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Growth at a crossroads:

Measuring the cost of financial
fragmentation



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About this report

Growth at a crossroads: Measuring the cost of financial fragmentation is an Economist Impact report, sponsored by Swift. It explores the future of financial fragmentation and its impacts on the global economy, based on an economic modelling study and expert interviews. Economist Impact thanks the following individuals for their time and insights:

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Executive summary

The steady march of globalisation over the last several decades has transformed economies across the globe. While its impacts may be debated, globalisation has seeded the belief that international markets and enterprise have the potential to impact lives and livelihoods. The global financial system provides the foundation for trading everything from consumer goods to real estate to complex derivatives across continents and oceans. In low- and middle-income economies across the world, it has opened doors and unlocked opportunities, although its benefits have not always been evenly distributed. Nevertheless, it has fostered global interdependence, creating a more connected world.

Yet the rich tapestry of global economic integration is now under threat. **Financial fragmentation—defined as a reduction in international financial integration and the disruption of cross-border payments, credit and investment that ultimately reduces cross-border capital flows—threatens to untie the complex linkages that drive employment, business growth and countries’ development.**

What could be lost due to fragmentation?

Fragmentation harms cross-border capital flows, such as foreign direct investment (FDI), which

support consumption, investment financing, risk diversification and resource allocation. Foreign capital enhances productivity by bringing in new knowledge and technology while strengthening domestic financial sectors. Additionally, fragmentation raises the risk of financial instability by increasing funding costs, reducing bank profitability and depressing lending. Without the ability to seamlessly transfer assets and capital, these risks could compound and flare up. Fragmentation can also set back financial inclusion, advancing a world of ‘haves and have nots’. With investment flows impeded, the gains from decades of globalisation will be put at risk, and further progress on sustainable development and poverty reduction will be increasingly difficult.

This study attempts to predict how financial fragmentation could play out to 2030 and quantifies its potential effects on global and national GDP and employment. The analysis is grounded in a robust scenario-building exercise that examines probable drivers of fragmentation in the short- to medium-term and maps out three potential futures. These qualitative scenarios are integrated into a comprehensive modelling and quantitative analysis, further enriched by in-depth interviews with experts in global and regional finance.

Key research findings

The table below lays out how much lower GDP and jobs would be in each of the three future scenarios of differing levels of fragmentation, compared with the current 2030 forecast set out by The Economist Intelligence Unit.¹

The worst-case scenario in the decline of cross-border capital flows would see GDP roughly 6% lower and nearly 280 million

fewer jobs. Looking at individual countries, no country included in our modelling benefits from fragmentation. However, the hit to GDP and jobs would be the greatest in China, Kenya and South Africa, underscoring the potential impacts on countries that are heavily reliant on FDI.² In employment, fragmentation would take a bigger bite out of the 2030 pool of high-skilled workers, compared with their lower-skilled counterparts.

Figure 1: Scenarios

Decline in pace of cross-border capital flow (in reference to recent norms)

Scenarios	GDP(%)	GDP (US\$)	Employment (%)
New normal Pace of cross-border capital flow decline is roughly in-line with recent norms.	-2.6%	-2.8trn	-4.3%
Escalation Pace of cross-border capital flow decline is 2x recent norms	-5.9%	-6.5trn	-9.1%
Mitigation Pace of cross-border capital flow decline is 0.5x recent norms	-1.2%	-1.3trn	-2.1%

¹ Although some fragmentation is factored into each baseline EIU country forecast, our model takes a more global view, also capturing the secondary and tertiary impacts of fragmentation and aggregating the likely impact at the global level.

² https://data.worldbank.org/indicator/BX.KLT.DINV.WD.GD.ZS?most_recent_value_desc=true

Manifest financial destiny

Ensuring that these scenarios do not come to pass means not just taking steps to reverse fragmentation, but also putting in place safeguards that ameliorate fragmentation's worst effects. Reducing fragmentation requires harmonised regulation, international co-operation to reduce risks for investors and strengthen the financial system's integrity, and continued market and regulatory innovation to leverage the digital tech revolution. A focus on establishing common standards and enhancing interoperability across financial systems will be essential to ensure these solutions work seamlessly and securely across borders.

