

Geoeconomic fragmentation: handling inflation pressures and volatility, increasing resilience

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1 Introduction

Ladies and gentlemen,

it is a great pleasure to be here at Tokyo University. In past weeks, international observers had been holding their breath in anticipation of the results of the presidential election in the United States. Now we know the outcome.

President-Elect Donald Trump has announced plans to significantly increase tariffs on a broad spectrum of goods. If the incoming US (United States) administration makes these promises a reality, this could mark a significant turning point for the international system of trade.

However, the election in the United States is just one prominent example of a broader theme that has recently started to play out on the international stage. After several decades of increasing global integration, the world has now shifted into a new phase of what is known as “geoeconomic fragmentation”. As intriguing as this term may sound, many of us might have different interpretations of what it actually means.

Rather surprisingly, the first word of that term – “geoeconomics” – actually has a long history and dates back to the work of political scientist and author Edward Luttwak in 1990.[1] Back then, Luttwak defined geoeconomics as: “the admixture of the logic of conflict with the methods of commerce – or, as Clausewitz would have written, the logic of war in the grammar of commerce.”

He argued that the end of the Cold War marked a shift away from traditional geopolitical competition, characterised by military and strategic rivalry. In this new era, he wrote, economic power and commercial competition would become the primary means of achieving national objectives and exerting influence on the global stage.

Contrary to Luttwak’s expectations, the world experienced a period of increased global cooperation after the end of the Cold War, culminating in the creation of the World Trade Organisation ([WTO \(World Trade Organization\)](#)) in 1995 and China’s entry into the [WTO \(World Trade Organization\)](#) in 2001. In recent years, however, this trend has seemingly come to a halt.

To the point, the International Monetary Fund recently defined geoeconomic fragmentation as a “policy-driven reversal of global economic integration”.[2] Geoeconomic fragmentation thus has an overlap with deglobalisation, which also encompasses non-policy-driven reductions in global integration.[3]

In my speech today, I would like to address geoeconomic fragmentation from three perspectives. First, I will examine the current extent of geoeconomic fragmentation. Second, I will explore the implications of increased geoeconomic fragmentation for central banks. And third, I will discuss how other policy areas can enhance resilience against geoeconomic fragmentation.

Throughout my speech, I will be taking a primarily European or euro area perspective. However, given the various similarities between Europe and Japan regarding their exposure to geoeconomic fragmentation, I will also occasionally refer to the situation in Japan.

2 Geoeconomic fragmentation: where do we stand?

Allow me to begin by examining the extent of the geoeconomic fragmentation that we can observe thus far.

First of all, what we can clearly see is that the number of imposed trade restrictions has risen significantly since 2019.^[4] From 2009 to 2019, the Global Trade Alert database recorded around three thousand new trade restrictions each year. In 2020, the number of new trade restrictions jumped to six thousand and has remained largely at this level ever since.

Protectionist measures can take many forms, such as tariffs, quotas or subsidies. A closer examination of the data reveals that subsidies alone accounted for approximately two-thirds of the protectionist trade measures implemented between 2020 and 2023. Subsidies not only rose strongly in absolute terms, but their share in trade-restricting measures also grew.

We have observed an increase in protectionist measures in all of the G20 (Group of 20) countries, including members of the euro area as well as Japan. Some of these measures were implemented as sanctions against Russia in response to its invasion of Ukraine. The most significant increases have been observed in the United States and China. More specifically, out of all of the protectionist measures implemented by the G20 (Group of 20) countries, the United States accounted for around 23 percent and China for 17 percent.

Notably, many of the protectionist measures between the United States and China are reciprocal. This highlights the risk that each initial increase in protectionism can lead to a self-reinforcing feedback loop.

Somewhat counteracting this trend towards protectionism, we can also see intentions of deepening trade relationships through regional free trade agreements. Recent examples include the Regional Comprehensive Economic Partnership (RCEP (Regional Comprehensive Economic Partnership)), which encompasses Japan and the economies of the Asian-Pacific region, as well as agreements between the EU (European Union) and Vietnam, and the EU (European Union) and Singapore.

