Oil, Uncertainty, and the Stock Market: How Geopolitical Risk Shapes an Oil-Dependent Economy

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ABSTRACT

Purpose
This study examines the macroeconomic and financial effects of geopolitical risk in Oman. Oman is an oil-dependent economy facing ongoing regional instability. The study explores dynamic links among geopolitical risk, private investment, household savings, and stock market performance.

Methodology
Monthly data from 2004 to 2023 are used for the Geopolitical Risk Index, gross fixed capital formation, private sector deposits, and the Muscat Securities Market index (MSX30). A Vector Autoregressive (VAR) framework captures endogenous interactions and feedback. Unit root tests confirm stationarity. The analysis uses impulse response functions, forecast-error variance decompositions, Granger causality, and CUSUM tests to assess shock transmission, causal links, and model stability.

Findings
Geopolitical risk strongly affects financial variables. Over time, it has a growing impact on private deposits and stock market fluctuations. There is bidirectional causality between savings and equity market performance. This suggests increased precautionary behavior and greater financial sensitivity during periods of uncertainty. Gross fixed capital formation, however, responds little to short-term geopolitical shocks. This implies investment decisions mainly depend on structural and macroeconomic factors.

Conclusion
The findings show that geopolitical risk in Oman mainly acts through financial and behavioral channels. There is little evidence of an immediate decline in investment. This highlights the importance of financial resilience and savings-based stabilization in resource-dependent economies.

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1. Introduction

Geopolitical risk (GPR) refers to the potential negative impacts of political or security-related events, such as armed conflict, diplomatic hostility, terrorism, or state-imposed sanctions, on economic stability, which can lead to economic discomfort and financial instability. Through mechanisms that affect investor sentiment, exchange rates, energy prices, and capital flows, GPR has the potential to generate systemic disturbances with macroeconomic consequences that may, on occasion, surpass or be comparable to those associated with previous economic shocks (Caldara & Iacoviello, 2022; Ji, 2025). Geopolitical risk (GPR) has become an important factor of macroeconomic and financial uncertainty in the global economy. Heightened geopolitical tensions stemming from armed conflicts, diplomatic disputes, terrorism, and regional instability have increasingly influenced economic decision-making, financial market behavior, and capital allocation (Caldara & Iacoviello, 2022). Geopolitical risk poses an even more profound challenge for oil-dependent economies, affecting energy markets and fiscal revenues, investor confidence, and overall economic stability.

Oil-exporting economies, by virtue of their high dependence on hydrocarbon revenues, vulnerability to fluctuations in the world energy markets, and sensitivity to regional political developments (Hamilton, 2011; Apergis & Payne, 2014). Fluctuations in oil prices driven by geopolitical factors are often quickly transmitted to domestic financial markets, private investment decisions, and household behavior. In such environments, increased uncertainty may lead to precautionary savings, delay private capital formation, and increase stock market volatility (Bloom, 2009; Aisen & Veiga, 2013). Understanding these transmission mechanisms is therefore essential for designing policies that enhance economic resilience. Against this backdrop, Oman makes a compelling case for studying the economic and financial implications of geopolitical risk. As a small, open oil-dependent economy situated in a geopolitically sensitive region, Oman is vulnerable to both global and regional political risks. Despite continued efforts to diversify the economy and develop the financial sector, the Omani economy remains closely tied to the oil market and to external shocks (IMF, 2023). These features make Oman an enjoyable and policy-relevant environment for analyzing the effects of geopolitical risk on investment behavior, household saving, and stock market performance.

Fiscal stabilization mechanisms are most effectively applied in regimes characterized by significant resource extraction, where commodity market fluctuations primarily determine fiscal flexibility. In Oman, more than 60% of state revenues come from oil and gas, a significant share of the gross domestic product. The country's maritime borders with Iran, a regional player with frequently hostile relations with various Western governments, present multifaceted geopolitical risks. These various security dynamics have direct and indirect impacts on the Omani economy (Al Jazeera, 2023; Reuters, 2023). The current literature is extensive on uncertainty and economic activity, with particular focus on geopolitical risk and its impact on macroeconomic and financial market outcomes. Previous research shows that high geopolitical risk tends to weigh on investment, change consumption and savings behavior, and raise stock market volatility (Pastor & Veronesi, 2013; Bekaert et al., 2014). However, much of the empirical evidence focuses on advanced economies or larger emerging markets, while relatively little attention is paid to smaller oil-dependent economies in the Gulf region. Moreover, many studies investigate these channels individually rather than in an integrated framework that reflects their dynamic interdependence.