Drivers of fragmentation may continue to fester, but a poorer, more divided world is not a given. Policymakers can ease access to financial services, notably via digital channels. Financial institutions can take more proactive measures to mitigate geopolitical risk. International organisations can foster co-operation and support national financial inclusion endeavours. And technology providers can integrate their solutions more deeply up and down the financial stack, from consumer-facing applications to back-end systems. Countering fragmentation will take hard work and dedication, but the rewards are undeniable.



Brave new fragmented world: modelling three potential futures

Given the decades-long push towards integration that has only recently begun to shift into reverse, the consequences of financial fragmentation may feel distant and mild. But they are real and will compound over time. “The trend towards integration has been such that marginal increases in integration are not that impactful, but going backwards makes a big difference,” says Michael Plummer of Johns Hopkins University’s SAIS Europe division. “There is a lot more to lose than there is to win.”

This programme was designed to answer one question: what would happen to the global economy in 2030 if cross-border capital flows decreased between different country blocs? Overall, we included 141 countries in our modelling and divided them into three broad categories: those that are strategically west leaning, those that are strategically east leaning, and those that are in the middle. Alignment metrics encompass free trade agreements, sanctions, military imports, participation in China’s Belt and Road Initiative³ and various other factors. The core assumption of our model is that flows of capital (specifically, FDI and FPI) will decline between blocs, with the largest declines occurring between east-leaning and west-leaning blocs.

The modelling reflects the fact that the China-US divergence has become the most significant fault line in geopolitics since the end of the cold war. The spheres of influence that this rupture has given way to, however, are in many ways more subtle than their cold war counterparts,

given China’s high degree of integration into the world economy relative to the Soviet Union at its peak; China is also less inclined to explicitly export its political ideology abroad and more likely to pursue trade and investment of all stripes. Few countries can afford to wholly alienate either China or the US, but several are casting chips in either direction, creating novel sources of geopolitical tension.

