Stronger together: Safeguarding financial stability in a fragmented world

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Geoeconomic fragmentation is a risk to financial stability, but Regional Financing Arrangements (RFAs) are well placed to mitigate this risk.[1] In this blog, we outline the effects of geoeconomic fragmentation on trade and financial flows. Such fragmentation distorts trade flows and disrupts supply chains, but it has also led to new patterns of economic integration with increased importance on regional cooperation. Europe's economic and financial openness creates the need for sustained cooperation in an increasingly multipolar global system. Regional financing arrangements and the International Monetary Fund (IMF) have contributed to building trust and stability over the years, demonstrating that their cooperation and support will remain crucial.

Geoeconomic fragmentation on the rise... as are its risks

Geoeconomic fragmentation, the reversal of progress towards global economic and financial integration due to political and military conflict as well as deliberate and strategic policy decisions, is on the rise. [2] This year's RFA research seminar offered different regional and international organisations across the world the opportunity to examine this phenomenon from their varied perspectives. Collaborative efforts of the multilateral institutions that are part of the global financial safety net, the IMF and RFAs, help bolster global and regional resilience and safeguard financial stability.[3]

Globalisation has, in some respects, already slowed over the past decade. Merchandise trade as a share of global gross domestic product (GDP) increased rapidly between 1990 and 2010, flattening to stable since. Major shocks to the world economy, the global financial crisis, and the Covid-19 pandemic exposed the vulnerabilities of an interconnected world. Heightened geoeconomic frictions, particularly tensions between the United States (US) and China, have become a persistent and structural challenge to the global economy. Armed conflicts, notably Russia's war on Ukraine and the crisis in the Middle East, cause tragic losses of human lives and destruction and, economically, disrupt trade routes, distort supply chains, lead to a misallocation of resources, and ultimately undermine trust. Consequently, price pressures emerge, and global growth suffers.

We see the impact of the US-China tensions, the predominant global friction, on trade. China's role in world trade has increased markedly over the past few decades, particularly in merchandise exports. Meanwhile, the US remains the key source of global demand. The US has historically been China's primary export destination, but dynamics have shifted notably since the trade conflict began. [4] China's trade with other regions has been impacted too. [5]

Fragmentation also has implications for capital flows and financial stability through increased credit risk,[6] reduced diversification, and a decline in capital buffers. It can tighten financial conditions and raise risk premia, thereby increasing vulnerabilities. The European Central Bank has also pointed to how geopolitical risk can impair financial markets and negatively impact the funding, lending, solvency, asset quality,[7] and profitability of banks and non-banks such as insurance funds.[8]

Our in-house analysis corroborates that in such a geopolitically tense environment, there is a higher risk of capital outflows from the euro area. Euro area assets tend to have safe haven characteristics, but portfolio inflows appear to change across different asset classes and geopolitical risk regimes. Increased geopolitical tensions or political realignment of foreign countries, particularly when they distance themselves from European positions, can trigger a significant decline in portfolio investments to and from the euro area.

More broadly, barriers to trade and capital mobility increase the risk of sudden stops,[9] generate suboptimal capital allocation, and reduce investment globally. Geopolitical alignments within a subset of countries can limit a country's choice of financial partners and increase its dependence on more concentrated sources of financing. Financial fragmentation may also have serious implications for global imbalances, as the rise of competing large economic blocs linked to different currencies can complicate the balancing of global financial flows in the long term. [10]

However, the emergence of distinct economic blocs can be mitigated or even counteracted by other new or strengthened patterns of economic cooperation. The economic logic of diversification and the geopolitical desire for security can act beneficially in tandem. Trade patterns have become more complex, but less concentrated.

A closer look at re-globalisation reveals that integration has indeed continued to advance along several dimensions. [11] Rather than the emergence of solid blocs, trade between countries takes the form of changing global value chains and international production networks. As US-China direct trade plummeted over the years, some countries emerged as crucial connectors. [12] In addition, the emergence of geoeconomic fragmentation has strengthened the importance of intra-regional integration, especially in Europe, which helps offset external pressures.