Fiscal stabilization mechanisms are most effectively applied in regimes characterized by significant resource extraction, where commodity market fluctuations primarily determine fiscal flexibility. In Oman, more than sixty per cent of state revenues come from oil and gas, a significant portion of the gross domestic product. The country's maritime borders with Iran, a regional player with frequently hostile relations with various Western governments, present multifaceted geopolitical risks. These various security dynamics have direct and indirect impacts on the Omani economy (World Bank, 2023).

This study aims to fill these gaps by conducting a comprehensive analysis of the influence of geopolitical risk on private capital formation, household savings, and stock market behavior in Oman. By jointly analyzing key economic and financial variables, the paper provides a more comprehensive understanding of how geopolitical uncertainty propagates in an oil-based economy. Unlike previous studies, which are based mainly on cross-country panels, the present research adopts a country-specific time-series approach, thereby enabling a detailed discussion of the peculiarities of Oman's economic structure and institutional setup.

This study employs a vector autoregressive (VAR) model to examine the dynamic interactions among geopolitical risk, investment, savings, and stock market performance. The VAR approach facilitates the analysis of impulse responses, variance decompositions, and causal linkages, thereby providing insights into the short-term and dynamic effects of geopolitical shocks (Sims, 1980; Lütkepohl, 2005). The VAR framework is particularly appropriate in this context because it endogenizes all variables and accounts for feedback effects through economic and financial channels.

The contributions of this study are threefold. First, it extends the existing geopolitical risk literature by providing new evidence from an understudied oil-rich economy. Second, it provides an integrated analysis of household behavior, private investment, and stock market dynamics under geopolitical uncertainty. Third, the policy-relevant insights into strong financial stability and economic resilience amid persistent geopolitical risks.

The rest of the paper is organized as follows. Section 2 examines the related literature and presents the theoretical framework. The description of the data and econometric methodology is provided in Section 3. Section 4 presents empirical results, and Section 5 discusses the study's findings and policy implications. Section 6 concludes the study.

2. Literature Review

The economics of geopolitical risk synthesizes concepts from theories of uncertainty in macroeconomics, decision theory, and behavioral economics. The Protection Motivation Theory (PMT) describes the threat appraisals, including severity and vulnerability. It consists of self-generative efficacy and response efficacy, which are directly associated with adaptive financial behaviors, such as prudent spending, during times of geopolitical turbulence. Similarly, Kahneman and Tversky (1979) developed Prospect Theory to explain why potential losses are weighted more heavily than equivalent gains and why risk-averse behavior predominates in high-stakes environments. Prospect Theory emphasizes the roles of loss aversion and reference dependence in investment and consumption decisions under risk.

Complementing these approaches, Real Options Theory holds that, in uncertain settings like those faced by Oman, where geopolitical and oil market uncertainties prevail, firms

should delay irreversible commitments to optimize outcomes. Standard consumer theory falls short in fully capturing household reactions to geopolitical shocks, as the Permanent Income Hypothesis (PIH) generalizations do not account for all observed responses. Together, these theoretical frameworks provide a comprehensive model of household, firm, and cross-market dynamics, explaining how geopolitical risk—particularly in resource-dependent nations—affects economic actors and market interactions. Geopolitical shocks significantly affect capital markets, especially in frontier economies such as Oman. Microstructure theory indicates that during periods of heightened risk, information asymmetry increases, liquidity declines, and the bid-ask spread widens, resulting in market inefficiency (Kyle & Obizhaeva, 2016).

One of the main ways geopolitical shocks manifest is through volatility spillover, particularly in the inter-regional nexus of the Middle East and North Africa. When geopolitical disturbances affect a particular nation, the uncertainty generated is likely to be transmitted to relevant equity markets, further intensifying regional financial instability. Major geopolitical events, such as armed conflicts and regional crises, lead to high volatility in MENA financial markets (Gharaibeh & Kharabsheh, 2023).

Strengthening financial integration and enhancing risk management are vital for Oman and its neighbors to contain contagion from volatility spillovers. Stock market indices often respond sharply to significant geopolitical events, as seen during the 2017 Qatar diplomatic crisis. The relationship between geopolitical risks and stock markets is most evident in energy-exporting countries, where economic frameworks are relatively weak and financial diversification is limited, as in the Omani economy. When shocks arising from geopolitical imbalances materialize, structural fragilities, coupled with behavioral biases, amplify market volatility and erode investor confidence (Nam, 2021).

