BROOKINGS

The Impact of Geopolitics on International Finance: Evidence and Implications

Chapter 1. External portfolios

Anusha Chari	University of North Carolina, CEPR, and NBER
Nathan Converse	Federal Reserve Board
Arnaud Mehl	European Central Bank and CEPR
Gian Maria Milesi-Ferretti	Hutchins Center on Fiscal and Monetary Policy, The Brookings Institution and CEPR
Isabel Vansteenkiste	European Central Bank and CEPR

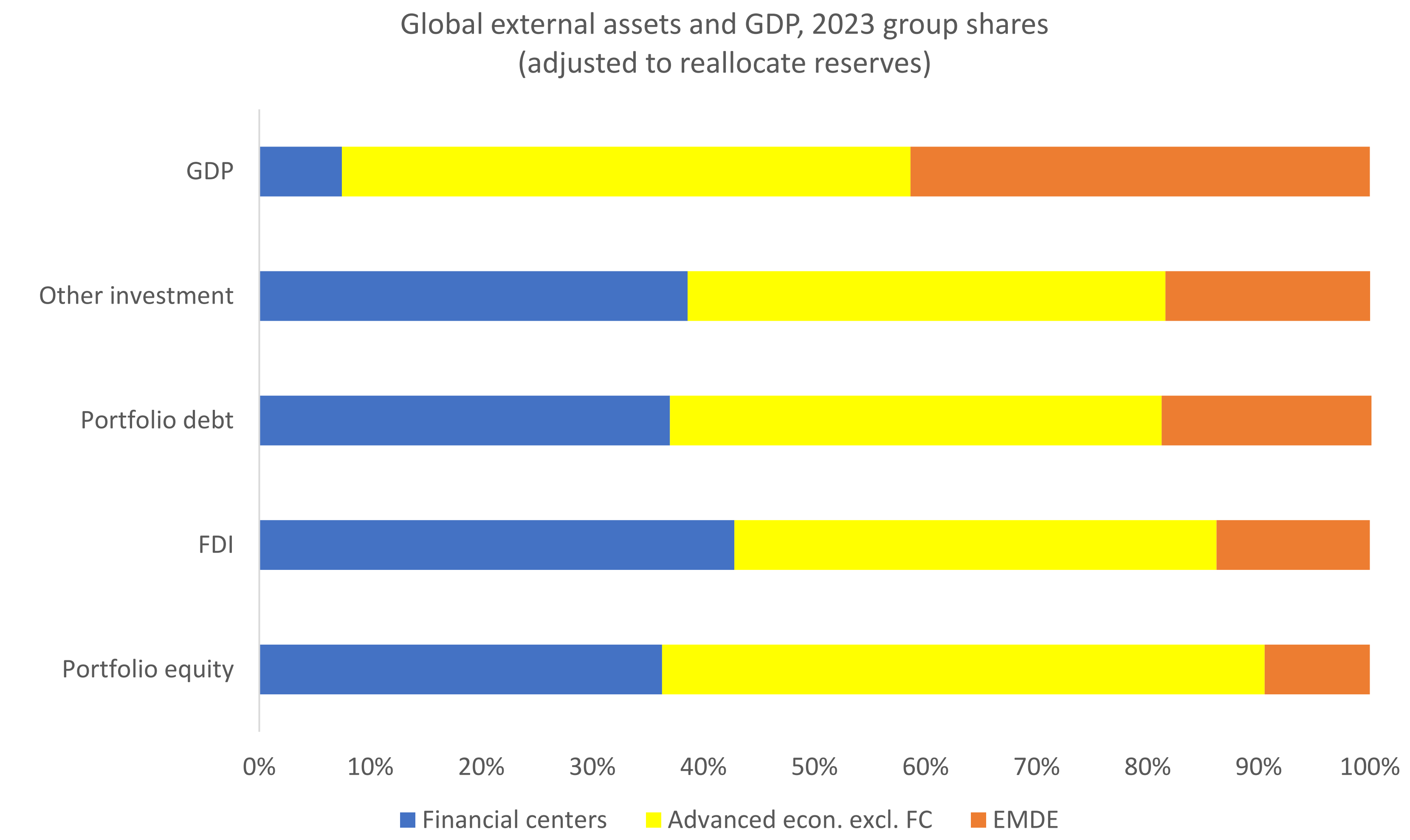
Evolution of geopolitical alignments

- At the start of the report, we were thinking of a “Western” bloc and a China/Russia bloc, with many non-aligned countries.
- The world looks much more complex now.
- But the evidence we present is useful to think about implications and risks arising from different geopolitical configurations.