So, how have these developments impacted flows of global trade thus far? Here, the picture is mixed.

On the one hand, the degree of global trade integration has not yet changed much and remains high from a historical standpoint. In 2023, global trade accounted for 58 percent of global GDP (gross domestic product). This was just slightly lower than the 61 percent recorded in 2008, when global trade integration started to level off. On the other hand, international trade is regionalising.^[5] In particular, while the United States and China continue to trade with other countries, trade between the United States and China has declined noticeably.

On the whole, we are witnessing some clear signs of geoeconomic fragmentation. However, the significance and longevity of this development remain uncertain.

In any case, the euro area and Japan find themselves in similar situations, as they both have close economic ties to the United States and China, the key players in recent trade conflicts. In 2023, China and the United States were the main trading partners for both the euro area and Japan. Furthermore, regarding trade in goods, both the euro area and Japan are recording trade deficits with China and trade surpluses with the United States.

3 Handling inflationary pressures and inflation volatility

What could an increase in geoeconomic fragmentation mean for central banks and their goal of maintaining price stability? This is the second perspective from which I will look at this issue.

3.1 Inflationary pressures

Let me start with inflationary pressures that may affect the medium to long-term level of inflation. An increase in global integration is usually associated with declining inflationary pressures.^[6]

One important channel through which global integration affects domestic inflation is the cross-border trade in intermediate goods and services, otherwise known as global value chains.^[7] With the increase in global value chains, countries were able to specialise in areas in which they had a comparative advantage. As a result, international trade promoted productivity and economic growth, whilst also dampening inflationary pressures to some degree. And some studies suggest that this effect has been particularly pronounced in Japan.^[8]

Accordingly, one of the reasons why we should be concerned about geoeconomic fragmentation is that inflationary pressures might rise if global integration were to reverse.

How concerned should we be about such a scenario? When considering the risk of higher inflation alone, I would say not overly.

The main reason for my optimism is that, although empirical studies show that the effect of global integration on domestic price dynamics is statistically significant, it appears to be economically small.[9] In other words, while we can be quite sure about the direction of this impact, its magnitude seems minor. Accordingly, global integration would have to decrease substantially to cause a noticeable rise in inflationary pressures. And, so far, we have not seen this.

Furthermore, subsidies, which constitute a substantial part of all of the protectionist measures enacted over recent years, can actually be disinflationary.[10] Of course, a sudden and drastic increase in trade restrictions, like tariffs, might change the picture. If one country raised tariffs strongly and the countries affected were to retaliate, we could see a significant rise in inflationary pressures.

But, even if we do witness a significant increase in geoeconomic fragmentation leading to greater inflationary pressures, central banks have all of the tools necessary to handle a situation like this. Ultimately, for the Eurosystem, a noticeable reduction in global integration would mean that it would have to set interest rates higher to keep inflation at bay. The Bank of Japan is certainly also well-equipped to counter higher inflationary pressures.

Whilst I am sure that we, as central bankers, can cope with potentially greater inflationary pressures, this does not mean that geoeconomic fragmentation is harmless. Output growth would be lower because we would lose some of the benefits provided by efficient international division of labour.[11]

To give you some numbers: According to IMF (International Monetary Fund) economists, a mild strategic decoupling would result in a permanent loss of GDP (gross domestic product) of 0.2 percent globally. However, in a scenario with severe fragmentation, in which the world would essentially split into two autonomous trading blocs, global output losses could rise to as much as 7 percent.[12]

3.2 Inflation volatility

So far, I have focused on inflationary pressures that could affect the medium to long-term level of inflation. But what about inflation volatility, which is to say temporary fluctuations in the rate of inflation?

The empirical evidence on how global integration affects inflation volatility is rather limited. However, recent events clearly show the potential effects, both direct and indirect.

Especially in Europe, many of us still quite vividly remember when the Russian invasion of Ukraine led to a severe reduction in the supply of natural gas and caused major disruptions to the international trade of food commodities. This is a clear example of geoeconomic fragmentation at play.