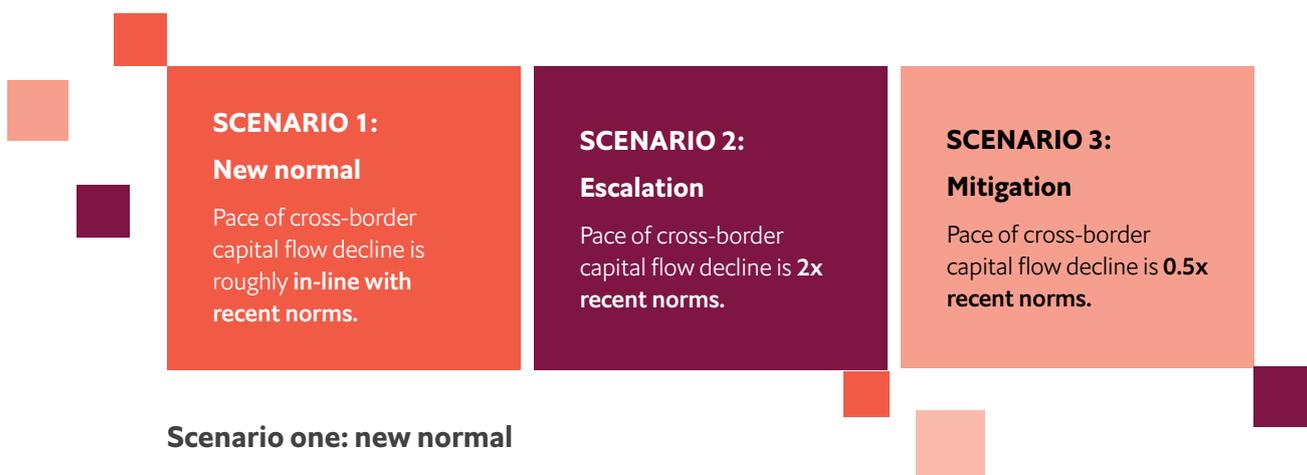
Mapping three future scenarios

Following the country groupings, we then used a rigorous assumption-building process to inform the corresponding quantitative shocks associated with each scenario in the model. With expert input, we conducted a qualitative scenario-building exercise to identify the potential triggers of financial fragmentation that may arise in the near future, such as trade wars, economic protectionism, technological decoupling, financial system reconfiguration and fragmented financial market infrastructure. To assess the macroeconomic impacts of these potential shocks, we developed an econometric model designed to capture the complex interactions that drive financial fragmentation. This model provides a comprehensive understanding of how these forces could influence global economic stability and financial integration. An analysis of historical changes to capital flows supplemented our findings, to ensure that assumptions were realistic and representative of each region-region/country-country relationship.

³ <https://www.cfr.org/backgrounders/chinas-massive-belt-and-road-initiative>

The three potential futures that emerged from our modelling each represent different levels of fragmentation: one in which the status quo persists as a **new normal**, one in which fragmentation **escalates** and one in which stakeholders come together to **mitigate** the

effects of fragmentation. The latter scenario assumes that the drivers of fragmentation persist but multiple stakeholders within countries take proactive steps to connect financial mechanisms, rather than encouraging divergence or remaining neutral.



Scenario one: new normal

Financial fragmentation continues at the current rate, exposing the global economy to significant challenges. Persistently high uncertainty lowers investor risk tolerance, while new sanctions and trade barriers disrupt specific sectors. Increasing protectionism perpetuates technological decoupling. Financial infrastructure development occurs in silos, with countries defining regulations independently, preventing harmonisation.

Scenario two: escalation

Increasing geopolitical tensions and protectionism intensify fragmentation. Widespread use of broad and weaponised sanctions severely restricts capital flows. Technological fragmentation isolates countries digitally and trade dynamics consolidate towards on- and friend-shoring, prioritising alliances over international trade and reinforcing geopolitical blocs. Heightened sanctions and regulatory pressures lead to siloed financial infrastructures that increase transaction costs and risks.

Given these factors, we assume that the level of fragmentation in the escalation scenario will be double that seen in the new normal scenario; in other words, the average decline in capital flows between blocs will be twice that of scenario one.

Scenario three: mitigation

In this scenario, financial market infrastructures become more integrated, with improved interoperability and investor-friendly regulations. The global adoption of new forms of digital value could enhance financial transaction efficiency, (their widespread use is not guaranteed) and existing systems will also achieve significant efficiencies through interoperability and digitalisation. Challenges like incompatible financial market infrastructures may persist, but overall a more interconnected and efficient global financial system could evolve, making systems faster and cheaper and fostering stability amid ongoing complexities. Given these factors, we assume that fragmentation in the mitigation scenario will be half that seen in the new normal scenario.

Across the three scenarios, we find that fragmentation leads to significant costs for the global economy, impeding global economic growth and highlighting the critical role of financial integration in underpinning prosperity, as seen in the next chapter.

Making the world go 'round: the impact of financial fragmentation on economic growth

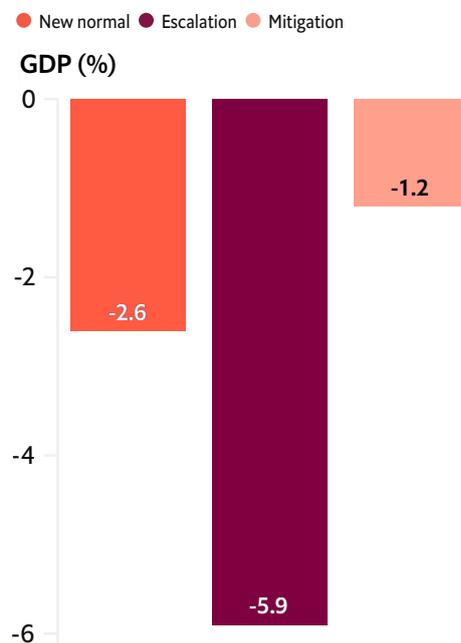
The conclusions of our study leave no room for ambiguity: financial fragmentation makes the world worse off. As Cyn-Young Park of the Asian Development Bank, emphasises, “overall, no country truly benefits” from fragmentation. Carolina Moehlecke of Brazilian university and think-tank Fundação Getulio Vargas, meanwhile, lays out the consequences in stark terms: “A more fragmented world in terms of trade and finance is a poorer world, especially for emerging markets. Even if governments try to navigate this new landscape, it’s quite tricky in the long run.”

