Box 1. Potential effects of recent trends in geoeconomic fragmentation

A trend of geoeconomic fragmentation has emerged at international level in recent years, and the outbreak of the war in Ukraine has given it a boost. The process involves the reconfiguration of supply chains to increase the importance of national or regional links, lifting trade barriers, supporting areas of activity deemed strategic or monitoring and regulating foreign investment more closely and marks a major structural change in international economic relations.

Fragmentation became evident with the measures adopted by the US starting in 2018, which set the tone for a paradigm shift, particularly in relation to China. The United Kingdom's exit from the European Union, a process that took place from 2016 to 2020, was part of the same context. The COVID-19 pandemic and the heightening geopolitical tensions have once again tested international relations, raising more questions about the benefits of an open trade system, especially considering that the participation in transnational supply chains has, in some cases, taken on the dimension of strategic vulnerability. Russia's invasion of Ukraine has led to alliances along geopolitical lines and to sanctions that have disrupted global trade, put pressure on the global financial architecture and heightened tensions and uncertainty.

Table A
Extra-EU imports of natural gas – major trading partners

2022 Q1			2022 Q4		
Partner	Value (share %)	Net mass (share %)	Partner	Value (share %)	Net mass (share %)
Russia	31.3	33.3	Russia	15.8	12.5
Norway	25.8	21.3	Norway	25.8	26.0
United States	16.1	14.4	United States	16.3	15.3
United Kingdom	6.8	6.1	United Kingdom	9.4	9.4
Algeria	5.5	10.8	Algeria	9.1	12.4
Azerbaijan	4.1	3.1	Azerbaijan	7.4	7.5
Qatar	3.6	3.5	Qatar	5.3	4.3
Nigeria	2.1	3.6	Nigeria	2.7	2.6
Egypt	1.0	0.8	Egypt	2.3	2.0
Other countries	3.6	3.0	Other countries	6.0	7.9

Source: Eurostat (Comext) and Eurostat estimates

Against this background, the vulnerability stemming from the reliance on Russian energy commodities has become visible[1] Europe-wide, supply disruptions affecting the European industrial production and boosting producer and consumer price dynamics. The new economic sanctions imposed on Russia were implemented gradually, in several "waves", throughout 2022 and in early 2023. This has led to a reshaping of supply chains, especially as regards the supply of energy to the EU bloc. In 2022 Q1, Russia delivered one third of the total volume of natural gas imported into the EU from extra-EU countries, while in 2022 Q4, this share shrank to 12.5 percent, amid the shutdown of the Nord Stream 1 pipeline over the summer. The diversification of gas sources was fostered, *inter alia*, by the further adaptation of logistics facilities for liquefied natural gas imports from the US, Qatar

[1] In 2018-2022, approximately 50 percent for used natural gas and over 25 percent for oil.

or Nigeria, alongside the increased purchases from countries such as Norway, the United Kingdom, Algeria or Azerbaijan. Similarly, there has also been a reduction in exposure for imports of crude oil and processed products (Tables A and B).

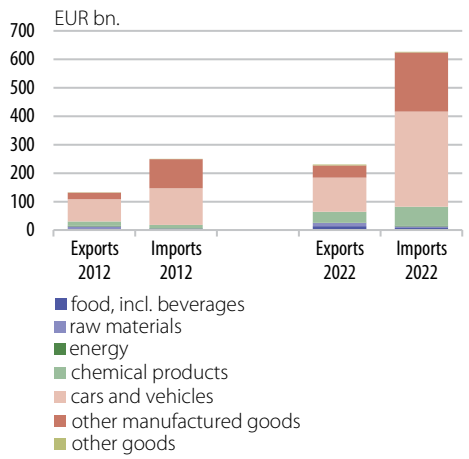
Table B
Extra-EU oil imports – major trading partners

