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Research Report

Exposure of the euro area's financial sector to risk coming from Russia, China, and the Middle East

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BOFIT Policy Brief

2025 No. 1

Katja Ahoniemi, Eeva Kerola and Kimmo Koskinen

Exposure of the euro area's financial sector to risk coming from Russia, China, and the Middle East



Bank of Finland, BOFIT
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The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.

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Katja Ahoniemi, Eeva Kerola and Kimmo Koskinen

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Abstract

This paper examines the current dependencies and exposures of the euro area's financial sector in a context of rising geopolitical tensions. Focusing on Russia, China, and the Middle East, we analyze direct exposures through lending and securities holdings of banks and large investors. Our findings suggest that the already modest exposures of the euro area have decreased in recent years. Notably, euro area banks and investors have significantly reduced their exposure to Russia in the wake of the Ukraine invasion, and China in response to regulatory uncertainty. Euro area banks reacted quickly to heightened geopolitical risk in the Middle East by reducing their exposure to countries affected by recent turmoil. A new set of potential risks have emerged, however, as a result of strengthened financial ties with the United States.

Keywords: Geopolitical tensions, financial exposure, banking sector, China, Russia, Middle East

1. Introduction

Increased geopolitical risk threatens the stability of the global financial system. Events such as Russia's brutal war on Ukraine, turmoil in the Middle East, and rising tensions between the United States and China are drivers of geoeconomic fragmentation and division of the world into competing blocs (Norrington, 2024).

Adverse conflict events can trigger rapid shifts in market sentiment and sharp increases in uncertainty, laying bare the existing vulnerabilities of financial institutions and markets (ECB, 2024). Heightened uncertainty can also escalate financing costs for banks and non-financial corporations, weigh on business profitability, and diminish the willingness of banks to lend. A possible rise in bond interest rates reduces the value of assets on bank balance sheets and adds to financing costs. An unsettled operating environment can exacerbate credit losses, erode bank solvency, and burden banks with higher costs in complying with financial restrictions and dealing with sanction regimes (Ahoniemi et al., 2024; IMF, 2023).

In this Policy Brief, we focus mostly on the dependencies of the EA financial sector on Russia, China, and the Middle East. Our discussion focuses on direct exposures arising through lending and securities holdings. In addition to examining the situation from the perspective of banks and investment funds, we also consider the external borrowing of euro area corporates to gauge the dependency of the euro area's corporate sector on funding from Russia, China, and the Middle East. We also consider whether financial market participants have increased or decreased their exposures to our focus countries in recent years. Such changes in exposures in our time series likely indicate reactions to geopolitical tensions.

Our findings paint a relatively reassuring picture. Euro area financial exposures and dependencies vis-à-vis Russia, China, and the Middle East tend to be modest. Furthermore, euro area banks and investors have reacted quickly in reducing their exposure to countries experiencing heightened geopolitical risk. The borrowing of euro area corporates from foreign banks has decreased over the past decade, with funding from our focus countries particularly restrained (although Middle Eastern and Chinese banks have increased their lending in recent years).

As exposure to Russia, China, and the Middle East has fallen, the euro area has become increasingly financially the US. Euro area banks have increased their US exposures, making the US by far the largest recipient of euro area portfolio investment. American banks are also one of the largest sources of foreign financing for euro area corporates. While the US has traditionally been considered a safe haven, the current geopolitical climate has created conditions for new types of risk to emerge (Mosley, 2023; Galston and Kamarck, 2022).

This article proceeds as follows. Section 2 looks at the aggregate banking sector statistics from the Bank of International Settlements (BIS). Section 3 tackles more granular euro area banking sector data from the European Central Bank's AnaCredit dataset to analyze the lending of euro area banks outside the euro area and foreign bank lending to euro area corporates. Utilizing ECB Securities Holdings Statistics (SHS) and balance-of-payments data, we consider the security holdings and international investment positions of euro area investors in Section 4. Section 5 concludes.

2. Aggregate banking sector exposures

In this first section, we will look at the evidence provided by the Bank for International Settlements (BIS) banking statistics. This data set covers banking sector bilateral claims by sector and by country,

as well as an aggregate picture of countries' cross-border claims and interlinkages. The banks are categorized by the country where the banking group's parent is headquartered. The data is quarterly and available for some countries already from the 1980s. However, the data set is much more complete from the end of 2013. Hence, we will include data from 4Q 2013 up to 2Q 2024.

There are various limitations to what we can see from the BIS statistics. A total of 26 countries report their aggregated banking sector data to BIS for the counterparty countries that we are interested in.¹ These reporting countries include the key Western nations, but not for example China. Therefore, we are not able to see the exposures of the Chinese banking sector. However, the countries that do report their banking statistics to the BIS report all counterparty countries. In practice, this means that we can see the exposures of most euro area (EA) countries to China (and to all other countries).

The BIS data is available by sector, which means that we are able to identify exposures towards banks, non-banks, and non-financial corporates (NFC) separately. NFC data is not fully available in the data set, but can be quite reliably proxied by using data for the non-financial private sector, which equals the non-bank private sector less non-bank financial institutions. In what follows, the terms non-financial private sector, corporates, and NFCs will be used interchangeably.

We look at two aspects of the BIS dataset:

1. Claims of banks in all reporting countries on Russian, Chinese, and Middle Eastern banks,² non-bank financial intermediaries (NBFI), and corporates.
2. Claims of banks in non-EA reporting countries on EA corporates.

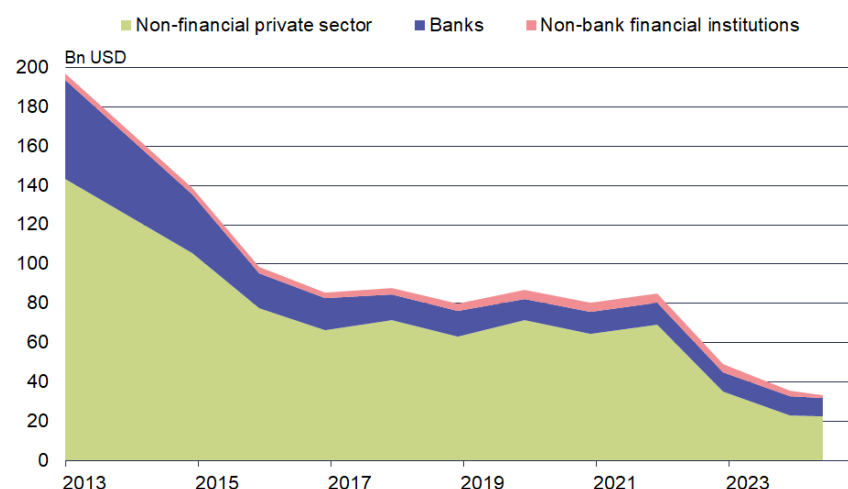
2.1. Claims on Russia, China, and the Middle East

First, we will look at the exposures of the 26 reporting countries towards Russia. The chosen data period of 4Q 2013 to 2Q 2024 covers the invasion of Crimea in addition to the attack on Ukraine. Figure 1 shows that the claims of foreign banks on all Russian sectors have plummeted. A clear drop occurred already after the invasion of Crimea in 2014, and exposures were more or less halved from around 200 billion USD to 100 billion USD by 2016. A further decline happened after the start of the 2022 attack on Ukraine, and current exposures are less than 40 billion USD.