Cooperation and adaptability - key to success

The shifting environment brings a more multipolar system to the fore, making it crucial whether the system is managed cooperatively or competitively. [13] Particularly for Europe, the most open among the advanced economies, ensuring a stable global economic and financial system is vital. The euro area's trade with other regions amounts to more than 60% of its GDP, compared to close to 30% of GDP for the US. [14] Europe has an interest in cooperation where it can be preserved and backed by a rules-based system of economic and financial relationships.

The IMF and RFAs form the financial backbone of a multilateral global financial safety net, making the work of regional rescue funds like the ESM pivotal to navigating geoeconomic fragmentation for two reasons:

First, regional funds have a role to play in supporting multilateralism. The antidote to heightened uncertainty and mistrust among countries is continued dialogue. It sends a strong message of stability when the IMF and RFAs continue to cooperate closely. The landscape in which RFAs operate is changing, most notably in recent years with the enlargement of BRICS. Maintaining cooperation supports the functionality of the system when a crisis emerges.

Second, as risks increase, the IMF and RFAs strengthen their economic monitoring, lending, and capacity within their respective remits to remain fit for purpose in a more shock-prone and volatile world. The IMF has recently concluded a review of its precautionary instruments and different RFAs are assessing how to strengthen their toolkits in view of these new challenges. At the ESM, we will soon conclude the review of our financial assistance instruments that considers the changing economic landscape.

Over the past decade, the ESM has cultivated and nurtured an open and candid dialogue with its global and regional peers to share knowledge and strengthen interinstitutional ties. The organisation of the annual RFA research seminar since 2017, which brings together experts from around the world, the joint analytical studies, and the annual high-level dialogue among the RFAs and the IMF every October, are the tangible examples of enhancing mutual understanding and international cooperation, in a more fragmented geoeconomic environment.

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Further reading

Regional Financing Arrangements (RFAs) | European Stability Mechanism (europa.eu)

Footnotes

[1] Apart from the ESM, the other major RFAs are: the Arab Monetary Fund, the BRICS Contingent Reserve Arrangement, the Chiang Mai Initiative Multilateralisation and its surveillance unit the ASEAN+3 Macroeconomic Research Office, the Eurasian Fund for Stabilization and Development, the EU Balance of Payments facility and the EU Macro-financial Assistance facility managed by the European Commission, and the Latin American Reserve Fund.

[2] Shekhar Aiyar, Andrea Presbitero, Michele Ruta (2023), Geoeconomic Fragmentation: The Economic Risks from a Fractured World Economy | CEPR

[3] Together RFAsformthe regional layer of protectionofthe Global Financial Safety Net, which helps prevent and mitigate crises.

[4] Hongyan Zhao (2024), How the US-China Trade Conflict Affected China's Trading Patterns

[5] Vikram Singh, Henrique Correa da Cunha, Shivanie Mangal (2022), Do Geopolitical Risks Impact Trade Patterns in Latin America?: Defence and Peace Economics: Vol 0, No 0 - Get Access (tandfonline.com)

[6] Wilko Bolt, Jan Willem van den End, Jos de Grip, Kostas Mavromatis, Ralph Verhoeks, Nander de Vette (2023), Geoeconomic fragmentation: economic and financial stability implications (dnb.nl)

[7] Daniel Dieckelmann, Christoph Kaufmann, Chloe Larkou, Peter McQuade, Caterina Negri, Cosimo Pancaro, Denise Rler (2023), Turbulent times: geopolitical risk and its impact on euro area financial stability (europa.eu)

[8] A non-bank (also callednonbankingfinancialinstitution)is a financial institution that does not have a full banking license and cannot accept deposits from the public.

[9] Eduardo A. Cavallo, Jeffrey A. Frankel (2008), Does openness to trade make countries more vulnerable to sudden stops, or less? Using gravity to establish causality - ScienceDirect

[10] Robert N McCauley, Hiro Ito (2018), A key currency view of global imbalances (bis.org)

[11] Asian Development Bank, 2023, Measuring Globalization: Framework, Analysis, and Implications (adb.org)

[12] Gita Gopinath, Pierre-Olivier Gourinchas, Andrea F Presbitero, Petia Topalova, 2024, Changing Global Linkages: A New Cold War? (imf.org)

[13] Stijn Claessens (2019), Fragmentation in global financial markets: good or bad for financial stability? (bis.org)

[14] European Commission (2024), Euro area competitiveness: trade performance and risks of trade fragmentation