SUOMEN PANKKI EUROJÄRJESTELMÄ FINLANDS BANK EUROSYSTEMET

Exploring Euro Area Exposure to the Risk of Geoeconomic Fragmentation

Authors: Gergely Hudecz, Alexandre Lauwers, Yasin Mimir, Graciela Schiliuk, Li Lian Ong, Hongyan Zhao, Diana del Rosario

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Discussion by: Tuuli McCully
Bank of Finland Institute for Emerging Economies (BOFIT), Bank of Finland

Summary of the paper – Part 1:
From integration to fragmentation

- Economic and political uncertainty due to geopolitical tensions adversely impacts both the supply side and the demand side of the economy.
- Fragmentation can be observed through reduced cross-border flows of people, goods, services, and capital.
- Financial fragmentation:
    - Bilateral financial interlinkages have weakened, and cross-border investment is becoming concentrated on partner countries.
    - Financial fragmentation can lead to reduced risk appetite, disruptions in payment systems, and limited financing sources.
    - Fragmentation may also result in a higher risk of sudden stops, suboptimal capital allocation, and reduced investment globally.

→ These trends could threaten macro-financial stability.

Summary of the paper – Part 2:
Exploring euro area exposure to the risk of geoeconomic fragmentation

- The euro area appears generally resilient, yet its trade and financial exposures to geopolitically distant countries present some vulnerabilities if geopolitical tensions escalate.
    - Countries are classified into geopolitical groups based on their votes in the UNGA in 2022.
- Empirical part: What are the implications of geoeconomic fragmentation for euro area countries, with a particular focus on the financial transmission channel?
    - Research question 1: Do investors factor in geopolitical alignment when allocating capital to foreign resident partners?

      - Gravity model (PPML) applied to bilateral cross-border financial ties.
    - Research question 2: What are the impacts of geopolitical risk shocks on financial flows in the euro area?

      - Bayesian vector autoregression (BVAR) models with endogenous regime shifts in geopolitical tensions.

Main findings 1

Research question 1: Do investors factor in geopolitical alignment when allocating capital to foreign resident partners?

- Geopolitical factors shape financial ties between countries.
  → Investors allocate smaller investment shares to geopolitically distant partners.
- Portfolio investment to and from the euro area are particularly sensitive to geopolitics.
  → Potential for portfolio flow reversals if geopolitical tensions escalate.
- Foreign reserves in euros are more sensitive to geopolitical distance than reserves in US dollars.

Main findings 2

Research question 2: What are the impacts of geopolitical risk shocks on financial flows in the euro area?

- Rising geopolitical risks increase global financial uncertainty and reduce euro area stock prices.
- Euro area displays safe haven characteristics, but capital inflows vary across asset classes and geopolitical risk regimes.
- When geopolitical tensions are elevated, there is a higher risk of portfolio outflows from the euro area.
- Euro area investors tend to sell foreign equities and debt securities, while foreign investors buy euro area instruments during geopolitical shocks.

General impressions

- Informative and well written paper.
- Important, timely, and policy-relevant topic.
- Trade fragmentation is under heavy research agenda, but fragmentation of financial flows less so; the paper helps fill this gap.
- Information overload; how to make key points and findings stand out?
- Data availability is an issue (as always).
  - Are there alternatives to the GPR?
  - Measuring geopolitical distance: *s*-score method / ideal point estimates / others?

Discussion

- The concentration of euro area financial exposures in FDI and portfolio debt liabilities highlights potential vulnerabilities.

  → How can the euro area mitigate these risks, especially given the significant role of geopolitically distant countries as ultimate investors?

- The role of financial hubs like Luxembourg and the Netherlands in conduit FDI is notable.

  → How can the euro area ensure that these hubs do not become points of vulnerability in times of geopolitical tension?

- The paper suggests several policy recommendations, such as enhancing resilience through regional cooperation and financial integration.

  → What specific steps can be taken to implement these recommendations effectively?

- The paper highlights the need for further analysis on the implications of geoeconomic fragmentation.

  → What specific areas should future research focus on to provide more comprehensive insights?

Thank you!

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