¹ Australia, Austria, Belgium, Canada, Chile, Chinese Taipei, Finland, France, Germany, Greece, Hong Kong SAR, Ireland, India, Italy, Japan, South Korea, Netherlands, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Türkiye, United Kingdom, and United States.

² Bahrain, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Oman, Palestinian Territories, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen.

Figure 1. Combined exposure of the 26 reporting countries' banking sectors to Russia has plummeted
Claims of foreign banks on Russian entities

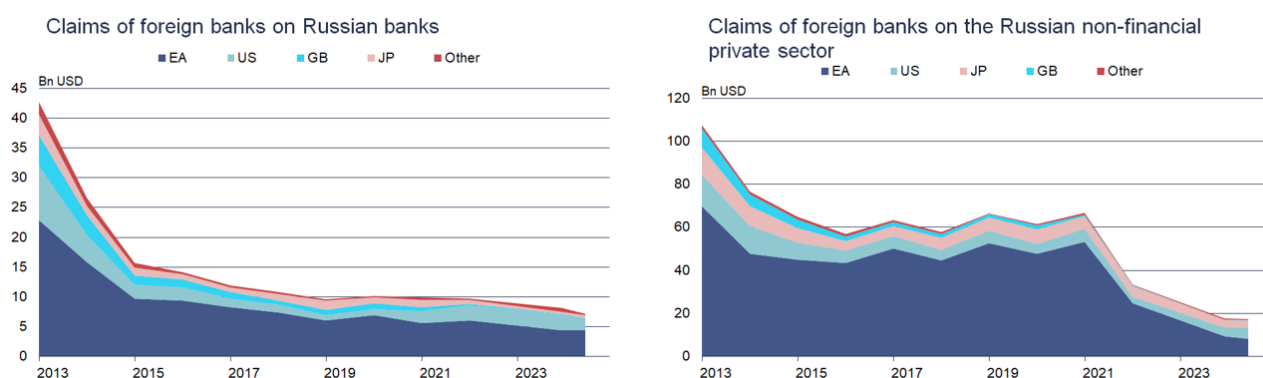


Note: Most recent observation is June 30, 2024.

Source: BIS.

Euro area banks have long been the largest creditor of both Russian banks and corporates, and this continues to be the case (Figure 2). U.S. banks have the second-highest exposures towards both sectors.

Figure 2. Euro area banks remain Russia's largest foreign credit providers.

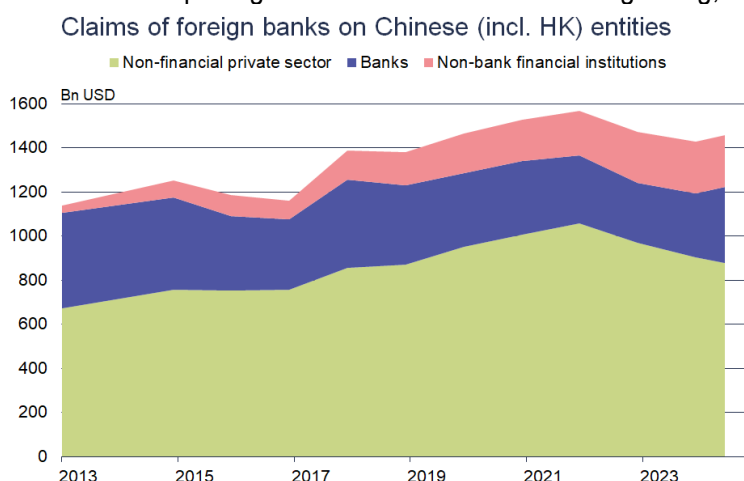


Note: Most recent observation is June 30, 2024. EA = AT, BE, DE, ES, FI, FR, GR, IE, IT. Other = AU, CA, CL, IN, KR, SE, TW.

Source: BIS.

Second, we will look at exposures of foreign banks towards China (including Hong Kong). The importance of China in the global economy has been growing for a long time. Meanwhile, China's regulatory environment continues to be hard to predict, which may make foreign banks and investors wary. The status of Hong Kong has also been changing rapidly.

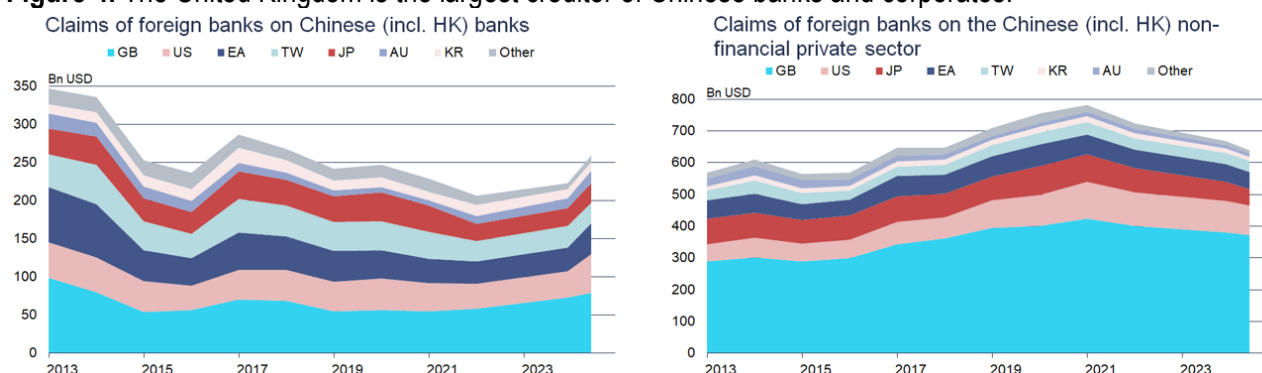
Figure 3 shows that overall exposures to China have grown from where they were around ten years ago. Exposures have grown from less than 1.2 trillion USD to over 1.4 trillion USD by the end of June 2024. However, exposures have fallen somewhat from their peak over the past two years, possibly due to the aforementioned regulatory unpredictability. As was the case with Russia, exposures towards corporates are clearly larger than exposures towards the financial sector.

Figure 3. Overall exposures of 26 reporting countries to China have been growing, but not massively

Note: Most recent observation is June 30, 2024.

Source: BIS.

The largest creditor in China is not the euro area, but rather the United Kingdom (Figure 4), which has the largest exposures towards both banks and corporates. The second-largest exposures belong to the United States. Euro area countries have cut their exposure to the Chinese banking sector by half over the past ten years: from 72 billion USD to 30 billion USD. Corporate exposures have been much more stable, varying between 50 and 68 billion USD between 2013 and the end of June 2024.

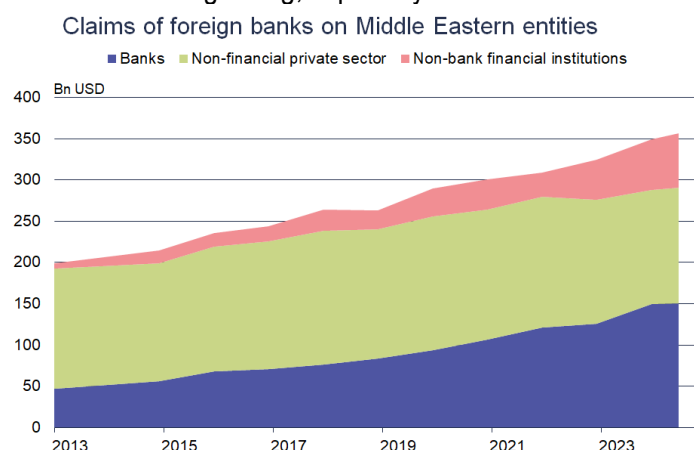
Figure 4. The United Kingdom is the largest creditor of Chinese banks and corporates.

