

GEOPOLITICAL SHOCKS AND GEOECONOMIC FRAGMENTATION

Implications for financial stability in the euro area from the ESM's perspective

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INTRODUCTION: THE ESM'S PERSPECTIVE

The ESM's mandate is to safeguard financial stability



Three mega-trends are shaping our future:
ageing, climate change and geoeconomic fragmentation

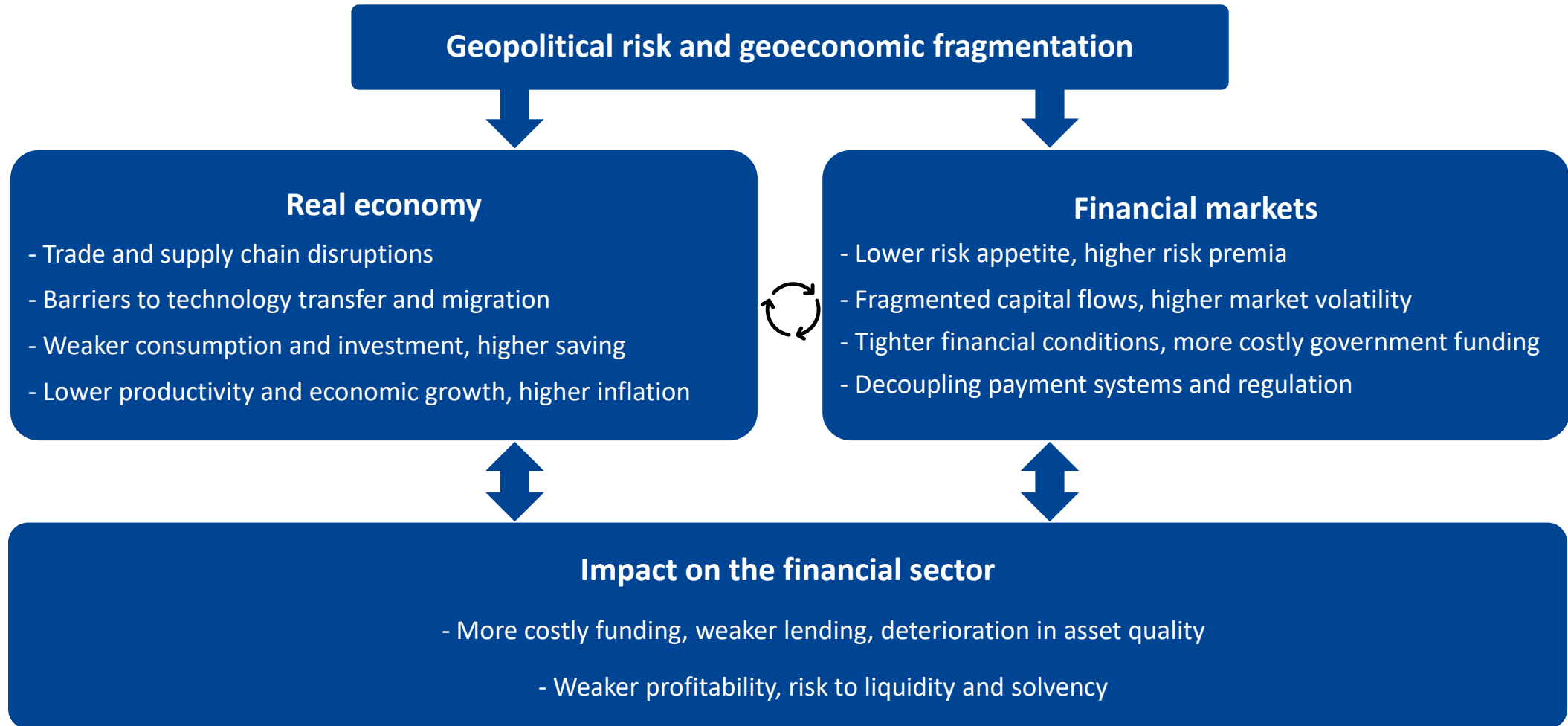


Geoeconomic fragmentation raises the risk of external shocks



The ESM can help enhance resilience against these shocks

LASTING CONSEQUENCES THROUGH VARIOUS CHANNELS



OVERVIEW



Global trends

Slowing globalisation
Geopolitical shocks
Goeconomic fragmentation



Risks to the euro area

Trade links
Financial flows
Financial sector



Policy implications

For Europe
For the ESM

GLOBAL TRENDS



DIFFERENT TRIGGERS AND CHANNELS OF FRAGMENTATION

Major crises that challenged global integration: Global Financial Crisis, Covid-19

- Not directly linked to geopolitics, but policy response may have contributed to weaker global flows (e.g. prudential measures and lockdowns).

Geopolitical shocks: Russia's war against Ukraine, Middle East crisis, etc.

- Physical disruption of infrastructure and trade (e.g. commodities);
- Instantaneous financial stress: general risk aversion, increased credit risk.

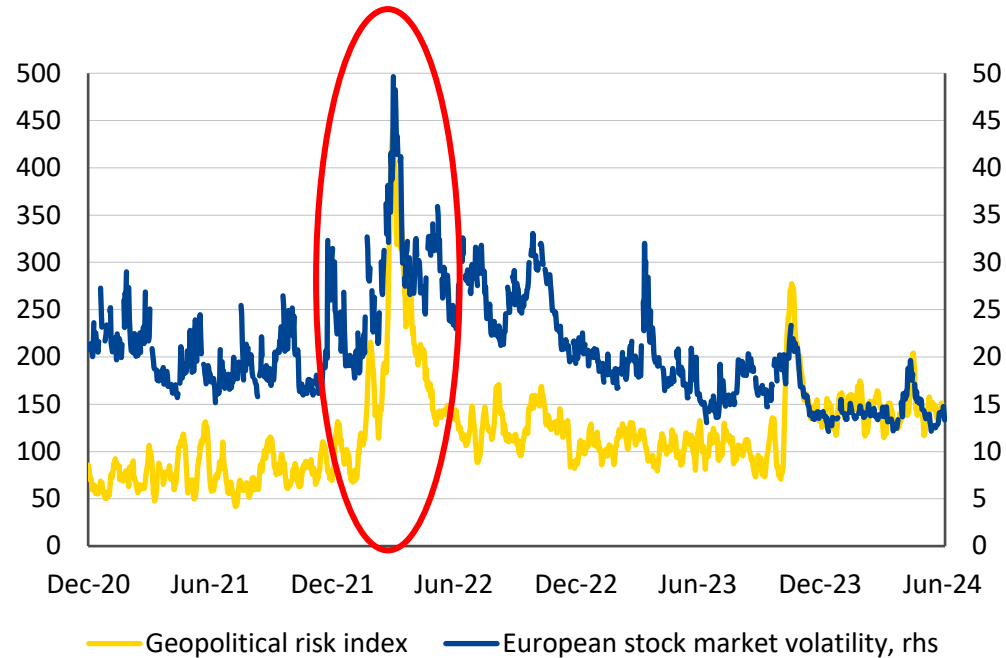
Goeconomic fragmentation, persistent structural shifts: US-China tensions

- Policy-induced decoupling: gradual shift with long-term impact on trade flows;
- Less focus on cost-efficiency, barriers to technology transfer, weaker productivity;
- Impact on financial flows: more segmented, more concentrated, less diversification.

GEOPOLITICAL SHOCKS: IMPACT ON FINANCIAL MARKETS

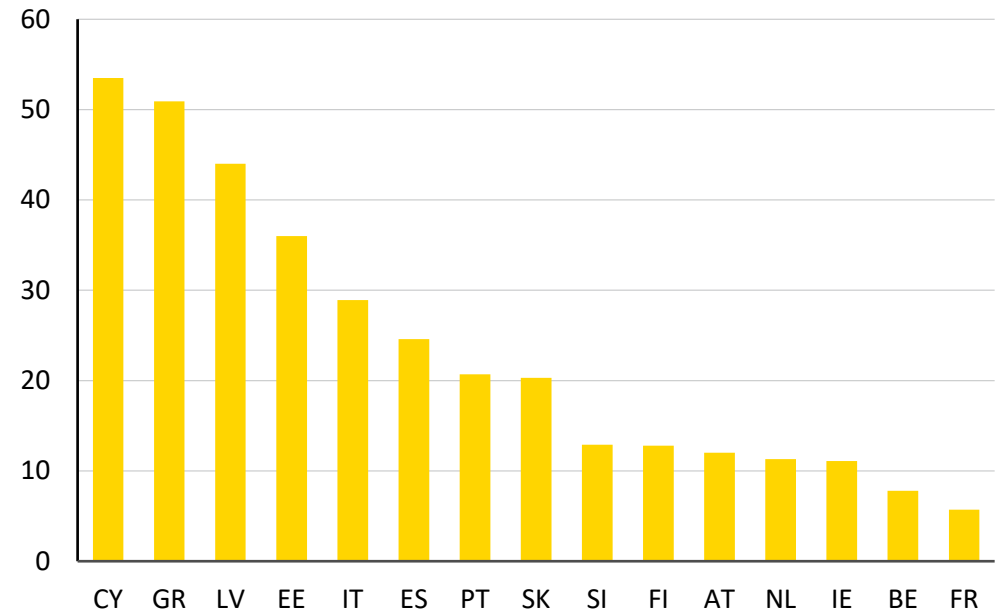
Geopolitical risk triggers market volatility...