Our modelling reflects this, as declines in private consumption and investment largely drive GDP losses, demonstrating the importance of stable investment flows to a prosperous world. The complex domino effects of these declines will compound and influence different sectors of the economy, ultimately delivering blows to economic growth that differ in severity based on the level of fragmentation.

Can't we all just get along?

Under the new normal scenario, where current levels of fragmentation persist, global GDP in 2030 would be 2.6% lower than it would be in the baseline Economist Intelligence Unit forecast. Losses of nearly 6% of global GDP in the escalation scenario demonstrate the compounding effects of fragmentation: capital flows decline by twofold that in the new normal scenario, but the GDP loss is more than double.

Figure 2: Breaking up is hard to do
Global GDP impacts across the three scenarios

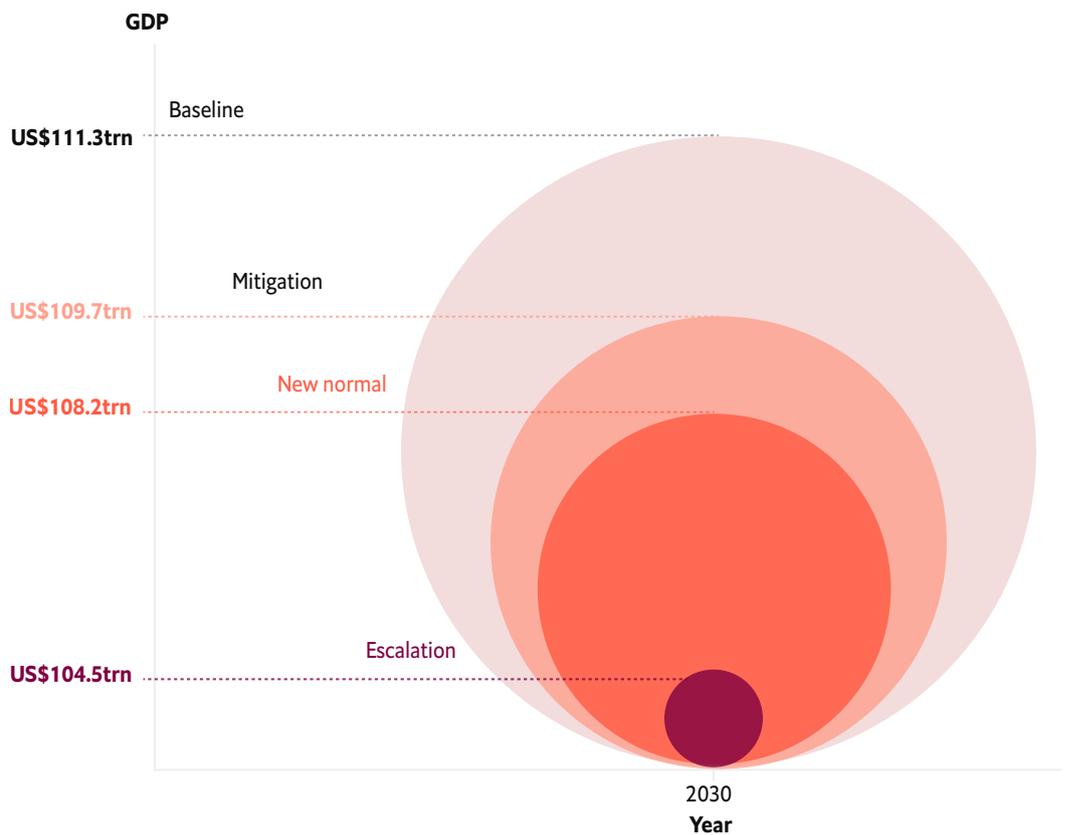


We see the lowest impact on global GDP in the mitigation scenario, where some of the current symptoms of fragmentation begin to reverse and capital flows do not decline nearly as much in the first two scenarios. This reflects the benefits of pursuing international co-operation