Note: Most recent observation is June 30, 2024. EA = AT, BE, DE, ES, FI, FR, GR, IE, and IT. Other = CA, CH, CL, IN, and SE.

Source: BIS.

Finally, we will look at the exposures of foreign banks towards Middle Eastern countries. The Middle East is a heterogeneous area that includes several oil-rich countries, but also some incredibly poor countries. Israel is naturally a part of the Middle East group. While currently there is much turmoil in parts of the region, the Middle East has long been volatile and prone to conflicts.

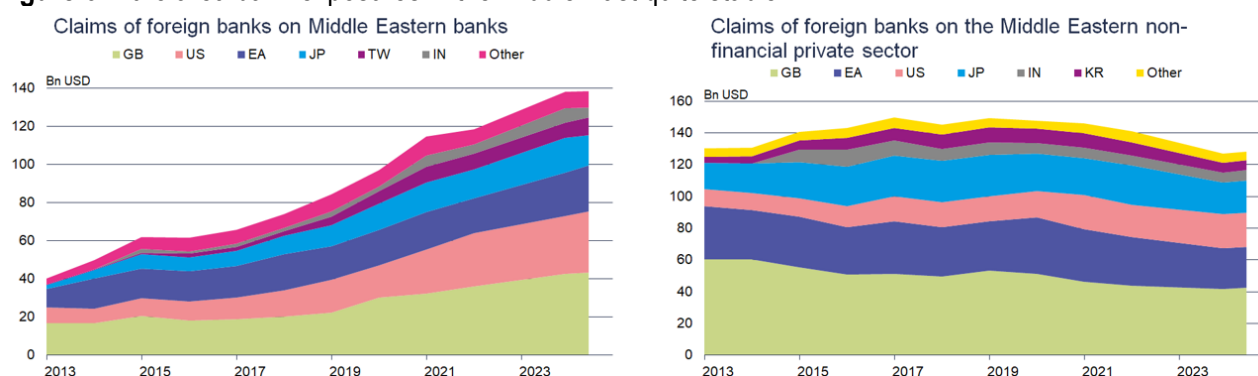
Figure 5 shows that over the past ten years, foreign banks have steadily increased their exposures in the Middle East. The growth in exposures has been clearest towards banks, with the total amount increasing threefold from around 50 billion USD to the current 150 billion USD. During the same time, total exposures have grown around 1.75 times, from 200 to 350 billion USD. Non-bank exposures are small but also growing, whereas corporate exposures have been quite stable.

Figure 5. Exposures to the Middle East growing, especially in the financial sector

Note: Most recent observation is June 30, 2024.

Source: BIS.

Looking next at the country split, the United Kingdom, euro area, and United States are the top three in exposures, followed by Japan (Figure 6). The growth in banking sector exposures has been driven mainly by UK and US banks in terms of dollars, even though the Japanese bank exposures have grown almost tenfold from 2013. The exposures of euro area banks have grown, but only moderately. The corporate exposures of euro area banks have been very stable, as the dollar exposure has varied between 25 and 30 billion USD over the past ten years.

Figure 6. Euro area bank exposures in the Middle East quite stable.

Note: Most recent observation is June 30, 2024. EA = AT, BE, DE, ES, FI, FR, GR, IE, and IT. Other = AU, CA, CH, CL, KR, SE, and TW.

Source: BIS.

We can draw several conclusions from this first subsection. First, foreign banks' claims on Russia have plummeted - although euro area banks remain the largest creditor of both Russian banks and corporates. Second, even if the importance of China in the global economy has been growing fast over the past decade, foreign banks' claims on Chinese entities have increased much less. Moreover, exposures have actually fallen from their peak over the past two years. The largest creditor in China remains the United Kingdom. This is likely due to the fact that two large banks, HSBC and Standard Chartered, are headquartered in the UK, while a large share of their operations is in China. Meanwhile, the euro area has cut its exposure to the Chinese banking sector by half over the past ten years, whereas corporate exposures have been much more stable. Third, over the past ten years,

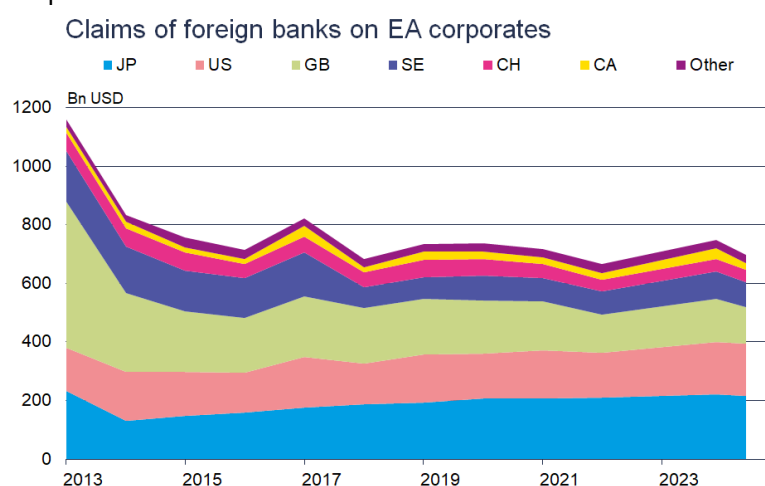
foreign banks have steadily increased their exposure to the Middle East. Mainly UK and US banks have increased their exposures, whereas euro area banks' exposures have grown only moderately.

2.2. Claims of non-EA banks on euro area corporates

In this subsection, we look at how much euro area corporates have borrowed from outside the bloc. This analysis with BIS data complements the analysis with AnaCredit data in section 3.2, as the picture provided by the BIS data is more complete for those countries that report their banking statistics to the BIS. However, AnaCredit is the data set that provides at least a glimpse into the exposures of Chinese banks operating in the euro area, for instance. Further details on comparing the data sets are provided in section 3.2.

Figure 7 shows that the borrowing of euro area corporates from banks outside of the bloc has remained rather stable since 2018 at around 700 billion USD. However, the BIS data does not include any borrowing from Chinese or Middle Eastern banks, for example. Out of the countries that do report their banking statistics to the BIS, euro area corporates borrow the most from banks in Japan, the United States, the United Kingdom, and Sweden.

