

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

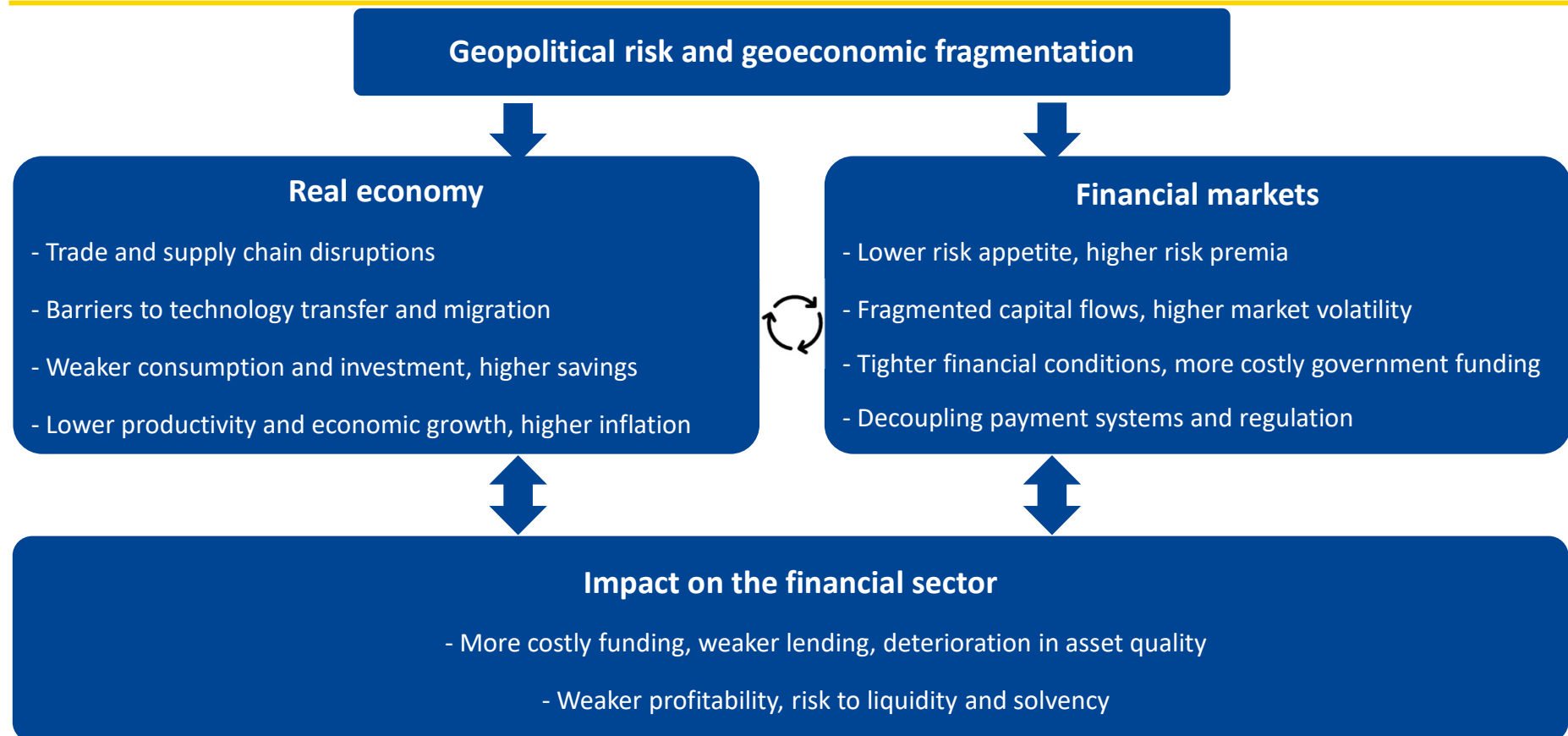
The ESM's mandate is to safeguard financial stability

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



Source: [Turbulent times: geopolitical risk and its impact on euro area financial stability \(europa.eu\)](https://ec.europa.eu/economy_finance/turbulent-times-geopolitical-risk-and-its-impact-on-euro-area-financial-stability)

OVERVIEW



Global trends

Slowing globalisation
Geopolitical shocks
Goeconomic fragmentation



Risks to the euro area

Trade links
Financial flows



Policy implications

For Europe
For the ESM

GLOBAL TRENDS



WHAT IS THE BIGGEST CHALLENGE LITHUANIA IS FACING TODAY?



DIFFERENT TRIGGERS AND CHANNELS OF FRAGMENTATION

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

- **Not** necessarily **directly linked to geopolitics**, but policy response affected 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.

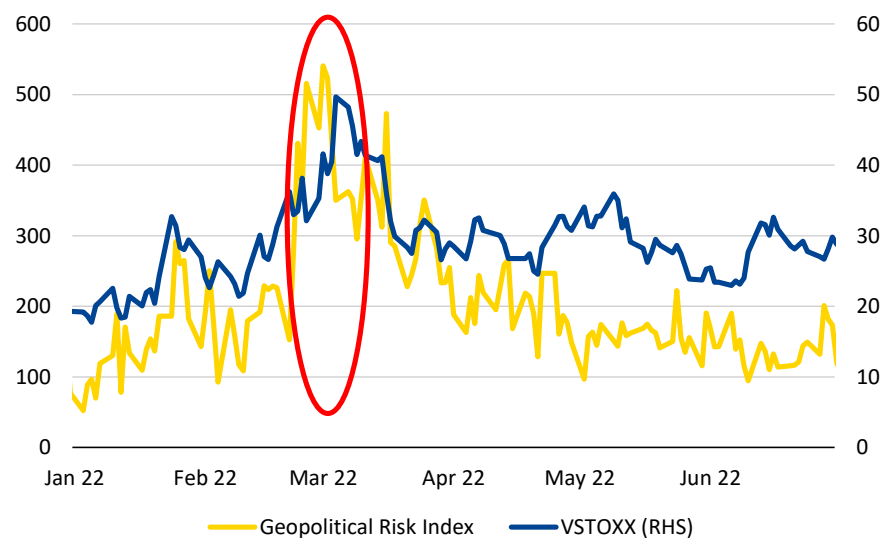
Goeconomic fragmentation, persistent structural shifts: US trade tariffs, US-China tensions

- Policy-induced decoupling: US tariffs accelerating a 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, role of USD.

GEOPOLITICAL SHOCKS: IMPACT ON FINANCIAL MARKETS

Geopolitical risks trigger market volatility...

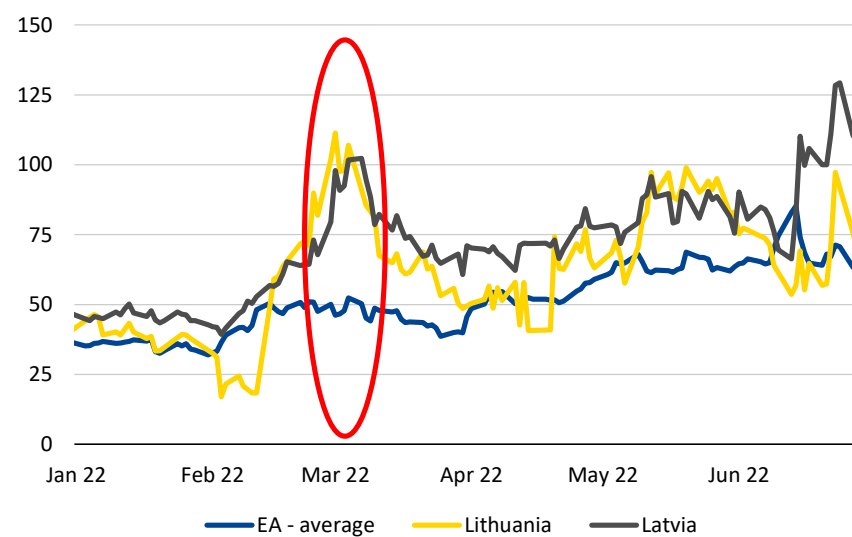
Geopolitical Risk Index and euro area stock market volatility at the onset of Russian invasion of Ukraine (index)



Source: Caldara and Iacoviello and Bloomberg

...and raise sovereign risk

Sovereign spreads against Germany at the onset of Russian invasion of Ukraine (5Y, bps)