Impact of Russia's invasion of Ukraine in February 2022



...and raise sovereign risk

Change in euro area sovereign credit spreads in February 2022, bps



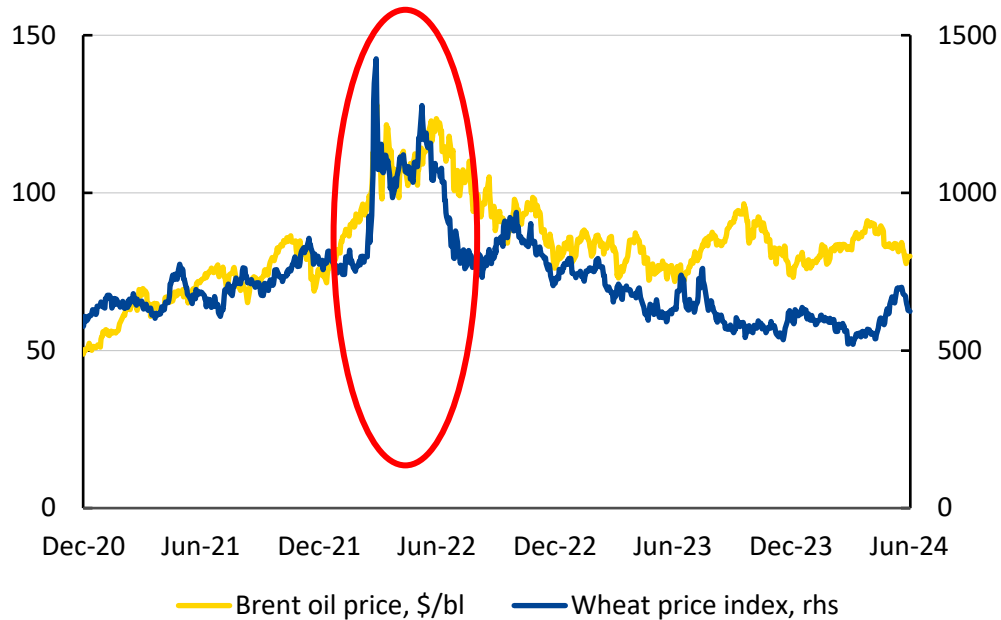
Source: Caldara and Iacoviello and Bloomberg.

Source: ESM based on Bloomberg.

GEOPOLITICAL SHOCKS: IMPACT ON PRICES AND ACTIVITY

Shocks lead to spikes in prices...

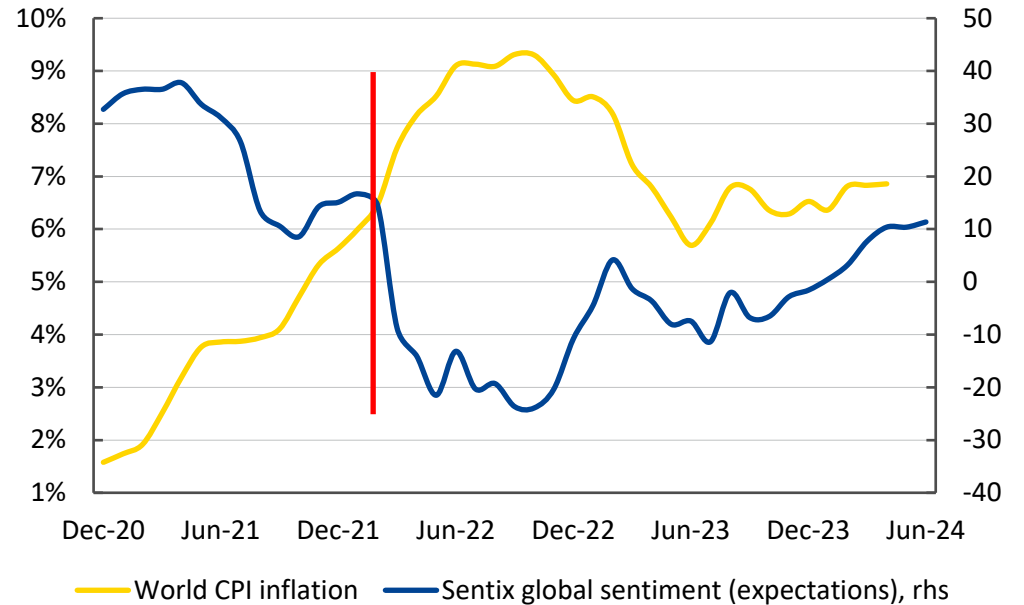
Commodity prices



Source: Bloomberg

...and drop in confidence

Consumer prices and business confidence

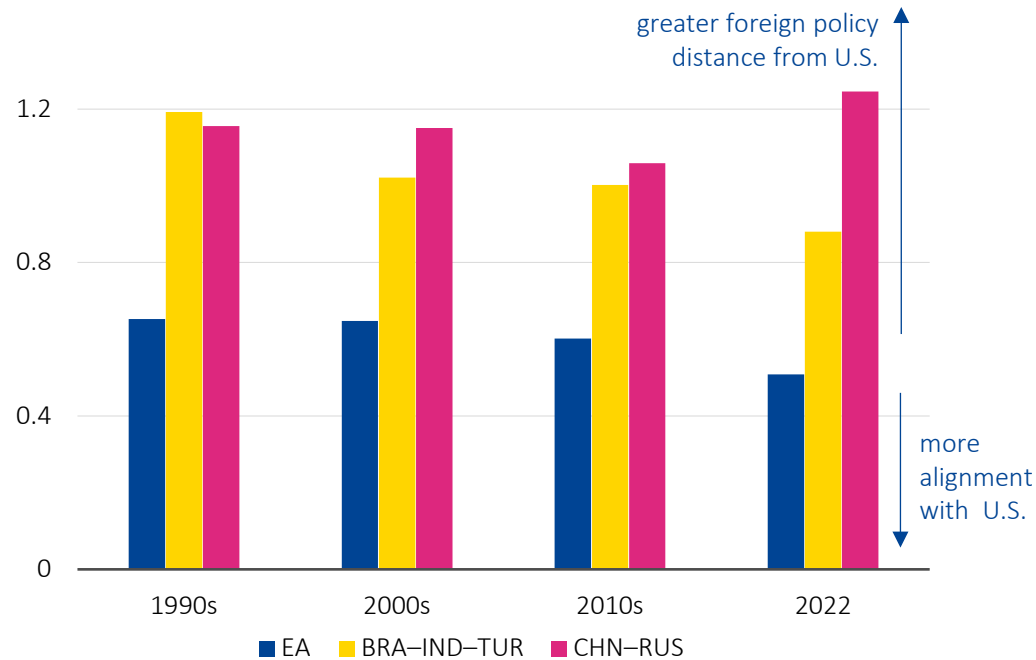


Source: Haver

GEOECONOMIC FRAGMENTATION IS A LONGER-TERM TREND...

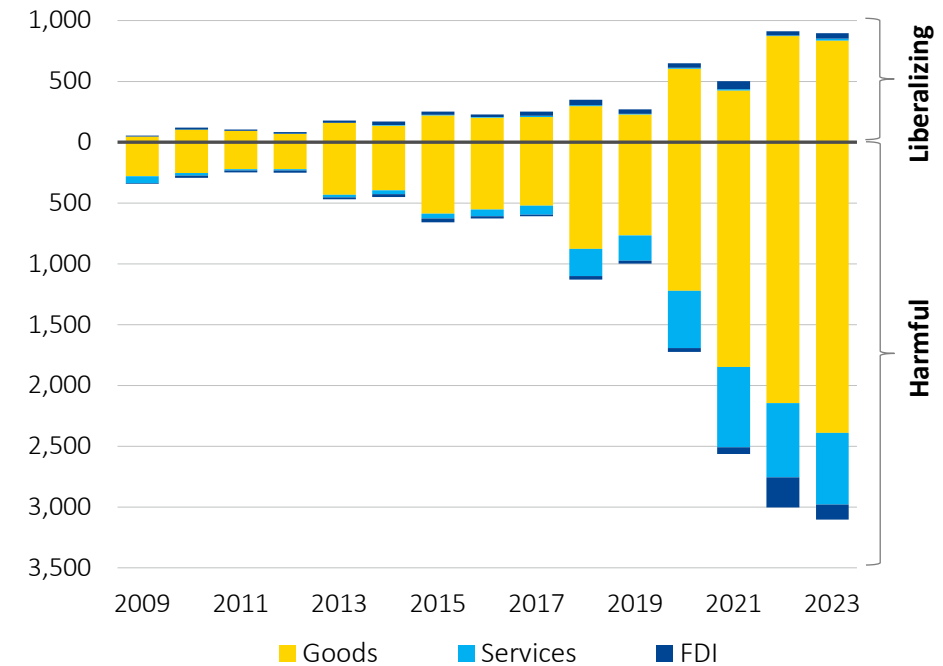
Geopolitical distance increased...