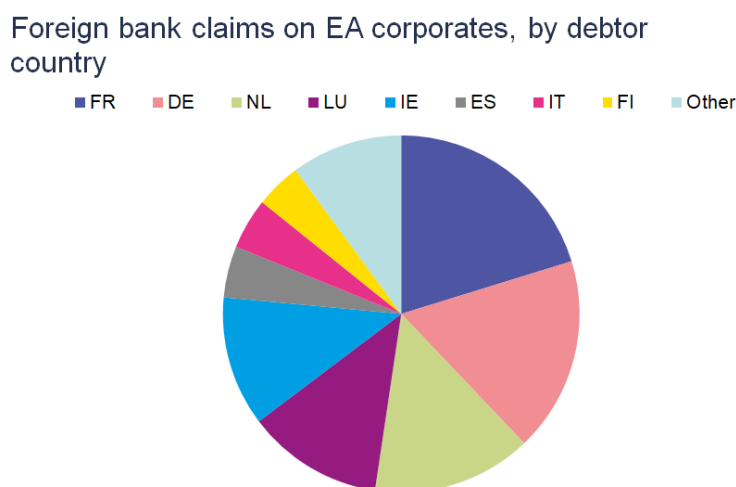
Figure 7. Euro area corporates have borrowed 700 billion USD from outside the bloc



Note: Most recent observation is June 30, 2024. Other = AU, CL, IN, KR, TR, and TW.
Source: BIS.

Where does the 700 billion that euro area corporates have borrowed from outside the bloc go? The BIS data shows that the three largest recipient countries are France, Germany, and the Netherlands (Figure 8). Finland is the eighth-largest recipient in terms of euros, most likely due to borrowing from Swedish banks.

Figure 8. France, Germany and the Netherlands account for over half of the total loan volume from outside of the bloc.



Note: Situation as of June 30, 2024. Other = AT, BE, CY, EE, GR, HR, LT, LV, MT, PT, SI, and SK.

Source: BIS.

Next, we turn to micro-level data to gain a more granular picture of euro area lending to and borrowing from countries outside of the bloc, including Russia, China, and the Middle East.

3. Micro-level evidence on euro area exposures

Using the ECB's AnaCredit dataset, which contains detailed information on individual corporate loans from banks in the euro area harmonized across all member states,³ we consider EA bank lending to external entities and foreign bank lending to the euro area. Here, our main interest is bank lending to non-financial corporates, but at the end of the first subsection we also consider the lending of EA banks to other banks. The second subsection focuses on EA corporate lending provided by banks outside the EU.

We should state at the outset what AnaCredit shows and does not show. AnaCredit only registers corporate loans larger than EUR 25,000. It covers all credit institutions, including foreign subsidiaries and foreign branches resident in a reporting member state (RMS). It also contains foreign branches in non-reporting member states if the legal entity of those branches is located in an RMS. Thus, we cannot see RMS bank subsidiaries located outside the RMS. For example, we cannot capture the lending of a French bank subsidiary resident in London, so we cannot fully capture the foreign exposure of euro area banks with this dataset.⁴ Moreover, it is not possible to see foreign banks' lending to euro area customers if the foreign banks lack subsidiaries or branches in the RMS. Thus, looking solely at AnaCredit data, we cannot capture the aggregate foreign financing of EA corporates.

³ For more information on the dataset https://www.ecb.europa.eu/stats/ecb_statistics/anacredit/html/index.en.html

⁴ In this note, banks' country is defined by the country of residence of the parent of that bank.

We consider two aspects of the AnaCredit dataset:

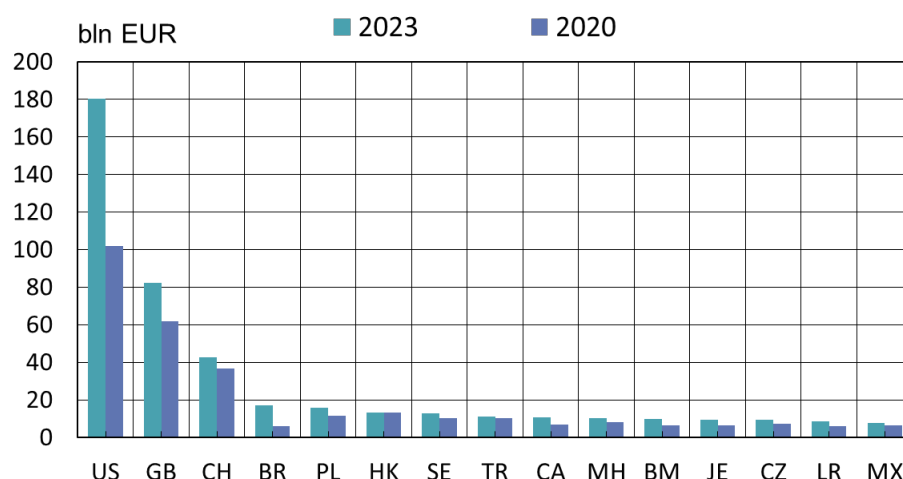
1. The lending of euro area banks outside the euro area across countries and industries.
2. The lending of foreign banks (particular Russian, Chinese, and the Middle Eastern banks) to euro area corporates.

3.1. Extra-EU corporate lending

With respect to euro area (EA) bank lending outside the EU, we consider all EA-owned banks, their branches, as well as their subsidiaries located in the reporting member states.

Figure 9 shows that the largest exposures of euro area banks are to the US and UK. Together they accounted for 46 % of all euro area bank extra-EA exposures at the end of 2023. The US share increased from 24 % in 2020 to 32 % in 2023. The third-largest exposure was to Switzerland, followed at some distance by Brazil, Poland, Hong Kong, and Sweden. In all, the share of exposure to the US, UK, and Switzerland combined increased by 52 % between 2020 and 2023.

Figure 9. Corporate exposures of euro area banks by country of debtor firm.



Sources: ECB AnaCredit and Bank of Finland calculations.

Grouping extra-EA exposures by country groups, we see that the small overall exposure of EA banks to Russia, China, and the Middle East has decreased in recent years (Figure 10, right panel). Exposures to Russia and Belarus remain marginal (less than 4% in 2020), declining by about two-thirds after Russia's full-scale invasion of Ukraine.

Similarly, following the Hamas attack on Israel in October 2023 and Israel's actions in Gaza and elsewhere, euro area banks decrease their exposures to the Middle Eastern countries most affected by the crisis. The left panel of Figure 10 shows EA bank exposures to the "Unstable Middle East" and "Other Middle East."^{5,6} The initial abrupt decrease affects to Unstable Middle East countries more directly involved in the conflict (dashed purple line in Figure 10, right panel). In mid-2024, exposures to these countries were about 50 % lower than in September 2023. Lending to other, mostly oil-rich, Middle Eastern countries experienced no sharp drop and stabilized over the course of 2024.