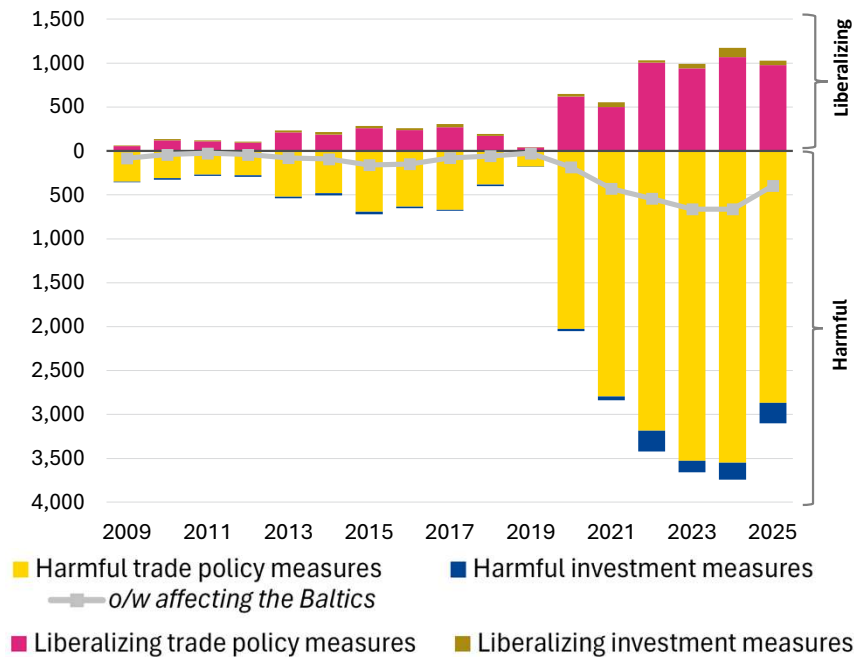


Note: Euro area average weighted by the ECB capital key.
Source: Bloomberg

GEOECONOMIC FRAGMENTATION IS A LONGER-TERM TREND...

Restrictive measures have multiplied

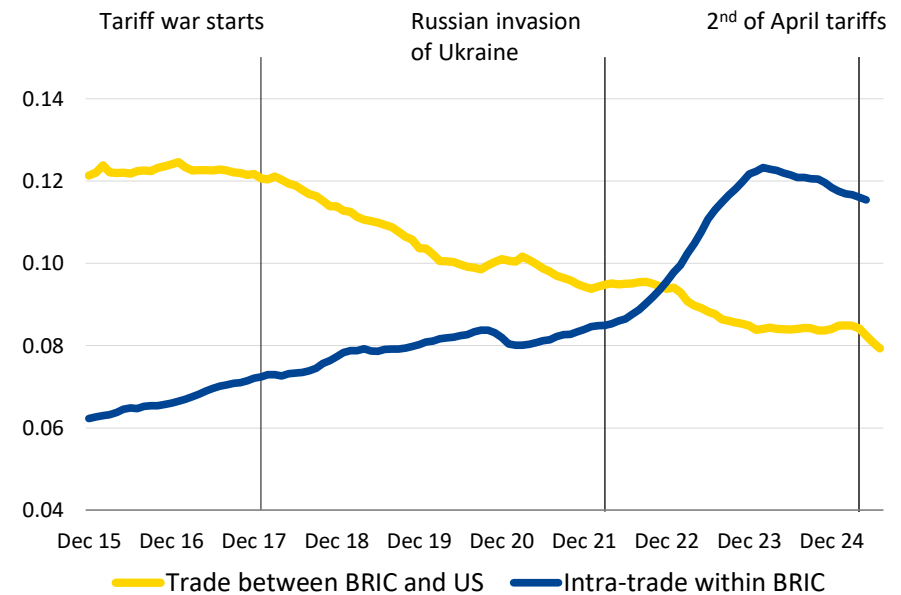
Number of new trade and investment measures globally



Notes: The chart includes the number of new trade policy measures (affecting good & services) and investment policy measures (FDI & capital controls) implemented globally per year. Series adjusted for reporting lag using 31 Dec as cutoff date.
Source: based on Global Trade Alert

Trade realigning among geopolitical blocks

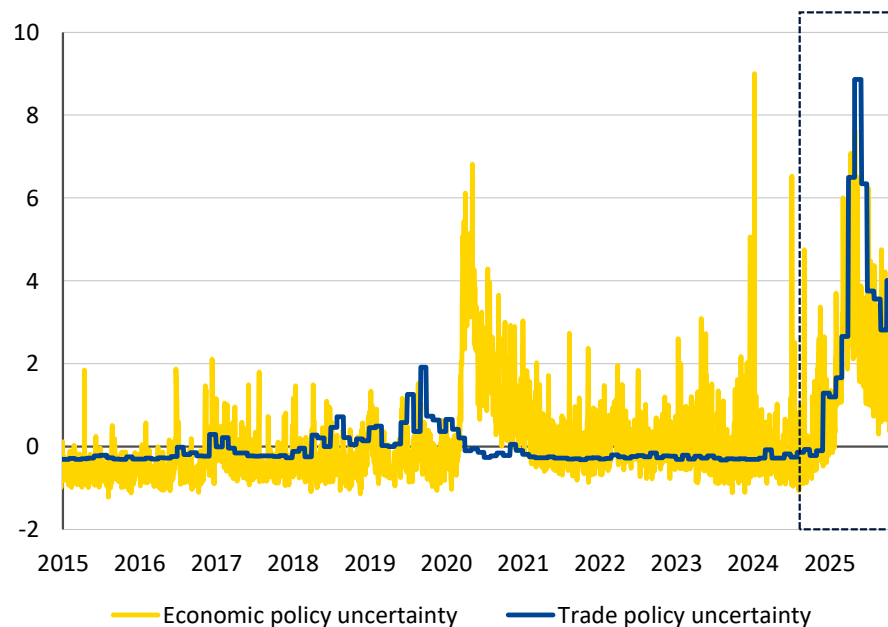
Trade links BRICs and US, as share of BRICs trade



Notes: Trade links are measured as the sum of imports and exports in merchandise goods. Last data points: July 2025 for US-BRIC trade, May 2025 for intra-BRIC trade.
Sources: US Census Bureau and IMF Direction of Trade Statistics

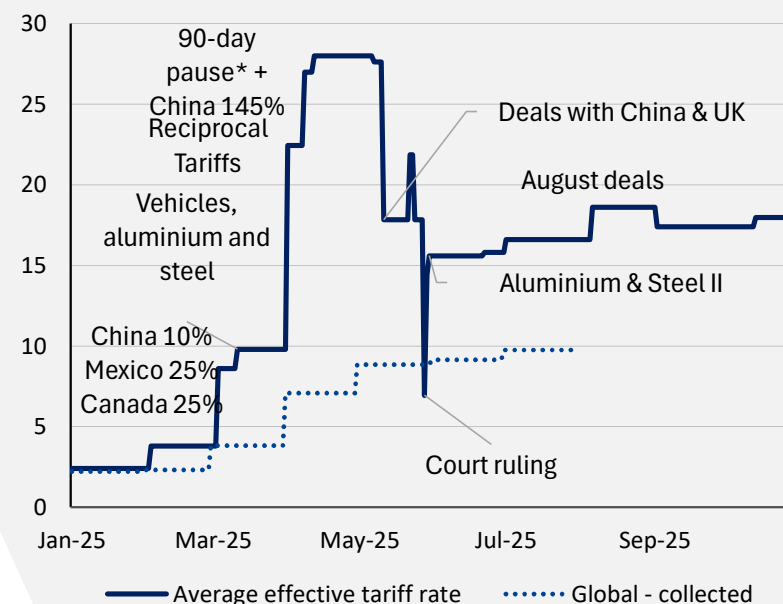
US TARIFF POLICY HAS ADDED UNCERTAINTY AND COSTS TO TRADE AND THE OUTLOOK...

