil-importing (Germany, France, Italy, Japan, and the US) countries.[7] For instance, in Canada, unanticipated shocks to the country's risk could lead to a short-lived increase in oil prices, in line with Chen et al. (2016). In the United States, those shocks may have a different impact on the world economy than for other oil-importing countries, given the size of the US economy and the place of the US dollar in the international monetary system.

The remaining recent studies on the impact of political tensions on oil price fluctuations can be split according to the type of variables used to measure political risks, threats, and tensions. On the one hand, some empirical studies (Miao et al., 2017; Perifanis and Dagoumas, 2019) rely on the number of terrorist attacks coming from the Global Terrorism Database, following the approach of Coleman (2012). On the other hand, some more recent empirical investigations (Abdel-Latif and El-Gamal, 2020; Qin et al., 2020; Caldara and Iacoviello, 2022) use the Geopolitical Risk index (hereafter GPR) introduced in the literature by Caldara and Iacoviello (2022).[8]

Using a sample of daily data spanning from January 04, 2002 to September 25, 2015, Miao et al. (2017) aim at forecasting WTI crude oil prices with several types of variables (supply factors, demand factors, financial factors, commodity market factors, speculative factors, and political factors). The authors find that geopolitical risk factors, captured by the number of terrorist attacks in the Middle East and North Africa, are one of the most important determinants of oil prices.

Aiming at quantifying the impact of the fundamental drivers of oil prices over the 2007-2018 period using monthly data, Perifanis and Dagoumas (2019) consider various variables: (i) traditional variables for market forces, (ii) US shale oil production for supply factors, and (iii) number of terrorist attacks in oil-producing countries for the geopolitical factor. Relying on cointegration analysis, they find that the geopolitical factor does not significantly influence oil prices in the long run.

As stressed above, Caldara and Iacoviello (2018, 2022) introduce the geopolitical risk (GPR) index, a monthly index obtained by running automated text searches on the electronic archives of 11 newspapers, available since 1985.[9] They distinguish between geopolitical threats—which tend to increase uncertainty—and geopolitical acts. Their measure has the advantage to be largely independent of business cycle fluctuations, although the authors acknowledge that their index can be viewed as: "as a measure of risks that are mostly relevant from a North-American and British perspective." In their empirical investigation, they rely on a Bayesian VAR analysis over the 1985-2016 period, and consider several macroeconomic variables (GPR index, EPU index, consumer sentiment, US production, US trade balance, S&P 500 index, oil prices (WTI), and yield on two-

---

[7]Thanks to an open-economy dynamic stochastic general equilibrium model for Norway, Bergholt et al. (2019) provide theoretical evidence that helps in understanding the different transmission mechanisms at play for oil-exporting and oil-importing countries. They highlight that the commodity industry supply chain has a key role.

[8]The index is available since 2018.

[9]The historical index is available since 1900, but only based on 3 newspapers.

year US treasuries). Their results show that an increase in the GPR index leads to a short-lived decrease in oil prices of around 7% after 3 months.

Abdel-Latif and El-Gamal (2020) use the GPR index to assess the dynamic interactions between oil prices, financial liquidity, and geopolitical risks over the period spanning from 1979 to mid-2017. To this end, they consider a Global VAR (GVAR) model as they argue that financial liquidity and geopolitical risks are probably endogenous to the US. They find that a one-standard-deviation shock to the geopolitical risk index induces a persistent and significant increase in oil prices (around 4%).

Qin et al. (2020) use quantile regressions to investigate the asymmetric effects of geopolitical risks on energy returns (including crude oil). Their sample period spans from June 28, 1990 to October 31, 2018, and they use four dummies that correspond to the four spikes in the GPR index: the Gulf War, the 2003 Iraq invasion, the 2014 Russia-Ukraine crisis, and the 2015 Paris terrorist attacks. They find that the GPR index has a negative impact on crude oil returns at the lower quantiles, and a positive effect at the higher quantiles. Besides, geopolitical threats have a higher impact than geopolitical acts in absolute value.

To our best knowledge, our study is the first to use a quantitative index of bilateral political relationships between the US and China to quantify the effect of political shocks on the oil market. This lack in the literature is quite surprising since, given the weight of these two economies in terms of GDP, oil consumption, and oil production, the dynamic of their political relations is likely to play a key role in the oil market. Our structural analyses aim at (i) deciphering the complex structural interactions between political relations, market forces, and oil price movements; and (ii) determining the respective contributions of these factors to the oil price dynamics.

3. Methodology and data

3.1. The SVAR specification

The widely used method to investigate the impacts of macroeconomic shocks is structural vector autoregression (SVAR) models.[10] Obtaining structural shocks are crucial to impulse response analysis, forecast error variance decomposition, historical decomposition, and VAR-based counterfactual analysis. Let us recall that the SVAR specification is given by:

$$\mathbf{A}_0 y_t = \mathbf{c} + \mathbf{A}_1 y_{t-1} + \mathbf{A}_2 y_{t-2} + \cdots + \mathbf{A}_p y_{t-p} + \mathbf{B} u_t \tag{1}$$

where y_t is the vector of endogenous variables, $\mathbf{c}$ is a constant term, $\mathbf{A}_0, \mathbf{A}_1, \cdots, \mathbf{A}_p$ denote the structural coefficients, and u_t are the orthonormal unobserved structural innovations with $\mathbf{E}(u_t u_t') = \mathbf{I}_k$; $\mathbf{I}_k$ being the identity matrix. By assuming $\mathbf{A}_0$ is invertible, we can rewrite (1) as follows:

$$y_t = \alpha + \mathbf{Q}_1 y_{t-1} + \mathbf{Q}_2 y_{t-2} + \cdots + \mathbf{Q}_p y_{t-p} + \varepsilon_t \tag{2}$$

---

[10]As an example, Herwartz and Plödt (2016) estimate an SVAR model to analyze the dynamics in the global crude oil market. They find a strong impact of aggregate demand and oil-specific demand shocks on oil prices, but a small effect of both shocks on oil production.

where $\alpha = \mathbf{A}_0^{-1}\mathbf{c}$, and $\mathbf{Q}_1 = \mathbf{A}_0^{-1}\mathbf{A}_1$, $\mathbf{Q}_2 = \mathbf{A}_0^{-1}\mathbf{A}_2$, $\cdots$, $\mathbf{Q}_p = \mathbf{A}_0^{-1}\mathbf{A}_p$. The reduced-form error ε_t can be expressed by:

$$\varepsilon_t = \mathbf{A}_0^{-1}\mathbf{B}u_t = \mathbf{S}u_t \tag{3}$$

$$\mathbf{E}(\varepsilon_t\varepsilon_t^{'}) = \Sigma_\varepsilon = \mathbf{A}_0^{-1}\mathbf{B}\mathbf{B}^{'}\mathbf{A}_0^{-1'} = \mathbf{S}\mathbf{S}' \tag{4}$$

with $\mathbf{S} = \mathbf{A}_0^{-1}\mathbf{B}$.

To recover $\mathbf{S}$, we rely on the recursive identification scheme by using Cholesky decomposition to obtain a lower-triangular matrix. The benchmark-SVAR model is specified as $y_t = [pri_t, pro_t, dem_t, rpo_t]'$, where pri_t, pro_t, dem_t and rpo_t denote US-China political relations, oil supply, oil demand, and oil prices at time t, respectively. According to our ordering, the identified shocks of US-China political relations contemporaneously impact oil-related variables, but the reverse effects of other oil shocks take time.[11] It is worth mentioning that since we are only interested in the responses of oil market variables to US-China political relation shocks, only the first column of $\mathbf{S}$ needs to be identified. We use the moving block bootstrapping method proposed by Brüggemann et al. (2016) to generate confidence intervals at 68% and 90% significance levels.

3.2. Data

We use monthly data over the period spanning from January 1971 to December 2019. We chose to work over a long-time period, although the role of China as an international key player has been effective since the beginning of the 2000s. Relying on an extended period allows us (i) to highlight the growing influence of the Chinese economy on the international scene, and (ii) to have a complete picture of the evolution of the political relationships between China and the US through time. To assess the effect of US-China political tensions on the oil market, we rely on the US-China political relation index (PRI) developed by Yan and Qi (2009) and Yan et al. (2010). The index is available on the Institute of International Relations website at Tsinghua University,[12] and mainly describes the political relations between China and the US. It is divided into six sections, ranging from -9 to 9, which classify the political relations as confrontation (-9), rival, disharmonious, common, harmonious, and friendly (9).[13]

Figure 1 displays the evolution of PRI over the 1971-2019 period. As shown, the index maintains around -7.5 before Kissinger's secret trip to China in 1971, and sharply increases due to Nixon's China visit in 1972. After a continuously growing trend, it dramatically rose in 1978 due to the agreement on normalization and Deng's visit to the US. The PRI index maintains common (over 2) from 1980 to 1989. Then, the US-China political relation was disturbed by the Tiananmen Square event, which led the US government to suspend military sales to China, freezing political relations between the two countries. From 1989 to 1999, the US-China political relation was disharmonious because of the negative effects of the Tiananmen Square event. Since 1996, the

---

[11]We will further investigate the robustness of our findings to the ordering of the variables (Section 5).

[12]PRI is available at http://www.tuiir.tsinghua.edu.cn/

[13]The minimum unit of the index is 0.1. For details about the construction of the index, see Du et al. (2017), Yan and Qi (2009), and Yan et al. (2010). In the empirical analysis, the PRI index (pri) is expressed as follows: $\log(pri_t + \sqrt{1 + pri_t^2})$.