Difference of UN voting compared to the US



...and restrictive measures have multiplied

Number of new trade and FDI measures globally



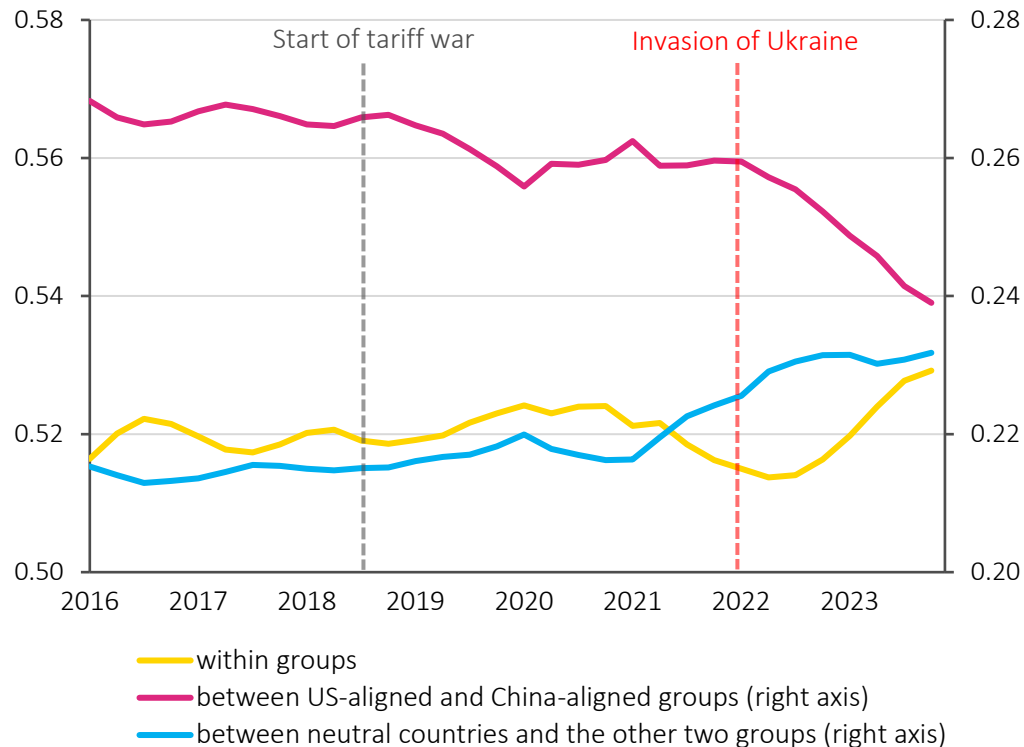
Notes: Ideal point distance to the U.S. based on voting alignment in the United Nations General Assembly. Larger values imply greater geopolitical distance to the U.S. Source: ESM Discussion Paper 23: [Geoeconomic fragmentation: Implications for the euro area and ASEAN+3 regions](#), based on Bailey et al. (2017).

Notes: The chart includes measures implemented by all government bodies (supranational, national, subnational) and by international and national financial institutions. Series are adjusted for reporting lag using 31 December as cutoff date. Source: ESM Discussion Paper 23: [Geoeconomic fragmentation: Implications for the euro area and ASEAN+3 regions](#), based on Global Trade Alert.

...THAT LEADS TO ECONOMIC AND FINANCIAL REALIGNMENT

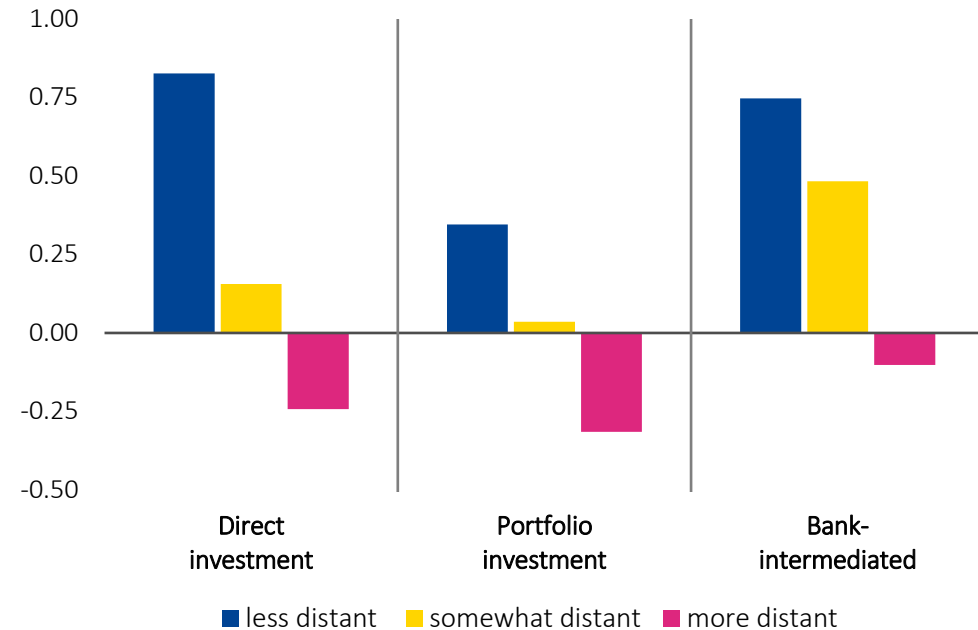
Trade between groups pulling apart...

Shares of global trade within and between geopolitical groups



...and financial flows are affected by geopolitics

Deviation relative to average world portfolio, 2009-22, percentage points



Notes: The figure plots the shares of global trade in goods within and between stylized groups of countries based on United Nations General Assembly votes in 2022, as a proxy for geopolitical alignment. Source: ESM Discussion Paper 23: [Geoeconomic fragmentation: Implications for the euro area and ASEAN+3 regions](#), based on UNGA voting dataset retrieved from Voeten (2013, version 30) and IMF Direction of Trade Statistics.

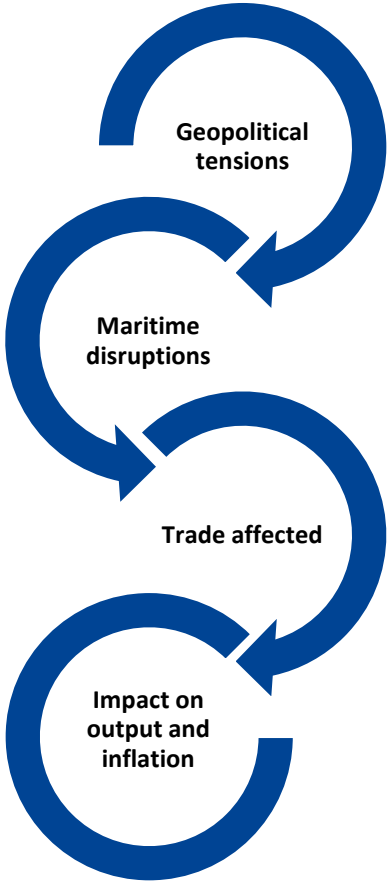
Sources: ESM Discussion Paper 23: [Geoeconomic fragmentation: Implications for the euro area and ASEAN+3 regions](#), based on IMF Coordinated Direct Investment Survey (CDIS) and Portfolio Investment Survey (CPIS), OECD, and BIS Locational Banking Statistics (LBS), and European Commission FinFlows bilateral dataset.

EXPOSURES OF THE EURO AREA



TRADE: THE BUTTERFLY EFFECT OF GEOPOLITICAL CONFLICTS

“A butterfly flapping its wings in Brazil can produce a tornado in Texas” (Lorenz 1972)



Exports Imports

Category	Sea	Other
Exports	~70	~10
Imports	~70	~10

- Shipping is the main trade channel for Europe...
- ...mainly via Red Sea, Strait of Hormuz, South China Sea

Cape of Good Hope Suez Canal

23 Jan-24

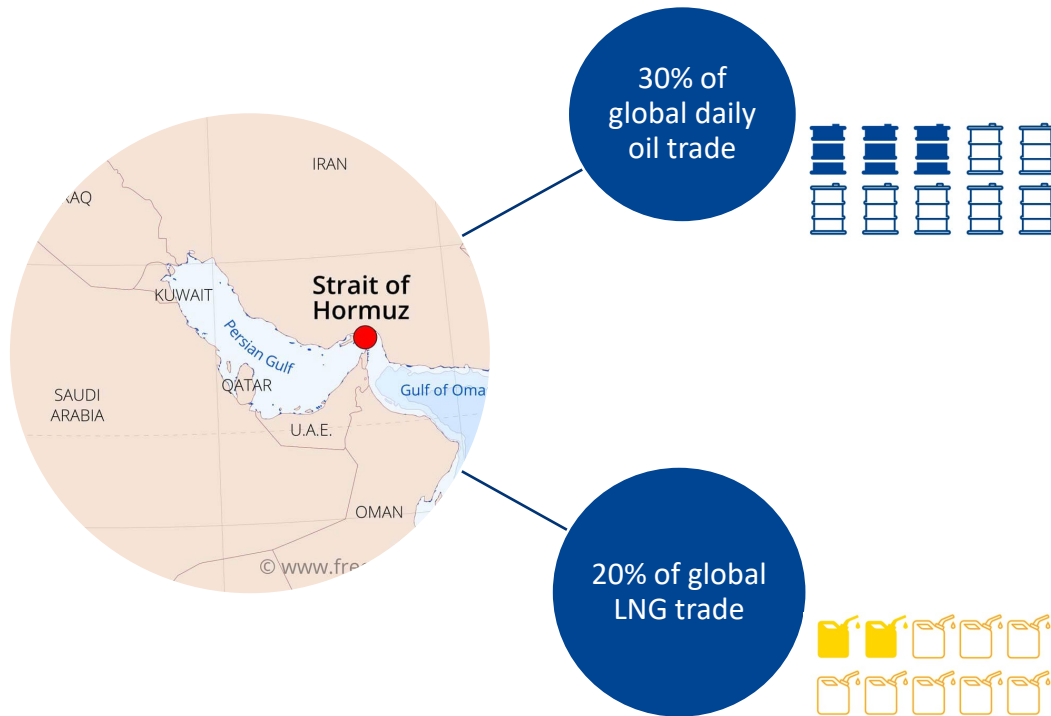
- Key maritime routes vulnerable to geopolitical conflicts
- Recent attacks in Red Sea - limited impact as re-routing of ships around Cape of Good Hope

What if disruptions persist..?

