# Klaas Knot: Geopolitics and economics - a high-traffic intersection

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the 27th Annual Netherlands Bank Research Conference "Geopolitics and Economics: a high-traffic intersection", Amsterdam, 21 November 2024.

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Good morning, everyone. Welcome to Amsterdam.

Ten days ago, on the 11th of November, many countries remembered the official end of the First World War in 1918.

Unfortunately, it took a second World War to make the European nations realise that everything should be done to prevent such a devastating event from ever happening again.

And so, in the aftermath of that immense tragedy, the process of European economic and political integration started. One that still continues today. One that is still devoted to peace, democracy and prosperity.

Important, and fairly recent milestones include the EU winning the Nobel Peace Prize in 2012. Or Croatia becoming the 28th country to join the Union in 2013. Or when, in times of crisis, we went from 'the ECB is ready to do whatever it takes', to a common EU response to the COVID-19 pandemic.

And even though I was talking about the European Union in my example, this goes for the entire world – a world that, for a long time, was becoming ever more integrated, or at least interdependent.

However, for a few years now, we have been seeing countries withdrawing from the community of nations in a desire to reduce their dependencies on others. We have been seeing large economies engaging in protectionist policies. In short, we are seeing nations becoming increasingly tangled up in geopolitical tensions.

As citizens, this serves as a reminder that, whatever the milestones, we cannot take our peace, democracy and prosperity for granted.

As economists, we're naturally curious about these geopolitical trends and events. Because they can have real-world economic consequences. They can slow down economic growth, affect trade, and disrupt financial stability.

And this is why we analyse them. We draw lessons from them. And then we use that knowledge to advise policymakers on current and future policies.

In that process, our challenge lies in understanding how geopolitical risks and tensions affect our economies, the channels through which this happens, and how these channels are interconnected.

So let me elaborate a bit on that, to set the stage for your more in-depth discussions afterwards.

For starters, I see four areas where geopolitical tensions have a clear economic impact.

First, corporate investment.

Investment decisions depend on expectations about the future. The more uncertain the future looks – whether due to the threat of conflict, instability, or political shifts – the more cautious companies get. And the more they reduce productive investment, postpone expansion plans, and pull back capital expenditures. As a result, innovation slows down, and both actual and potential output decrease.

Second, geopolitical risks can have significant effects on household consumption.

Similar to companies, households adapt their behaviour to the political or economic outlook. Rising geopolitical tensions will cause households to cut back on spending and start saving more. These precautionary household measures dampen business revenues and contribute to a slowdown in economic growth.

Recent data supports this. Since the beginning of 2022, both the euro area's investment and consumption have remained below the trend. Of course, multiple factors are at play. However, there is evidence that countries whose sectors are closely linked to global markets have been hit harder. Similarly, proximity to geopolitical tensions increases countries' vulnerability. And so, exposure to geopolitical risk is tied to a country's aggregate activity(Refers to an external site), a link that can be observed in recent country level data.

Third, the effect on trade.

Geopolitical tensions often lead to increased trade barriers, tariffs, and other strategic restrictions. According to the IMF(Refers to an external site), the number of trade-restricting policy measures has more than tripled since 2019 – to over 3000 in 2023.

As a result, the cost of doing business rises – especially the more globally integrated a company's operations are. This naturally leads to costly supply chain reconfigurations, higher consumer prices, less competition, and reduced access to technology and knowledge.

Looking at the data, we see that global trade relative to world GDP still remains relatively stable. But we are picking up signs of trade fragmentation. For example, there is some evidence(Refers to an external site) suggesting that strategic sectors in the euro area are de-risking and aligning with geopolitically similar countries. This raises the broader question of whether we are seeing a slow-moving shift towards deglobalisation, or rather a form of 'slowbalisation' – which is merely a temporary slowdown in globalisation when it comes to trade.

Fourth and last, increased geopolitical tensions can affect the stability of the financial sector. This is because financial institutions may incur losses, for instance when companies with big exposures default on their loans. Or because financial institutions have less flexibility to diversify geographically as much as they would like – with an eye to hedging geographical risks. And on top of that, global capital flows are likely to reverse – which in turn leads to higher lending costs for households, companies and governments.