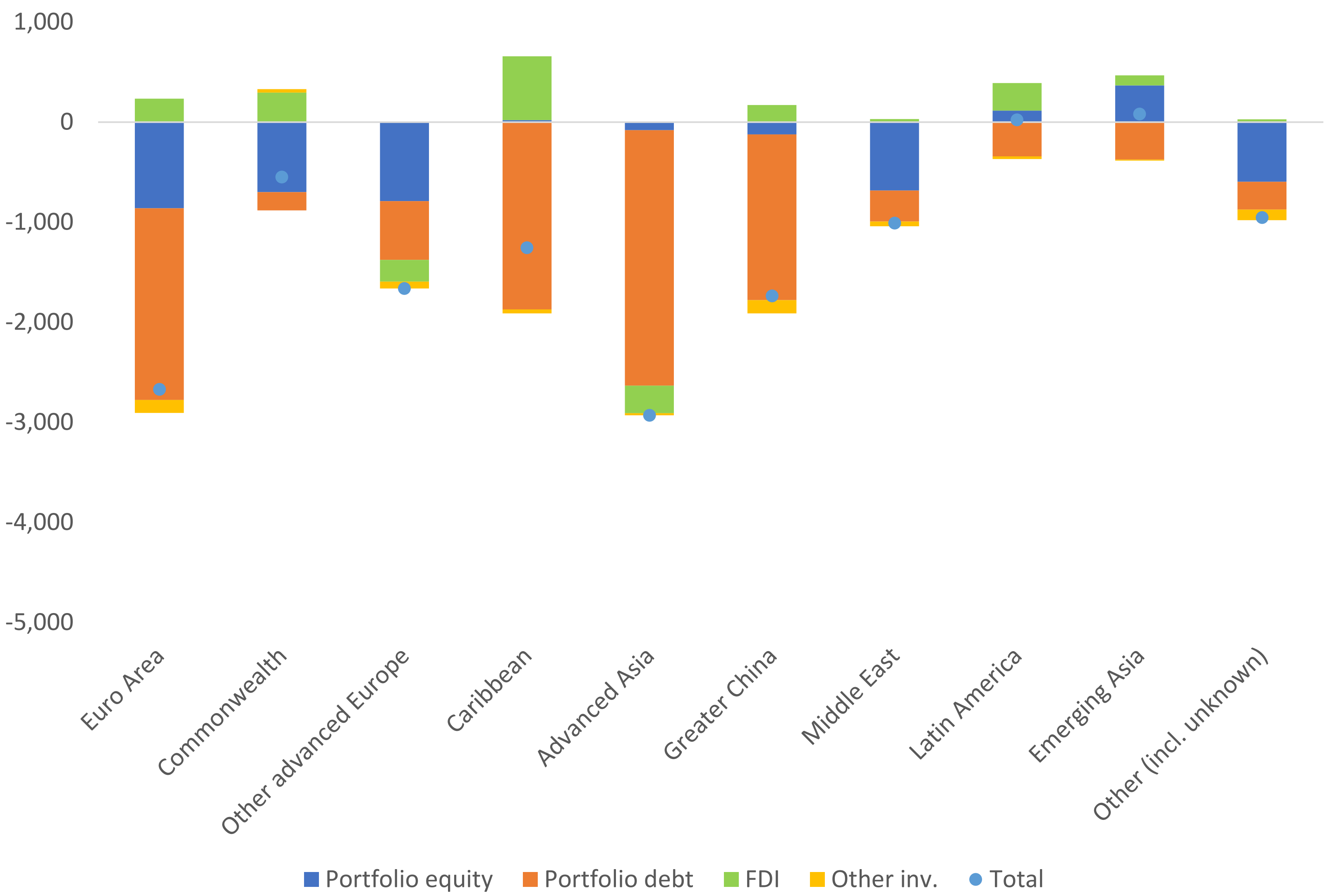
Road Map

- Role of EMs in Global Finance
- The US and its creditors: financial connections among advanced economies
- China and its investment pattern