- ...disrupting goods supply from Asia?
- ...disrupting energy supply in the Strait of Hormuz?

TRADE: VULNERABILITIES DUE TO ENERGY AND RAW MATERIALS

Energy supply routes are vulnerable...



...and raw material sources are concentrated

Global sources of selected commodities, 2020

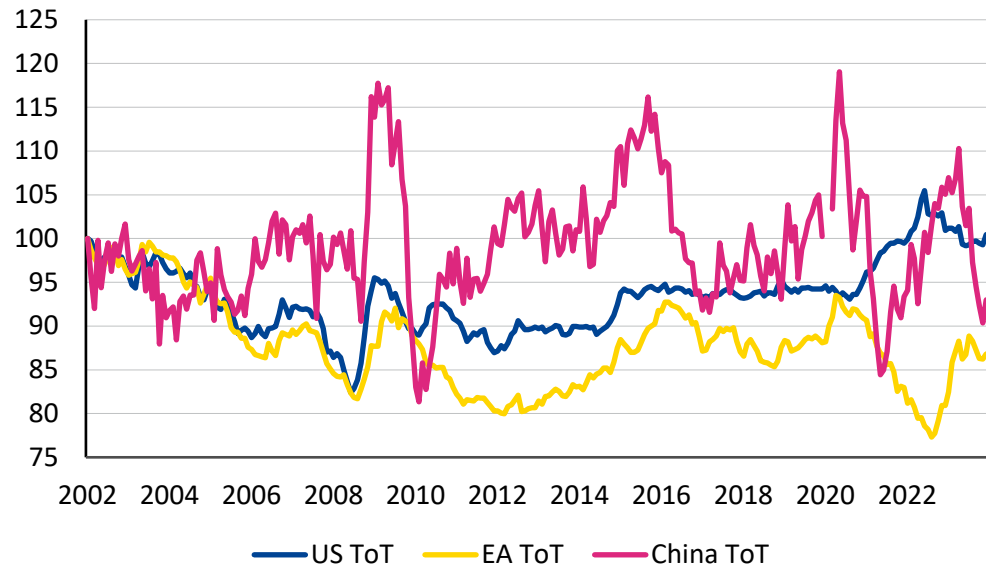


• Note: Countries in black are under sanctions; China is shaded in grey. Source: IMF SDN Geoeconomic Fragmentation and the Future of Multilateralism (2023).

TRADE: SHOCKS HAVE A DIFFERENTIATED IMPACT

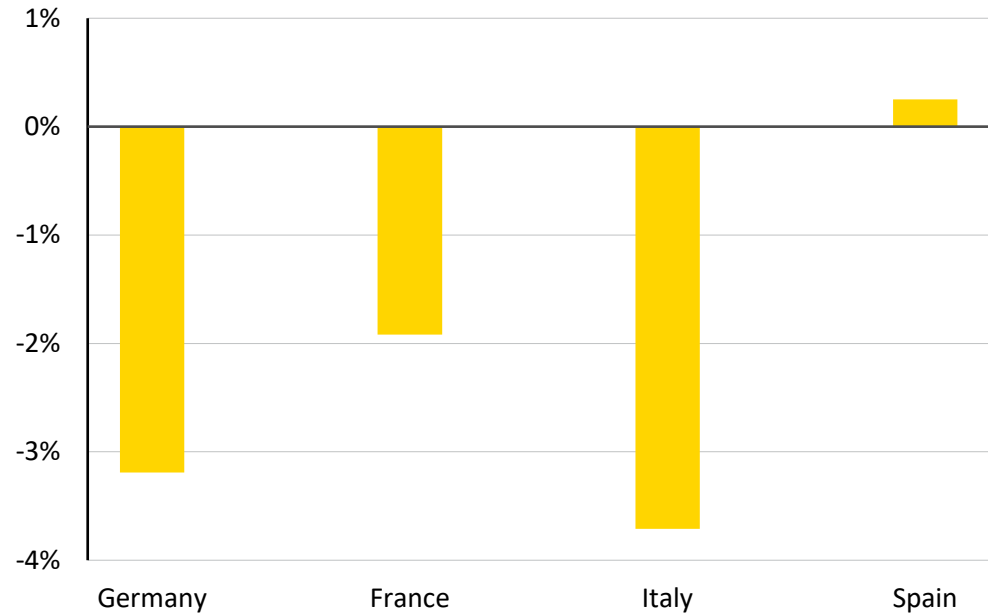
Energy prices weigh on EA's terms of trade...

Terms of trade indices, January 2002=100



...with a different effect across member states

Change in trade balance between 2021 and 2022, % of GDP



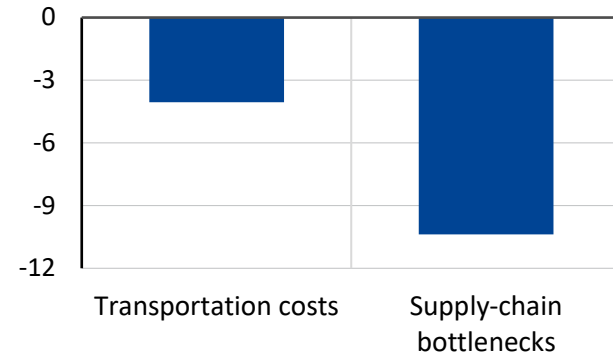
Note: An increase (or improvement) in the terms of trade index reflects higher export prices or lower import prices. Source: Haver, General Administration of Customs of China

Source: ESM based on Eurostat via Haver.

ESM ANALYSIS: WHAT IF SUPPLY ROUTES ARE DISRUPTED?

Supply-chain bottlenecks more harmful

- Impact on industrial production in % (same impact on inflation)

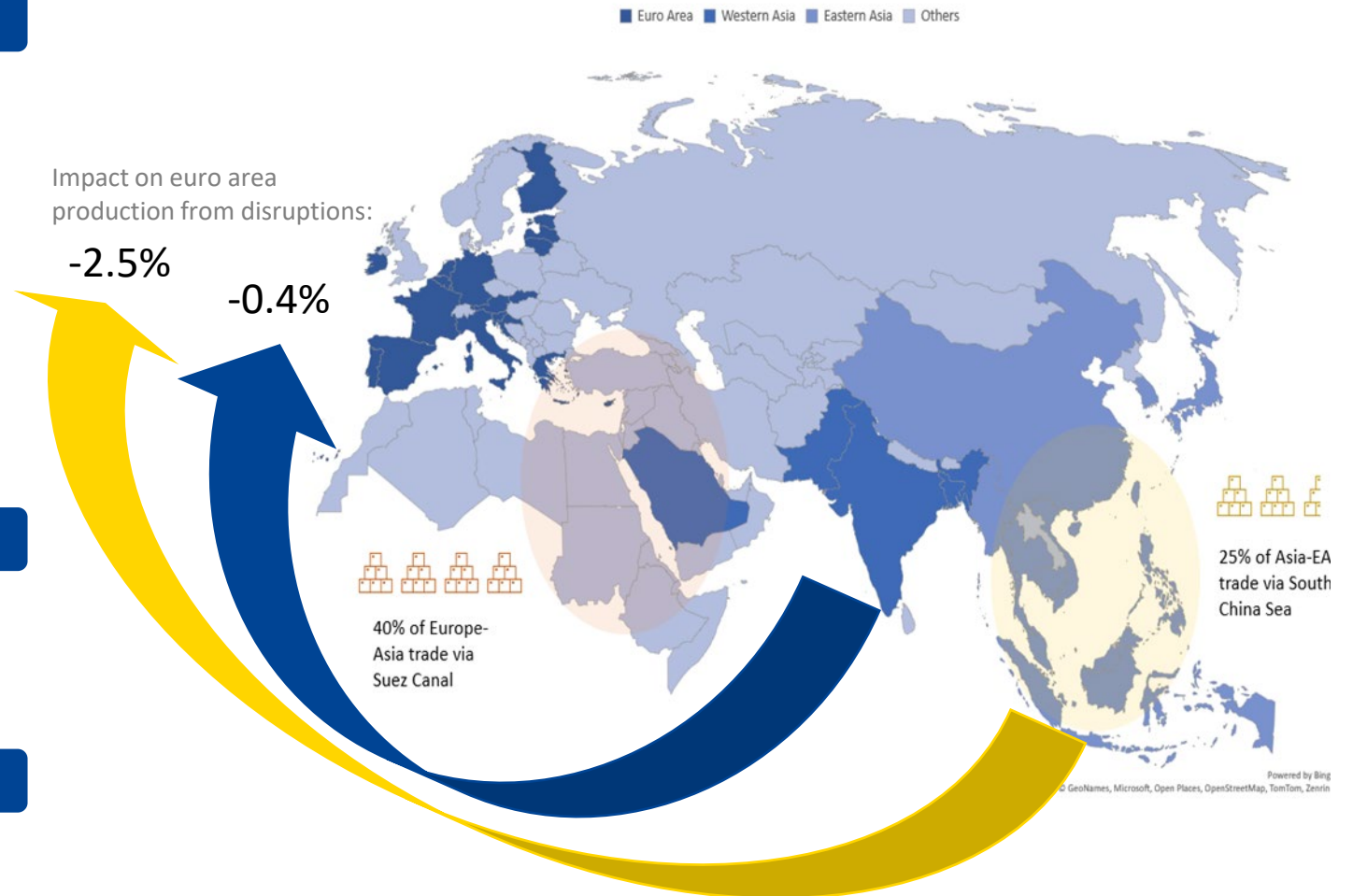


Goods from East Asia very important

- Worst case scenario: input goods arriving late or not arriving at all via maritime trade.
- **Production in euro area could fall by 3%.**