Compared to Europe, Japan was less reliant on natural gas imports from Russia. However, as Europe increased its imports of liquefied natural gas (LNG (Liquefied Natural Gas)), global demand surged, leading to higher costs for Japan as well. Furthermore, given Japan's heavy reliance on food imports, the country felt the rise in international food prices particularly strongly.[13]

Of course, higher gas and food prices were not the only cause of the recent spike in inflation in the euro area, but they certainly played a significant role. In turn, once European economies had adapted and found new suppliers, falling natural gas prices contributed significantly to the disinflation process. And so, too, did the normalisation of trade in food commodities.[14]

However, the vulnerabilities extend beyond fossil fuels and food. Other areas that immediately spring to mind are computer chips and critical minerals, including rare earths. Sudden disruptions in any of these areas could trigger another inflation spike.

These vulnerabilities have not gone unnoticed, prompting various policy measures in both Japan and Europe. Japan has been a frontrunner with its "Economic Security Promotion Act".[15] Amongst other objectives, this act aims to ensure stable supplies of critical materials, such as semiconductors and rare earths, and to enhance the development of specific critical technologies.

The European Union's "Open Strategic Autonomy" initiative intends to reduce dependencies that pose risks to security.[16] One important aspect of this plan is the reshoring or "friendshoring" of global value chains. And the "Net-Zero Industry Act" includes support for green technologies to boost Europe's ability to manufacture net-zero technologies and their key components.

Both strategies aim to move production in strategically relevant areas to Europe. This should reduce vulnerabilities to global developments, ultimately lowering the risk of renewed inflation volatility. However, there is a trade-off here, as Europe itself is thereby contributing to geoeconomic fragmentation and giving up some of the benefits of the international division of labour. And this may also come at the cost of greater inflationary pressures.

If geoeconomic fragmentation causes higher inflation volatility, what does that mean for the Eurosystem or central banks more generally?

A sudden eruption of geoeconomic fragmentation resembles a negative supply shock that creates a stabilisation trade-off, as inflation rises and output falls. The mandate of the Eurosystem is very clear: price stability. However, even a central bank focused solely on price stability cannot completely neglect output. In the euro area, we operationalise our mandate by aiming for inflation of 2% over the medium term. This allows us to respond flexibly and avoid overreactions that could lead to destabilisation.

During the recent period of high inflation, we took decisive action to keep medium to long-term inflation expectations under control. This was crucial, as inflation rates were quite high during certain months. We tolerated some volatility in inflation, but without compromising our mandate.

If we see more inflation volatility in the future, it might become even more important to show strong commitment to achieving our price stability target and stabilising inflation expectations.[17]

4 Increasing resilience

As I have hopefully made clear by now, monetary policy can deal with both greater inflationary pressures and increased inflation volatility. It is evident that monetary policy is essential in combatting the inflationary impact of geoeconomic fragmentation.

However, other areas of economic policy could also help if we see an intensification of geoeconomic fragmentation. My third and final perspective on geoeconomic fragmentation concerns exactly this: how can other policy areas enhance resilience?

In terms of trade policy, Europe as a whole should continue to support an open and rules-based system of international trade. Additionally, Europe should continue to foster trade agreements with countries seeking mutually beneficial exchange. The Japan-EU (European Union) Free Trade Agreement finalised nearly seven years ago is a shining example of this. At the same time, firms need to take measures to increase the resilience of their supply chains and business models.

When it comes to limiting the volatility of inflation, the obvious elephant in the room is price caps and subsidies. Several European countries and Japan have implemented measures like these to handle the large increases in the prices of electricity and natural gas following the Russian invasion of Ukraine.

Such measures may be justified under exceptional circumstances, for example, when inflation increases very quickly and drastically. However, any such measures should be temporary, targeted at those who really need them, and designed to create the right incentives. Because, ultimately, they are just a temporary bandage over a large and deep wound.

In general, they should not be a long-term solution, as they obscure the price signals that indicate the relative levels of supply and demand, and consequently, the scarcity of goods and services. For example, Germany's temporary gas price brake relieved the burden on citizens and firms, but kept price signals intact, so that the demand for natural gas was significantly reduced.