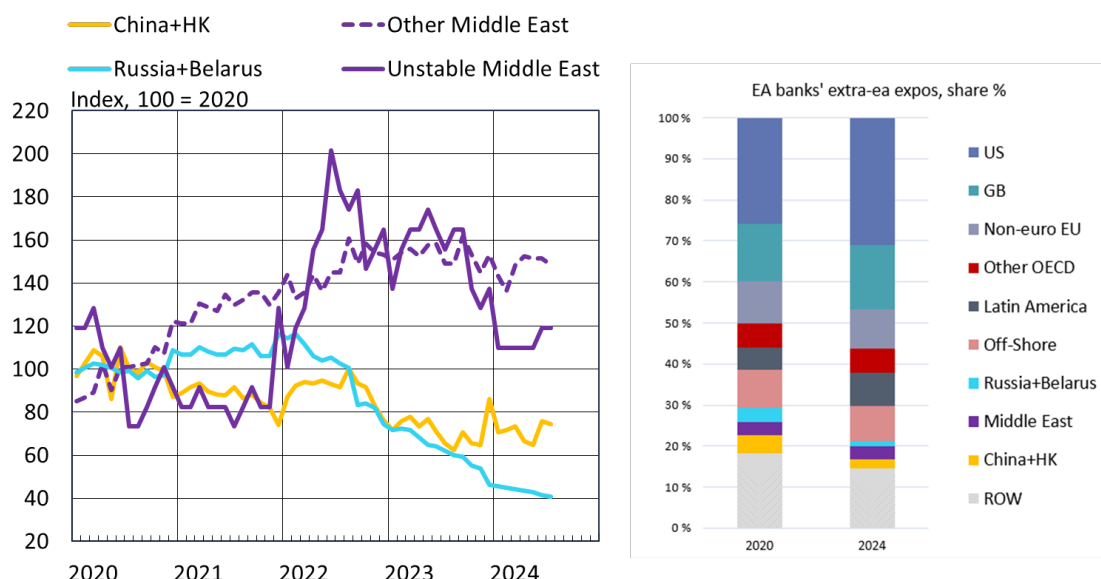
Exposures to China and Hong Kong are rather stable for the period running from 2020 to end-2022. EA banks thereafter reduce their exposures, which currently are down by about a third.

⁵ Here, the Unstable Middle East comprises Israel, Palestine, Lebanon, Iran, Iraq, Yemen, Syria, and Jordan.

⁶ Other Middle East countries comprise the United Arab Emirates, Saudi Arabia, Oman, Bahrain, Kuwait, and Qatar.

Exposures to the US, UK, Latin America, non-euro EU member states, and other OECD increase in the same period.⁷

Figure 10. Extra-EA corporate exposures of EA banks by country groups.



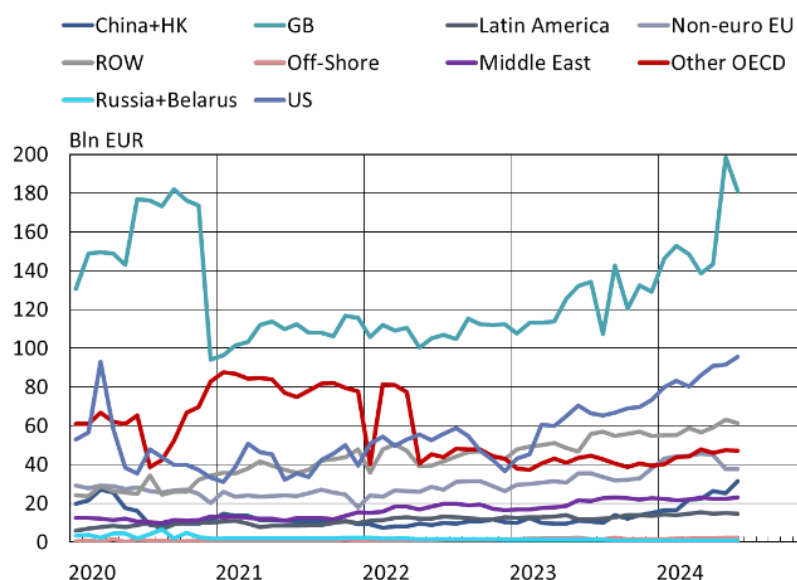
Sources: ECB AnaCredit and Bank of Finland calculations. Off-Shore countries: British Virgin Islands, Jersey, Bermuda, Mauritius, Cayman Islands, Curacao, Bahamas, Gibraltar, Seychelles, Belize, Guyana, Liberia, Marshall Islands, Saint Vincent and the Grenadines, Anguilla, Isle of Man.

Looking at the AnaCredit data (which do not include EA bank subsidiaries located outside reporting member states), we conclude that the geographical exposures of the largest member states are largely similar. The US exposure is largest for Dutch and German banks. For French, Italian, and Spanish banks, the largest exposure is divided between the US and UK. Switzerland accounts for a large share of French, Italian, and Dutch banks extra-EA exposures, while Brazil accounts for a large share of Spanish bank exposure.

The exposure of EA banks to China largely involves wholesale and retail trade, manufacturing, or support service activities. Direct exposure to the real estate sector is tiny. Exposures to Russia and Belarus mostly involve mining & quarrying or manufacturing. Industrial coverage is more dispersed in Unstable Middle East countries, whereas in other oil-rich Middle East countries exposures mostly involve energy or manufacturing.

Although we focus on bank lending to the non-financial corporate sector, we also consider the lending of EA banks to extra-EA banks (Figure 11). The largest exposure is to British banks, which saw post-Brexit lending first decrease sharply then bounce back to exceed pre-Brexit levels. The second-largest exposure is to American banks, which also saw a rising share in 2024.

⁷ Countries not already included in other country groups.

Figure 11. Extra-EA bank exposures of EA banks.

Sources: ECB AnaCredit and Bank of Finland calculations. ROW = Rest of the world.

Generally speaking, the exposures of EA banks to Russia, China and the Middle East were small to begin with and declined in reaction to heightened geopolitical risk. The largest foreign exposures of EA banks were to the US and UK. Overall, exposure to like-minded countries (US, UK, and other EU member states) has markedly increased in recent years.

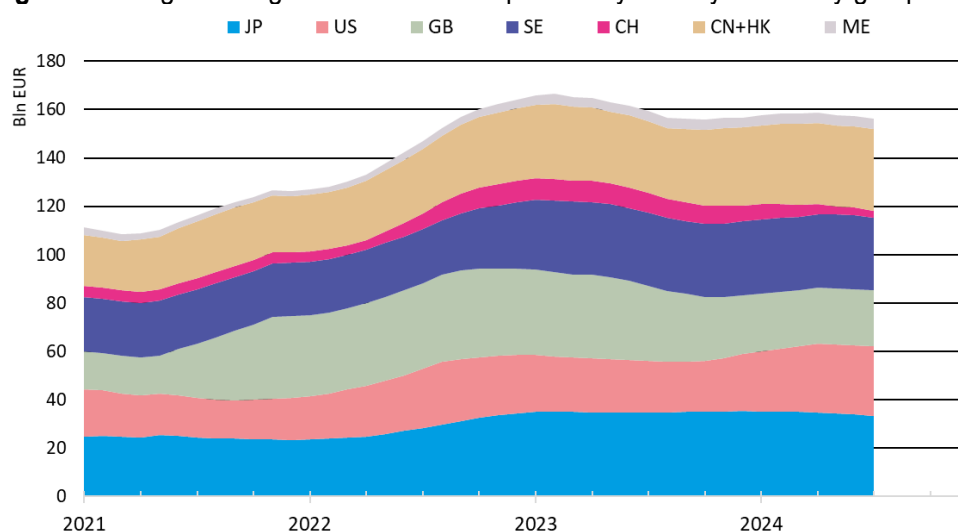
3.2. Lending of foreign banks to EA entities

Our assessment of lending of foreign banks to entities in the euro area relies solely on the AnaCredit data.⁸ We capture the lending of foreign-owned banks, their subsidiaries and branches for reporting member states (plus all branches in non-RMS if the legal entity is itself a resident in an RMS). AnaCredit data do not capture the balance sheets of foreign banks based in a reporting member state.

