

Geopolitics and Financial Fragmentation: Implications for Macro-Financial Stability

Rising geopolitical tensions among major economies have intensified concerns about global economic and financial fragmentation. Financial fragmentation brought on by geopolitical tensions could have potentially important implications for global financial stability by affecting the cross-border allocation of capital, international payment systems, and asset prices.

In the chapter, geopolitical tensions are proxied by the dissimilarity in the foreign policy orientation of investing and recipient countries, and these are found to matter significantly for cross-border portfolio and bank allocation. In general, investing countries tend to allocate less capital to recipient countries with a more dissimilar foreign policy outlook.

The chapter empirically examines the channels through which geopolitical tensions affect cross-border portfolio and bank allocation. Our analysis suggests that a one standard deviation increase in geopolitical tensions between an investing and a recipient country—equivalent to the diverging voting behavior of the United States and China in the United Nations since 2016—could reduce bilateral cross-border portfolio and bank allocation by about 15 percent.

An increase in geopolitical tensions with major partner countries could cause a sudden reversal of cross-border capital flows, with the impact being notably larger for emerging market and developing economies than for advanced economies. This could pose macro-financial stability risks through an increase in banks' funding costs, a decline in their profitability, and lower credit provision to the private sector. These impacts are likely to be disproportionately larger for banks with lower capitalization ratios.

Greater financial fragmentation stemming from geopolitical tensions could also exacerbate macro-financial volatility in the longer term by reducing international risk diversification opportunities in the face of adverse domestic and external shocks.

Supervisors, regulators, and financial institutions should be aware of the risks to financial stability stemming from a potential rise in geopolitical tensions and commit to identify, quantify, manage, and mitigate these risks. A better understanding and monitoring of the interactions between geopolitical risks and “traditional” risks related to credit, interest rate, market, liquidity, and operations could help prevent a potentially destabilizing fallout from geopolitical events. To develop actionable guidelines for supervisors, a systematic approach that employs stress testing and scenario analysis is needed to assess and quantify geopolitical shock transmission to financial institutions.

Based on assessments of geopolitical risks, banks and nonbank financial institutions may need to hold adequate capital and liquidity buffers to mitigate the adverse consequences of rising geopolitical risks.

In the face of rising geopolitical tensions, the adequacy of the global financial safety net needs to be ensured through strong levels of international reserves held by countries, bilateral and regional financial arrangements, and precautionary credit lines from international financial institutions.

Given the significant risks to global macro-financial stability, countries should make utmost efforts to strengthen engagement and dialogue to diplomatically resolve geopolitical tensions and prevent economic and financial fragmentation.

To see the full report, please refer to the English version here:

<https://www.imf.org/en/Publications/GFSR/Issues/2023/04/11/global-financial-stability-report-april-2023>