Figure 1: US-China political relation index
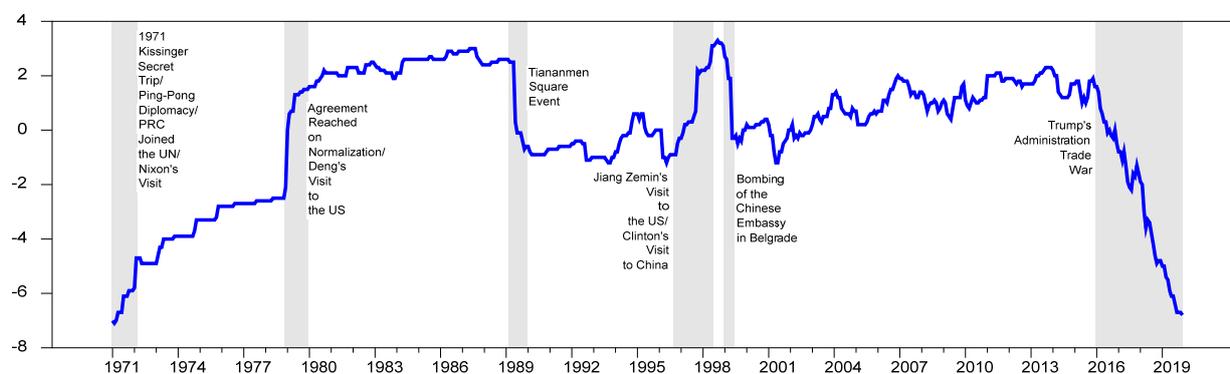
Note: The US-China political relation is drawn from the official website of the Institute of International Relations at Tsinghua University (http://www.tuiir.tsinghua.edu.cn/). The shaded areas represent the periods when particular political events occur.

political relation warmed up again due to Jiang Zemin's visit to the US and Bill Clinton's visit to China. Such an improving trend was disrupted by the bombing of the Chinese Embassy in Belgrade in 1999, freezing the political relation between the two countries again. In October 2000, President Clinton signed the US-China Relations Act, granting Beijing permanent normal trade relations with the US and paving the way for China to join the World Trade Organization (WTO) in 2001. After that, US and China experienced a long-term slow recovery in their political relations. In addition, China also enjoyed a fast-growth stage during this period. Since Donald Trump came to power in 2017, PRI had significantly dropped because of the trade war—the US labeling China a currency manipulator—Hong Kong's judicial independence, intellectual property issues, and other conflicts. To sum up, the PRI index is informative enough to describe the changes in US-China political relations.

Regarding the variables related to the oil market, we follow Baumeister and Hamilton (2019) and use their dataset by including global oil supply, world oil demand, and the real price of oil—all these variables being expressed in logarithmic terms.[14] The oil price series is the WTI spot price deflated by the US consumer price index.[15] The world industrial production index is measured by Baumeister and Hamilton (2019) by considering 23 OECD countries and six emerging economies (Brazil, China, India, Indonesia, the Russian Federation, and South Africa). As a robustness check regarding the proxy for world oil demand, we also consider the global real economic activity index introduced by Kilian (2009), which is constructed from ocean bulk dry cargo freight rates.

---

[14] All oil-market related series are extracted from Christiane Baumeister's personal website: https://sites.google.com/site/cjsbaumeister/.

[15] Our choice of the WTI series compared to Brent is explained by the fact that WTI is the US benchmark. WTI is thus the North American reference, but it has a crucial weight on the other barrels because of its high trading volumes. As the US is the world's largest oil producer, the importance of the WTI price has strongly increased at the world level. For those reasons and given that our paper deals with the US, we retain the WTI series.

4. Empirical results

As stressed above, we rely on the recursive identification strategy to obtain desired US-China political relation shocks and use the Cholesky decomposition to recover the contemporaneous impact matrix. We order US-China political relations at first, and follow Kilian (2008) regarding the ordering of the rest of the variables: oil supply, oil demand, and oil prices. As previously mentioned, this variable ordering indicates that US-China political relation shocks contemporaneously impact oil market variables, but the reverse effects take time.[16]

We include 24 lags into the model because the dataset contains strong persistency. Although China has had significant economic successes after entering the WTO, the US still plays a more important role in their political relation especially during deteriorating times. The political attitude of the US towards China is not easily changed because of the President's political slogan and congress's influence. Kilian (2009) suggests using longer lags to describe enough dynamics in the oil market. Additionally, we check the stability of the estimated VAR with the method proposed by Lütkepohl (1991). The results reported in Appendix (Figure A.1) demonstrate no unit root lies outside the unit root circle, indicating the stationarity of the VAR.[17]

### *4.1. Impulse response functions (IRFs)*

As the two leading economies in the world, the worsening bilateral political relations could create worries about potential conflicts and geopolitical risks, and affect the oil market. We first report the IRFs results, which represent the effects of a 1% decrease in US-China political relations on oil market-related variables.

As shown in Figure 2, an unanticipated decrease in US-China political relations raises oil production and persistently pulls down oil demand. More in detail, the IRFs of oil supply are insignificant in the short run and peak at 0.02% after two years given the immediate shock. The long-run impacts of the identified political relation shocks are significant. In contrast, the IRFs of oil demand continuously drop down after the unanticipated decrease in PRI. Finally, the pattern of the real price of oil is not significant in the short run, but significantly rises after 40 months. It is worth noticing that the decrease in demand is not accompanied by a decline in oil prices due to the nature of the considered shock. Indeed, while an oil price increase is expected to follow a positive demand shock, our results show that oil prices are affected by other factors than market forces, such as geopolitical and political events.

Overall, deteriorating political relations between the US and China harm world economic growth and, in turn, the demand for oil. In that case, OPEC does not control its production based on demand changes, but rather increases supply to gain extra fiscal benefits from rising prices. The latter vary following such a sudden decrease due to unanticipated worries about future political relations between the two countries. Barsky and Kilian (2004) demonstrate that the supply decisions of OPEC are heavily dependent upon political situations. Using a novel oil price uncertainty index, Cross et al. (2022) identify both precautionary and speculative demand

---

[16]See Section 5 for a robustness analysis to the ordering of the variables.

[17]For the sake of completeness, note that we have investigated the sensitivity of our findings to the lag number. The results, available upon request to the authors, are robust to the choice of the lag number.

Figure 2: Baseline impulse responses: Effects of a 1% decrease in US-China political relations
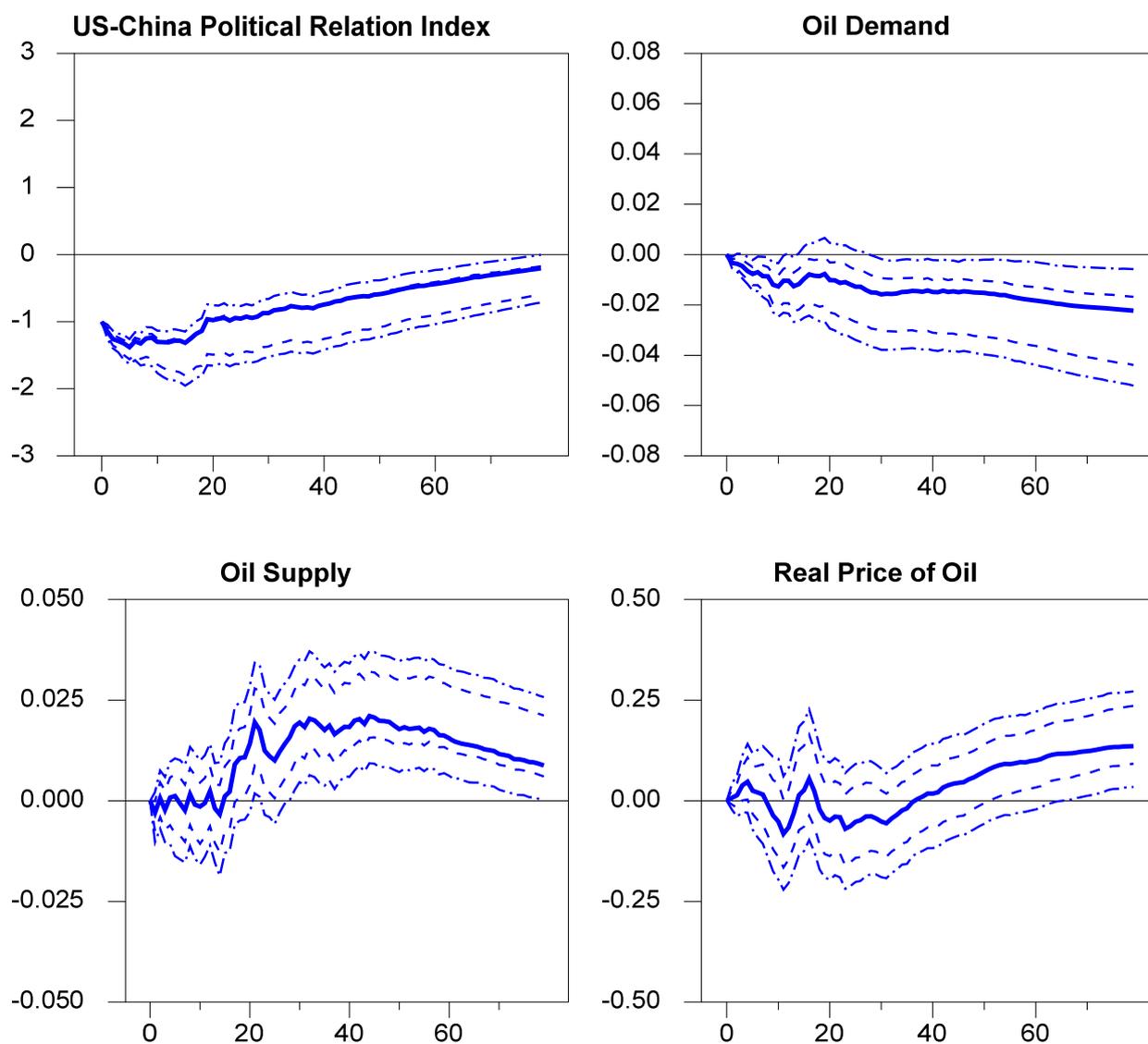
Note: The baseline SVAR model is estimated over the period from January 1971 to December 2019. It is specified as $y_t = [pri_t, pro_t, dem_t, rpo_t]'$ (variables expressed in logarithmic terms) and includes 24 lags. Impulse-response horizons: 80 months. The shock is explained by a 1% decrease in $\log(pri_t + \sqrt{1 + pri_t^2})$. The dashed lines are 68% and 90% significance levels.

shocks, and confirm that the precautionary motive is the primary driver of oil price fluctuations. However, from the perspective of speculators and arbitrageurs, they are more likely to utilize this opportunity to gain excess returns when political tensions rise. When political tensions increase at the very beginning, the participants in the oil market cannot precisely forecast the future movement of oil prices. This can be supported by the insignificant results of the oil prices' IRFs in the short run. Therefore, it is natural to suspect that oil price changes after unexpected political tensions cannot reflect the actual market demand and supply variations. Another explanation for our results is that we rely on a long-time span, including the period before the 2000s during which China's international role is out of all proportion to nowadays. Beyond that, the US-China political relation varies all the time because of multiple sudden events during the whole period. This illustrates the relevance of implementing a series of sub-sample analyses (see Section 4.3).

4.2. Counterfactual analysis

An interesting question is to assess what the evolutions are when the impacts of US-China political relation shocks are excluded from the SVAR model. To construct the counterfactual variables in the absence of the effects of US-China political relation shocks, we follow Peersman (2022)'s method by using the actual dataset minus the historical decomposition of the identified shocks. The results of historical decomposition and counterfactual evolution are displayed in Figures 3 and 4.