Recent research often treats the Gulf Cooperation Council (GCC) as a homogeneous bloc, ignoring Oman’s geographic context and focusing mainly on geopolitical risks and their effects at the regional or global level (Caldara, 2022; Gharaibeh, 2023; Nasouri, 2025). The complexity of this relationship is intensified by fiscal uncertainties, investor behavior, and geopolitical volatility within Oman's unique institutional and economic context. Consequently, integrated empirical frameworks are not suitable for representing the interactions among capital market dynamics, institutional and fiscal risks, and investor responses to geopolitical uncertainty in Oman. This imbalance is especially problematic given Oman's market position, which is highly dependent on oil price fluctuations and geopolitical tensions (IMF, 2024). The lack of sophisticated predictive models hinders policymakers' capacity to formulate targeted risk-mitigation strategies and, accordingly, impedes a broader understanding of how geopolitical shocks are transmitted to financial markets and the broader economy in Oman. A substantive lacuna in the existing scholarship could be bridged by developing a multidimensional, empirical framework (anchored in the Omani context) that provides actionable recommendations for boosting economic resilience to regional volatility while also generating deeper insights into the country's vulnerabilities. This endeavor is particularly relevant as Oman transitions from a hydrocarbon-dependent economy, necessitating the balancing of budgetary pressures amid converging global inflationary trends, climate change imperatives, and changing geopolitical dynamics. An evidence-based framework would give policymakers greater room to anticipate and respond to external shocks, foster confidence and discipline among investors and fiscal authorities, and ultimately promote greater macroeconomic stability in a diverse, fast-evolving regional context (Caldara, 2022).

Real Options Theory asserts that heightened geopolitical risk increases uncertainty, prompting enterprises to postpone or reduce irreversible investments (Dixit & Pindyck 1994; Bloom et al. 2022). In Oman, where public and private fiscal expenditures are closely tied to oil revenues and regional stability, rising geopolitical risk is likely to lead to a significant decline in fixed capital formation, resulting in strategic delays and investor reticence.

H_1: Geopolitical risk has a significant effect on Oman's fixed capital investment.

H_2: A significant impact of Geopolitical Risk on Private Sector Saving.

Empirical studies on precautionary behavior support the Permanent Income Hypothesis (PIH) in uncertain contexts, indicating that households increase precautionary savings as uncertainty rises. Within the Omani context, geopolitical uncertainty. In Oman, geopolitical uncertainty is expected to delay consumption due to the absence of social safety nets and significant income fluctuations resulting from variations in oil exports. Studies by Kyle and Obizhaeva (2016) and Cai et al. (2023) suggest that geopolitical risk increases information asymmetry and risk premiums, thereby reducing market liquidity and heightening volatility. The relatively small size of the markets and an overreliance on oil equities make frontier markets, such as the Omani MSM-30, especially vulnerable to external shocks.

H_3: The Oman stock market serves as a transmission channel for external shocks.

The literature on volatility spillover in MENA markets indicates that Oman's financial markets are interconnected with those of the United Arab Emirates, leading to volatility in the latter spilling over into Oman. Due to relatively low trading volumes and heightened sensitivity to regional volatility, Oman's capital market functions more as a conduit for external geopolitical shocks than as an absorber of regional volatility (Elsayed & Helmi, 2019; Gharaibeh & Kharabsheh, 2023).

3. Methodology

This section outlines the methods used to examine the impact of geopolitical risk on Oman's economy, behavior, and financial markets. The objective is to assess how such risk influences these areas using an integrated econometric approach that combines time-series modeling and volatility forecasting to capture the dynamic nature of economic decisions and market responses. This approach addresses the research questions from earlier chapters. Further details the methodological approach for assessing the effects of Government Procurement Reform on economic behavior and financial market responses. The primary objective is to evaluate the influence of geopolitical risk on key economic variables, including capital markets, investment, and savings. The study employs an integrated econometric framework to capture the evolving nature of economic decisions and market reactions, combining time-series modeling with volatility forecasting to address the research questions presented in earlier chapters.

4. Results and Discussions

4.1. Data Description and Sources

Monthly data from 2004 to 2023 were collected to examine the time-series dynamics of economic variables and market performance across different levels of geopolitical risk. Indices and monetary variables were log-transformed when suitable, and percentage changes were computed to achieve stationarity and reduce heteroscedasticity.