and regulatory harmonisation, resulting in 2030 global GDP that is only 1.2% lower than it would be otherwise. Although this would still negatively impact the global economy, it demonstrates that de-escalating fragmentation should be the priority, even in an increasingly polarised world.

Results for scenarios are presented for the year 2030. They show the deviation from the EIU's current forecast for that year. The 2.6% decline in scenario one, for example, denotes that global GDP will be 2.6% below the baseline trajectory in 2030, not an absolute decline below current levels.

Figure 3: Global GDP in 2030
Divergence from EIU baseline forecasts

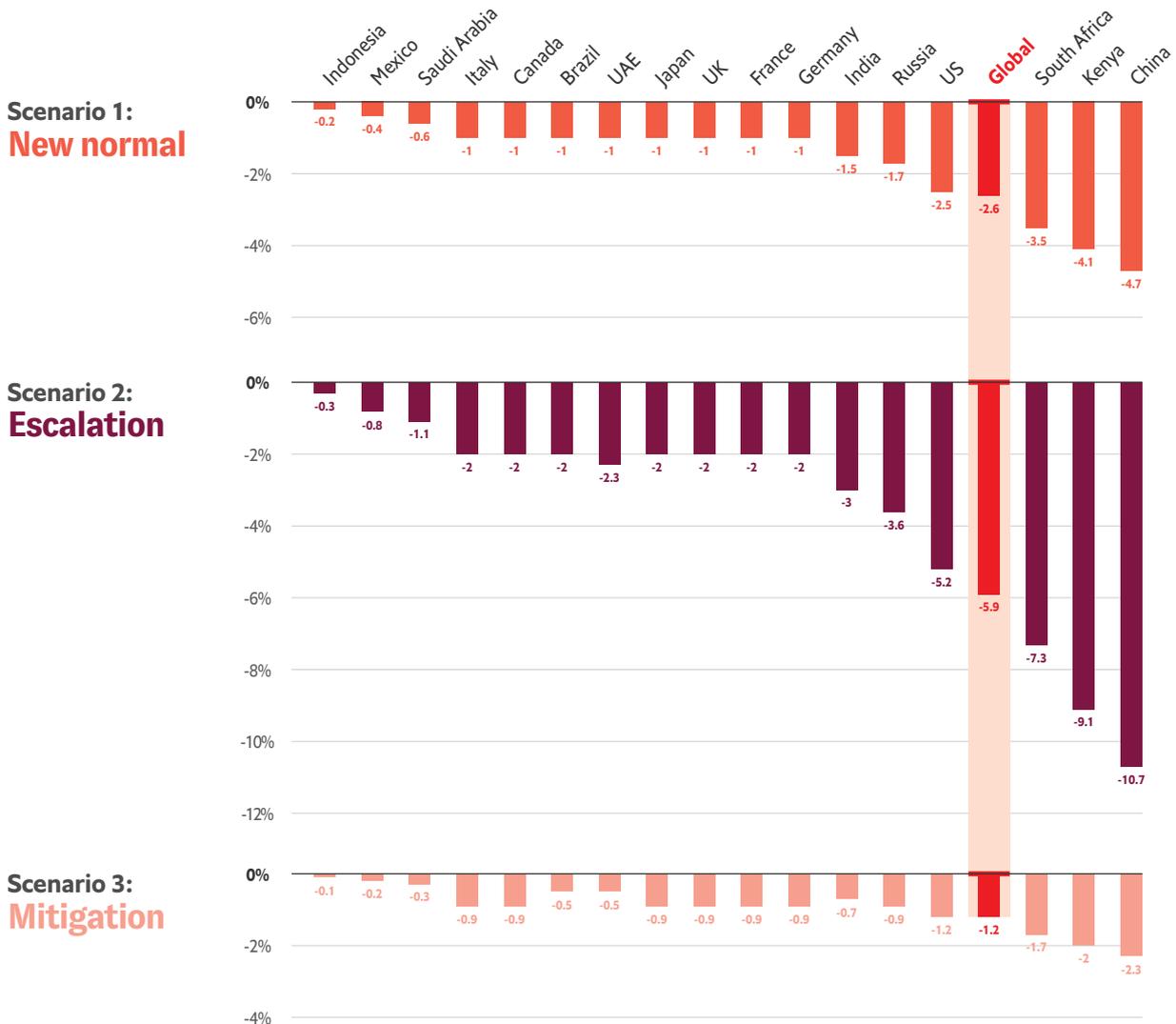


Nobody wins

The irony of fragmentation is that even as countries see the development of national financial infrastructures as an unalloyed good, failing to consider the global context and smooth out interlinkages makes the whole weaker than the sum of its parts. Our modelling demonstrates that no country as a whole benefits from fragmentation; the best they can hope for is a relatively small hit. The worst-affected, meanwhile, will suffer mightily.

Divergence in national outcomes reflects countries' differing abilities to absorb shocks and spur domestic investment to counteract declines in inbound foreign investment. In addition, more developed economies, particularly the G7, can spur growth through public spending and consumption (the US may be an exception—see below). The structure of each economy and what most tends to drive economic activity determines much of this. Additionally, geopolitical schisms and the formation of blocs will play a part in determining each country's

Figure 4: Free fallin'
GDP impact in key regional economies across the three scenarios



economic outcome, as various relationships and alliances shape our new financially fragmented global economy.

In middle-income countries like Brazil, Russia, India, China and South Africa (BRICS), investment makes up a disproportionately large share of the economy: equivalent to 36% of GDP, compared with an average of roughly 25% in the other countries modelled. Consequently, BRICS are particularly exposed to a breakdown in investment flows. South Africa, for example, relies heavily on external capital flows to hold up national investment levels and capital stocks. The real economy would falter in the event of a withdrawal of foreign equity and real-asset investment. As capital stocks shrink and business activity contracts, declining private consumption will weigh down real GDP.

Stuck in the middle