According to Figures 3 and 4, the identified shocks negatively contribute to the variations in US-China political relations before 1980, in several months from 1989 to 1995, and after 2016. These results are not surprising because of the historical events between US and China during these periods. Before 1980, the international role of China was negligible, and US and China political relations were still fragile and easily disturbed by sudden changes. During the first mid-1990s, excluding the identified political relation shocks shows that PRI is above the actual evolution. The identified shocks negatively impacted US-China political relations due to the Tiananmen Square event.

The most interesting result concerns the period starting in the 2000s, during which the influence of China on the international scene has continued to grow. Until 2016, counterfactual PRI generally evolves below its actual dynamics and the historical decomposition of the PRI shocks remains positive. This comes from the fact that the US and China tried to maintain a good relationship through diplomatic methods, although some sudden events affected it. Since the end of the 1990s and the beginning of the 2000s, US companies have been increasingly trading with this growing China, which appears to be a land of economic opportunity. However, in 2005, George W. Bush described the Chinese-American relationship as mixed and urged China to democratize. Under Barack Obama's presidency, some concerns emerge in the face of the rise in China's international power. This led the US to develop contracts with other countries in Southern Asia, including Vietnam.

Finally, during Trump's administration, US-China political relations reached the freezing point due to multiple economic and political events, including the trade war, Hong Kong's judicial independence, intellectual property issues, and the international status of Taiwan. As shown, since Trump's election, the shocks have negatively contributed to the variations in US-China political relations. The conflicts against China during Trump's presidency completely change the evolution

**Figure 3:** Historical decomposition
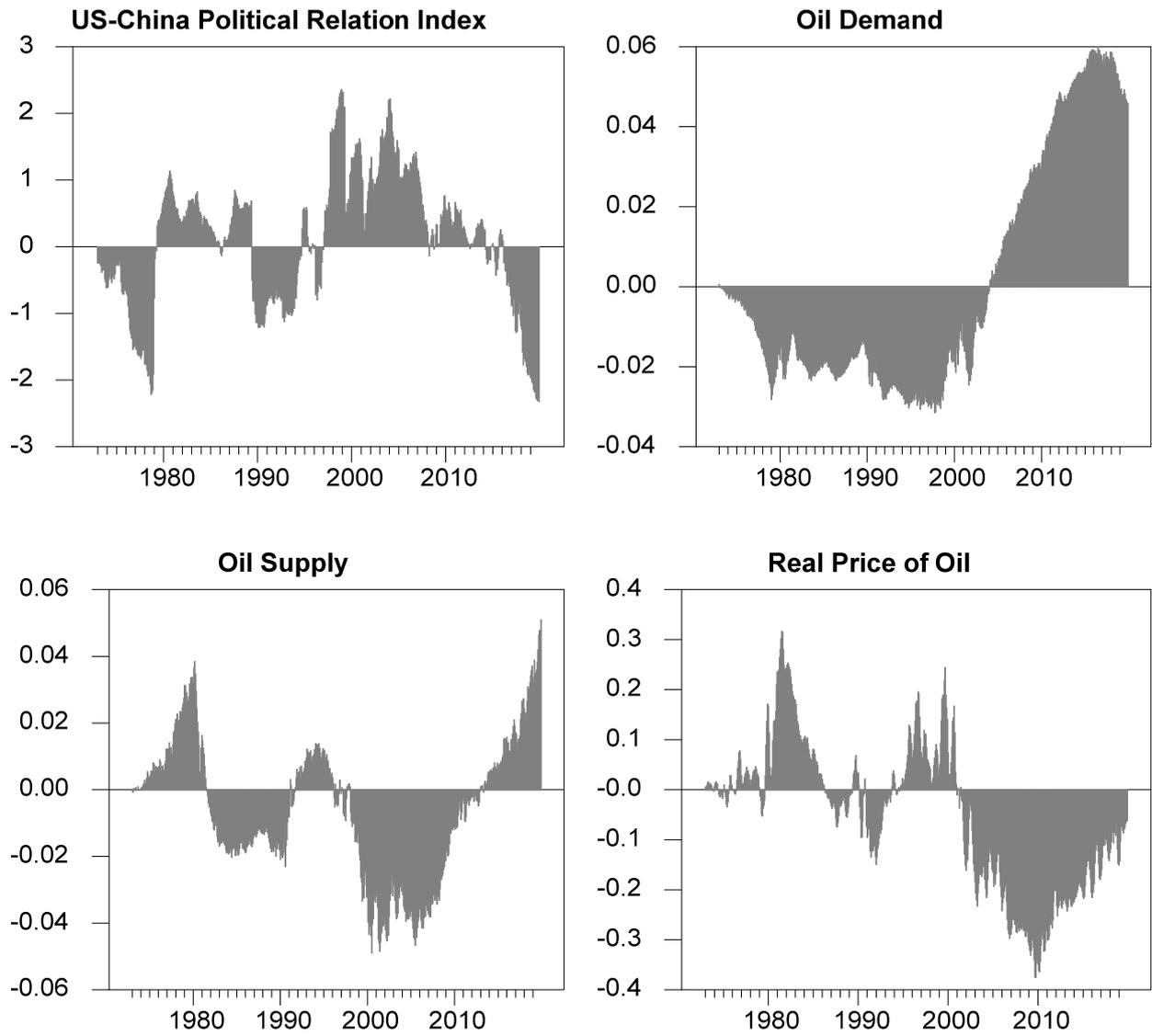
Figure 4: Counterfactual evolution
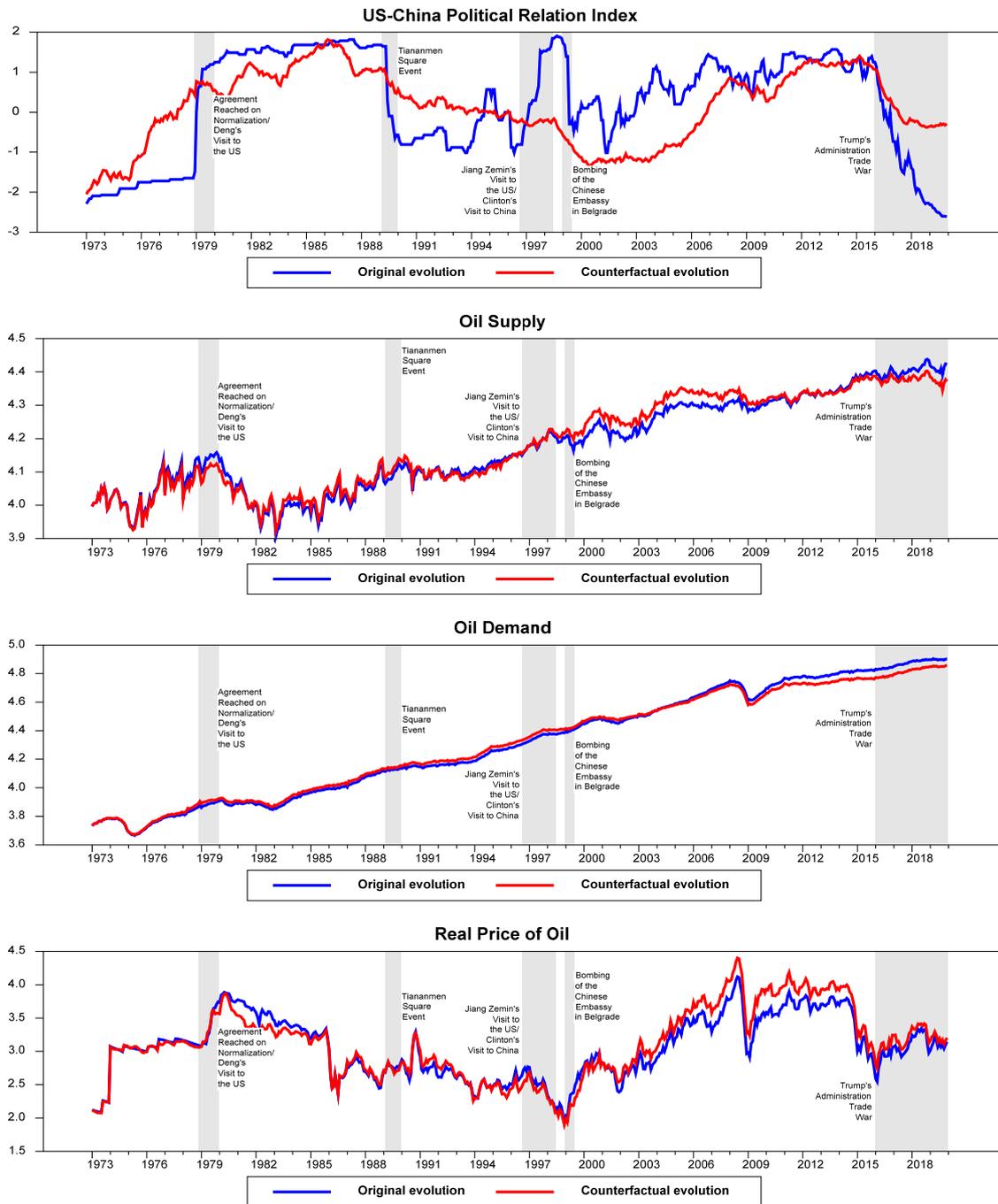
of the bilateral political relation. According to Figure 4, the counterfactual PRI shows that the relation between the two countries should be common other than the confrontation described by the actual dataset when negative impacts of the PRI shocks are filtered out.

Turning to oil supply, the identified US-China political relation shocks positively contributed to oil production for several months from 1971 to 1985, and after 2017. The shocks negatively contribute to variations in oil demand before 2003. A few years after China entered into WTO, the impacts were positive and significantly increased in the following years. This result was expected as China's rapid economic growth started from entering into WTO, and the country has gained much of benefits from trading with external partners. In Trump's administration, China is even labeled as a strategic competitor of the US. In other words, the political shocks make positive contributions to world oil demand and economic activities. Regarding oil prices, the shocks positively contribute before 1985, and negatively after 2002.

4.3. Sub-sample estimates

Since US-China political relations and the oil market are both easily disturbed by unanticipated changes in international political affairs, the baseline results may differ depending on the considered sub-sample period. Moreover, since the whole period includes different regimes of political relationships and because the international influence of China has considerably evolved through time, working on the full sample may mask—by averaging those diverse regimes—important facts regarding the impact of US-China political relationships during some specific sub-periods. According to Figure 1, four main periods can be distinguished: repaired relation, fluctuating relation, common relation, and deteriorating relation. The most interesting periods are the last two because they correspond to the growing international influence of China. For the sake of completeness, we also report the results for the two first sub-periods, although China was not a key international player during those times. Since the sub-samples contain fewer observations, we estimate the VAR models with 12 lags, and the impulse response horizons are set to 50 months.