US economic and trade policy uncertainty
(z-scores)



Source: Baker, Bloom and Davis (2016), updated data retrieved from www.policyuncertainty.com, accessed October 28

US global tariff rates
(average effective tariff rate, %)

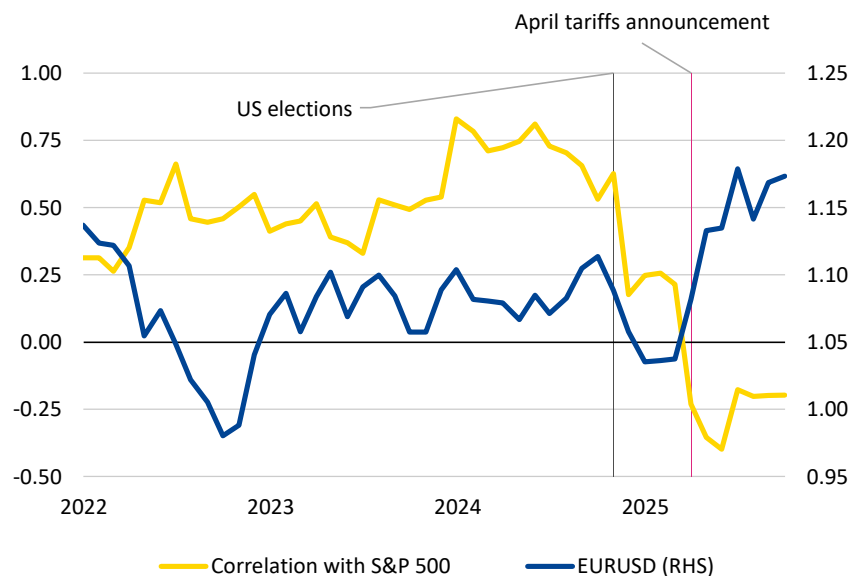


Notes: Global – collected calculated as duties/customs value. The “90-day pause” modified the Reciprocal Tariffs from 2 April.

Sources: ESM, Yale Budget Lab, US International Trade Commission, and Bloomberg

... AND RAISED QUESTIONS ON THE US SAFE-HAVEN STATUS

EURUSD rate and its correlation with S&P 500
(indexed to Nov 1, 2024=100)

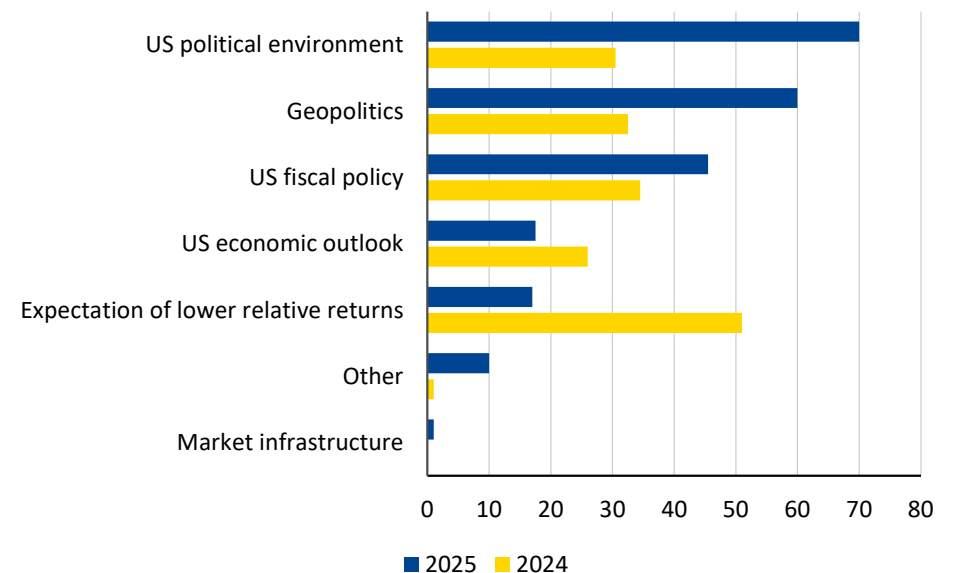


Note: Twelve-month rolling correlation of monthly changes of EURUSD and S&P 500.
Source: Bloomberg

Reserve managers survey:

Which of the following factors discourages you from investing in the US dollar?

(% share of respondents)



Source: OMFIF Global Public Investor, June 2025. Report available at:
<https://www.omfif.org/global-public-investor-2025>

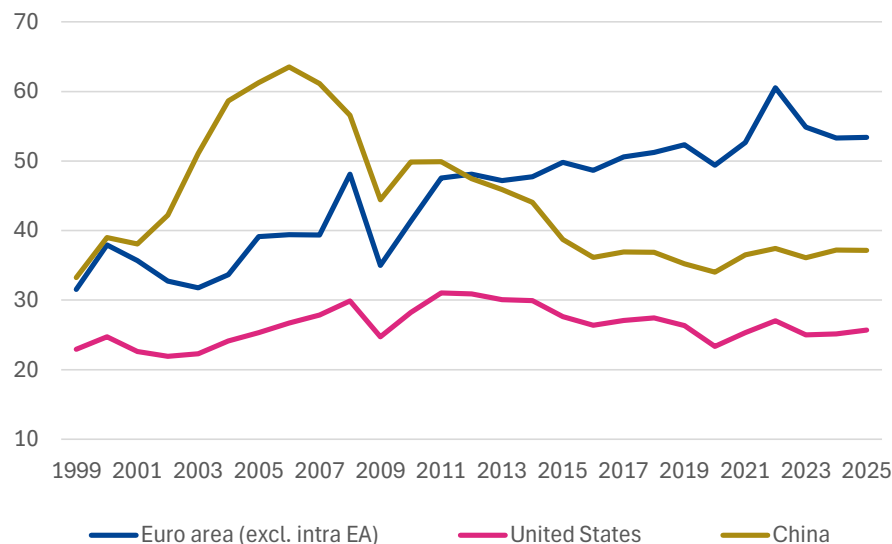
EXPOSURES OF THE EURO AREA



THE EURO AREA IS PARTICULARLY VULNERABLE TO GEOECONOMIC FRAGMENTATION

The euro area is highly integrated in global trade...

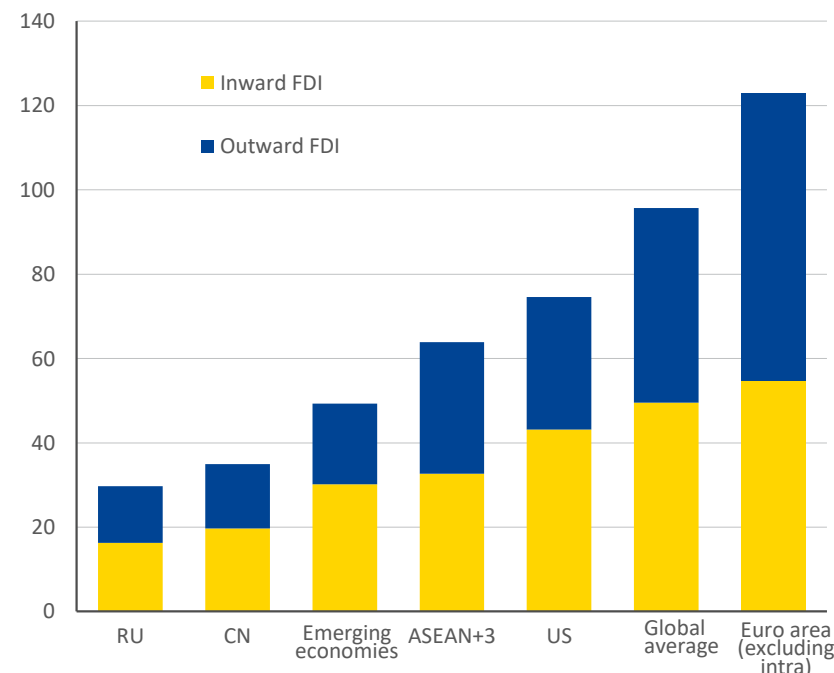
Trade openness ratio (exports and imports of goods and services), as a % of GDP



Notes: Trade openness is defined as the ratio of imports and exports of goods and services to GDP. The series excludes trade between euro area countries. Last data is June 2025.
Sources: ESM's calculations based on aggregate BOP data sourced from the ECB and the IMF (for the Euro Area, prior to 2013), from Eurostat (for the EU series), and from national statistical offices (for the US and China series).