2022 Q1			2022 Q4		
Partner	Value (share %)	Net mass (share %)	Partner	Value (share %)	Net mass (share %)
Russia	26.0	27.7	Russia	9.9	13.0
United States	10.4	9.7	United States	11.7	10.8
Norway	9.5	8.9	Norway	10.9	10.7
Kazakhstan	8.5	8.2	Saudi Arabia	8.4	8.3
Libya	7.2	6.9	Iraq	7.5	7.8
Iraq	6.1	6.5	Kazakhstan	7.7	7.4
Nigeria	6.4	6.1	Libya	7.7	7.4
United Kingdom	6.0	5.9	Nigeria	6.3	5.6
Saudi Arabia	4.8	5.1	United Kingdom	5.3	5.2
Azerbaijan	4.5	4.2	Azerbaijan	4.8	4.4
Algeria	3.3	3.0	Algeria	4.0	3.6
Brazil	2.1	2.2	Brazil	2.8	2.8
Other countries	5.2	5.7	Other countries	12.8	13.0

Source: Eurostat (Comext) and Eurostat estimates

In parallel, European countries have been taking steps to expand their renewable energy capacity, the REPowerEU plan aiming to increase the share of renewable sources in final energy consumption to 45 percent by the end of the decade. The EU's green energy transition already has a significant impact[2], solar and wind sources generating 22 percent of the EU bloc's electricity in 2022, exceeding the share of natural gas (20 percent).

Chart A
EU-China trade in goods, groups of products 2012 vs. 2022



Source: Eurostat

However, the new international context transcends the energy issue and the challenges facing the EU go beyond this topic. The bloc's trade relationship with China looms as a source of vulnerability, given that the strategic vision of the Asian state has changed in recent years. China's shift towards domestic consumption and production, and the slowdown in its long-term economic growth trend implicitly pose a risk to certain EU sectors that further rely on China's demand for exports of certain specialised goods, i.e. machinery and transport equipment, chemicals and agricultural products (Chart A). These industries are vulnerable to China's import tariffs and regulatory barriers, as well as to its efforts to boost domestic production and reduce dependence on foreign suppliers. On the imports side, the EU is exposed to China's dominance in global supply chains and its potential to disrupt them, the COVID-19 pandemic highlighting the risks associated with transnational production links. Against this backdrop, the European Commission has launched a new industrial strategy aimed at enhancing the EU's competitiveness and resilience.

[2] According to a *Report* by energy think tank Ember.

Its objectives include reducing dependence on foreign suppliers and strengthening the sustainability of supply chains. In a study published in 2022, the IMF points out that the EU is among the most vulnerable advanced economies in case of a potential slowdown in China's economy.

Despite the most recent divergence trends, the high trade integration of the global economy means that the impact of trade conflicts is significant. The IMF (2023a) identifies several channels through which global economic fragmentation could manifest its impact, namely the changing patterns of trade, technology and its geographical diffusion, labour, capital, and the provision of global public goods (such as the international legal framework, peace, public health, and the environment). These channels interact within and across national borders as well as geographic blocs, and can operate with greater force during periods of uncertainty, both in terms of the uncertain transition to a more fragmented world, as well as due to lack of clarity about the final shape that a more fragmented world might take. Along these lines, the ECB (2023) suggests that trade fragmentation can have sizeable effects on business, albeit heterogeneous across the affected economies. Welfare losses, captured by the size of the contraction in gross national expenditure, range between 0.9 percent and 5.3 percent, depending on the setup. This suggests that losses could be sizeable in the near term should a sharp correction in trade flows take place, and are gradually absorbed as substitute inputs of production are found either via increased domestic production or increased intra-bloc trade. Welfare losses also vary across economies, as countries that rely on global value chains and trade extensively with other blocs experience the largest losses. The fragmentation of trade also generates price effects, the pick-up in global inflation ranging between 0.9 percent and 4.8 percent, depending on the scenario. These price changes also have a distributional impact, affecting the evolution of wages based on skill levels, to the benefit of low-skilled workers in certain regions, while the wages of high-skilled workers may decrease. Other studies, such as Cerdeiro *et al.* (2021), IMF (2023a,b) and Bolhuis *et al.* (2023) suggest losses of up to 8.5 percent of global GDP under severe scenarios of trade decoupling between different political and technological blocs, disproportionately affecting countries with extensive trade relations in the Asia-Pacific region. Similarly, the study by Goes and Bekkers (2022) projects relatively modest losses in case of limited trade decoupling, but significant losses in case of drastic decoupling.

