CHAPTER 2

Geopolitical Risks: Implications for Asset Prices and Financial Stability

Global geopolitical risks remain elevated, raising concerns about their potential impact for macro-financial stability. A rise in geopolitical risks that prevents cross-border trade and investment activity, or raises uncertainty, can trigger a reallocation of capital flows, disrupt supply chains or inflict adverse demand shocks on an economy. This can lower asset prices, in turn affecting the intermediation capacity of financial institutions and raising the risk of a negative macro-financial feedback loop.

Against this background, Chapter 2 of the latest Global Financial Stability Report assesses the impact of geopolitical risk events on prices of financial assets and discusses potential policy measures for maintaining financial stability.

The chapter finds that geopolitical risk events generally exert a modest influence on asset prices. However, major events, particularly military conflicts, can lead to a substantial decline in stock prices and raise sovereign risk premiums, especially in emerging market economies with limited fiscal space or international reserve buffers.

Geopolitical risks can also propagate to other countries through trade and financial linkages, or changes in global commodity prices. For instance, firm stock prices are significantly lower if a country's main trading partner is involved in an international military conflict.

Investors tend to price geopolitical risk into equity and option markets to some extent, but the materialization of these risks can trigger financial market volatility.

Geopolitical risk events can also weigh on the stability of banks and nonbank financial institutions, especially in emerging market economies. Bank equity tends to decline when its home country or key foreign counterparts are involved in an international military conflict, contributing to a decline in lending activity. Similarly, investment funds exposed to countries involved in a conflict tend to experience lower returns and higher outflows.

To mitigate financial stability risks arising from geopolitical events, financial institutions and their oversight bodies should allocate sufficient resources to identify, quantify, and manage geopolitical risks, including through stress testing and scenario analysis. Emerging market and developing economies should continue efforts to develop and deepen financial markets and maintain adequate fiscal policy space and international reserves to cushion against adverse geopolitical shocks.