...and more financially open

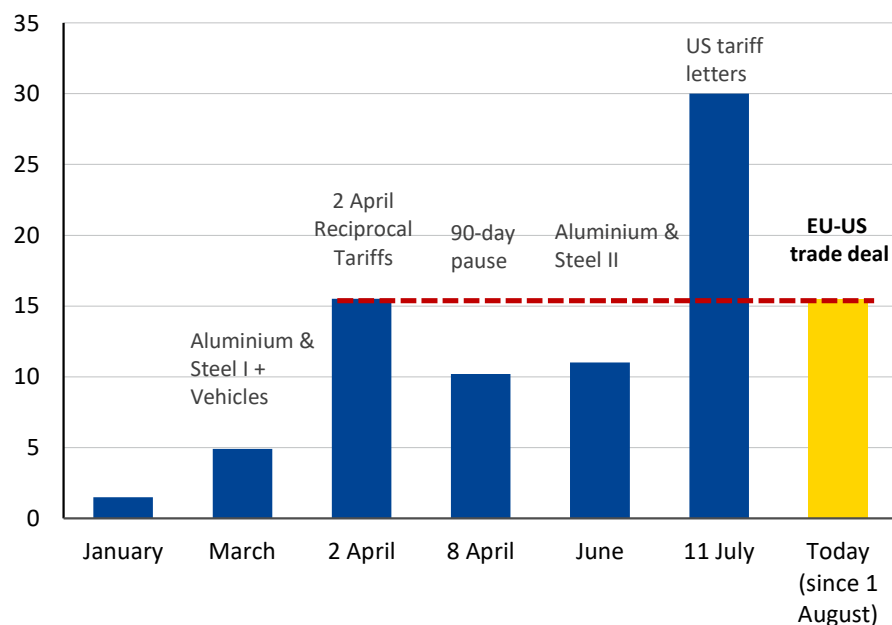
Foreign Direct Investment (FDI): assets and liabilities stocks, % of GDP



Source: Authors' calculations based on IMF's Coordinated Portfolio Investment Survey data

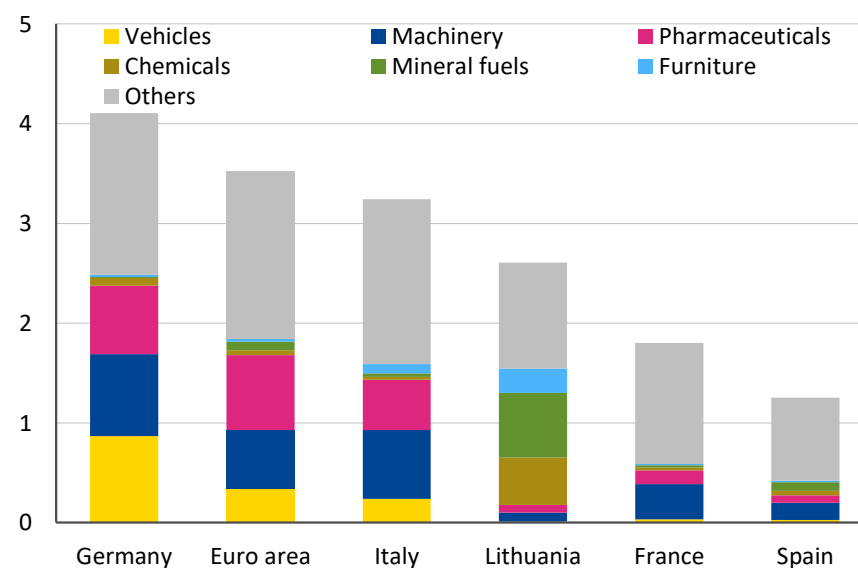
TRADE (I): RISE IN US TARIFFS, HETEROGENEOUS IMPACT ACROSS EURO AREA COUNTRIES AND SECTORS ...

US tariff rates announced on EU exports
(average effective tariff rate, %)



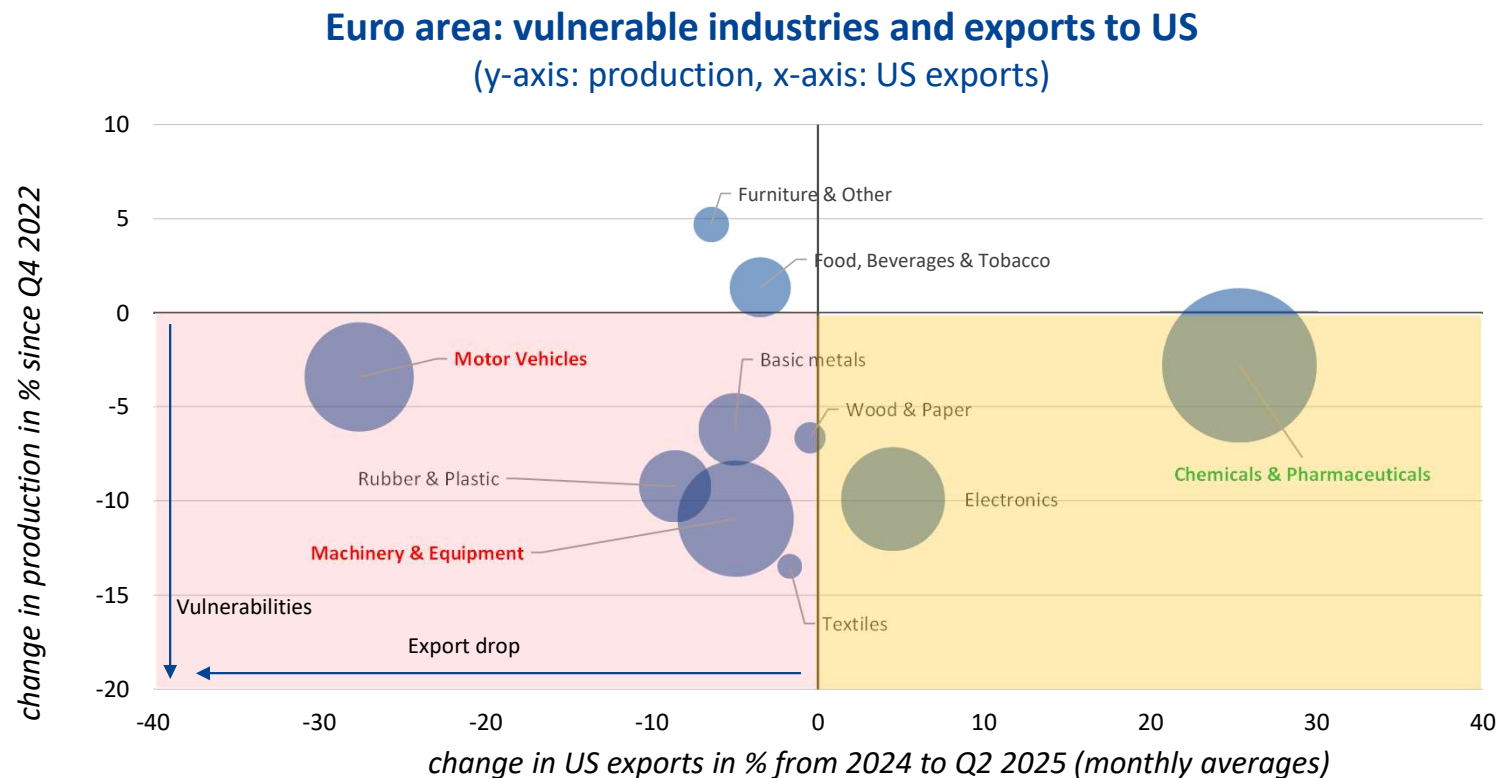
Note: Calculations are based on US announcements.
Source: ESM calculations

Importance of products at risks through tariffs
(goods-specific exports to US in % of gross value added)



Notes: Gross value added from 2024. The chart shows the sum of exports to US as share of gross value added. Machinery is a short label for "Nuclear reactors/Boilers/Machinery".
Sources: Eurostat and ESM calculations