Repaired relation (January 1971-December 1988). The first period describes a repaired relationship between the two countries since Kissinger's secret trip to China in 1971. This period lasted for nearly 20 years, and included many important events such as Ping-Pong diplomacy, Kissinger's secret trip, Nixon's visit to China, the agreement on normalization, and Deng's visit to the US. During this period, PRI quickly raised and described a repaired relation between the two countries. As shown in Figure A.2 in Appendix, the IRFs of oil demand and supply are insignificant. These results reflect that China is not a main contributor to world economic growth, and the political relation between US and China was not crucial to international affairs during this period. Thus, the US-China political relation is not influential enough to impact the global oil market.

Fluctuating relation (January 1989-December 1999). Some particular events suddenly disrupted the previous improving political relation. Specifically, the Tiananmen Square event and the Belgrade Bombing shortly iced the warming relation in 1989 and 1999, respectively. As shown in Figure A.3 in Appendix, oil demand tends to follow the PRI evolution. Specifically, when the US-China relation ameliorates, oil demand and supply significantly rise, reflecting favorable prospects regarding world economic activity.

Common relation (January 2000-December 2010). PRI falls into a common relation period and has maintained for nearly ten years until China became the second-largest economy in the world. During this period, President Clinton signed the US-China Relations Act in October 2000, granting Beijing permanent normal trade relations with the United States, and paving the way for China to join the World Trade Organization in 2001—which was crucial for China's economic growth. In addition, Deputy Secretary of State Robert B. Zoellick initiated a strategic dialogue with China. Recognizing Beijing as an emerging power, he called on China to serve as a "responsible stakeholder", and used his influence to draw nations such as Sudan, North Korea, and Iran into the international system in 2005. During this "golden age" period for Chinese growth, US and China experienced a relatively stable relation. As displayed in Figure A.4 (Appendix), the results are highly significant. Specifically, the identified US-China political relation shock decreases the three oil-related variables, except a temporary increase in oil prices in the very short run. The rising Chinese economy significantly increases global oil demand. However, as the bilateral political relation deteriorates, the world oil demand significantly drops, and, consequently, OPEC may adjust its supply accordingly to avoid an oil glut. The short-run increase in the real price of oil reflects rising precautionary saving motives. Since the adjustments in oil supply are usually lagged behind the shifts in oil demand, the mismatch in demand and supply sides may finally lead to a decrease in the oil price in the long run.

Deteriorating relation (January 2011-December 2019). The last period corresponds to deteriorating political relations. "US 'Pivots' Toward Asia" was viewed as a most important signal to illustrate that the opinions of the US towards China were completely changed. In 2012, trade deficit tensions raised. In Trump's administration, the conflicts between US and China are becoming more explicit. The political relation significantly dropped down and nearly touched the bottom since US and China established Diplomacy because of a series of events such as the trade war, disputes regarding China's human rights, Chinese currency manipulator accusation, and Hong Kong's judicial independence. As displayed in Figure A.5 in Appendix, the short-run IRFs of oil demand are not significant, the oil supply IRFs are negative in most of the horizons, and oil prices positively respond to such a sudden decrease. Compared to the previous sub-period, the significance of the effects of US-China political relation is lower. This result is not surprising as deteriorated relationships between the two countries are already at play. Indeed, the trade war has begun, and uncertainty is thus lower for firms compared to the previous period. Put it differently, further degradation of the US-China relation produces lower effects in a worsened environment than in a calm context. This finding is in line with Caldara and Iacoviello (2022), who underline different impacts between (i) threat of war that generates uncertainty for firms, and (ii) war that reduces uncertainty due to the habituation of firms to a troubling context. In addition, the industrial scale of China has already been formatted in the common relation period. Thus, the worsening political relation cannot certainly impact global oil demand and supply. But oil, as an asset traded in the market, is not always guided by market forces; other factors such as political tensions, military conflicts, and geopolitical risks would play an important role in this circumstance.

5. Robustness analyses

To assess the robustness of our results, we implement several sensitivity analyses. First, we check the validity of our conclusions regarding the ordering of the variables in the Cholesky decomposition. Then, we evaluate the sensitivity of our findings to the choice of the proxy used for oil demand. Finally, we check that our conclusions remain unchanged if we use the local projection method as an alternative to the SVAR model.

5.1. *Variable ordering*

As it is well known, IRFs depend upon the variable ordering used in the Cholesky decomposition. To assess the robustness of our results, we locate PRI at other positions. We report in Figures A.6 and A.7 in Appendix the results when PRI is ordered at the second and last positions, respectively. When PRI is located at the second position, the identified PRI shock can contemporaneously affect oil demand and prices, but the reverse effects take time. When PRI is ordered last, all oil price shocks would instantaneously impact the bilateral political relation between US and China. Interestingly, the IRFs patterns obtained with these orderings are similar to those reported in Figure 2, illustrating the robustness of our findings.

5.2. *Proxy for oil demand*

Our previous findings are obtained using the world industrial production index measured by Baumeister and Hamilton (2019). An alternative proxy for oil demand has been suggested by Kilian (2009), who proposed a world real economic activity index. The IRFs obtained when replacing the world industrial production with the world real economic activity index are shown in Figure A.8 in Appendix. The dynamics are globally similar to those displayed in Figure 2, although the decrease in oil demand is more pronounced. Thus, our baseline estimates are robust against the choice of oil demand indicators.

5.3. *Local projections*

As an alternative to SVAR IRFs, Jordà (2005) proposes to estimate local projections, allowing to compute IRFs without specifying and estimating the underlying multivariate dynamic system. Comparing local projections and SVAR approaches, Montiel Olea and Plagborg-Møller (2021) and Plagborg-Møller and Wolf (2021) show that the former is more robust than the latter, especially when the dataset is highly persistent. As shown by Plagborg-Møller and Wolf (2021), local projection and VAR methods lead to the same median impulse responses in the short and medium run, but disagree substantially in longer horizons. To assess the sensitivity of our results to the choice of methodology, we complement our SVAR analysis with the implementation of the lag-augmented local projection method.

As shown in Figure A.9, the SVAR impulse response patterns are highly consistent with local projections in the first 20 horizons. There are slight differences in the IRFs of oil demand and supply in longer horizons, in line with the remarks formulated by Plagborg-Møller and Wolf (2021). Regarding the patterns of local projections, impulse responses in longer horizons more quickly recover to zero than typical SVAR models. Indeed, based on the SVAR results, the impacts of US-China political relation shocks are more persistent in longer horizons and do not disappear

after 80 horizons. Put differently, local projection impulse responses describe more dynamics in the long run. Overall, our main conclusions are not altered when considering Jorda's procedure as we find similar impulse response patterns.[18]

6. Conclusion

This paper examines the effects of US-China political relation shocks on the oil market. Relying on a quantitative measure of these relationships, we investigate how their dynamics impact demand, supply, and prices in the oil market over the 1971-2019 period and various sub-samples.

The estimation of a structural VAR specification shows that political tensions between China and the US pull down oil demand, reflecting threats of a global economic downturn, and raise oil supply in the medium to long run. The potential threat *vis-à-vis* the dominant position of the US caused by the increasing international role of China feeds a climate of uncertainty reflected in the oil market. Overall, our findings show that other factors than market forces impact the oil market, as illustrated by the political tensions between US and China.

We complement our analysis with a counterfactual investigation aiming at assessing what are the evolutions when the impacts of US-China political relations shocks are excluded. Our results corroborate the significant effect of political tensions between the two countries on the oil market.

From a policy viewpoint, our findings show that political tensions between these two major players in the oil market may have crucial impacts, especially during the last two decades, when China's role in the international scene has grown considerably. In particular, this leads to the development of new strategic partnerships. Whereas Iran had seen its oil exports drop considerably following the US sanctions in 2018, the path towards a recovery seems to be well confirmed. Indeed, Chinese oil imports from Iran have dramatically increased again, and this trend is expected to continue. This may reinforce the tensions between the US and China. The Biden administration could see this rapprochement as a dangerous geostrategic alliance, especially if it becomes too great a hindrance to the defense of Washington's interests in its trade war with Beijing. Furthermore, this rapprochement could also prompt the US to quickly lift sanctions with Iran to reassert its role in the Middle East.

---

[18]Ramey (2016) suggests that Jorda's procedure imposes fewer restrictions on the impulse responses and does not estimate IRF based on nonlinear functions of the reduced-form parameters. However, both local projections and VAR still impose the recursiveness assumptions to identify the desired structural shocks. Therefore, it is natural to find similar impulse response patterns.

References

Abdel-Latif, H. and M. El-Gamal (2020). Financial liquidity, geopolitics, and oil prices. *Energy Economics 87*, 104482.

Alhajji, A. F. and D. Huettner (2000). OPEC and world crude oil markets from 1973 to 1994: cartel, oligopoly, or competitive? *The Energy Journal 21*(3), 31–60.

Barsky, R. B. and L. Kilian (2004). Oil and the macroeconomy since the 1970s. *Journal of Economic Perspectives 18*(4), 115–134.

Baumeister, C. and J. D. Hamilton (2019, May). Structural interpretation of vector autoregressions with incomplete identification: Revisiting the role of oil supply and demand shocks. *American Economic Review 109*(5), 1873–1910.

Baumeister, C. and L. Kilian (2016). Forty years of oil price fluctuations: Why the price of oil may still surprise us. *Journal of Economic Perspectives 30*(1), 139–60.

Baumeister, C. and G. Peersman (2013). The role of time-varying price elasticities in accounting for volatility changes in the crude oil market. *Journal of Applied Econometrics 28*(7), 1087–1109.

Bergholt, D., V. H. Larsen, and M. Seneca (2019). Business cycles in an oil economy. *Journal of International Money and Finance 96*, 283–303.

Bodenstein, M., L. Guerrieri, and L. Kilian (2012). Monetary policy responses to oil price fluctuations. *IMF Economic Review 60*(4), 470–504.

Bouoiyour, J., R. Selmi, S. Hammoudeh, and M. E. Wohar (2019). What are the categories of geopolitical risks that could drive oil prices higher? acts or threats? *Energy Economics 84*, 104523.

Brüggemann, R., C. Jentsch, and C. Trenkler (2016). Inference in VARs with conditional heteroskedasticity of unknown form. *Journal of Econometrics 191*(1), 69–85.