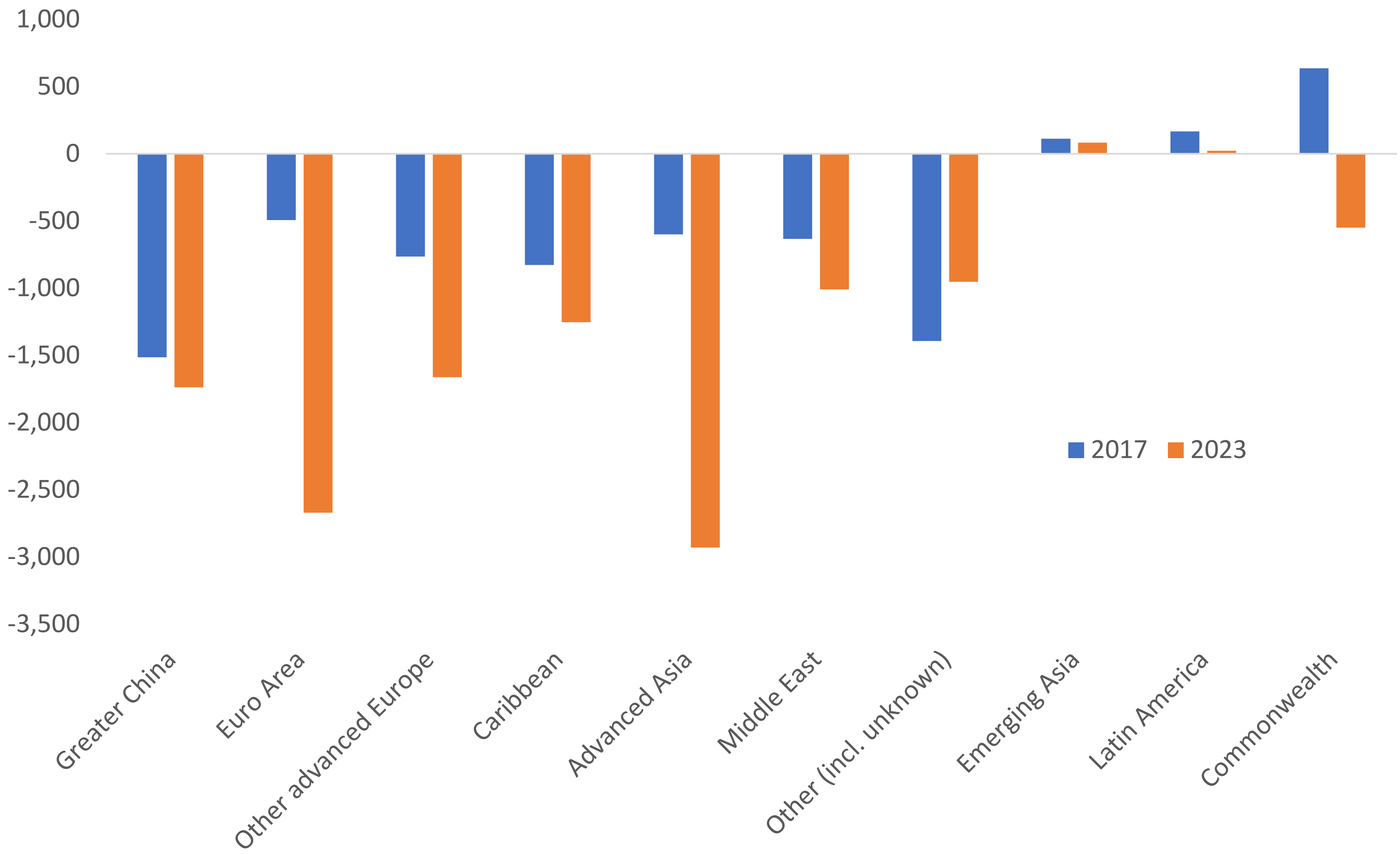
EMDEs have a modest weight in global finance



United States and its Creditors, 2023 (residence basis, US$ bn)



How did positions change, 2017-23 (residence basis, US$ bn)