Chart B
Developments in Romania's services exports

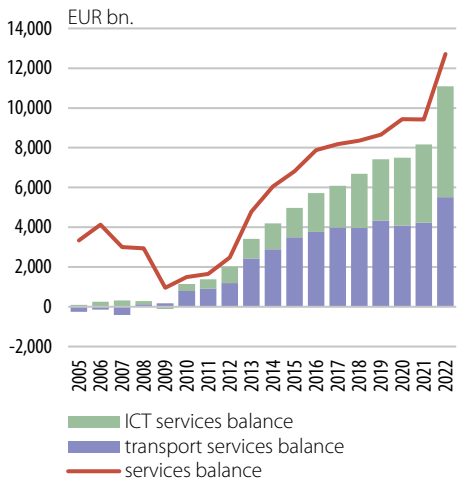
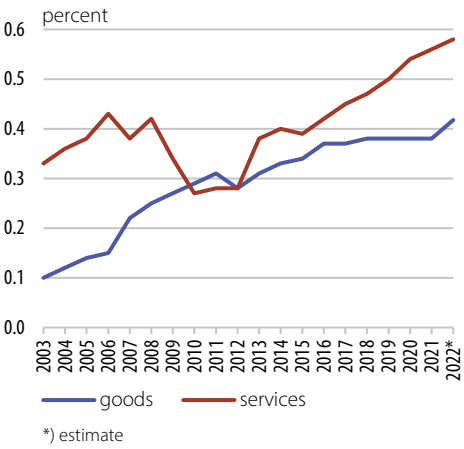


Chart C
Developments in Romania's export market share



Source: Eurostat, NBR calculations

International geoeconomic fragmentation will also leave a mark on Romania, given the country's trade and financial integration within the EU, a trend that has intensified

over the last decades. Romania's trade and financial exposure to the EU is significant, i.e. approximately 70 percent of its goods exports go to the EU and 74 percent of its imports come from EU countries. The EU is also a major source of capital for Romania (Chart B).

Amid ongoing trade tensions and global economic uncertainty, any changes in international demand could have a significant impact on Romania's export-oriented industries, by reducing direct exports from Romania to affected countries, and indirectly, especially by limiting imports from EU countries, which in turn would decrease their demand for inputs produced in the domestic economy. For instance, in the event of a negative economic shock emanating from China (the world's second-largest economy and primary exporter, being at the epicentre of discussions about global fragmentation in recent years), OECD TiVA data[3] suggest that Romania's exposure to final demand in the partner economy exceeds the level of exports by about 7 percent. Thus, direct trade exposure would underestimate the effect of a negative shock from the Chinese economy to the Romanian economy. The reverse is true for Germany (direct exposure exceeds value-added exposure by approximately 20 percent), as its exports to China include a significant amount of value added originating from other countries.