Caldara, D. and M. Iacoviello (2018). Measuring geopolitical risk. Technical report, Board of Governors of the Federal Reserve System (U.S.).

Caldara, D. and M. Iacoviello (2022). Measuring geopolitical risk. *American Economic Review 112*(4), 1194–1225.

Carlomagno, G. and E. Albagli (2022). Trade wars and asset prices. *Journal of International Money and Finance 124*, 102631.

Chen, H., H. Liao, B.-J. Tang, and Y.-M. Wei (2016). Impacts of OPEC's political risk on the international crude oil prices: An empirical analysis based on the SVAR models. *Energy Economics 57*, 42–49.

Choi, S., D. Furceri, P. Loungani, S. Mishra, and M. Poplawski-Ribeiro (2018). Oil prices and inflation dynamics: Evidence from advanced and developing economies. *Journal of International Money and Finance 82*, 71–96.

Chor, D. and B. Li (2021, October). Illuminating the Effects of the US-China Tariff War on China's Economy. NBER Working Papers 29349, National Bureau of Economic Research, Inc.

Coleman, L. (2012). Explaining crude oil prices using fundamental measures. *Energy Policy 40*, 318–324.

Cross, J. L., B. H. Nguyen, and T. D. Tran (2022). The role of precautionary and speculative demand in the global market for crude oil. *Journal of Applied Econometrics*, 1–14.

Du, Y., J. Ju, C. D. Ramirez, and X. Yao (2017). Bilateral trade and shocks in political relations: Evidence from China and some of its major trading partners, 1990–2013. *Journal of International Economics 108*, 211–225.

Dvir, E. and K. Rogoff (2014). Demand effects and speculation in oil markets: Theory and evidence. *Journal of International Money and Finance 42*, 113–128.

Hamilton, J. D. (2003). What is an oil shock? *Journal of Econometrics 113*(2), 363–398.

Hamilton, J. D. (2009). Causes and consequences of the oil shock of 2007-08. *Brookings Papers on Economic Activity 1*(Spring), 215–284.

Herwartz, H. and M. Plödt (2016). The macroeconomic effects of oil price shocks: Evidence from a statistical identification approach. *Journal of International Money and Finance 61*, 30–44.

Jordà, Ò. (2005). Estimation and inference of impulse responses by local projections. *American economic review 95*(1), 161–182.

Kilian, L. (2008). A comparison of the effects of exogenous oil supply shocks on output and inflation in the G7 countries. *Journal of the European Economic Association 6*(1), 78–121.

Kilian, L. (2009). Not all oil price shocks are alike: Disentangling demand and supply shocks in the crude oil market. *American Economic Review 99*(3), 1053–69.

Kilian, L. and B. Hicks (2013). Did unexpectedly strong economic growth cause the oil price shock of 2003–2008? *Journal of Forecasting 32*(5), 385–394.

Kilian, L. and T. K. Lee (2014). Quantifying the speculative component in the real price of oil: The role of global oil inventories. *Journal of International Money and Finance 42*, 71–87.

Kilian, L. and D. P. Murphy (2014). The role of inventories and speculative trading in the global market for crude oil. *Journal of Applied Econometrics 29*(3), 454–478.

Lee, C.-C., C.-C. Lee, and S.-L. Ning (2017). Dynamic relationship of oil price shocks and country risks. *Energy Economics 66*, 571–581.

Lippi, F. and A. Nobili (2012). Oil and the macroeconomy: a quantitative structural analysis. *Journal of the European Economic Association 10*(5), 1059–1083.

Lütkepohl, H. (1991). *Introduction to multiple time series analysis* (First ed.). Berlin: Springer.

Miao, H., S. Ramchander, T. Wang, and D. Yang (2017). Influential factors in crude oil price forecasting. *Energy Economics 68*, 77–88.

Montiel Olea, J. L. and M. Plagborg-Møller (2021). Local projection inference is simpler and more robust than you think. *Econometrica 89*(4), 1789–1823.

Morana, C. (2013). Oil price dynamics, macro-finance interactions and the role of financial speculation. *Journal of banking & finance 37*(1), 206–226.

Peersman, G. (2022). International food commodity prices and missing (dis) inflation in the euro area. *Review of Economics and Statistics 104*(1), 85–100.

Perifanis, T. and A. Dagoumas (2019). Living in an era when market fundamentals determine crude oil price. *The Energy Journal 40*(SI), 317–335.

Plagborg-Møller, M. and C. K. Wolf (2021). Local projections and VARs estimate the same impulse responses. *Econometrica 89*(2), 955–980.

Qin, Y., K. Hong, J. Chen, and Z. Zhang (2020). Asymmetric effects of geopolitical risks on energy returns and volatility under different market conditions. *Energy Economics 90*, 104851.

Ramey, V. A. (2016). Macroeconomic shocks and their propagation. *Handbook of macroeconomics 2*, 71–162.

Yan, X. and H. Qi (2009). Zhongwaiguanxidingliangyuce,[中外关系定量预测; quantitative forecasts of china's foreign relations]. *Shijieheshichubanshe, Beijing, China*.

Yan, X., Q. H. ZhuoFangyin, J. Xu, M. Zhaijiu, and Y. Liangzhu (2010). Zhongwaiguanxijianlan 1950–2005—zhongguoyudaguoguanxidinglianghengliang [中外关系鉴览1950–2005— 中国与大国关系定量衡量; china's foreign relations with major powers by the numbers 1950–2005]. *Gaodengjiaoyuchubanshe, Beijing, China*.

Appendix A. Supplementary materials

This section presents the details of supplementary materials about VAR stability, sub-sample estimates, and robustness checks.

VAR stability test

Since VAR stability significantly affects the empirical results, we do some stability checks by using the methodology of Lütkepohl (1991). The results reported in Figure A.1 show that the estimated VAR is stable as no unit root lies outside the unit root circle.

Figure A.1: Inverse roots of AR characteristic polynomial
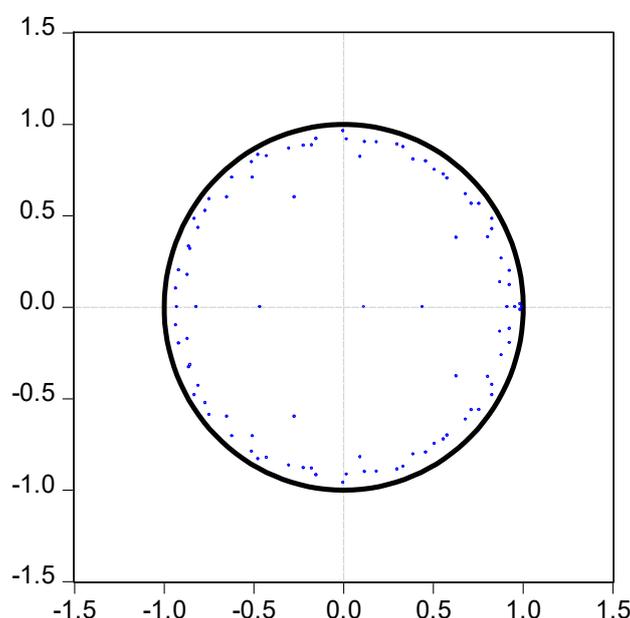
Note: The VAR is specified with 24 lags.

Sub-sample estimates

According to the results shown in the main text, we divide the whole sample into four sub-periods: recovery relationship period (January 1971-December 1988), fluctuating relationship period (January 1989-December 1999), common relationship period (January 2000-December 2010), and deteriorating relation period (January 2011-December 2019). The results are obtained under the same recursive identification scheme used in the baseline model. Due to the limited number of observations, we retain 12 lags. The results are available at Figures A.2, A.3, A.4, and A.5, respectively.