In order to make a lasting impact, I see three structural areas that could help Europe better withstand geoeconomic fragmentation, which I would like to touch on briefly.

First, fostering the transition to a carbon-neutral system of energy production. Second, strengthening the Capital Markets Union in Europe. And, third, introducing a digital euro. Allow me to explain my reasoning.

4.1 Fostering carbon neutrality

One way to increase our resilience against geoeconomic fragmentation is to diversify our sources of energy supply. The transition to a carbon-neutral economy could contribute significantly to this goal. This is because fossil fuels tend to make greater contributions to inflation volatility in economies that import a lot of oil and natural gas.[18]

And, in this regard, both Japan and the euro area are heavily exposed: [19] Japan imports almost all of its oil and natural gas, while the euro area imports the majority. And both regions rely on these fuel sources for more than half of their energy consumption.

The European Union has already embarked on an ambitious path of climate protection, aiming to achieve a net-zero economy by 2050.[20] And Japan has committed to achieving carbon neutrality by 2050 as well.[21] Increasing the production of renewable energy would also make our economies less vulnerable to global disruptions in fossil fuel prices, which is a very welcome side effect.

Europe could further enhance its economic resilience and energy security by integrating its power grids more closely, thereby facilitating more efficient distribution of energy. This way, hydropower stored in Norway can temporarily step in when the winds don't blow in the North Sea or the sun doesn't shine in southern Europe.

Shifting from fossil fuels to renewable energy requires significant additional investment, as parts of the existing capital stock need replacement. Under what is known as the "Fit for 55" policy scenario, the European Commission estimates that, compared to the average of the years 2011 to 2020, annual climate protection investments need to increase by €477 billion by the end of 2030.[22]

This additional investment might increase inflationary pressures during the transition phase. However, as I argued earlier, the Eurosystem can manage this.

4.2 Completing the Capital Markets Union

A second way to make the euro area more resilient against geoeconomic fragmentation in a wider sense is to complete the Capital Markets Union in Europe. Given that many of you are probably not closely familiar with this topic, allow me to provide some broader context.

The European Capital Markets Union has its origins in the global financial and European debt crises. In the aftermath of these crises, banks in several euro area member states struggled with large volumes of non-performing loans. This situation made it difficult for banks to provide enough lending to firms. It also highlighted Europe's strong reliance on banks for external financing. Consequently, European policymakers envisioned the Capital Markets Union as Europe's effort to improve pan-European capital market funding.

Let me illustrate this with some data.^[23] At the end of 2008, debt securities accounted for just 3 percent of liabilities among non-financial corporations, while shares listed on a stock exchange comprised around 15 percent. 15 years later, the share of capital market financing has hardly increased at all: debt securities now account for 3.5 percent, and listed shares for nearly 16 percent.^[24]

For comparison, the share of debt securities in Japan is around 4 percent. In the United States, which is often seen as a prime example of a market-based financial system, listed shares accounted for a substantial one-third of non-financial corporations' liabilities, while debt securities comprised around 7 percent.

What would be the benefits of a completed Capital Markets Union?

On the one hand, it would help to distribute the macroeconomic and financial consequences of geoeconomic fragmentation if euro area countries are hit asymmetrically. Bank lending is predominantly national and, in some cases, even regional or local. By contrast, capital market financing can be cross-border, thereby spreading the risks of a sector or region that is particularly strongly affected by geoeconomic fragmentation to a much broader investor base.

On the other hand, it would help to mobilise financial resources to finance investment in digitalisation, infrastructure and growth opportunities more generally. This would boost our growth potential and make the monetary policy stabilisation trade-offs arising from inflation spikes caused by geoeconomic fragmentation more bearable. And it would, of course, also help to finance the transition to a carbon-neutral economy.

What still needs to be done? I see three main areas of improvement.

First, firms need better access to venture capital in particular and equity in general. European firms certainly do not have a lack of innovative ideas. However, they often face challenges in turning these ideas into marketable products. This is where venture capital investors can be especially helpful.