Different impact on euro area countries

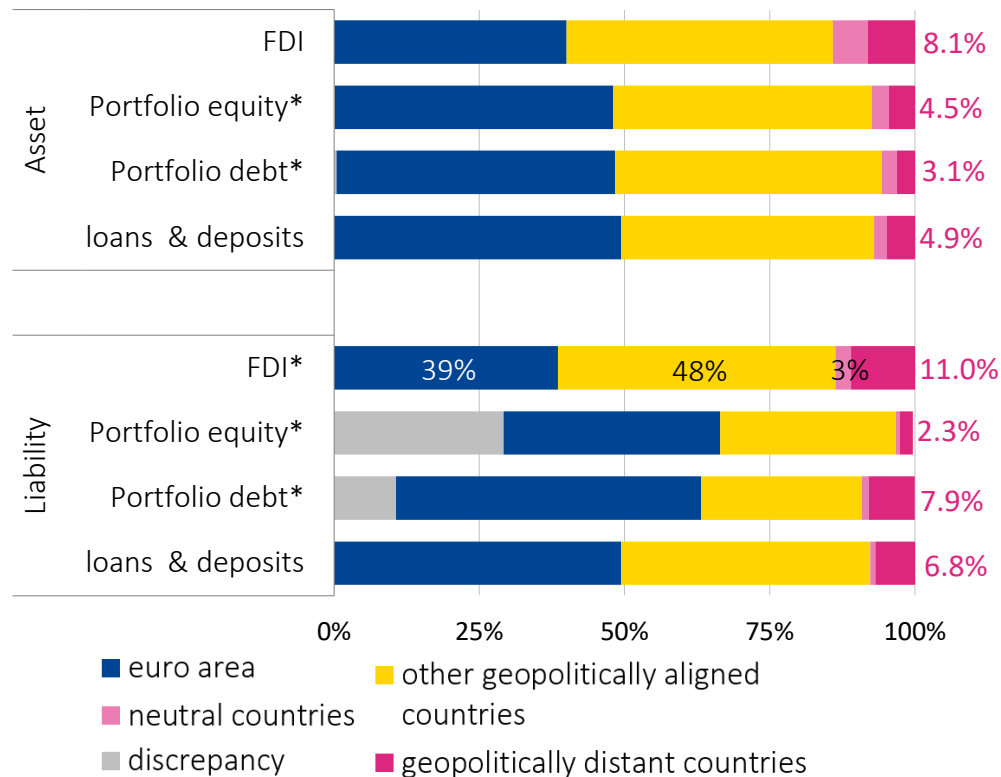
- Impact on Germany stronger than on France, Italy or Spain.



FINANCING: POCKETS OF EXPOSURE TO FRAGMENTATION RISK

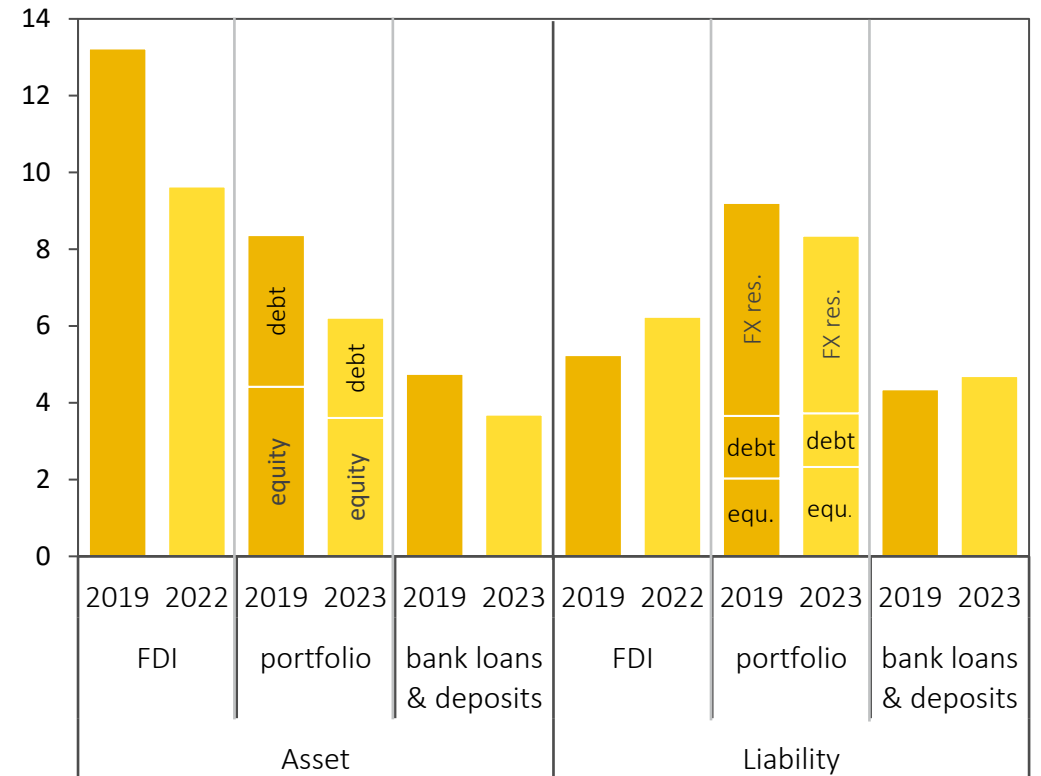
Exposure to political risk looks limited overall...

EA cross-border investment positions, latest, % of total



...but concentrated in FDI and portfolios

Exposures to geopolitically distant countries, % of EA GDP



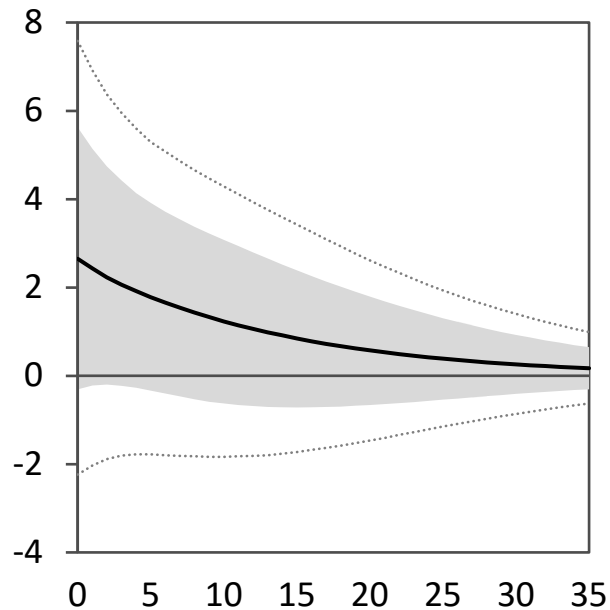
Note: * FDI based on ultimate investor basis. Source: ESM Discussion Paper 23: [Geeconomic fragmentation: Implications for the euro area and ASEAN+3 regions](#).

Source: ESM Discussion Paper 23: [Geeconomic fragmentation: Implications for the euro area and ASEAN+3 regions](#).

ESM ANALYSIS: GEOPOLITICAL SHOCKS AND PORTFOLIO FLOWS

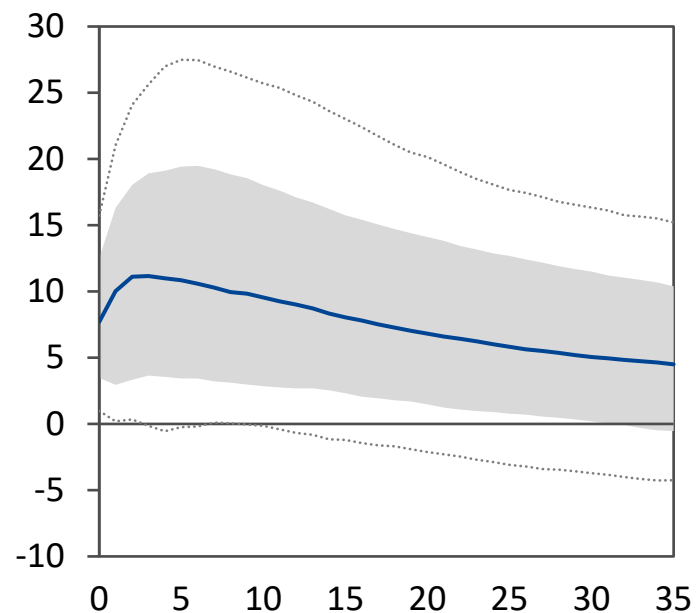
Euro area debt is seen as a “safe haven”...