When we compare AnaCredit data with BIS statistics for those countries that report their banking sector statistics (BIS statistics in Section 2), we see that AnaCredit captures some 20% of American, British, and Japanese banks' total lending to EA firms. For Swedish banks, the share is somewhat higher (35 %). Even if the AnaCredit data omit the majority of total lending of foreign banks, the granularity of the data allows us to detect patterns across countries and industries. Moreover, as the BIS statistics lack altogether data on Chinese and Middle Eastern banks, it is worthwhile to look at the AnaCredit data even if they only provide a small share of the total activity.

According to AnaCredit data, the largest foreign lenders to euro area firms are Japan, Sweden, the US, China, and the UK (Figure 12). They account for a combined share of 70 % of the extra-EA bank lending. We see an overall increasing development for Chinese, American, Swedish, Japanese, and Middle Eastern banks. In contrast, corroborating findings from BIS statistics in section 2.2, British banks have recently decreased their lending to EA corporates.

⁸ Foreign bank again defined by the country of residence of the parent.

Figure 12. Largest foreign lenders to EA corporates by country or country groups.

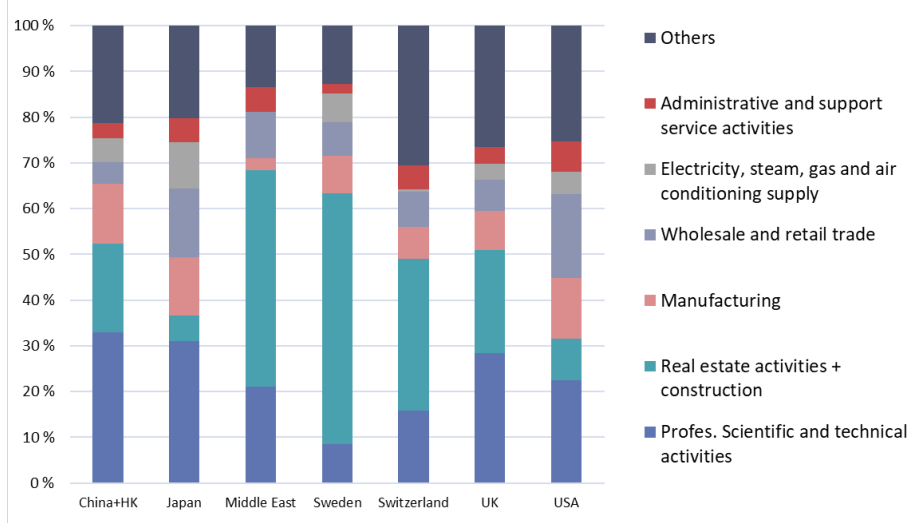
Note: January 2021–July 2024.

Sources: ECB AnaCredit and Bank of Finland calculations.

When divided among recipient countries, we detect several patterns. Japanese banks are relatively active in France, Germany, and the Netherlands. Chinese banks mostly lend to German, French, and Luxembourg firms. Swedish banks lend to corporates in Finland and the Baltic States. US banks are mostly active in France, Germany, and Spain, whereas British banks lend largely to French firms. Middle Eastern banks are most active in France.

From the perspective of EA member states, Chinese banks have a significant presence in Luxembourg, where the share of Chinese bank lending is around 10 % of total bank corporate lending. (A big part of this is the lending activity of *Banque Internationale à Luxembourg*, which has been majority-owned by China-headquartered Legend Holdings since 2018.) It is hard to tell how much of the total lending of Chinese banks is captured in the AnaCredit data as we have no aggregate statistics with which to compare. Figures from the annual reports of China's largest state-owned banks suggest that the AnaCredit data could capture some 30–45 % of their EA lending.

Figure 13 further divides foreign bank lending by economic activity. Half of Middle Eastern banks' lending to euro area firms is directed at firms in the real estate and construction sector. The same is true for Swedish banks. Almost half of the lending of Chinese bank goes to the service sector, but they also lend to firms involved in manufacturing, real estate, and construction. A majority of the lending of foreign banks visible in the AnaCredit data goes to EA-owned firms (i.e. companies with an EA parent).

Figure 13. Foreign bank lending to euro area firms by industry and extra-EA country groups.

Sources: ECB AnaCredit and Bank of Finland calculations.

In summary, the foreign lending to EA corporates coming from Russia, China, and the Middle East is limited. Lending from Middle Eastern and Chinese banks has apparently increased in recent years, but we are unable to capture the total lending from these countries from the AnaCredit dataset.

4. Portfolio investment of euro area investors

In this section, we consider portfolio investment from evidence provided by the ECB Securities Holdings Statistics (SHS) and portfolio investments and the international investment position from the ECB Balance of Payments data (BoP).

SHS is a security-by-security database providing information on securities held by selected categories of euro area investors. The figures are broken down, among others, by instrument type and holder country. Holdings data are collected on a security-by-security level (based on Regulation ECB/2012/24), and subsequently merged with the ECB Centralised Securities Database (CSDB) to complete the data set with additional attributes referring to individual securities and their issuers.

For certain sectors, data are collected directly from investors (mainly investors from the financial sector). For other sectors, data are collected via custodians. National particularities may apply.⁹ The data is quarterly and available from 4Q 2013. More detailed data is available from 1Q 2021. The most comprehensive limitation in SHS database is the granularity of holders. Only country- and sector-level aggregations are available. This caveat is most obvious in investment fund holdings; ultimate owners cannot be traced from fund holdings (owners of fund shares). In addition, securities holdings data is only recorded vis-à-vis the issuer residence country and not vis-à-vis the ultimate risk. Thus, this makes it difficult to fully assess the overall country exposures, since part of the exposures could be issued via offshore financial vehicles and registered in these countries instead of in the ultimate risk country.

⁹ [Securities Holdings Statistics - SHSS | ECB Data Portal \(europa.eu\)](https://ecb.europa.eu/press/pr/20230929)

The euro area BoP data summarizes, on a monthly and quarterly basis, all transactions between euro area residents and non-residents. Transactions between euro area residents are excluded. The international investment position shows the value of residents' financial assets and liabilities vis-à-vis non-residents, including the same breakdowns as for the financial account on a quarterly basis. From this information, we derive aggregated capital flows between EA sectors and non-residents.

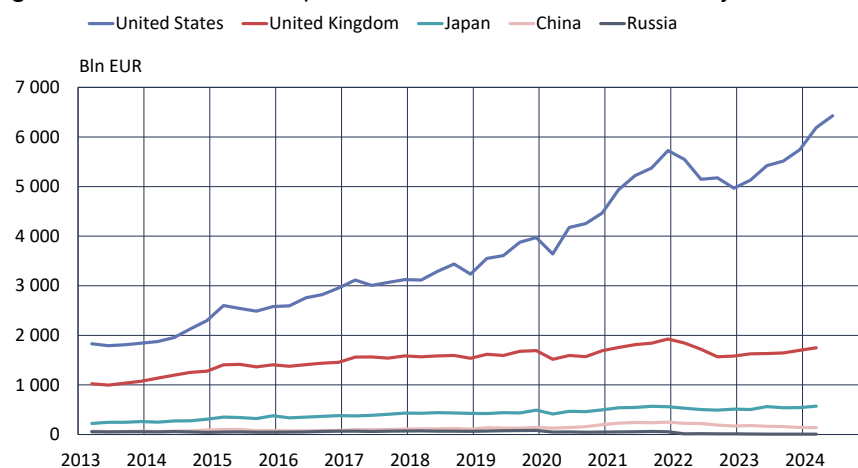
We consider two aspects of the SHS/BoP data set:

1. Where investors in the euro area direct their capital investments and how have the investment positions changed in recent years.
2. How large are the total portfolio investment claims of euro area investors vis-à-vis Russia, China, and Middle Eastern countries.