Second, the securitisation market should be revitalised. Securitisations serve as an ideal bridge between banks and capital markets. A transparent and high-quality securitisation market would enable banks to transfer portions of their loan portfolios to the capital market. This process distributes loans and the associated risks more broadly. Additionally, it would also free up lending capacity for additional loans. At the same time, we must ensure that we regulate the risks appropriately and avoid any negative impact on financial stability.

Third, insolvency laws should be harmonised. In the EU (European Union), with its 27 Member States, there are essentially 27 different insolvency laws. An effective and harmonised insolvency regime would have two significant effects. On the one hand, harmonisation would facilitate cross-border investment, as investors would have a better understanding of the associated risks, thereby broadening the investor base. On the other hand, improving its effectiveness would expedite insolvency proceedings, facilitating the reallocation of scarce resources to innovative firms striving to build a digital and carbon-neutral future.

4.3 Introducing a digital euro

A third way of promoting European resilience against geoeconomic fragmentation in the financial sphere would be to introduce a digital euro.

Currently, digital payments in the euro area often rely on non-European companies, making Europe vulnerable to geoeconomic fragmentation in the international payments system. By contrast, the digital euro, as currently envisaged, would be built on exclusively European infrastructure. Consequently, the digital euro would strengthen Europe's strategic autonomy and increase its resilience.

But this is, of course, not the only reason in favour of the digital euro. The digital euro would also be a digital complement to cash at a time when payments are becoming increasingly digital. This would enable people living in the euro area to hold central bank money in digital form.

Furthermore, the digital euro would provide the highest possible level of privacy, surpassed only by cash, since the Eurosystem is simply not interested in collecting and commercialising individual customers' payment data.

And, finally, the digital euro could be used to pay in every corner of the euro area, both online and offline, offering an unprecedented degree of universal acceptance and usability.

In November 2023, we entered what is being termed the preparation phase, laying the groundwork for how the digital euro could be designed. However, a final decision on issuing a digital euro has yet to be made.

5 Conclusions

The global landscape has clearly changed in recent years. A world once characterised by multilateralism and global cooperation has slowly shifted towards confrontation and fracture.

The first signs of geoeconomic fragmentation are becoming increasingly evident. And, unfortunately, we may be on the brink of significant escalation. This is a concerning development, and we should all strive to restore cooperation and free trade.

But, even if international tensions should intensify: Central bankers have all of the tools needed to address greater inflationary pressures or increased inflation volatility resulting from geoeconomic fragmentation. We can and will do what is necessary to maintain price stability.

And other policy areas have various tools to enhance the resilience of our economies against geoeconomic fragmentation, some of which I have outlined today. With this in mind, I am confident that we will find the best way in the coming years – as central banks, but also as societies.

Or, in the words of the famous Japanese manager Kōnosuke Matsushita: "The untrapped mind is open enough to see many possibilities, humble enough to learn from anyone and anything, forbearing enough to forgive all, perceptive enough to see things as they really are, and reasonable enough to judge their true value." [25]

Footnotes:

1. See Luttwak, E. (1990), From Geopolitics to Geo-Economics – Logic of Conflict, Grammar of Commerce, *The National Interest*, Summer 1990.
2. Aiyar, S. et al. (2023), Geoeconomic Fragmentation and the Future of Multilateralism, *IMF (International Monetary Fund) Staff Discussion Notes*, SDN/2023/001.
3. Norring, A. (2024) Geoeconomic fragmentation, globalization, and multilateralism, *BoF Economics Review*, No 2/2024. See section 2 for a detailed discussion of the distinctions between the different terms.
4. See Global dynamics ([globaltradealert.org](http://www.globaltradealert.org)) [https://www.globaltradealert.org/global_dynamics].
5. See Gopinath, G. et al. (2024), Changing Global Linkages: A New Cold War, *IMF (International Monetary Fund) Working Paper No 76*.
6. See, for example, Ciccarelli, M. and B. Mojon (2010), Global Inflation, *The Review of Economics and Statistics*, Vol. 92(3), pp. 524-535 and Forbes, K. (2019), Has globalization changed the inflation process?, *BIS (Bank for International Settlements) Working Papers 791*.
7. Auer, R. et al. (2017), The globalisation of inflation: the growing importance of global value chains, *BIS (Bank for International Settlements) Working Papers 602*.