Portfolio debt inflows to the EA, % of GDP, in full sample



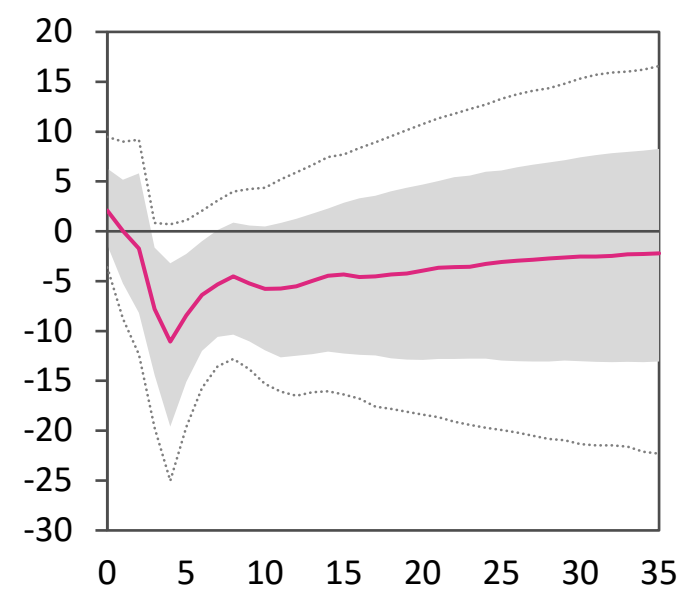
...in a low geopolitical risk regime...

Portfolio debt inflows to the EA, % of GDP, in a low geopolitical risk regime



...but may be at risk when geopolitical tensions rise

Portfolio debt inflows to the EA, % of GDP, in a high geopolitical risk regime

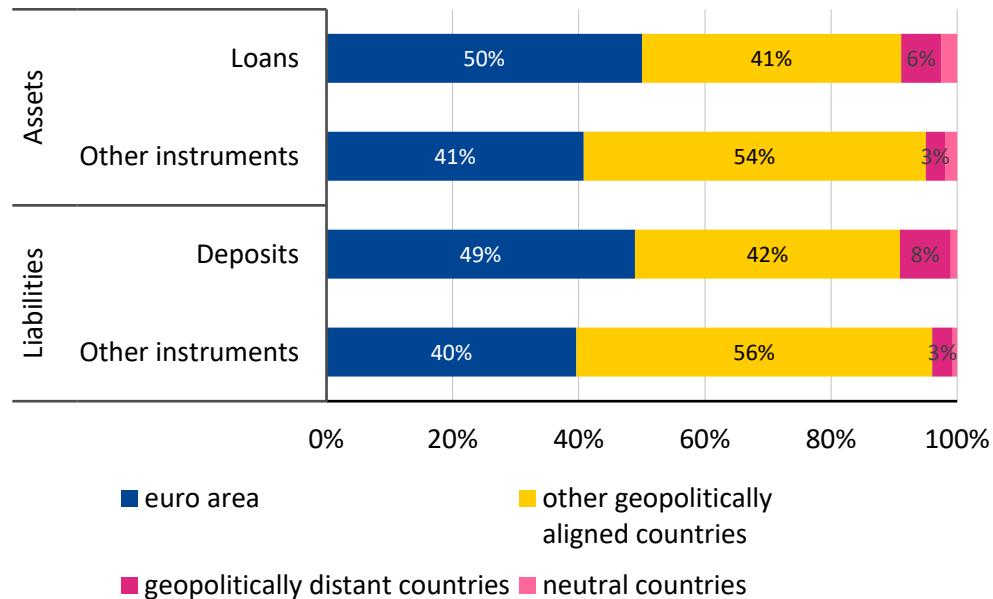


Effect of a one-standard-deviation shock to the geopolitical risk index, based on Bayesian VAR model; GPR shock identified by Cholesky decomposition, (ordering first the GPR index)

BANKS: RE-FOCUS ON EURO AREA AND FRIENDLY COUNTRIES

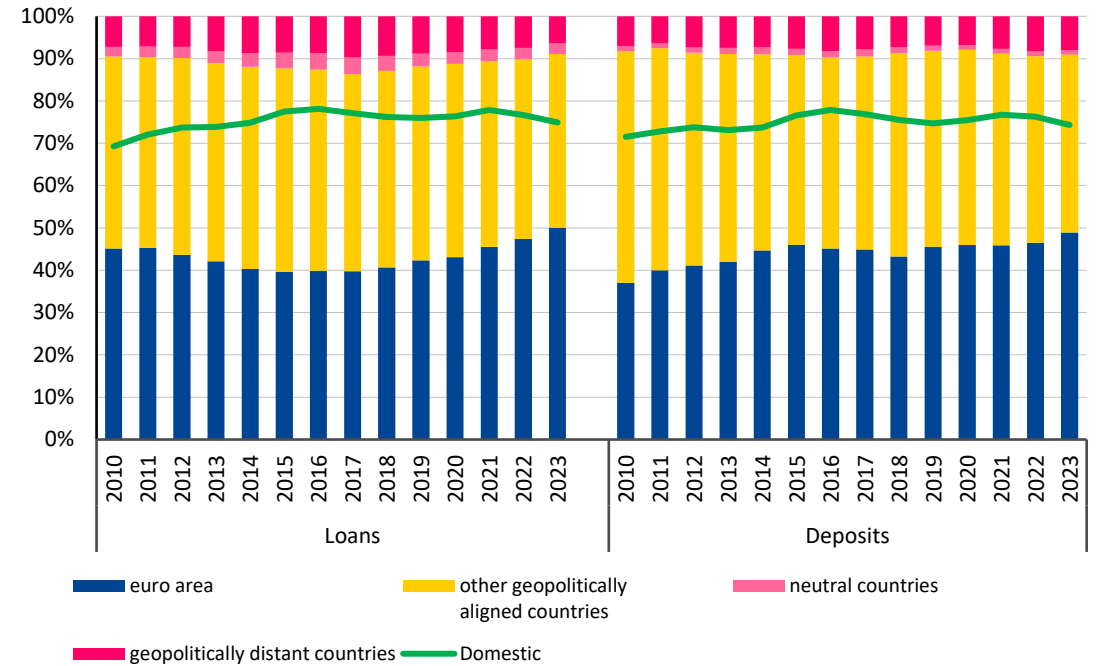
Banks' exposures are mainly to EA and friendly countries...

EA banks' cross-border assets and liabilities, latest (2023Q4), % of total



...and are increasing towards EA countries

Evolution and composition of EA banks' cross-border loans and deposits, % of total, and domestic exposures as a % of total exposures

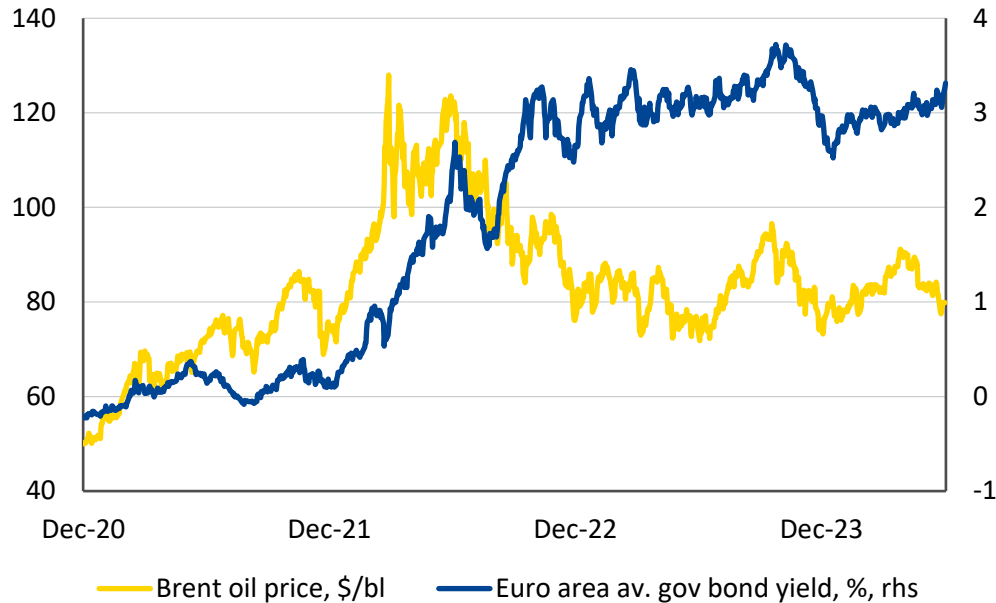


Note: Bank's cross-border holdings of assets and liabilities is collected from the BIS Locational Banking Statistics and excludes domestic holdings of the reporting bank. Countries are grouped into three stylized geopolitical groups based on their votes in the UNGA during 2022, as a proxy for their alignment on global issues. In the right-hand side graph, domestic refers to the percentage of domestic loans/deposits over total loans/deposits. Source: ESM Discussion Paper 23: [Geoeconomic fragmentation: Implications for the euro area and ASEAN+3 regions](#).