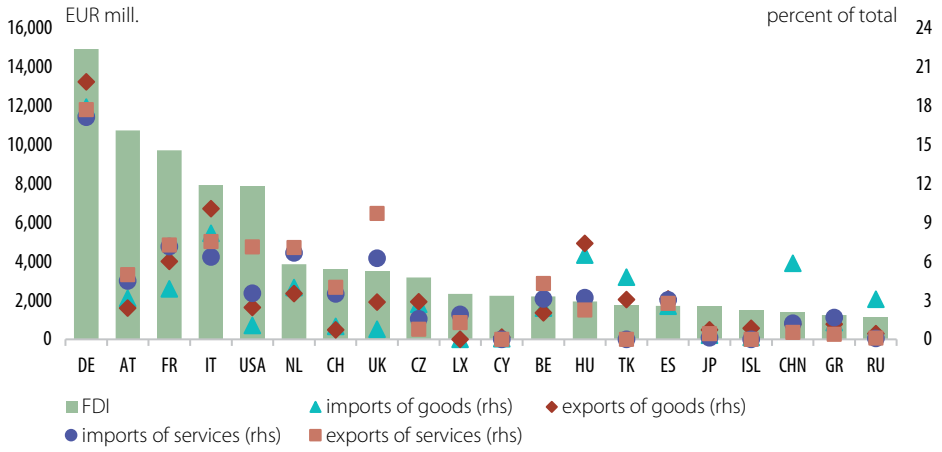


Chart D
Foreign direct investment and trade flows in Romania

Source: Eurostat, NBR, NBR calculations

Another dimension of the effects of geopolitical fragmentation on the domestic economy involves the reconfiguration of foreign direct investment, Romania being a potential beneficiary of the near-shoring trend. An example is the partial relocation of operations, including employees, from Ukraine to Romania by an automotive cable manufacturer that has long operated in the region. Similarly, a Finnish tyre manufacturing company decided to return to Romania after the outbreak of the conflict in Ukraine. In recent years, several automotive companies have expanded their operations to Romania, contributing to the development of the ecosystem

3 TiVA (*Trade in Value Added*) https://www.oecd.org/sti/ind/measuring-trade-in-value-added.htm is a tool developed by the Organisation for Economic Co-operation and Development that provides detailed and comparative information on global value chains and their contribution to international trade. TiVA analyses how goods and services are produced, distributed and consumed in different countries, highlighting the added value at each stage of the production process. This tool enables the tracking of international trade flows in a more precise and detailed manner than traditional export and import data.

around that industry. However, when looking at the relocation of industrial production capacities amid the war in Ukraine, Romania does not seem to rank high among its regional peers. Opportunities for development via foreign investment also exist in domestic services; in fact, this sector accounts for an increasingly larger share of total exports and its market share is higher than that of goods (Charts C and D). In the IT sector, Romania already boasts a complex sectoral architecture, with a skilled workforce and competitive costs. During the pandemic, the demand for digital solutions picked up significantly, a trend that could continue in the coming period as well. The activities in niche areas such as cybersecurity or process automation have led to the emergence of globally relevant local players in recent years, which have established themselves alongside multinational companies operating in Romania over the past two decades. Furthermore, due to the conflict on the eastern border, many IT firms have relocated to Romania, the IT sector reporting a significant increase in the number of Ukrainian-owned companies. In terms of transport, Romania has a strategic position, and in the coming period, the completion of investment in road and rail infrastructure could boost this sector, increasing its efficiency.

Frequent geopolitical shocks and the country's security and defence policies may lead to hikes in public spending, as well as the adoption of a suboptimal macroeconomic policy mix. A reassessment of globalisation could result in a regionalisation of trade flows and value chains, an increase in relocation initiatives, a decrease in global labour mobility or an intensification of industrial policies aimed at fostering local production of strategic goods. These dynamics may affect inflation in the short and medium term, both directly, through the replacement of cheaper inputs with more expensive, but "safer" inputs, and indirectly, through their effects on competition and market structure, on price-setting mechanisms and workers' bargaining power. Moreover, these dynamics may have implications for productivity, a critical variable in determining the natural interest rate. At the same time, efforts to diversify imports may lead to lower dependencies on some surplus countries, which may have an upward effect on global interest rates, given the significant impact of these countries' savings in recent decades. Global value chains may amplify economic shocks as they move up and down the production network, altering the Phillips curve slope. Furthermore, shocks across both central hubs and the supply of critical raw materials tend to generate wider economic fluctuations and price volatility through strong spillover effects. In addition, security and defence policies aimed at relocation may encourage either economic convergence or divergence among euro area countries, with potential implications for monetary policy transmission.

From an informational perspective, transitory geopolitical events may distort the assessment of economic situation by monetary policy makers, leading to a rise in uncertainty, especially if these events occur with high frequency, which is a new element compared to the last two decades. Such a context increases the risk of central banks choosing a suboptimal course of action, as the distinction between structural and temporary shocks becomes a more challenging task, given that the latter may subsequently prove to be persistent.

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