South Africa demonstrates why newly emerging economies stand to lose the most from financial fragmentation. These places have the broad components of a thriving economy but rely heavily on consistent inbound capital flows to catalyse growth and development. Importantly, they are also often led by governments that tend to contribute less to the economy as a share of GDP. These governments often operate tight fiscal budgets, which leave little room to intervene and lessen declines in private consumption. Lower

levels of economic growth in these countries as a result of fragmentation will make it more difficult for them to reach their development goals and lift their populations out of poverty.

Ms Park explains the plight of middle-income countries as a function of their position at the bottom of a u-curve, with low- and high-income countries on the upper ends of the curve. “Emerging markets that have slightly more developed capital markets are more adversely affected by shocks coming from abroad, because their markets are very shallow and potential overseas investors are going to have greater influence in domestic capital markets,” she notes. “When capital flows suddenly stop, this has a disproportionately large impact on mid-level, emerging financial markets.”

At the same time, some middle-income countries will remain relatively insulated from the effects of fragmentation; Mexico and Indonesia, for instance, both fall on the resilient end of the spectrum. For Mexico, this could be due to its advantageous position as a friend-shoring destination for US manufacturing. Indonesia’s strategic location in the Indo-Pacific, large workforce and fast-growing economy also make the country well-positioned to take advantage of shifting patterns of investment and reconfigured supply chains in the region.

Gulf economies are also less likely to suffer as much from geopolitical elements of financial fragmentation. In fact, Saudi Arabia and the UAE are well-placed to make some changes to the structure of their economies, and a fragmenting global financial system could catalyse this. These countries have had prolonged periods of high investment, benefitting from the steady development of professionalised human capital, maturing domestic financial sectors and increasing levels of innovation and productivity.⁴ Traditionally, they have relied on external capital flows, but as global systems fracture, deepening regional and sub-regional linkages could foster growth in some sectors, reducing the overall negative impacts of the shifting global financial order.