FISCAL RISKS – MORE SHORT-TERM SHOCKS

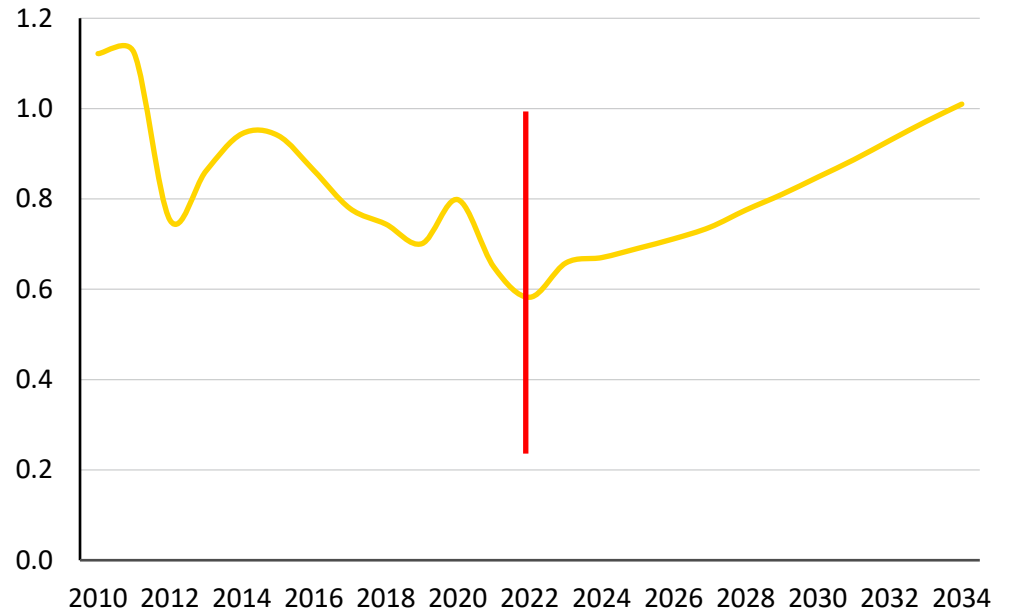
Geopolitical shocks affect borrowing costs...

Oil prices and government bond yields



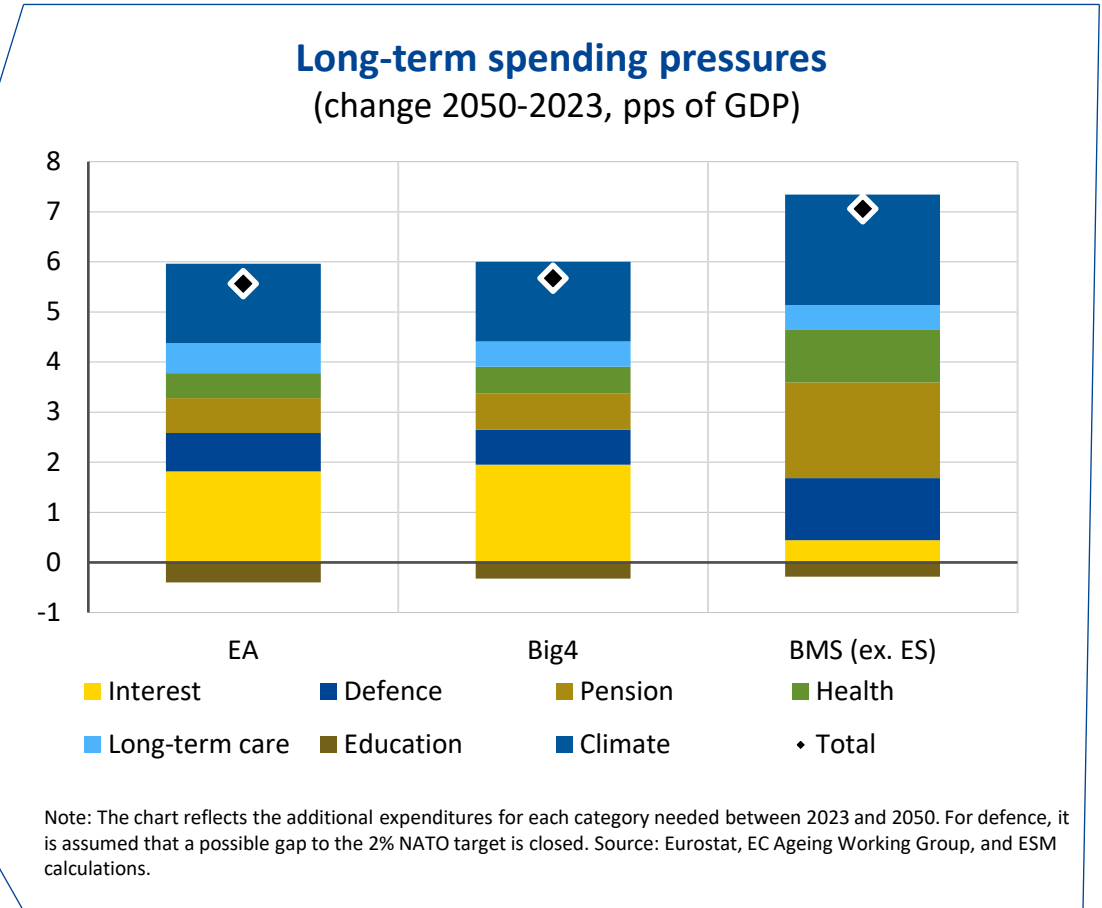
...and can contribute to lasting divergence

Standard deviation across member states as % of GDP



FISCAL RISKS – HIGHER LONG-TERM COSTS

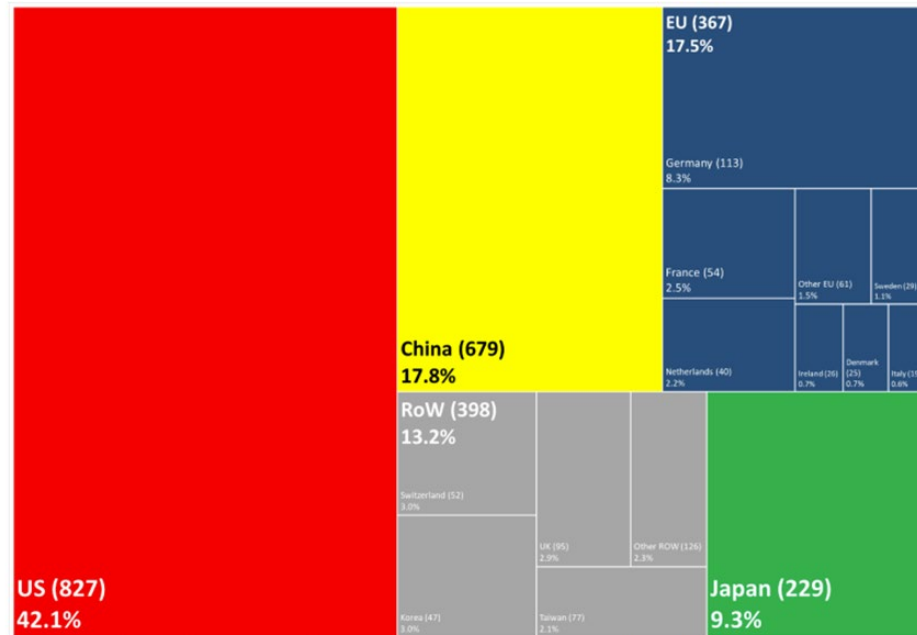
- Trade fragmentation, less migration:
Weaker productivity, weaker growth
- Financial fragmentation:
Higher risk premia, more volatility
- Additional long-term investment needs:
Higher equilibrium interest rates
- Upward pressure on borrowing costs:
Growth-interest rate differential deteriorates.



INVESTMENT NEEDS IN R&D AND DEFENCE

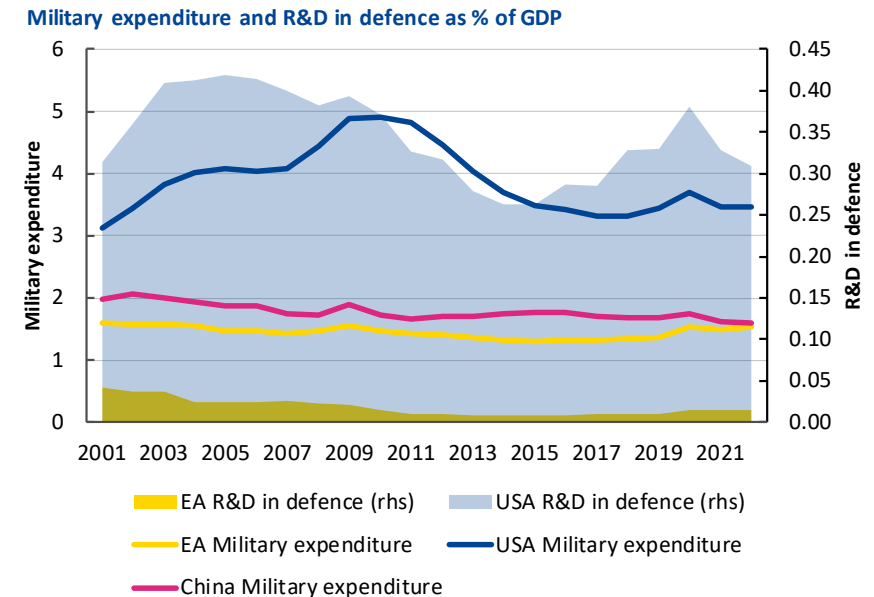
EU falling behind in private sector R&D...