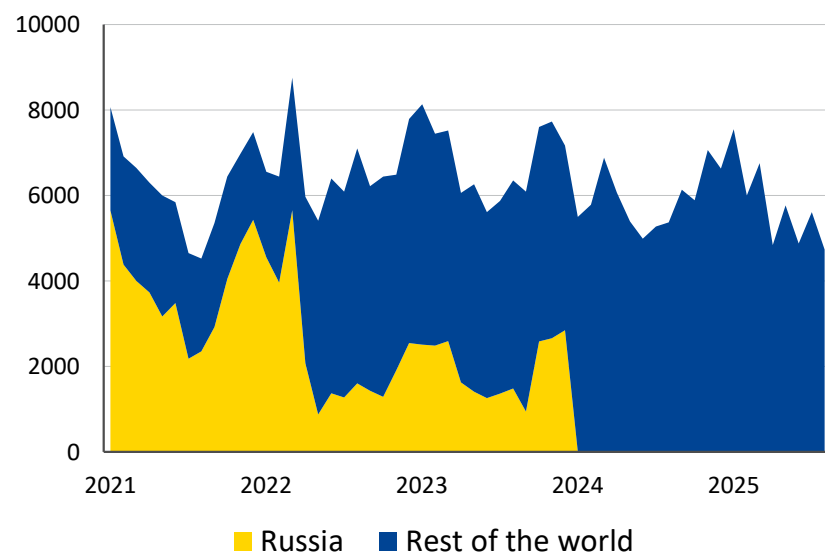
... WITH A NEGATIVE EFFECT ON LONG-TERM COMPETITIVENESS



Notes: The vertical axis reports the change of respective sectors' production from Q4 2022 to Q2 2025 in %. The horizontal axis shows monthly exports in Q2 2025 (averages) relative to monthly exports in 2024 (averages). Bubbles represent the US exports to gross value-added ratios.
Sources: Eurostat and ESM calculations

TRADE (II): SHIFTING TRADE RELATIONSHIPS & THE CASE OF LITHUANIA

Lithuania's imports of fuel and energy
(in natural thousand units, 3-month moving average)



Note: "natural units" refer to the physical units used for each fuel or energy product (not converted to a common energy unit).

Source: Statistics Lithuania and ESM calculations.

Lithuania's growth in real exports of goods and services

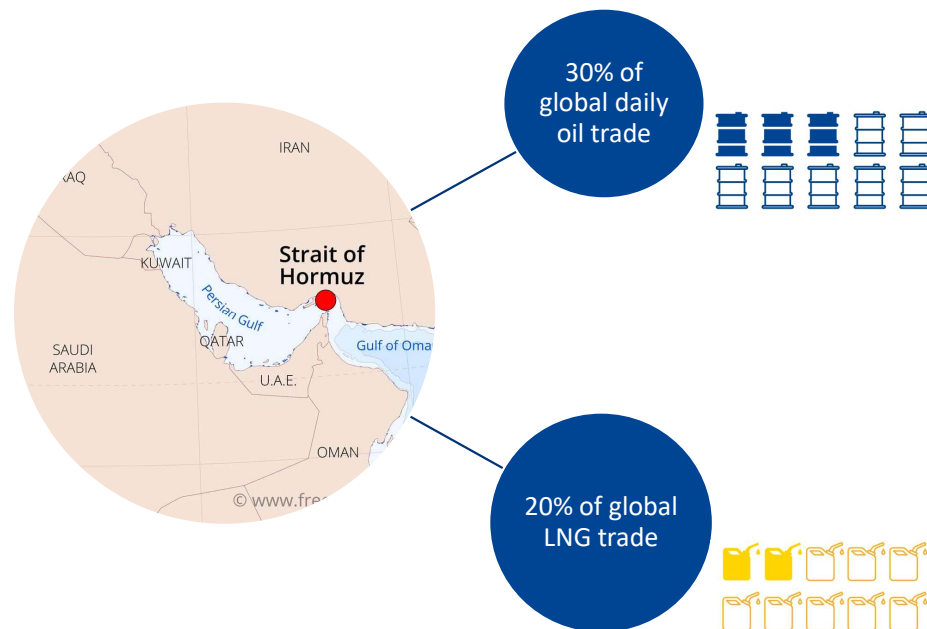
(year-on-year; in %)



Source: Eurostat and ESM calculations.

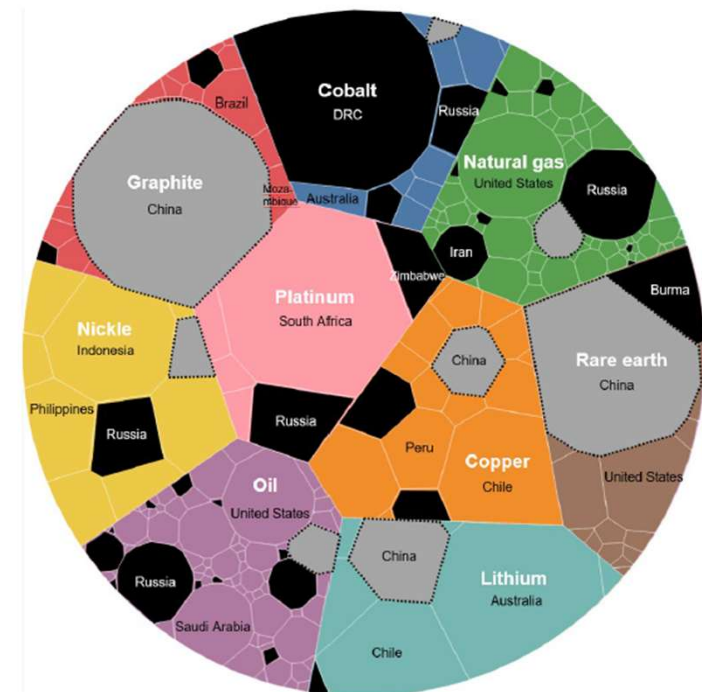
TRADE (III): STRONG EXTERNAL DEPENDENCIES ON ENERGY AND RAW MATERIALS

Energy supply routes are vulnerable...



...and raw material sources are concentrated

Global sources of selected commodities, 2020



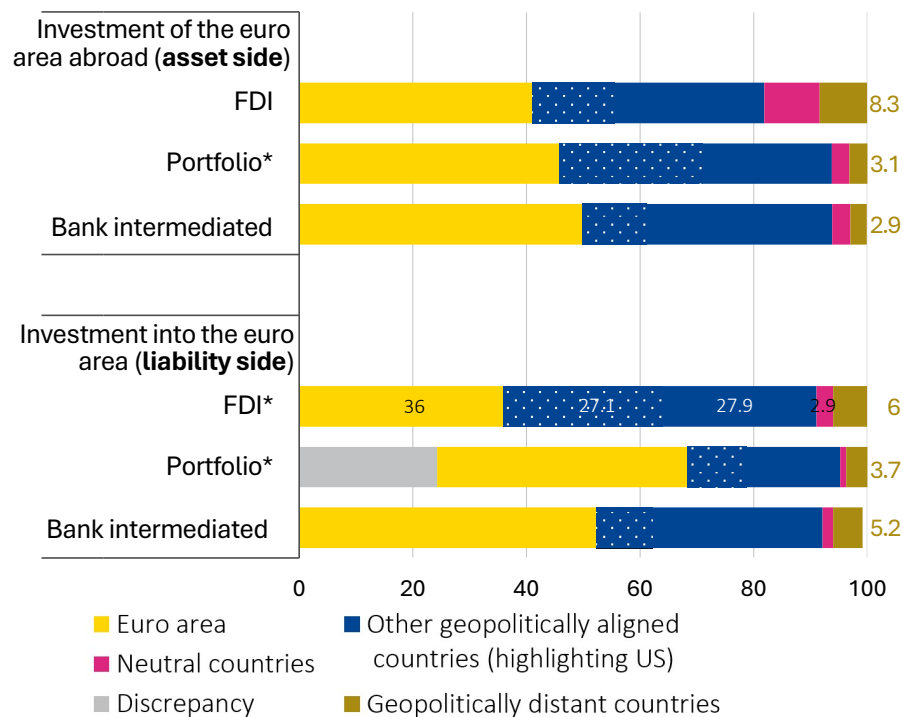
Note: Countries in black are under sanctions; China is shaded in grey.