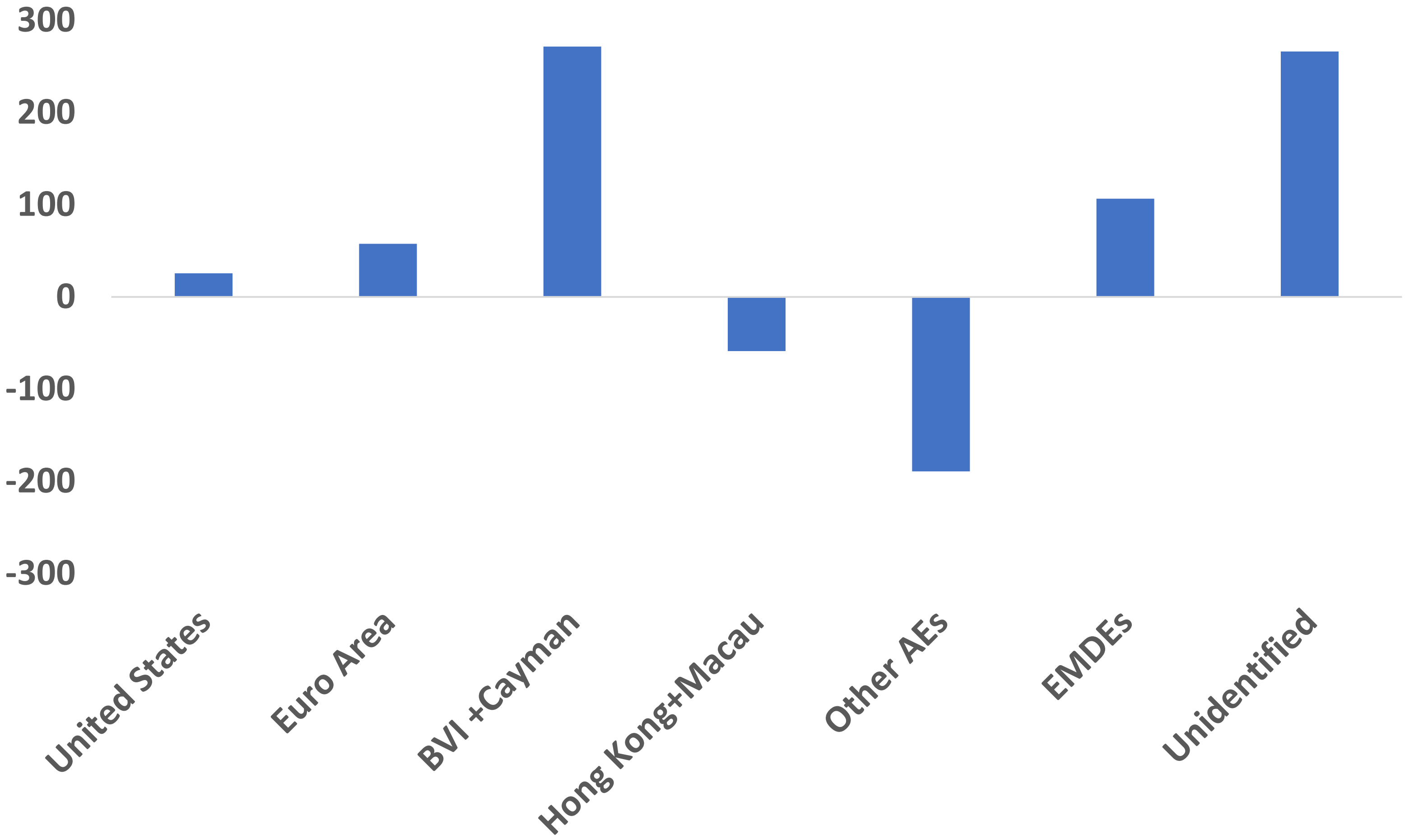
What explains these changes?

- **CA balances**. Large surpluses in the past few years for advanced European and Asian countries
- **Large valuation effects**. Advanced economies (especially from Europe) have large portfolio equity investments in the US, and those have increased in value with the US stock price boom
- In contrast, **many EMs (and China!) hold mostly bonds** (whose market value has declined with higher interest rates)
- Longer-term **process of diversification by China** in its external assets (rising claims vis-à-vis other EMs)

China’s creditor position

- FX reserves main identified asset category (vis-à-vis US, euro area)
- Difficult to establish ultimate destinations of investment
- Investment to and from CHN flowing through HK, Cayman Isl., BVI
- “Western” claims on CHN through VIEs incorporated in Cayman Isl. missing from the data

China: change in net creditor position, 2017-23 (US$ bn)



Fragmentation: global implications (I)

Portfolio diversification

- **Difficult for a “China” block to disengage from a Western block**, given its dominant role in financial markets.
- **Diversification losses for all blocks**, but clearly skewed towards blocks that are smaller in financial markets
- **Linkages within Western block very strong**—high and uncertain costs of geopolitical distancing

- Role of foreign investors in specific markets (eg US Treasuries)
- Higher frequency of shocks related to geopolitical developments: especially costly for countries more vulnerable to shifts in risk sentiment

Fragmentation: global implications (III)

Foreign direct investment

- Potentially salient repercussions for global economic activity. Closer link to global trade.
    - Restructuring of supply chains and global allocation of production
    - Control of natural resources
    - Technology transfers and spillovers.

Fragmentation: global implications (III)

- International borrowing and lending
  - Consequences for architecture of global banking?
  - More complex sovereign lending world
  - Ramifications for less developed countries (loss of correspondent banking – Chapter 3; debt restructuring difficulties – Chapter 4)
  - Role of international financial institutions (Chapter 4)

THANK YOU