Table.1.Variable Description

Variable	Notation	Description	Source
Geopolitical Risk	GPR	Regional/Global issues	Caldara & Iacoviello
Muscat Securities	MSX30	Stock index	Muscat Stock Exchange
Gross Fixed Capital Formation	GCF	Gross fixed capital formation	Oman's Ministry of Economy
Private Deposits	PD	Private sector's bank deposits	Central Bank of Oman

Source: Author's own elaboration

This study incorporates three theoretical frameworks to examine the impact of geopolitical risk on Oman's economic situation: the Black Swan Theory (Taleb, 2007), the transmission of macroeconomic shocks under geopolitical risk, and models of political uncertainty (Baur & Smales, 2019; Smales, 2021).

Building on these frameworks, it is important to consider how geopolitical risk is typically treated as an exogenous shock arising from events such as armed conflict, terrorism, or sanctions. Although exogenous in origin, the ramifications of geopolitical risk are often endogenous, producing significant responses across national economies (Ji, 2025). Three primary channels of transmission have been identified. First, investment decisions: in politically unstable environments, firms tend to delay or reduce capital expenditures. Second, household behavior: increased uncertainty prompts households to increase savings and reduce consumption (Baur & Smales, 2019). Third, in capital markets, geopolitical risk heightens asset volatility, increases capital outflows, and reduces liquidity (Ji, 2025; Smales, 2021).

4.2. Unit Root Test

Regression analysis of non-stationary data frequently yields spurious associations, as evidenced by inflated goodness-of-fit statistics and unreliable hypothesis test results.

The Augmented Dickey-Fuller (ADF) test (Dickey & Fuller, 1979) was employed to test the null of stationarity against the alternative of a unit root for each time series. Lag length selection was guided by the Akaike Information Criterion (AIC) and the Schwarz Bayesian Criterion (SBC) to ensure adequate capture of autocorrelation. Variables identified as non-stationary at their original levels were differenced iteratively until the transformed series satisfied the stationarity condition.

4.3. Variance Decomposition

Variance decomposition serves as a fundamental methodological tool in vector autoregressive (VAR) analysis. It quantifies the proportion of forecast-error variance attributable to shocks affecting each endogenous variable in the system, including each variable's contemporaneous shock. This method facilitates the evaluation of the relative importance and dynamic influence of various innovations on the variance of each variable across multiple forecast horizons.

Variance decomposition, also known as Forecast Error Variance Decomposition (FEVD), partitions the forecast error variance of a variable into components attributable to innovations in each variable in the system. It quantifies the extent to which forecast errors for a specific variable can be attributed to shocks in other variables over a defined forecast horizon.

$$FEVD_{i,k}(h) = \frac{\sum_{j=0}^{h-1}([\theta_j]_{ik})^2}{\sum_{j=0}^{h-1}[\theta_j\,\theta_j']_{ii}} \quad (1)$$

Numerator is defined as the sum of the squared responses of a variable, impulse.
The denominator represents the cumulative forecast error related to the variable "i" over the horizon represented by "h" (Law, 2024).

Table.2. Unit Root Test

Variables	ADF l(0)		ADF l(I)		PP l(0)		PP l(l)		Lags	Output
	t-stats	p-value	t-stats	p-value	t-stats	p-value	t-stats	p-value		
GPR	-4.432*	0.003	-14.766	0.001	-4.201*	0.001	-21.25	0.000	4	l (0)
MSX30	-1.762	0.297	-10.49*	0.000	-1.542	0.328	-11.631*	0.000	4	l (1)
GCF	-11.382*	0.001	-8.477	0.001	-13.321*	0.001	53.252	0.000	4	l (0)
PD	-7.345*	0.001	-10.034	0.001	-7.821*	0.000	-75.41	0.001	4	l(0)

Note: Lag Selection based on SIC
(*) significance at 5% level
P values presented in parentheses

Source: Author's own elaboration

The results of the I(0) stationarity test indicate that the Geopolitical Risk Index is non-stationary. However, it satisfies conventional criteria for stationarity. Therefore, the index is considered to exhibit no clear trend over the study period and is classified as a mean-reverting process.