Source: IMF SDN Goeconomic Fragmentation and the Future of Multilateralism (2023)

FINANCING: POCKETS OF EXPOSURE TO FRAGMENTATION RISK

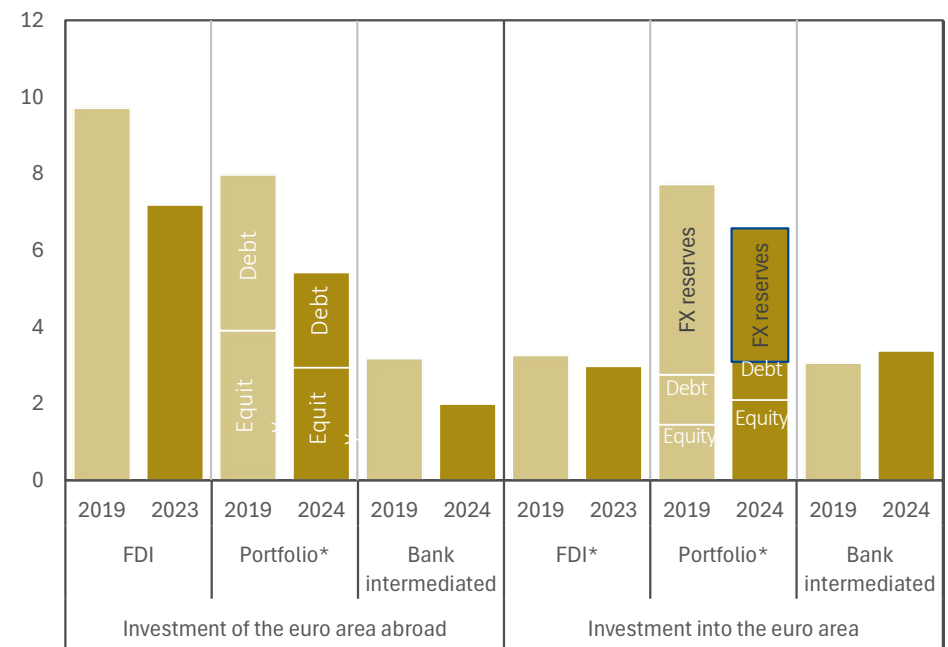
Exposure to political risk looks limited overall...

Euro area cross-border investment positions, latest, % of total



...but concentrated in FDI and portfolios

Exposures to geopolitically distant countries, (2019 vs. latest, % of euro area GDP)

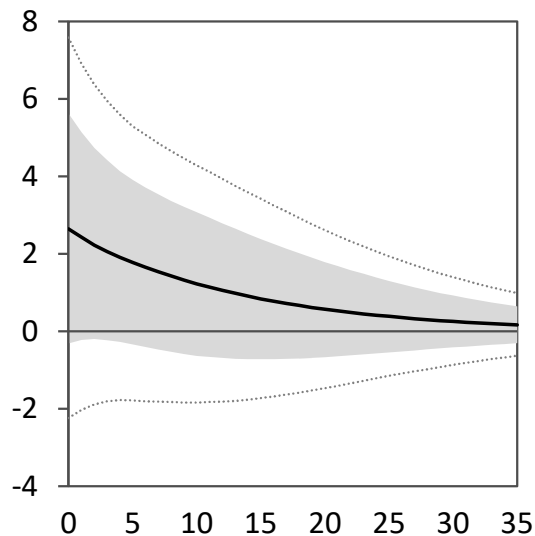


* restated: inward FDI estimated on an ultimate basis using the probabilistic approach of Casella (2019); Portfolio positions restated based on reallocation matrices from Beck et al. (2024) and including securities liabilities held as reverse assets by foreign central banks.

ESM ANALYSIS: GEOPOLITICAL SHOCKS AND PORTFOLIO FLOWS

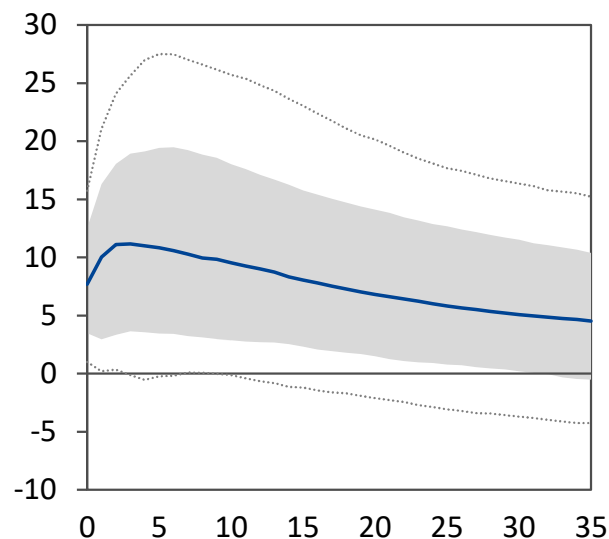
**Euro area debt is seen as
a “safe haven”...**

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



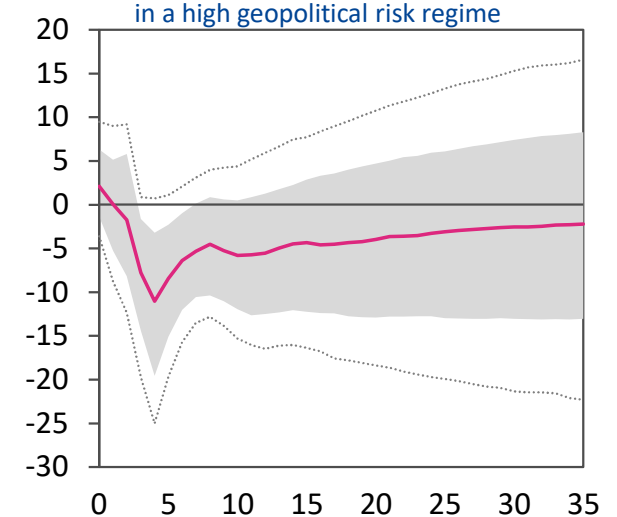
**...in a low geopolitical risk
regime...**

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



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

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

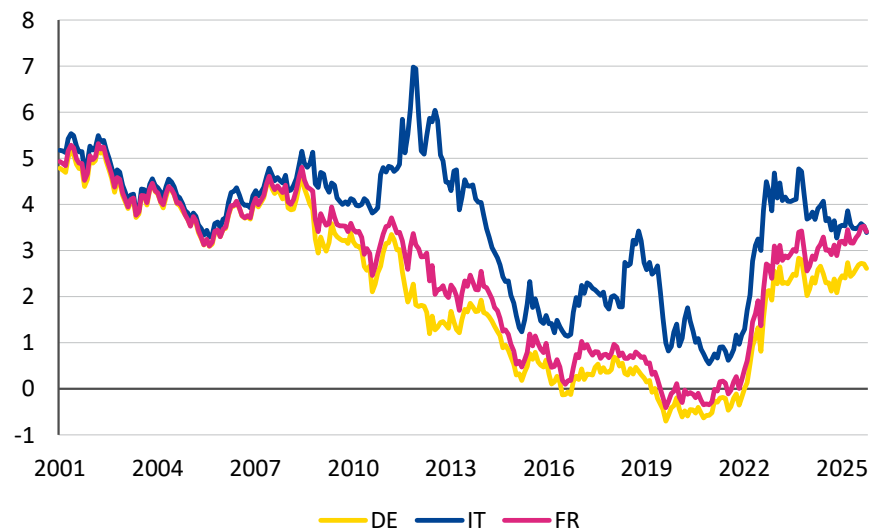


Effect of a one-standard-deviation shock to the geopolitical risk index, based on Bayesian VAR model; GPR shock identified by Cholesky decomposition, (ordering first the GPR index)

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

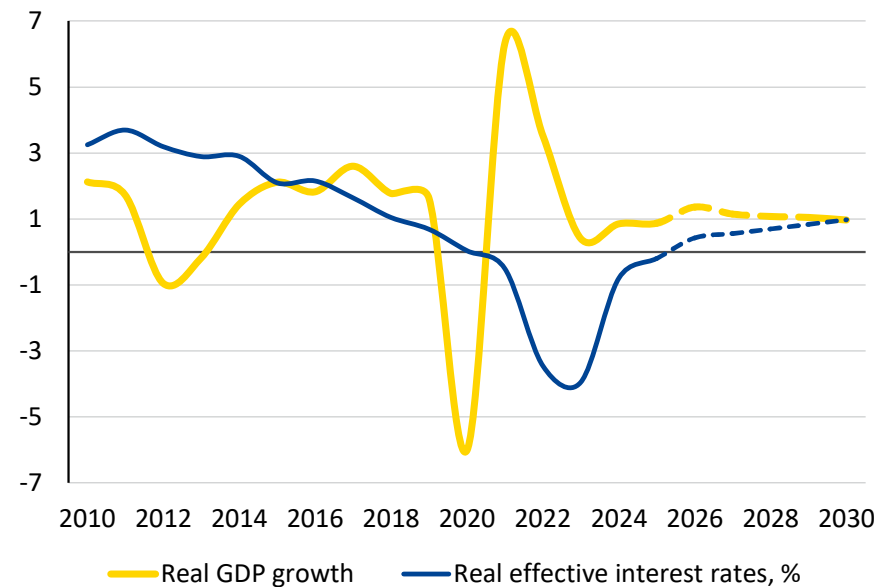
SOVEREIGNS NAVIGATE A TIGHT FISCAL SPACE...