Summing up: geopolitical tensions slow down economic growth, increase trade costs, and, most important for central bankers, lead to higher inflation.

As a result, monetary policy comes into play – to mitigate the short-term effects on the economy. A recent example is our response to the inflation dynamics that were aggravated by Russia's invasion of Ukraine. We explicitly adopted a data-dependent strategy in the euro area. And we introduced a separate tool – the Transmission Protection Instrument – to tackle transmission risks, while forcefully raising interest rates to contain inflation. I believe this was the right approach. It acknowledged the increased uncertainty around inflation and provided us with the flexibility to cope with unprecedented shocks.

Of course, monetary policy alone cannot fully mitigate the economic effects of geopolitical tensions. Fiscal policy, too, plays a key role. Ideally, fiscal measures safeguard economic activities while cushioning the blow for society's most vulnerable.

Today, however, many governments have limited fiscal space. Partly, but not entirely, due to the pandemic support measures from the past few years. And so, regaining fiscal headroom will remain a key priority in the future.

Turning to the medium-to-long-term strategies: the more geopolitical tensions we see, the more pressure there will be on international cooperation. And this is exactly the kind of cooperation we need to tackle our present-day challenges – challenges that go beyond national borders, and thus require cross-border solutions. And so, going forward, we must maintain multilateral cooperation.

Simultaneously, we must also boost supply chain resilience. In our interconnected world, disruptions can have widespread effects. We need to increase the shock-absorbing capacity of raw material and technology supply chains to mitigate this risk.

Related to this, we need a strategic approach to trade policies, while retaining our commitment to open markets and free trade. In this spirit, we must support our innovative industries to achieve global competitiveness(Refers to an external site) without turning to protectionist policies. Ultimately, strategic investments in technology and innovation will be critical for economic growth in an era of increased geopolitical tensions.

Finally, financial stability remains vital. Strong financial systems are the backbone of a stable economy, particularly in times of crisis. And so, we must ensure that our financial systems remain resilient in times of increased geopolitical tensions.

In the European Union, this will require adequate buffers and at the same time a more level playing field through the completion of the banking and capital markets unions.

Dear guests and colleagues, a few years after the Second World War, a small group of European leaders came together to agree on what eventually would grow into the European Union.

War – the extreme result of increasing geopolitical tensions – was still fresh on everyone's mind. And that was not to happen again.

Today, we live in an entirely different world. Over the past decades, both in Europe and globally, nations have become more and more dependent on each other. Both economically and politically.

Nevertheless, this has not prevented geopolitical tensions from rising again. And we are rightly concerned about this. Our world has become a more dangerous place.

Strengthening national security and curbing economic risks then seem the logical way forward. But this needs to happen in a thoughtful manner. Because if not, the economic costs of these policies could be high.

And so, against this backdrop, it is a pleasure to see so many colleagues, researchers and experts gathered here in Amsterdam to talk about these important questions.

For a start, I would be particularly interested in learning more about how to better measure the economic impact of geopolitical risks in their many manifestations – war, terrorism, trade barriers. Understanding their causal relationship with economic indicators would provide policymakers with insights they need to craft effective responses.

I also believe we would benefit from identifying, and differentiating, the risks that predominantly affect the financial sector, the macroeconomic environment, and international trade.

This would allow policy makers to effectively tailor the combination of policy responses – either fiscal, macroprudential or monetary.

In the same regard, I am curious to know more about the unequal impact of geopolitical risks. Based on their proximity to conflict zones or their economic openness, different regions, industries and sectors are likely to experience different degrees of geopolitical risk. For instance, the energy price shock has had different effects on inflation dynamics across the members of the euro area. Getting a precise quantitative estimate of what determines these differences and what the economic channels are should be a priority for academics and policymakers alike.

And, especially of interest to central bankers, we should better understand how exactly the supply and demand effects of geopolitical risks interact with monetary policy. This would allow us to further calibrate our strategy in order to deal with large shocks.

For all of these challenges, I look forward to your ideas, your expertise and your insights.

Thank you.