Figure A.2: Impulse responses in repaired relation: Effects of a 1% decrease in repaired relation
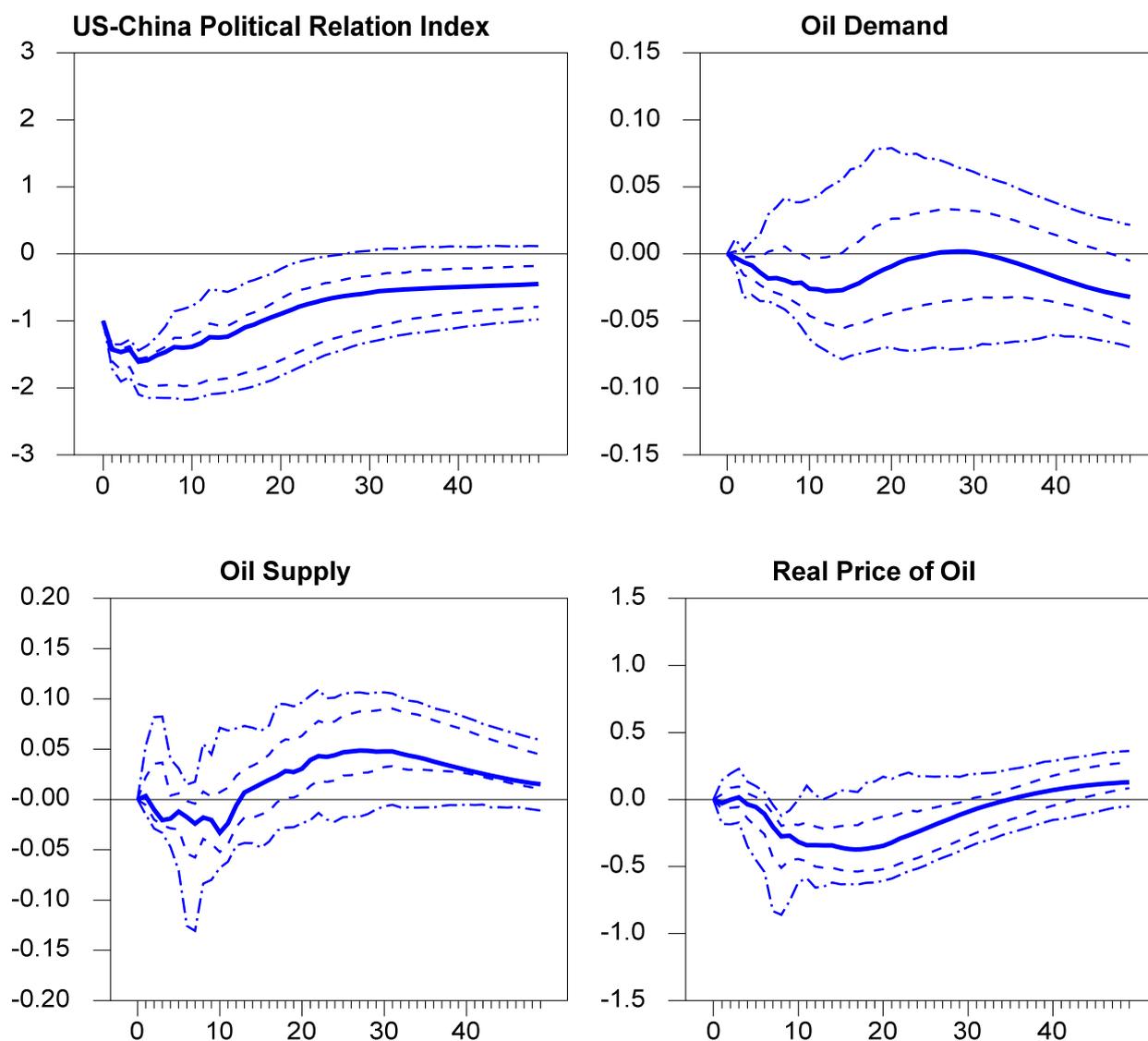
Figure A.3: Impulse responses in fluctuating relation: Effects of a 1% decrease in fluctuating relation
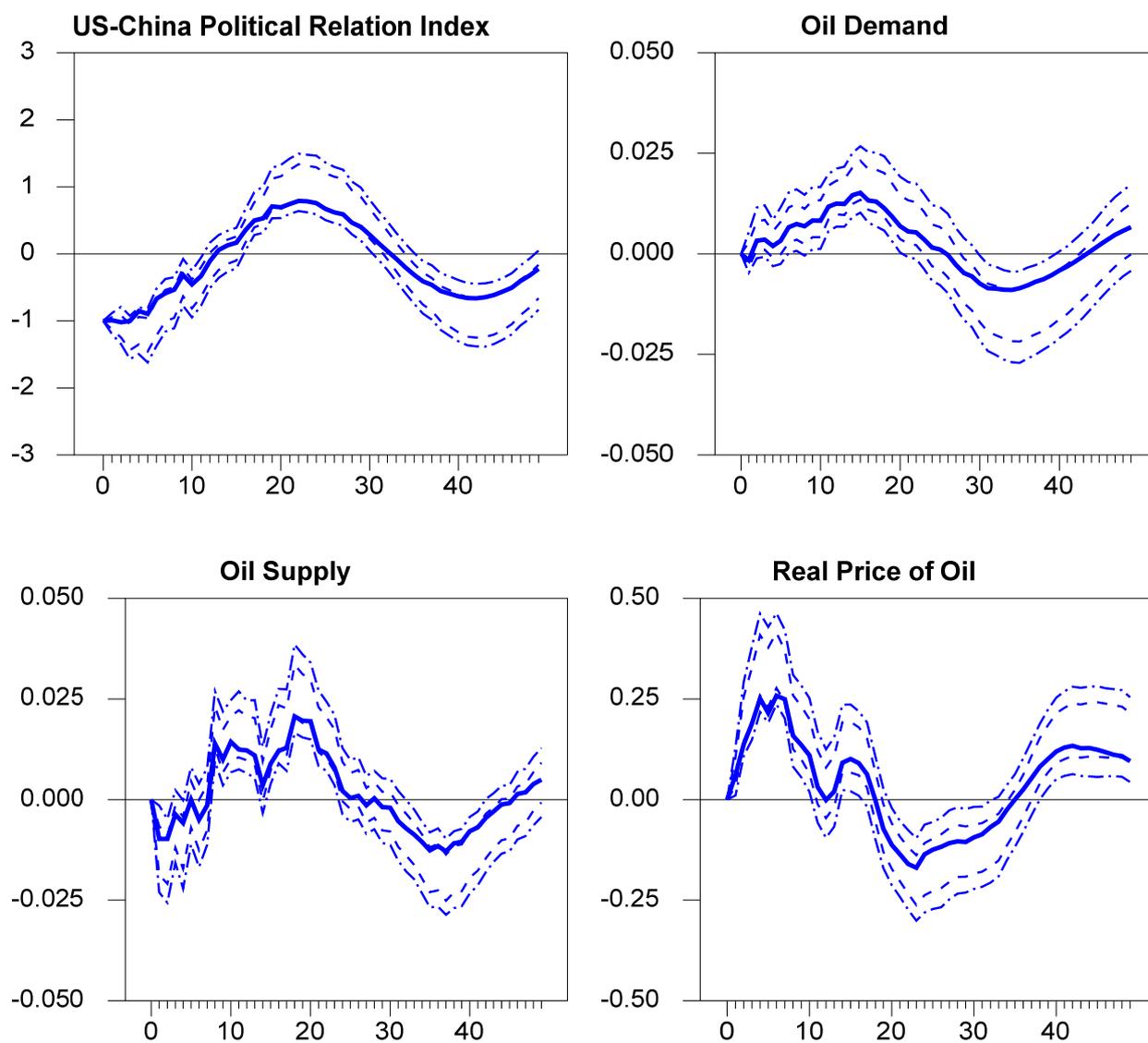

Note: The baseline SVAR model is estimated over the January 1989 to December 1999 period (variables expressed in logarithmic terms) and includes 12 lags. Impulse response horizons: 50 months. The dashed lines are 68% and 90% significance levels.

Figure A.4: Impulse responses in common relation: Effects of a 1% decrease in common relation
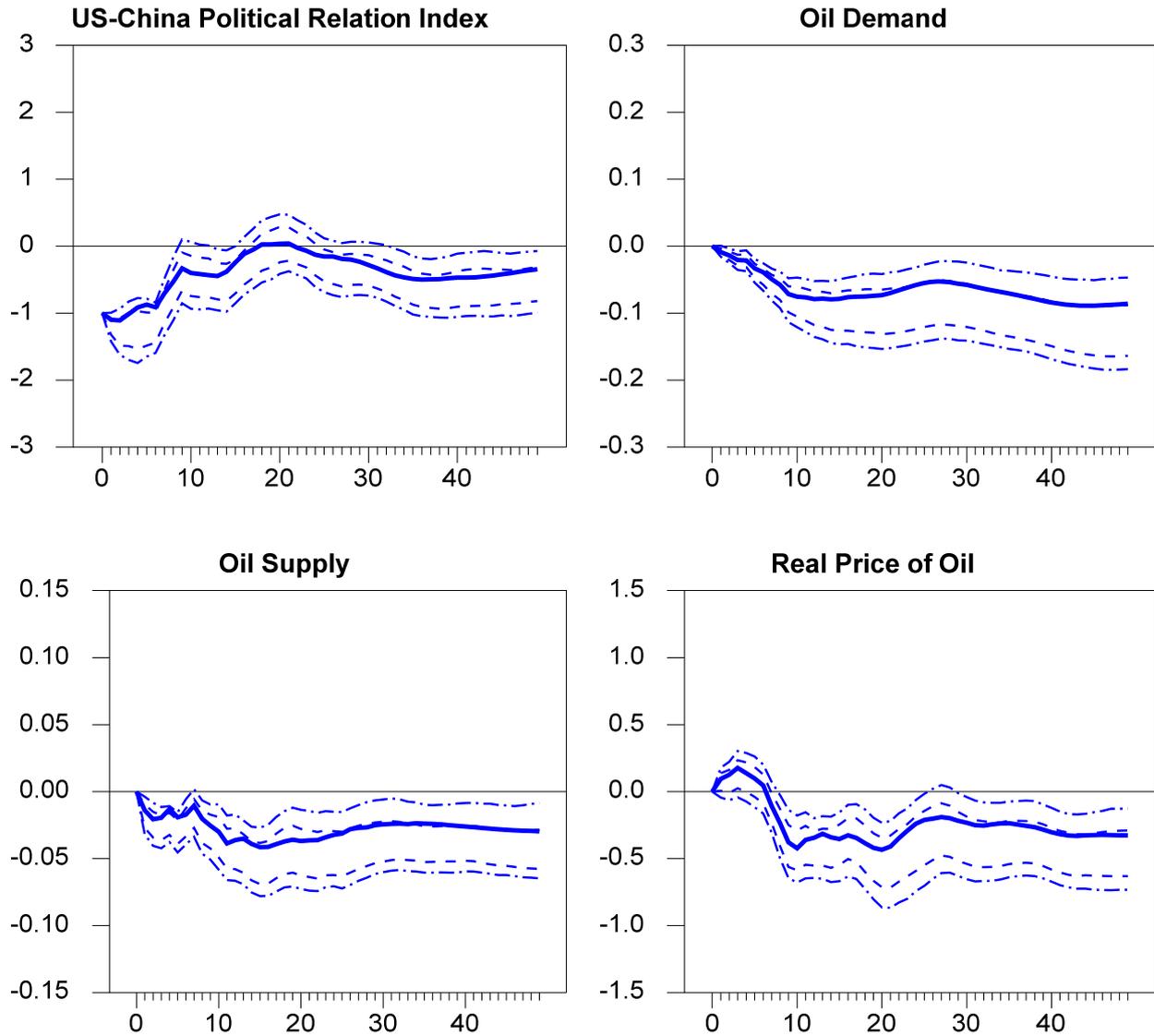
Note: The baseline SVAR model is estimated over the January 2000 to December 2010 period (variables expressed in logarithmic terms) and includes 12 lags. Impulse response horizons: 50 months. The dashed lines are 68% and 90% significance levels.