4.4. Results for Variance Decomposition

Table.3. Results for Variance Decomposition

Period	S.E.	GPR	D_MSX30	GCF	PD
GPR					
1	0.18	100.00	0.00	0.00	0.00
2	0.21	94.99	0.21	2.95	1.01
3	0.24	91.03	0.23	7.17	0.89
4	0.25	89.17	0.21	9.08	0.90
5	0.26	88.02	0.21	10.27	0.89
6	0.26	87.40	0.21	10.89	0.90
7	0.27	87.02	0.20	11.28	0.89
8	0.27	86.79	0.20	11.52	0.90
9	0.27	86.64	0.20	11.67	0.90
10	0.27	86.55	0.20	11.77	0.90
D_MSX30					
1	0.049	1.674	98.146	0.000	0.000
2	0.050	1.697	94.137	0.007	3.870
3	0.052	3.921	91.203	0.111	4.484
4	0.052	3.939	91.116	0.157	4.487
5	0.053	3.959	91.049	0.195	4.481
6	0.053	3.966	91.036	0.196	4.485

Period	S.E.	GPR	D_MSX30	GCF	PD
7	0.053	3.990	91.009	0.200	4.484
8	0.053	3.992	91.004	0.202	4.484
9	0.053	3.997	90.997	0.204	4.484
10	0.053	3.999	90.994	0.205	4.484
GCF					
1	1.000	0.340	0.256	91.315	0.000
2	1.028	4.598	0.494	86.512	0.012
3	1.033	4.906	0.534	86.186	0.066
4	1.034	4.944	0.537	86.082	0.066
5	1.034	5.015	0.540	85.981	0.101
6	1.034	5.015	0.543	85.971	0.108
7	1.035	5.024	0.543	85.948	0.123
8	1.035	5.025	0.544	85.938	0.132
9	1.035	5.028	0.545	85.924	0.144
10	1.035	5.029	0.545	85.914	0.154
PD					
1	0.046	1.294	1.682	0.370	96.625
2	0.055	5.519	4.345	0.948	89.016
3	0.064	4.155	3.844	0.732	91.033
4	0.070	3.509	4.237	0.664	91.393
5	0.076	3.144	4.232	0.711	91.717
6	0.081	2.874	4.330	0.774	91.844
7	0.085	2.795	4.364	0.887	91.785
8	0.089	2.765	4.412	1.000	91.663
9	0.093	2.811	4.441	1.127	91.470
10	0.096	2.881	4.468	1.249	91.257

Source: Author's own elaboration

An examination of the Muscat Securities Market Index (MSX30) indicates that its substantial historical variance (98.1461%) empirically supports the primary argument that market dynamics are primarily shaped by past performance. Additionally, temporal analysis reveals an upward trend in the contributions of GPR and PD, indicating that both external and internal economic determinants are gaining influence. Notably, the increased importance of PD signals more efficient capital use and investment patterns, highlighting the evolving interdependence among local financial markets (Lestari et al., 2022).

Analysis of Gross Fixed Capital Formation (GFCF) indicates that 91.32 percent of its fluctuations are explained by prior periods, strongly supporting the main claim that Oman's investment decisions rely heavily on historical data.

4.5. CUSUM Test Results

The CUSUM (Cumulative Sum) test assesses the stationarity of model parameters over time. In the results above, the blue line shows the cumulative sum of recursive residuals. If this blue line remains between the two red lines, it indicates model stability over the tested periods.

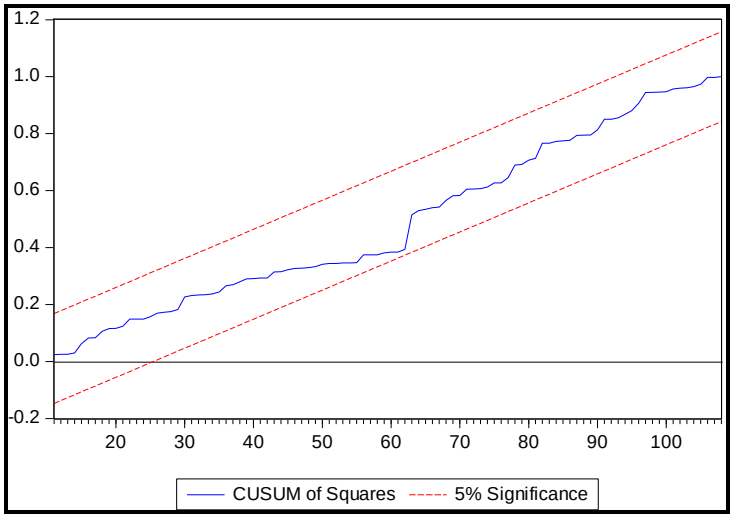

Figure.1.CUSUM of Squares
Source: Author's own elaboration

Furthermore, the presence of temporal variability in the analyzed economic growth rate is consistent with the hypothesis proposed by Ali et al. (2022), which asserts that stability is a prerequisite for ensuring model symmetry in accordance with econometric principles. This stability is necessary to enable credible interpretation of parameter estimates (Ali et al., 2022). This concern is particularly significant for policy-making, as unstable models may yield ineffective or counterproductive strategies, thereby undermining intervention efforts (Chakraborty & Maitra, 2021).