Sovereign bond yields rising
(10-year sovereign bond yields, %)



Source: Bloomberg

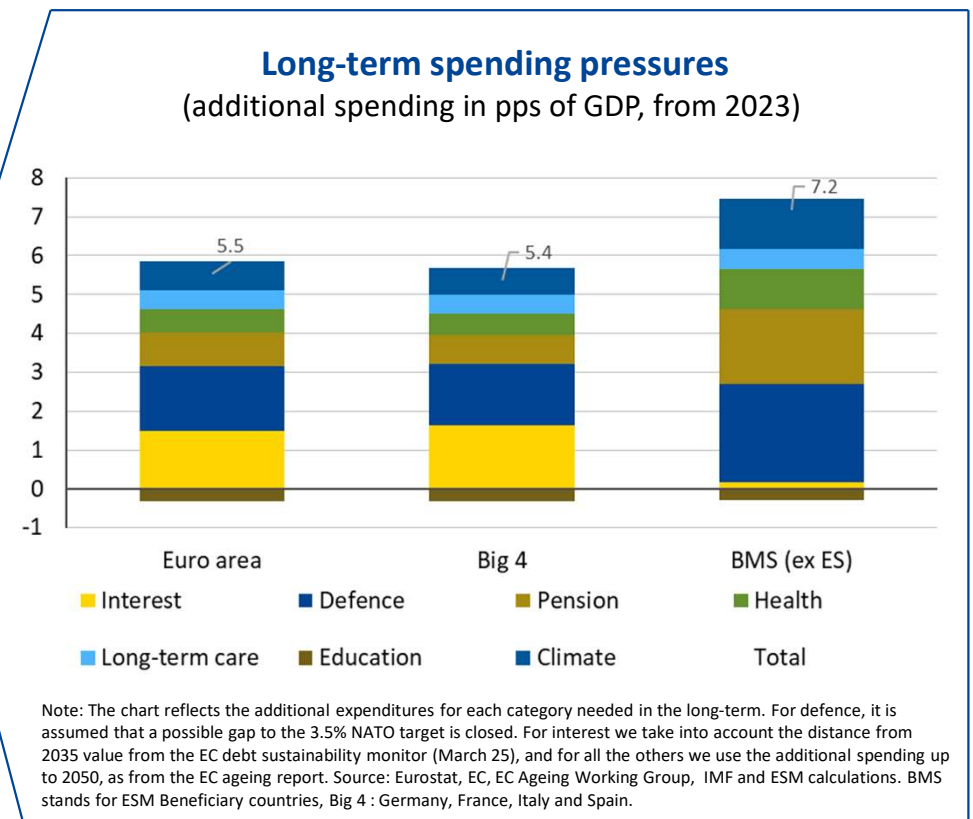
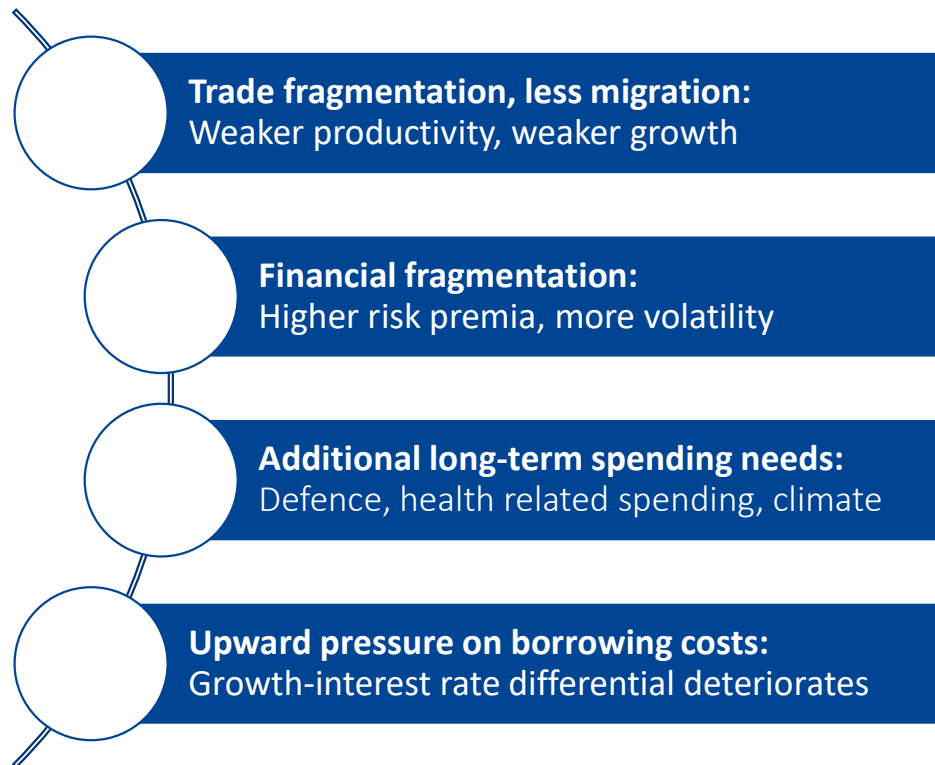
Fiscal space from favourable r-g is dissipating
(% points)



Note: Real effective interest rate estimates based on marketable debt securities and 10-year forward curves.

Source: ESM calculations based on Eurostat, European Commission, and Bloomberg data

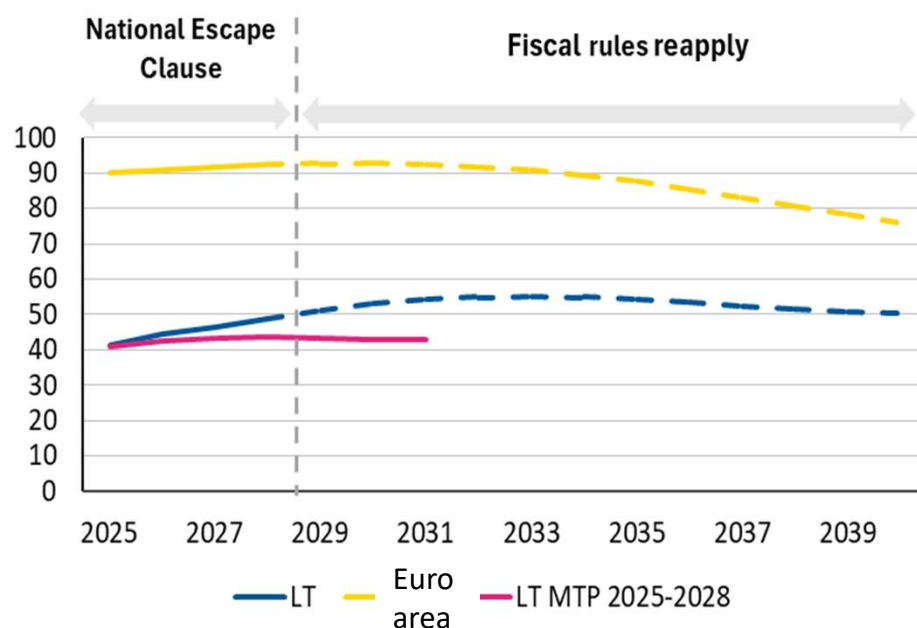
... AND HIGHER LONG-TERM COSTS...