Distribution of firms and R&D investment across regions, 2022



...and defence spending

Military expenditure and R&D in defence, % of GDP



Note: Figures in brackets show the number of companies per region/country; the percentage share refers to the regions'/country's share in total Scoreboard R&D. Source: The 2023 EU Industrial R&D Investment Scoreboard, European Commission, JRC/DG R&I

Notes: Data from 2001 until 2022. Data for R&D in defence is not available for China. Source: OECD, ESM calculations.

POLICY IMPLICATIONS: FOR THE ESM AND FOR EUROPE MORE BROADLY



THE ESM'S ROLE: FINANCIAL STABILITY VS. EXTERNAL SHOCKS



Monitoring the economic implications of fragmentation and deepening our understanding of how it affects financial stability in the euro area



Cooperating closely with our global and regional peers, conveying a strong message of support for multilateralism



Reviewing the ESM's lending toolkit to ensure its readiness to confront future challenges

THE ONGOING ESM REFORM

Common backstop



The Common backstop : ESM will serve as the permanent backstop to the Single Resolution Fund (SRF).

This common backstop will allow the use of ESM resources to contain banking crises if the resources of the SRF are depleted.

ESM precautionary instruments (PCCL & ECCL)

More effective precautionary credit lines: The eligibility process for the precautionary credit lines will be made more transparent and predictable

Stronger role

ESM more involved in the design of policy conditionality, monitoring and debt sustainability analysis with the European Commission. Outside programmes, the ESM will follow macro-economic and financial developments the euro area.

THE BROADER EUROPEAN AGENDA

Economic security is pivotal for the Single Market's future

- Broaden the scope of technologies to be "de-risked"
- Enhance European coordination of export controls
- Addressing the resilience of supply chains
- Define framework for economic cooperation with "rival partners"

Trade as a crucial tool to project the Single Market's influence

- Evidence-based policies to consider the costs/benefits of action and inaction
- Active regulatory cooperation

Enhancing economic cooperation with strategic partners

- Mutually beneficial framework to strengthen economic ties with the UK
- Intensify our efforts to improve economic relations with the US

REDUCING VULNERABILITIES WHILE BOOSTING RESILIENCE

Various concepts have emerged that generally point to the need for reducing vulnerabilities while boosting resilience in a wide range of policy areas

Open strategic autonomy

- Concept of strategic autonomy first mentioned in 2013
- For EU policymakers, it is the “capacity to act autonomously when and where necessary and with partners wherever possible”
- It initially focused on security and defence, but geopolitical events (US-China trade tensions, pandemic, war in Ukraine) prompted an expansion of its scope
- Wide range of initiatives in areas of health, space, digital, energy, etc.
- Recently rebranded as *open* strategic autonomy i.e. ability of the EU to act autonomously while maintaining openness

EU de-risking strategy

- Von der Leyen presented a new vision for Europe based on “de-risking” in a speech on EU-China relations in March 2023
- The economic de-risking strategy has four parts:
 - Making the EU more competitive and resilient (esp. in health, digital, clean tech)
 - Better using existing toolbox of trade instruments to address security concerns
 - Developing new defensive tools for some critical sectors (e.g. AI, biotech) to avoid leakage of sensitive tech
 - Aligning with other partners around the world and e.g. enhance cooperation in sectors such as digital and clean tech

COMPREHENSIVE RESPONSE FIT FOR THE CHALLENGE

- **Geoeconomic fragmentation touches on several, often interrelated, policy areas**
- **Action on various fronts will be needed to boost competitiveness and spur economic growth**
- **An industrial policy that supports EU competitiveness and the attractiveness of the Single Market**

Security	Industrial policy	Trade, investment	Social policy	Economic policy	Cooperation
<ul style="list-style-type: none"> • Boost military capabilities, cybersecurity • Safeguard data privacy • Fight disinformation 	<ul style="list-style-type: none"> • Support strategic R&D • Reduce strategic dependencies • Preserve Single Market rules 	<ul style="list-style-type: none"> • Revisit partnerships • Strengthen the toolbox • Cooperate within the international trade system 	<ul style="list-style-type: none"> • Ensure social cohesion • Leverage on migration • Focus on reskilling to match labour market needs 	<ul style="list-style-type: none"> • Revisit the growth model • Expand financing sources • Strengthen resilience to shocks 	<ul style="list-style-type: none"> • Support multilateralism • Promote EU values • Expand cooperation in strategic areas

PUBLIC INTERVENTION BECOMING PREVALENT

Competitive pressure from US and China

China: protectionism and state intervention to climb high-tech ladder

USA: CHIPS Act, Inflation Reduction Act

EU public investment needs

Energy transition
(including strategic green raw materials)

Competitiveness
(including AI and digital transition)

Military capacity and defence spending

EXAMPLES OF EUROPEAN POLICY ACTION



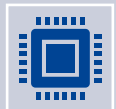
Next Generation EU (2020)

Recovery plan from the Covid pandemic to build a more resilient EU.
Focus on green and digital transition.



Temporary Crisis and Transition Framework (2022-2025)

Special regime within the EU State aid framework
Provides a crisis response to the war in Ukraine and the energy price shock.
Coupled with measures to facilitate green and digital transition



European Chips Act (2023)

Support large-scale technological capacity building and innovation
Incentivise investment in manufacturing facilities
Improve collaboration including in case of a future supply crisis



Critical Raw Materials Act (2024)

Boost European capacities along the entire value chain
Improve circular value chains for recycled critical raw materials
Improve research, innovation, and skills

REFORMS TO ADDRESS FINANCIAL FRAGMENTATION

Banking and Capital Market Union

Deepen banking and capital market integration to:

- Facilitate effective resource allocation
- Stimulate technological change
- Enable effective risk-sharing across countries

Digital euro

Introduce the digital euro to:

- Create electronic cash for the digitalised world
- Complement traditional banknotes and coins
- Reduce financial transaction costs

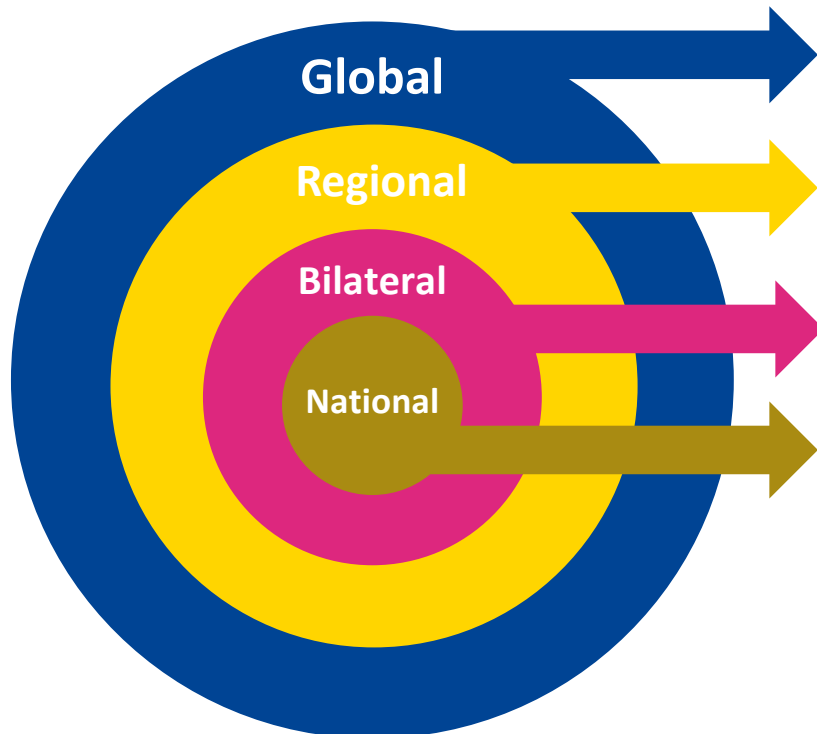
ESM and EA architecture

Adopt the revised ESM Treaty for:

- Common Backstop to the Single Resolution Fund
- More effective precautionary instruments
- Greater role in preventive monitoring and programme design

THE GLOBAL CONTEXT: WE MUST WORK TOGETHER

- The ESM is part of the regional layer of protection of the global financial safety net (GFSN)
- The ESM has strengthened its collaboration with global and regional peers to share crisis expertise
- This open and candid dialogue will remain essential to better meet the challenges ahead



- The **IMF** would need to navigate geopolitical tensions among major economies to effectively serve its global membership.
- **Regional financing arrangements (RFAs)** have lending instruments tailored to the needs of the region. The ESM has shown that our "toolbox" is adaptable to each crisis:
 - In the wake of the pandemic, the ESM created the pandemic crisis support, which was part of a wider package of measures at the European level. Other RFAs showed similar institutional agility.
- **Bilateral swap arrangements** among central banks could increasingly be guided by geopolitical considerations, further fragmenting access to international liquidity in times of stress.
- Faced with increased fragmentation and uncertainty, countries may beef up their **international reserves**, which can be costly to hold.

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