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Geopolitical risks: a significant challenge for the global financial stability

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This brief summarizes the major findings of NguyenHuu & Örsal (2023) on the significant impacts of geopolitical risks (GPRs) on global financial stability. In emerging economies, when financial stress (FS) is already at or above average, GPRs significantly amplify this instability; nevertheless, when financial conditions are stable, GPRs do not exert significant impacts. In these countries, foreign exchange markets, and to a lesser degree, the debt market and banking sector, are more severely impacted by geopolitical tensions than the stock market. The Group of Seven (G7), which represents developed economies, on the other hand, has seen negative effects of GPRs on their stock markets but not on other sectors.

Geopolitical risks & global financial conditions

The recent Gaza-Israel conflict, the Russo-Ukrainian War, terrorist attacks, trade disputes, political gridlock, climate change, cyberattacks, technology decoupling, and the COVID-19 pandemic are important geopolitical events that have happened recently. Geopolitical risks (GPRs) are one of the biggest threats to global financial stability (IMF, 2017–2023). Understanding the extent to which geopolitical uncertainties contribute to financial stress (FS) in emerging and advanced countries is of utmost importance for academic, political, and business circles.

Our analysis answers the question: How do different levels of GPRs affect the financial situation in different contexts—when the financial situation is experiencing favourable and stressful episodes?

Country-specific GPR indices are computed based on the number of articles related to GPRs divided by the total number of published articles in major international newspapers (Caldara & Iacoviello, 2022). Borrowing ideas from Balakrishnan et al. (2011), Park & Mercado (2014), and ADB (2021), we construct a comparable and complete dataset on FS for all major emerging economies. The FS index aggregates the financial instability indices for the banking sector, currency market, debt market, stock market return, and stock market volatility.

GPRs and FS in emerging economies

Our analysis shows that GPRs have negative and statistically significant impacts on the financial situation in emerging economies. The magnitude of such effects is nontrivial—equal to one-third of the contagion effects caused by the FS in advanced economies—and more severe than the impacts of a 1% decline in GDP growth.

Regarding quantile effects, GPRs do not have significant effects on the FS index at the lowest quantile, but the effects are considerably stronger at the middle and higher quantiles. This demonstrates that GPRs might put high pressure on financial stability when the economy already suffers from certain levels of stress, which means they can escalate a worsening financial situation. However, GPRs cannot trigger FS when the financial conditions are benign.

The impacts of geopolitical events are diverse across different segments of the financial market and across quantiles within a specific segment. First, banking sector stress is intensified by heightened GPRs, but only at the lowest or middle quantiles. In contrast, the effects of GPRs on foreign exchange markets are seen only at medium and high quantiles. In a pattern similar to that of the currency market, GPRs affect bond markets across all quantiles, and higher quantiles see more measurable impacts. In marked contrast to other segments of the financial system, stock markets, regarding both return and volatility measurements, are robust against geopolitical turbulence.

GPRs and FS in advanced economies

One crucial difference between advanced economies and emerging economies is that the impacts of GPRs in advanced economies are similar across quantiles. This indicates that geopolitical disorders in emerging economies might affect financial situations in advanced economies in a rather homogeneous pattern.

The stock markets in advanced economies see adverse impacts of GPRs on both market returns and market volatility. Furthermore, significant and destructive effects are found in high-stress episodes for both measurements of instability. One possible explanation for these impacts may be that the stock markets are internationally connected, and emerging markets play a significant role in advanced economies. Therefore, the spillover effect of shocks from the outside world, especially from emerging economies, is sizeable.

In contrast, other sections of the financial system, such as currency markets, bond markets, and banking sectors, are almost unaffected by geopolitical uncertainties from emerging economies.

In a nutshell

Our analysis suggests that appropriate reaction plans should be made against blooming geopolitical risks, especially when the financial markets are experiencing some level of stress. Furthermore, policymakers and investors should use different policies for different subsectors, because subsectors of the financial system may react very differently to the same geopolitical events.

Implications

Our findings could be useful for both political and business decision-makers. We show that geopolitical disturbances play a prominent role in shaping financial conditions in the world and in very different directions between emerging and advanced economies. Policymakers and investors in emerging and advanced economies should be very flexible in doing their jobs: their strategies should take into account not only the severity of the geopolitical risks but also the financial development of the economy and the sector where they want to see the impacts, and the financial situation of that sector for the time being.

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