... RISING RISKS TO DEBT SUSTAINABILITY

Defence spending puts euro area debt on an upward path under escape clause

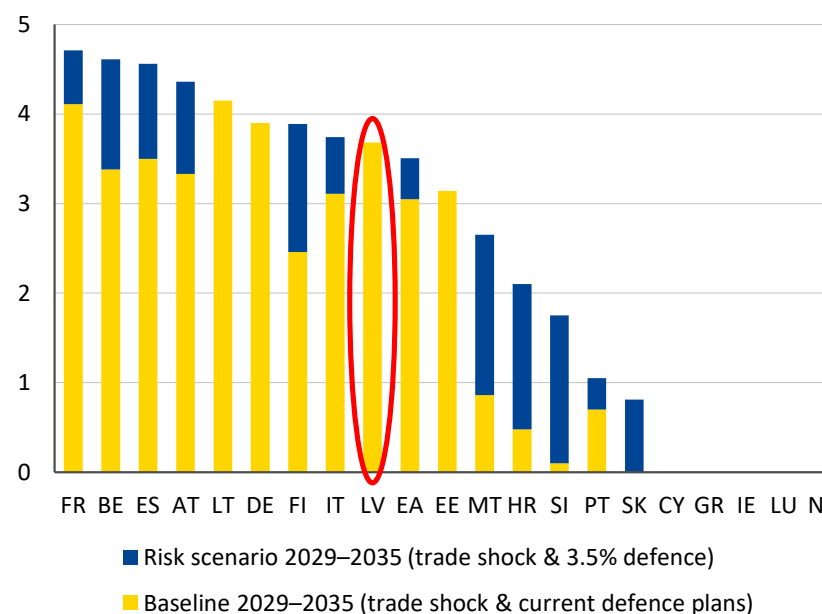
(public debt, % of GDP)



Source: ESM calculations

Stability and growth pact compliance from 2029 requires large adjustments

(cumulative adjustment needs as of 2029 in % of GDP)



Source: ESM calculations based on a seven-year adjustment plan

POLICY IMPLICATIONS: FOR THE ESM AND FOR EUROPE MORE BROADLY



WHAT SHOULD LITHUANIA'S TOP PRIORITY BE?



EU POLICY PRIORITIES IN A SHIFTING GLOBAL ENVIRONMENT

Manage geopolitical risks

- ✓ Defense capabilities
- ✓ Strategic autonomy
- ✓ Strengthen international role of the euro

Foster competitiveness and productivity

- ✓ Deepen single market
- ✓ Savings and investments union
- ✓ Structural reforms

Ensure sustainability

- ✓ “Smart” fiscal consolidation
- ✓ Strengthen European financing
- ✓ Green transition

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



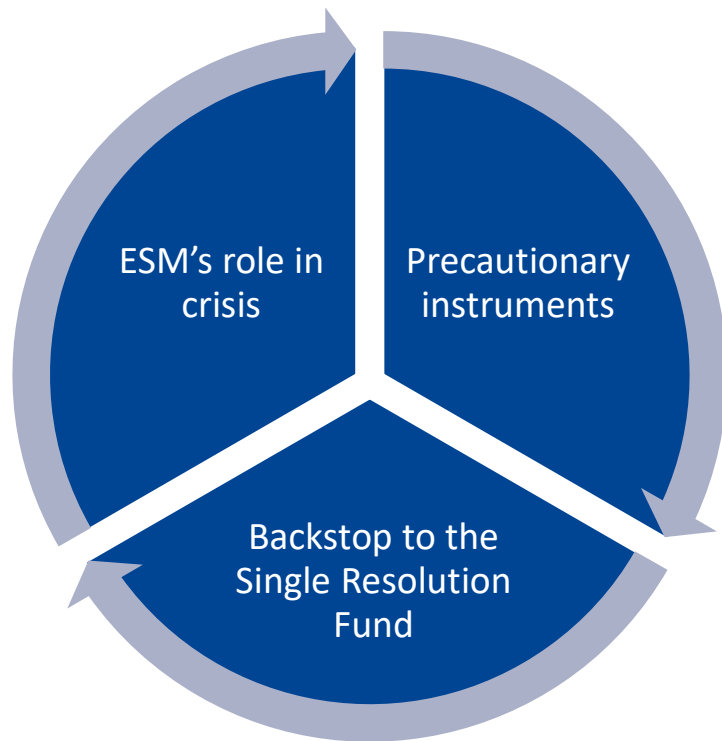
Cooperating closely with our global and regional peers, conveying a strong message of support for multilateralism



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

ESM'S TOOLKIT: PRECAUTIONARY LINES IN FOCUS

Precautionary instruments: an effective insurance against exogenous shocks



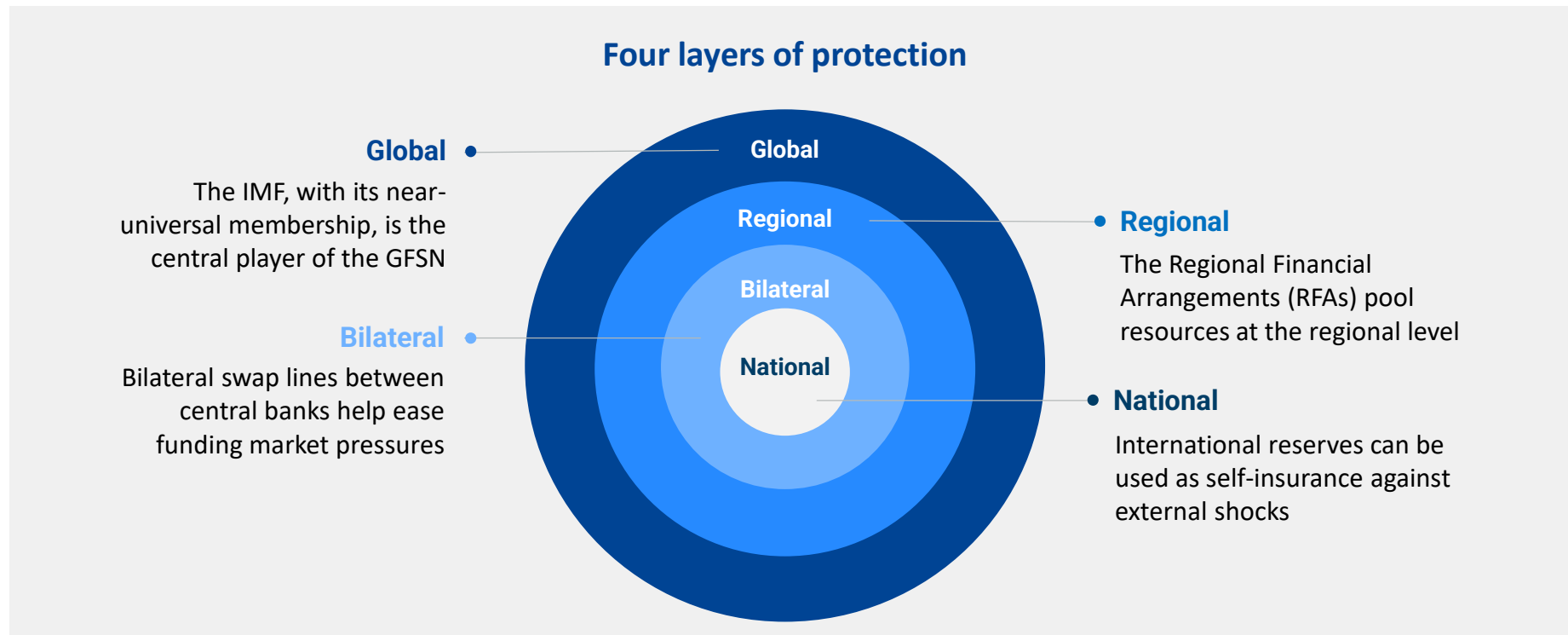
A flexible safety net that could support market confidence and keep borrowing costs contained

Confirmation of country's strong position: access is granted only to Member States with sound economic fundamentals

Builds on IMF experience with precautionary lending

THE GLOBAL FINANCIAL SAFETY NET (GFSN): WE MUST WORK TOGETHER

The GFSN provides insurance against crises, financing when shocks hit



EUROPE'S INDEPENDENCE MOMENT

“The size of the challenge we face far exceeds the size of our national economies. [...] In this world, it will be only through unity that we will be able to retain our strength and defend our values.”



Mario Draghi, Presentation of the report on the Future of European competitiveness

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