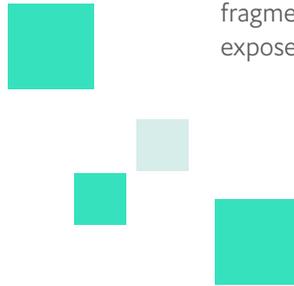


⁴ <https://gulfnews.com/business/markets/boom-in-the-gulf-five-reasons-why-the-gcc-is-a-magnet-for-foreign-investment-1.1720432666613>

Don't mind the outlier

The G7,⁵ meanwhile, is less exposed to the economic disruptions wrought by financial fragmentation. In comparison to BRICS, G7 countries tend to rely more on private and government consumption than on investment to drive growth. The US is an outlier, partly because it boasts the most sophisticated financial system in the world, enabling it to receive capital inflows from across the globe as foreign direct and portfolio investors seek safety, stability and growth opportunities.

America's perch atop the global financial pecking order means that US investment is expected to equal the combined total investment from the remaining six countries in the G7 by 2030. Therefore, any disruptions to the international financial order, and cash flows more broadly, are likely to have an impact on the US. Government consumption as a share of GDP is also smaller in the US than in other G7 countries, and because countries with higher government consumption levels as a share of total GDP are more likely to have the fiscal space (and willingness) to dampen the negative impacts of financial fragmentation on their economies, the US is exposed in this regard.



⁵ A grouping made up of Canada, France, Germany, Italy, Japan, the UK and the US

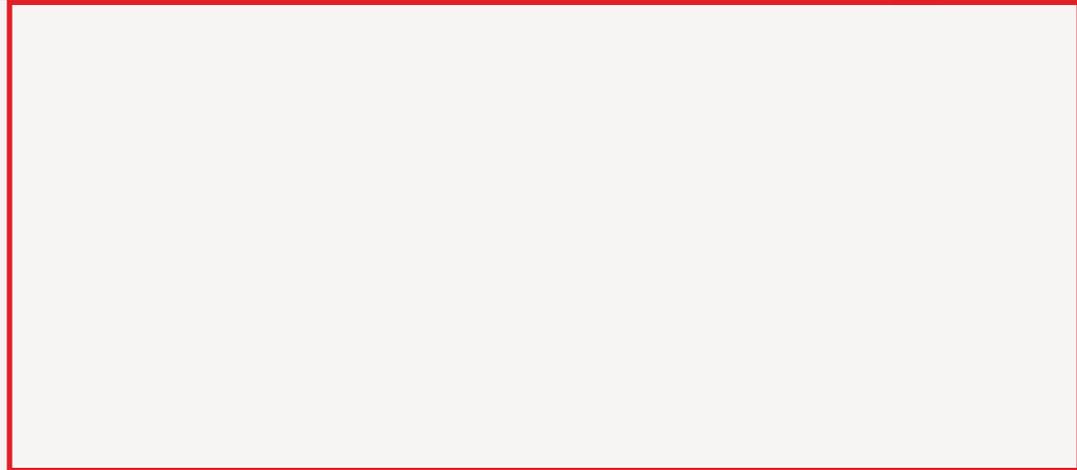
Conclusion: A real concern for the real economy



Financial fragmentation may seem like an abstract concern in this era of wars, pandemics, creeping nationalism and rapid technological change. But the promise of a richer, safer, more connected world hinges on a financial system that runs smoothly across national borders. Closing the door to deeper integration of the global financial architecture is a risk that stakeholders take at their peril.

The future trajectory of the global financial system depends on countries' ability to address the underlying drivers of fragmentation and ameliorate its worst impacts. While geopolitical tensions are likely to not only persist but intensify, countries must acknowledge the importance of creating a more interconnected and harmonised global financial system that prioritises stability, security, integrity, inclusion and growth. The alternative will be penury, division and an ocean of missed opportunity.

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