Abstract

Rising geopolitical tensions among major economies have intensified concerns about global economic fragmentation. This chapter examines how geopolitical tensions between countries can adversely affect investors' allocation of capital and financial stability. The analysis finds that capital flow reversals due to the change of capital allocation can lead to higher funding costs and lower performance of banking sector. Moreover, the fragmentation can increase macro-financial volatilities due to limited international investment opportunities. The chapter discuss policy responses including strengthening financial oversight, building buffers and safety nets, strengthening international cooperation.

In this presentation, we further elaborate on the impact of financial fragmentation on macro-financial volatilities with greater detail, in terms of the potential loss of international diversification benefits for the Group of Seven (G7) countries. It utilizes a two-country open-economy model to perform a counter-factual simulation under fragmentation scenarios in which G7 countries cannot trade with countries with high geopolitical distance, measured by voting disagreement in the United Nations. The simulation results indicate that the fragmentation could ruin the diversification benefits for G7 countries by limiting their trading partners to countries whose business cycles are highly correlated with G7 countries.