4.1. Main destinations of euro area portfolio investments

The total amount of euro area residents' cross-border portfolio investments vis-à-vis the rest of the world was over 12 200 bn euro at end of the 2023, which was about 85 % of the GDP of the euro area economy. The single most dominant destination of euro area portfolio investments is the United States. The investment position towards the United States is about 5 500 bn euros, and thus covers about 45 % of all foreign portfolio investments of all euro area residents (Figures 14 and 15). The exposure to the United States is relatively large also compared to euro area domestic investments. The US exposure is about 27 % of all intra-euro holdings of listed shares and bonds. Thus, the US exposure is a major source of financial stability risk in a case of major disruptions in US financial markets.

Figure 14. Total euro area portfolio investments to selected major economies.



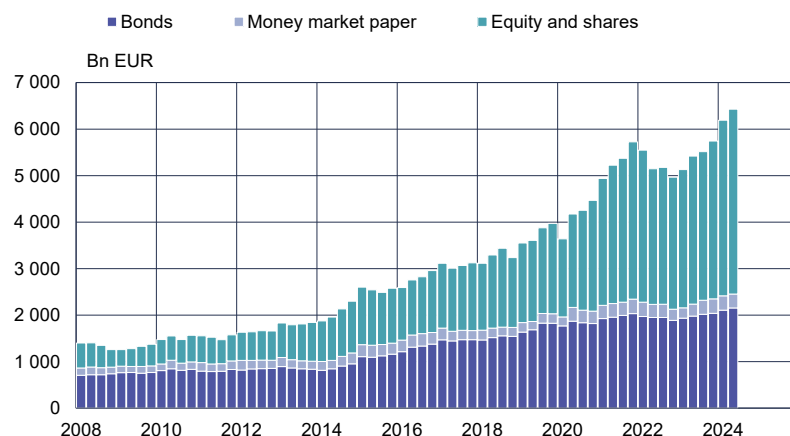
Source: ECB.

The US is the largest capital market in the world, making it a natural destination for foreign investors seeking to diversify their investments. The large single capital market also provides opportunities that cannot be found, at least on a large scale, anywhere else in the world.

The second largest destination for portfolio investment is the United Kingdom with 1 700 bn euros. Most of the investments are equities and investment fund shares, as well as bonds to a lesser extent. Other major economies such as Japan and China are minor portfolio investment destinations compared to their share of the global GDP, indicating the lack of significance of their capital markets

in globally. Regarding China, the closedness of the country's capital market and political risks partly explain the low investments in China.

Figure 15. Total euro area portfolio investments to the United States.



Source: ECB.

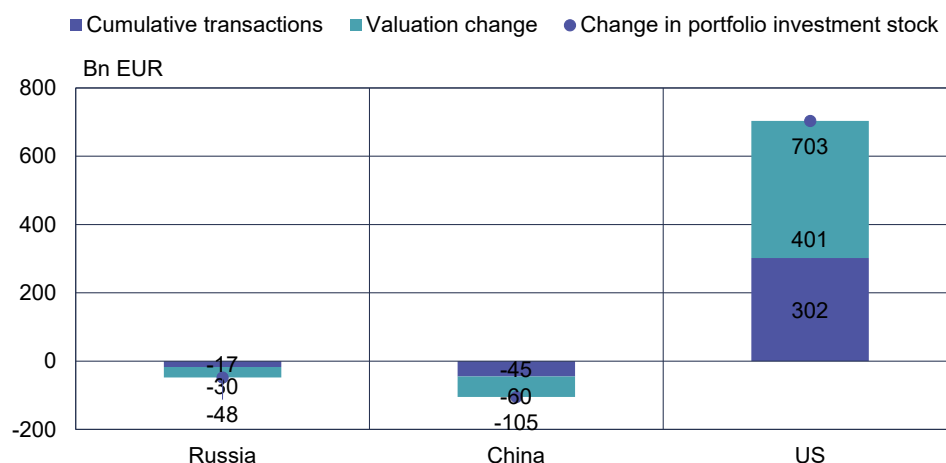
Recent geopolitical disruptions are likely to make US investments even more popular for European investors. Investments in the US are also driven by good economic development, high interest rates, good performance of the stock market and a successful technology sector led by the development of artificial intelligence. The increase in US investments will probably reduce investors' geopolitical risks (at least for the time being) but will make global diversification somewhat one-sided, and will expose euro area investors to even greater US country risk (which has so far been considered to be mostly financial).

4.2. Portfolio investment flows to Russia, China, and the Middle East

Russian attack on Ukraine was clearly a significant turning point for the willingness of euro area investors to invest in Russia and in China. Geopolitical events have often been a major trigger to de-risk positions towards risky countries. Investments to China are also being reduced due to the long-standing problems in the Chinese real estate sector.

Positions towards China and Russia have decreased substantially by assets sales (transactions) and valuation losses (Figure 16). Valuation losses have been substantial in other countries as well (such as in the US), due to inflation and increased interest rates.¹⁰ The clear difference has been transactions, which are clearly negative in Russia and in China (excl. HK), compared to the United States, for example.

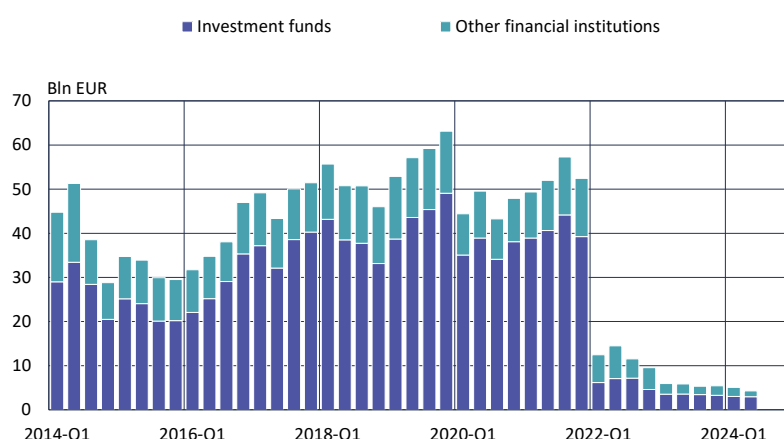
¹⁰ Most of the valuation loss e.g. from US investments is due to valuation loss of bonds. Cumulative loss from US equities is only 7.4 billion EUR.

Figure 16. Change from 4Q 2021 to 2Q 2024 in euro area portfolio investment stock in Russia, China (excl. Hong Kong), and the United States.

Sources: ECB and Bank of Finland calculations.