Figure A.5: Impulse responses in deteriorating relation: Effects of a 1% decrease in deteriorating relation
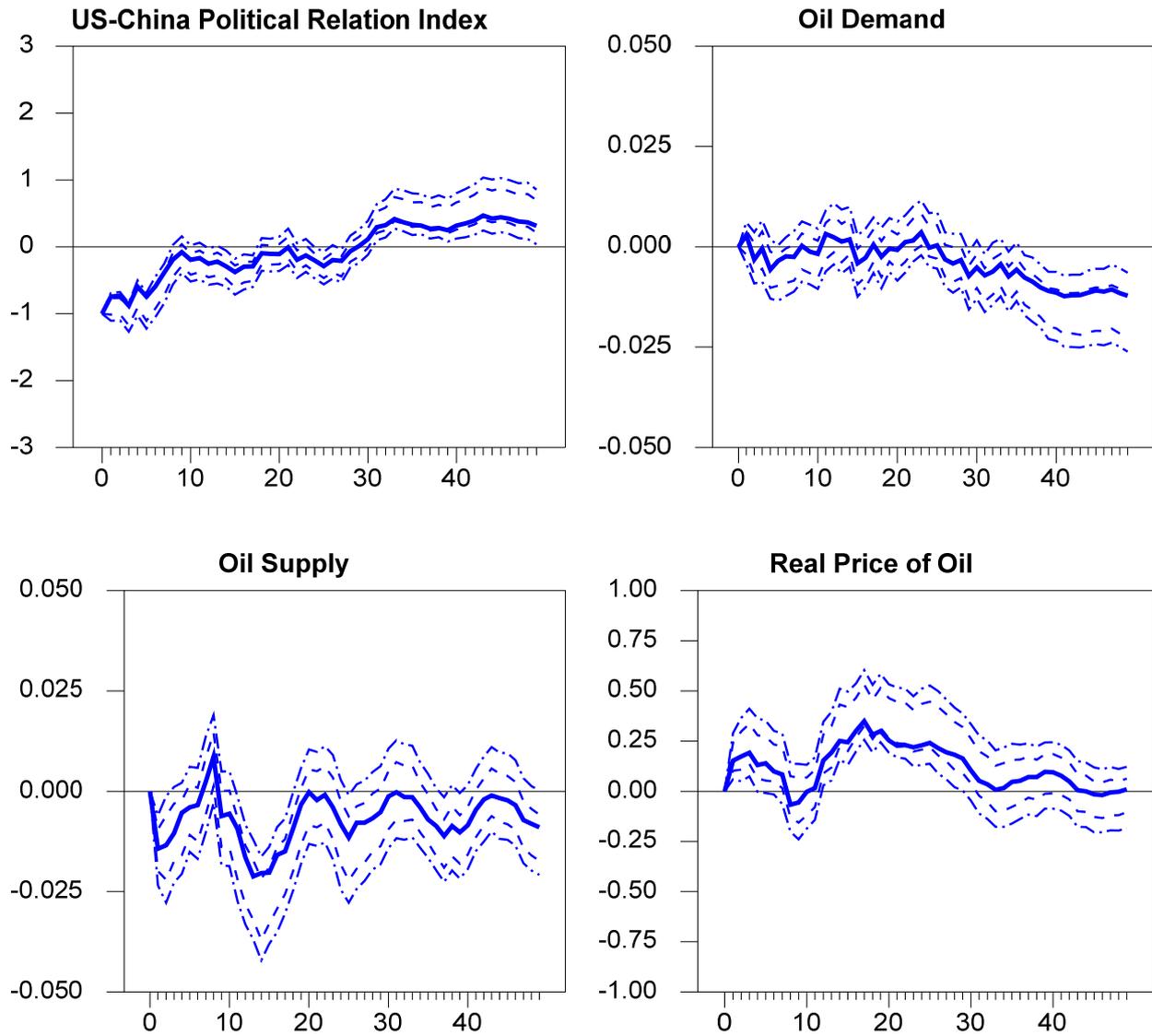
Note: The baseline SVAR model is estimated over the January 2011 to December 2019 period (variables expressed in logarithmic terms) and includes 12 lags. Impulse response horizons: 50 months. The dashed lines are 68% and 90% significance levels.

Robustness checks and sensitivity analysis

We check the robustness and sensitivity of the baseline results. First, we consider the robustness of alternative variable orderings under a recursive identification scheme. Second, we use another proxy for global oil demand, namely the world real economic activity index. Third, we utilize the local projections method proposed by Jordà (2005) to estimate the impulse response functions.

Variable ordering

As it is well-known, the baseline results of the VAR are sensitive to variable ordering under a recursive identification scheme. Figure 2 reports the impulse response functions by ordering US-China political relation index at first. This variable ordering indicates that the US-China political relation shock does not contemporaneously impact oil supply, however its impacts on oil demand and oil price take lags.

Figure A.6 displays the results when PRI is located at the second position, meaning that the identified PRI shock can contemporaneously affect oil demand and supply, whereas the reverse effects take time. Figure A.7 shows the impulse response results by ordering the US-China political relation at last in the SVAR model. This variable ordering illustrates that oil price shocks (supply, demand, and price) impact US-China political relations contemporaneously. However, the effects of the identified US-China political relation shocks take lags. Although this assumption is quite strict and unrealistic to some extent, the robustness checks are implemented to support that the US-China political relation shocks are exogenous in the VAR model. As shown, the results are similar to those displayed in Figure 2, illustrating the robustness of our findings to different orderings.

Alternative measure of global oil demand

In our baseline model, global oil demand is proxied by the world industrial production index developed by Baumeister and Hamilton (2019). Kilian (2009) proposed another proxy, namely the world real economic activity index. The IRFs results based on this proxy are reported in Figure A.8 and lead to similar conclusions.

Local projections

Figure A.9 shows the impulse responses of local projections with the baseline empirical specifications. The blue lines are baseline estimates, and the red lines denote local projections' results. The identification strategy used in the local projections method is also recursive. 24 lags are included, and impulse response horizons are determined as 80.

Figure A.6: Robustness against variable ordering: Locating US-China political relation at the second position
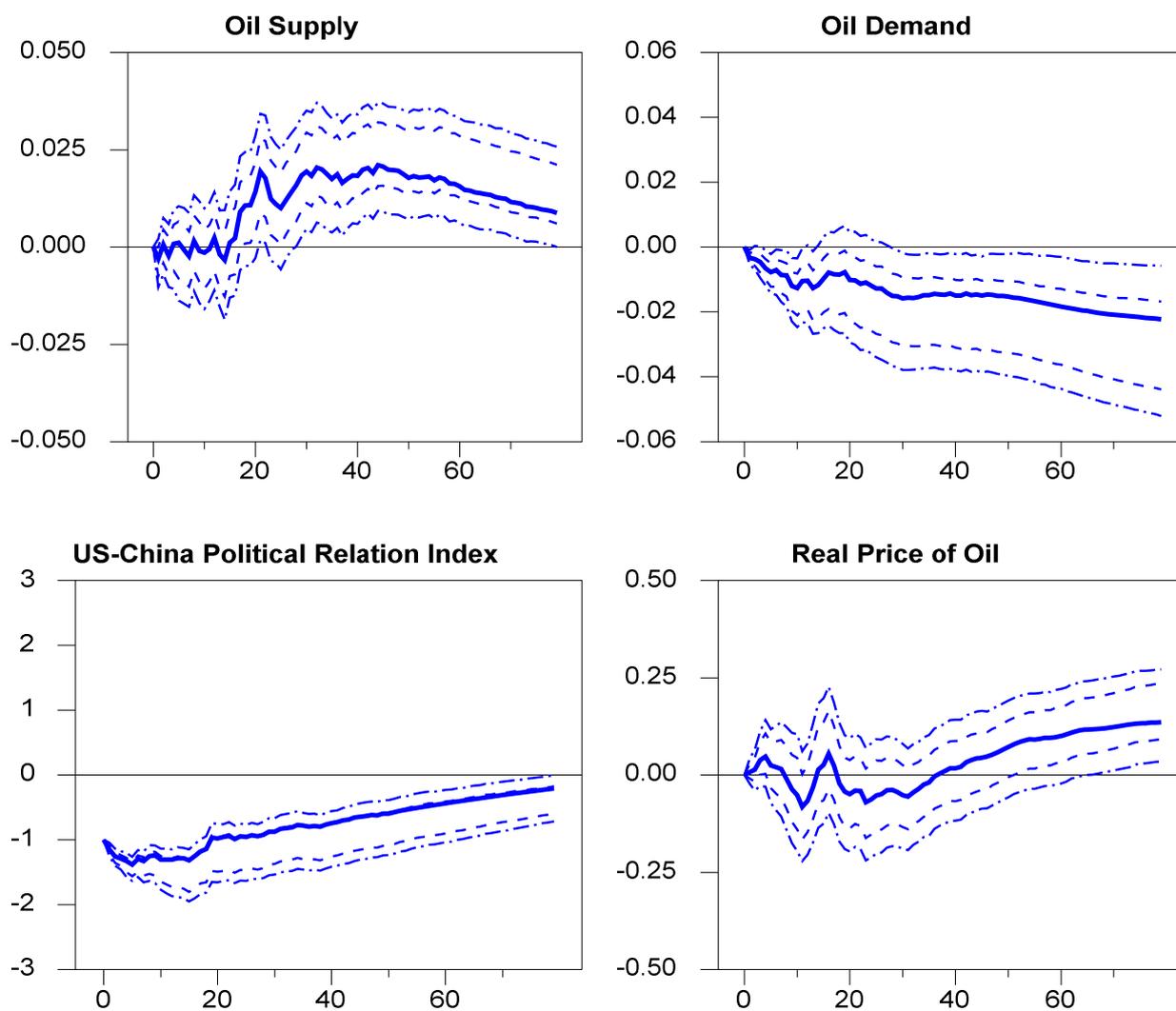

Note: The baseline SVAR model is estimated over the period from January 1971 to December 2019. It is specified as $y_t = [pro_t, dem_t, rpo_t, pri_t]'$ (variables expressed in logarithmic terms) and includes 24 lags. Impulse response horizons: 80 months. The shock is explained by a 1% decrease in $\log(pri_t + \sqrt{1 + pri_t^2})$. The dashed lines are 68% and 90% significance levels.