8. For an overview, see Hogen, Y. et al. (2024), Changes in the Global Economic Landscape and Issues for Japan's Economy, Bank of Japan Broad-Perspective Review Series, No 24-E-3.
9. See Attinasi, M. and M. Balatti (2021), Globalisation and its implications for inflation in advanced economies, ECB (European Central Bank) Economic Bulletin, Issue 4 and Lodge, D. et al. (2021), The implications of globalisation for the ECB (European Central Bank) monetary policy strategy, Occasional Paper Series 263, European Central Bank.
10. A recent study finds that heavily subsidised sectors with over-capacity in China could lower euro area consumer price inflation by 0.3 percentage point. If euro area producers reduce their prices in response to cheaper Chinese products, euro area inflation could drop by an additional 0.6 percentage point. See Al-Haschimi, A. and T. Spital (2024), The evolution of China's growth model: challenges and long-term growth prospects, ECB (European Central Bank) Economic Bulletin, Issue 5.
11. Gáal, N. et al. (2023), Global Trade Fragmentation – An EU (European Union) Perspective, European Economy Economic Briefs, European Commission.
12. Bolhuis, M. et al. (2023), Fragmentation in Global Trade: Accounting for Commodities, IMF (International Monetary Fund) Working Papers No 73. In the mild strategic decoupling scenario, there is no trade between the USA (United States of America)-EU (European Union) and Russia, and no trade in high-tech sectors between the USA (United States of America)-EU (European Union) and China. In the severe fragmentation scenario, the remaining countries join one of the two groups depending on the strength of their trade links with either the United States or China, resulting in zero trade with the respective other group. The lower bound in the scenario with severe fragmentation is 1.9%. The large range is the result of different assumptions regarding plausible values for trade elasticities.
13. Nakamura, K. et al. (2024), What Caused the Pandemic-Era Inflation?: Application of the Bernanke-Blanchard Model to Japan, Bank of Japan Working Paper Series, No 24-E-1.
14. Deutsche Bundesbank (2024), The global disinflation process and its costs, Monthly Report, July 2024.
15. <https://www.japaneselawtranslation.go.jp/outline/75/905R403.pdf>
16. For an overview, see Demosthenes, I. et al. (2023), The EU (European Union)'s Open Strategic Autonomy from a central banking perspective – Challenges to the monetary policy landscape from a changing geopolitical environment, Occasional Paper Series 311, European Central Bank.
17. Amatyakul, P. et al. (2024), The contribution of monetary policy to disinflation, BIS (Bank for International Settlements) Bulletin No 82.

18. Ha, J. et al. (2023), Understanding the global drivers of inflation: How important are oil prices?, *Energy Economics*, Vol. 127(A).
19. See Energy Institute (2024), *Statistical Review of World Energy*, 73rd edition.
20. See 2050 long-term strategy - European Commission ([europa.eu](https://climate.ec.europa.eu/eu-action/climate-strategies-targets/2050-long-term-strategy_en))
[https://climate.ec.europa.eu/eu-action/climate-strategies-targets/2050-long-term-strategy_en]
- .
21. For a detailed discussion of the economic implications, see Kurachi, Y. et al. (2022), *Challenges for Japan's Economy in the Decarbonization Process*, Bank of Japan Reports and Research Papers.
22. European Commission, SWD(2023) 68 final.
23. This comparison uses non-consolidated financial accounts data at market prices.
24. The share for debt securities in the euro area is probably higher because the available statistics cannot account for indirect issuance by non-financial corporations through their financial vehicles.
25. Matsushita, K. (1989), Nurturing Dreams My Path in Life. Quoted in: Tony Kippenberger (2002), *Leadership Styles: Leading 08.04.*, p. 73.