4.6. Results of Granger Causality

Table.4.Granger Causality

Dependent Variable	Variable	Chi-Square	df	p-value
GPR	MSX30	8.633	2	0.0117
	PD	6.283	2	0.0311
	GCF	7.852	2	0.0178
	All	18.933	8	0.0152
MSX30	GPR	0.730	2	0.6943
	PD	8.395	2	0.015
	GCF	0.002	2	0.999
	All	10.524	8	0.2301
PD	GPR	13.460	2	0.0012
	MSX30	3.433	2	0.1797
	GCF	0.519	2	0.7715
	All	18.343	8	0.0188
GCF	GPR	4.215	2	0.1216
	MSX30	0.295	2	0.863
	PD	0.263	2	0.8769
	All	6.161	8	0.6292

Source: Author's own elaboration

The Granger causality analysis shows a clear relationship among the Security Market Index, Private Deposits, Gross Fixed Capital Formation, and Geopolitical Risk. The analysis finds that MSX 30, PD, and GCF Granger cause GPR, as indicated by low p-values at the 5 percent significance level. Therefore, historical data on these economic indicators can help forecast geopolitical risk. This underscores the significant predictive power of economic variables in unstable geopolitical contexts.

Empirical evidence indicates that financial events, particularly the inflow of private funds, reflect collective perceptions of financial stability and play a significant role during geopolitical crises. The predictive power of PD over GPR supports the proposition that variations in private deposit availability serve as a reliable proxy for assessing public confidence amid external geopolitical tensions. Furthermore, the Granger causality from PD to MSX30 indicates a mutual dependency, with deposit-based measures of economic confidence directly influencing market performance, as corroborated by data from various emerging economies. A comprehensive assessment of the variables suggests that, while they collectively impact LGCP, they do not exert a statistically significant effect on GCF. This finding implies that gross fixed capital formation is insulated from abrupt geopolitical changes and is more responsive to macroeconomic volatility than to geopolitical dynamics.

5. Conclusion & Recommendations

The econometric analysis conducted in this thesis reveals significant interdependencies among key macroeconomic variables, specifically the Geopolitical Risk Index (GPR), gross capital formation (GCF), stock market performance, and personal deposits (PD). The most notable finding is a significant, positive relationship between historical and current levels of the Geopolitical Risk Index (GPR), supporting previous research indicating that past economic performance can influence contemporary outcomes.

Another important finding is that personal deposits (PD) serve as a key predictor of long-term growth performance (LGP), yet have an insignificant effect on gross capital formation (GCF). This interdependence suggests that individual fiscal decisions can directly influence geopolitical factors affecting capital inflows. The modestly positive association between PD and GPR suggests that robust economic resilience may increase private savings. However, the GCF's current insignificance suggests that the model framework does not adequately capture the determinants of capital formation.

This analysis leads to several recommendations for policymakers and economic stakeholders:

5.1. Economic Frameworks Development

The current economic framework should be enhanced by incorporating personal deposits (PD) and MSX30 indicators, both of which demonstrate strong predictive power for GPR and investment flows. Policymakers are encouraged to implement strategies that supplement domestic savings to mitigate the adverse effects of geopolitical uncertainties and promote greater economic stability.

5.2. Human Capital Investment

Given the significant contribution of individual deposits to macroeconomic indicators, investing in education and financial training programs to increase personal savings is recommended. Teaching individuals about savings and investment will boost their economic position and help them during geopolitical crises. Continuously update

frameworks based on ongoing assessments, as economic variables shift with geopolitical changes. Regularly measure these parameters to adjust policies quickly and strengthen resilience. Following these steps will help stakeholders address the challenges identified in this study and promote lasting economic growth and stability.

Author Contributions

Ahmed Adekunle carried out the conceptualization, formal analysis, and revision, estimation of results, data tabulation, and responses to reviewers' comments.

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Conflicts of Interest

No conflict of interest.

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