Figure A.7: Robustness against variable ordering: Locating US-China political relation at the last position
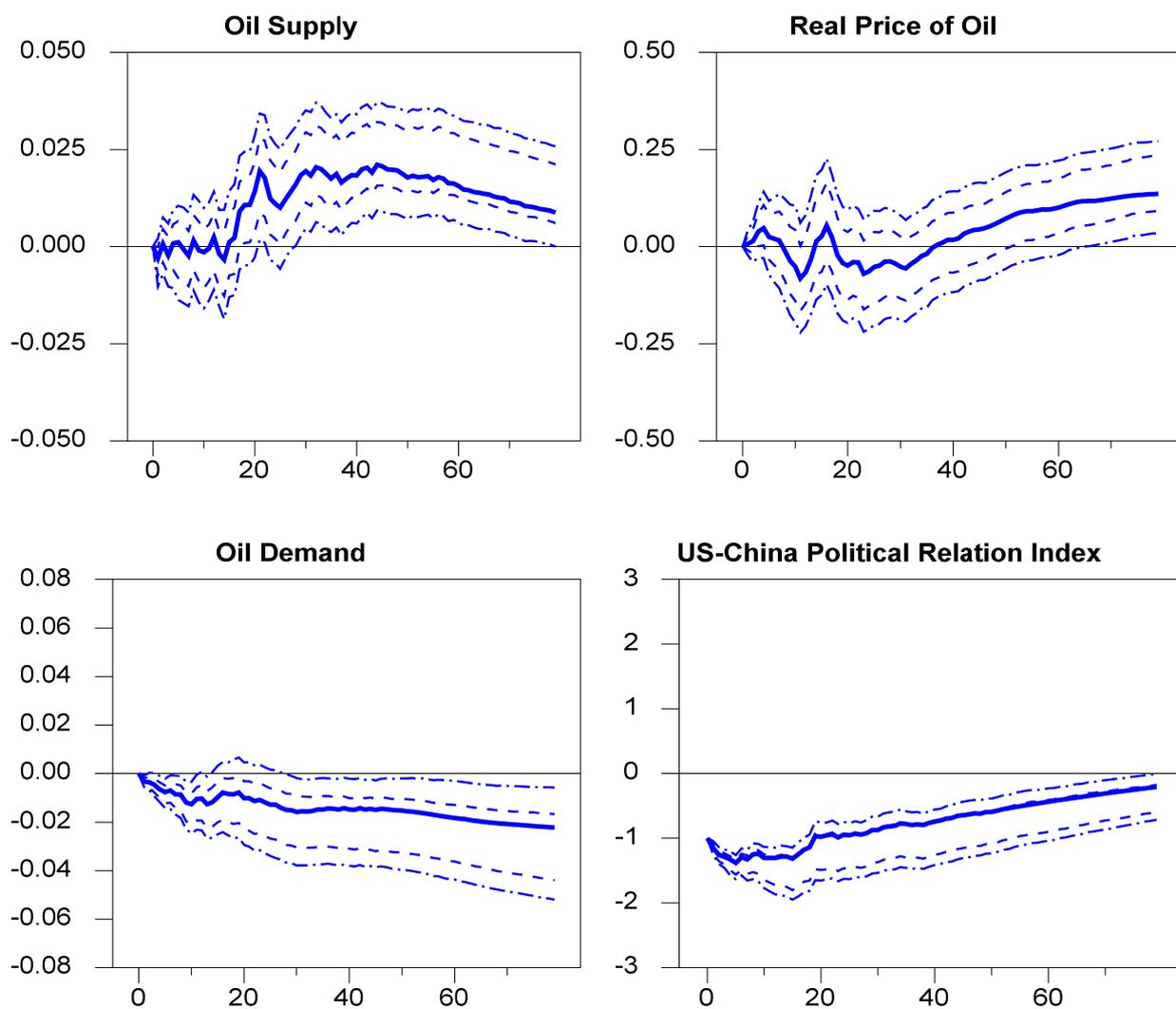
Note: The baseline SVAR model is estimated over the period from January 1971 to December 2019. It is specified as $y_t = [pro_t, dem_t, rpo_t, pri_t]'$ (variables expressed in logarithmic terms) and includes 24 lags. Impulse response horizons: 80 months. The shock is explained by a 1% decrease in $\log(pri_t + \sqrt{1 + pri_t^2})$. The dashed lines are 68% and 90% significance levels.

Figure A.8: Robustness against the proxy for world oil demand
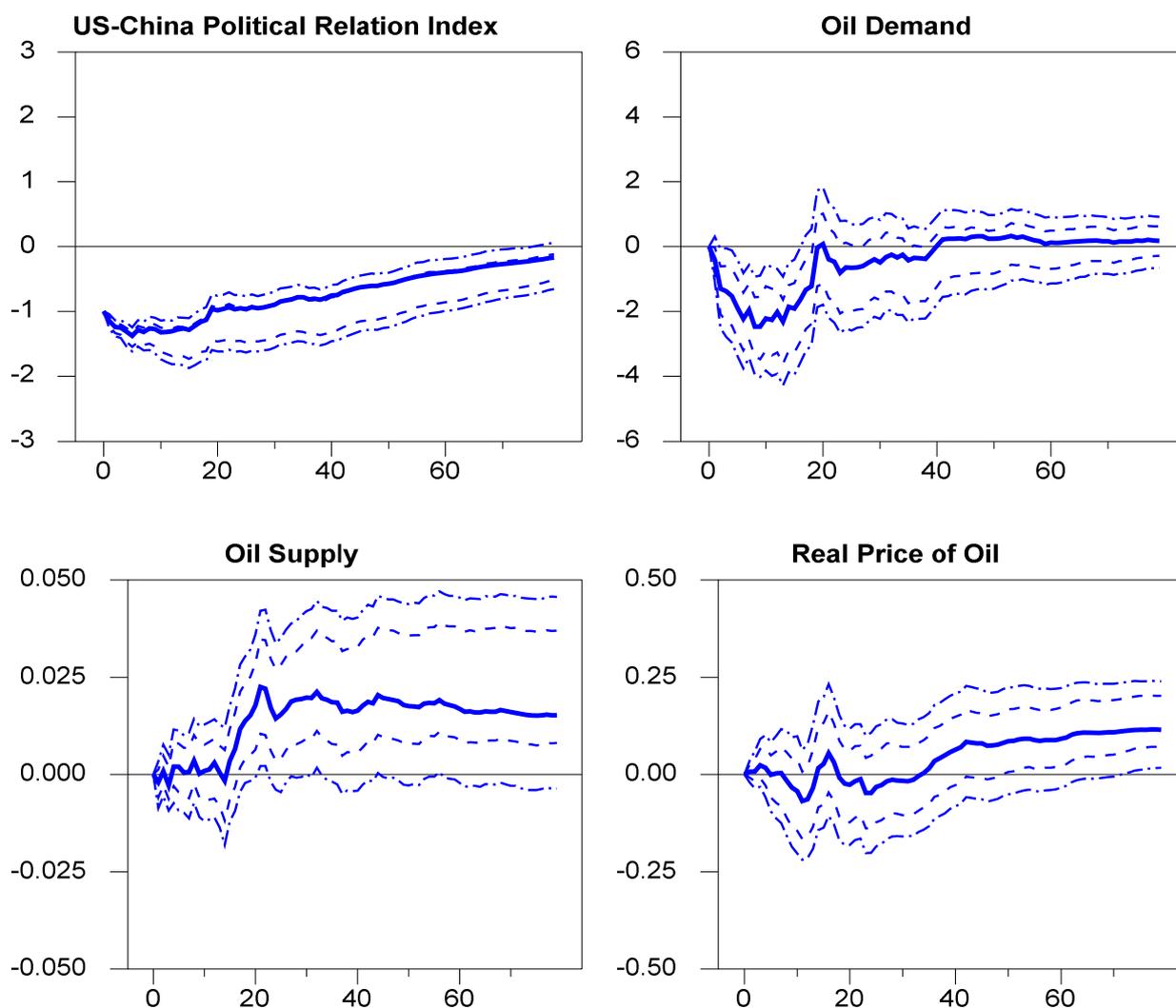
Figure A.9: Local projections impulse responses
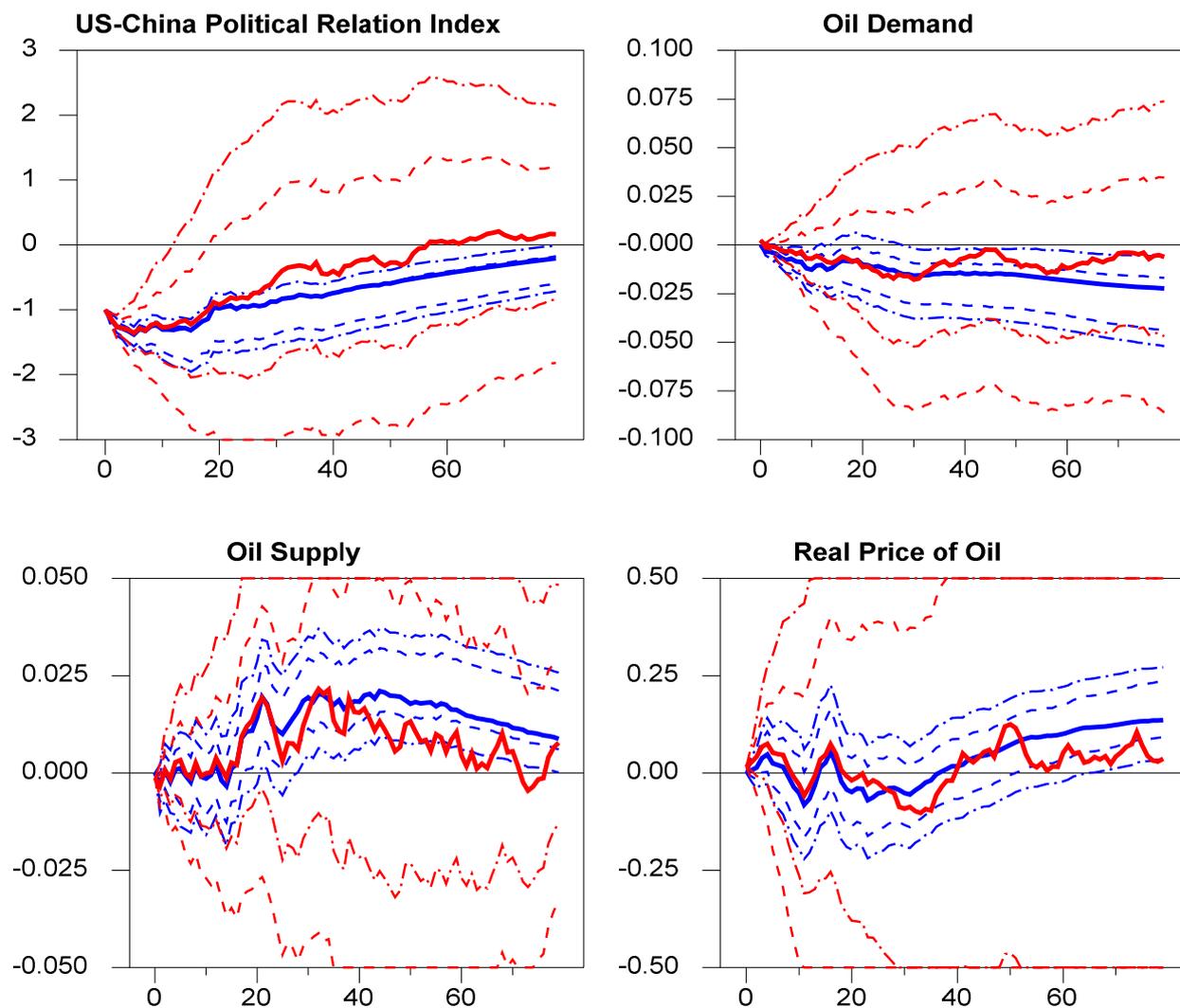
Note: The estimated model covers the period from January 1971 to December 2019, and includes 24 lags. Impulse response horizon: 80 months. The shock is explained by a 1% decrease in $\log(pri_t + \sqrt{1 + pri_t^2})$. The dashed lines are 68% and 90% significance levels