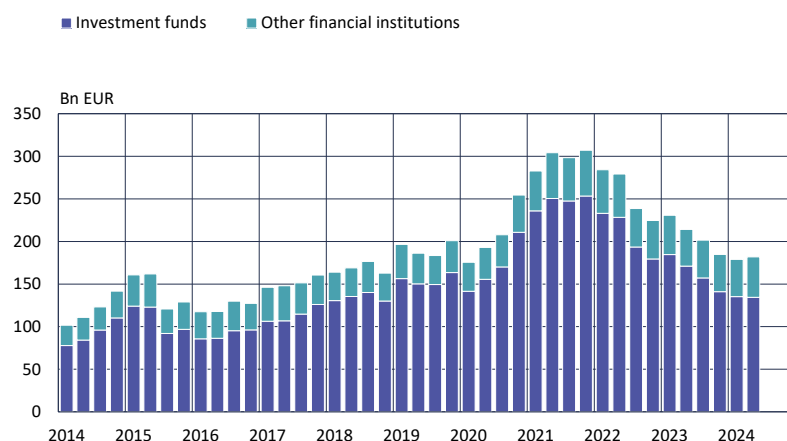
Typically, portfolio investments in developing economies have been made in global capital markets through investment funds. Investment funds spread risks and are a more cost-effective way to invest in small capital markets. The funds are typically operated by large global asset management houses, such as BlackRock or Pimco.

The increase in risk awareness after the Russian invasion can be seen most clearly as a collapse of investments vis-à-vis Russia in 1Q 2022. Economic sanctions made investing impossible. The Russian war caused many investors to sell or write off Russian receivables as losses. The amount of debt owed to Russia collapsed in one quarter from almost 50 billion euros to a few billion euros (Figure 17). The remaining receivables are possibly stranded assets, which investors have not been able to liquidate or record as losses for some reason or another.

Figure 17. Euro area portfolio investments to Russia and Belarus.

Source: ECB.

Chinese investments have been less impacted by geopolitical risks but have been declining now for almost two years. Investments in mainland China and Hong Kong have decreased from around 300 billion (4Q 2021) euros to around 170 billion euros in 2Q 2024 (Figure 18). The majority of investments have been made through investment funds.

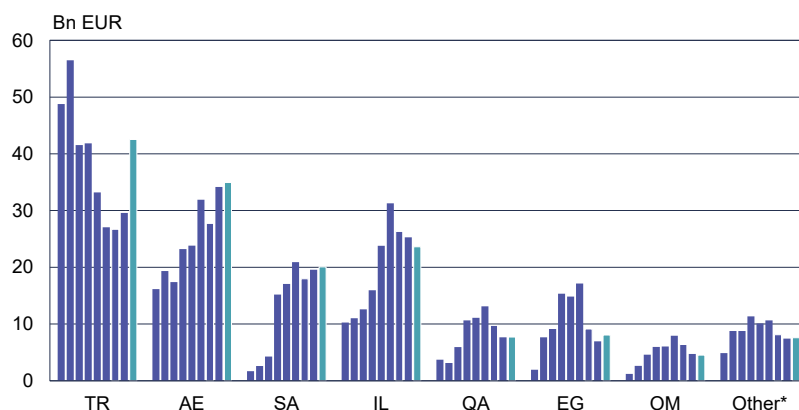
Figure 18. Euro area portfolio investments to China and Hong Kong

Source: ECB.

A large portion of euro area portfolio investment vis-à-vis China is equity investment to listed corporate stocks. Thus, a decrease in valuations in Chinese stock markets heavily impacts the value of euro area investments. A large part of bond investments is related to the public sector or Chinese banks.

The turbulence in the Chinese real estate market has heavily impacted the willingness of euro area investors to invest in Chinese corporate bonds. Corporate bond investments have declined from almost 8 bn euros in 4Q 2021 to less than 3 bn euros at the end of 2Q 2024. Also, the size of these investments is relatively small compared to the total corporate bond exposure of euro area investment funds (0.2 %).

The portfolio investments of euro area investors in the Middle East are relatively small. Most investments have traditionally been directed to Türkiye, but Türkiye's weak economic situation has led to investors withdrawing from the country. Between 2016 and 2023, investment stock in Türkiye has decreased from around 50 billion euros to around 30 billion euros, mainly by negative transactions. Investments recovered somewhat in the first half of 2024. In addition to Türkiye, other important investment destinations are the United Arab Emirates, Saudi Arabia, Israel, Qatar, and Egypt. From a statistical point of view, it's too early to say how the current military situation in Gaza or tensions between Israel and Iran will affect portfolio investments in the Middle East. However, it's quite evident that flows to the area have been stagnating in recent years.

Figure 19. Euro area portfolio investment stock in selected Middle Eastern countries, 2016 to end-June 2024.

Note: Other = BH, JO, KW, IQ, and LB.

Source: ECB.

To conclude, the single most dominant destination of euro area portfolio investments is the United States, followed by the United Kingdom. Although exposures to Russia, China, and the Middle East have been small to begin with, geopolitical events have triggered euro area agents to decrease their exposures even further. This is most visible in investments to Russia, which have plummeted after the full-scale invasion of Ukraine. Investments to China have also been reduced - here the long-standing real estate sector problems play a large role. As a significant share of euro area portfolio investment entails stocks of listed corporates, the decreasing valuation of the Chinese stock market further decreases the value of euro area investments.

5. Conclusions

Overall, our findings paint a relatively reassuring picture about the exposures and dependencies between euro area banks and other euro area investors vis-à-vis Russia, China and the Middle East. These exposures are relatively modest in size and have for the most part been falling over recent years.

Exposures to Russia have clearly plummeted after the attack on Ukraine in 2022, although a downward trend began already after the invasion of Crimea in 2014. This reduction in exposures holds both for banks and for investment funds and other non-bank financial institutions. Out of the small bank exposures of the 26 reporting countries that are left, the share of euro area banks is the largest, followed by U.S. banks. Euro area investors have also exited Russian portfolio investments almost completely.

The exposures of foreign banks to Chinese banks have fallen overall in recent years, including for euro area banks. The exposures of euro area banks to China have halved over the past ten years, with a clear decline visible also from the beginning of 2023. This may coincide with an increase in perceived regulatory uncertainty, with the Chinese government enacting various new measures that affect also foreign investors. In fact, portfolio investments to China have been trending downwards already since early 2022.

Exposures to the Middle East are growing globally, especially towards the banking and non-bank sectors. However, exposures of euro area banks to the Middle East have grown only slightly over the past ten years. Also, looking separately at unstable Middle Eastern countries, total lending from the euro area decreased markedly after October 2023 when the conflict between Israel and Hamas began. A similar pattern is also visible regarding portfolio investments of other euro area investors.

On aggregate, euro area corporates' borrowing from foreign banks has been on a decreasing trend over the past ten years. Even if the reliance on funding from Russia, China and the Middle East in particular seems to be limited overall, Middle Eastern and Chinese banks have somewhat increased their lending to euro area corporates in recent years.

While exposures to Russia, China and the Middle East have been falling, various types of exposures to the United States have been growing at the same time. Euro area banks have clearly increased their lending to customers in the U.S. over the past few years, and the U.S. is by far the largest recipient of portfolio investments from euro area investment funds and other non-bank financial institutions. American banks are also the second largest source of foreign financing of euro area corporates. While the U.S. has traditionally been considered a relative safe haven for investments, the current geopolitical climate, including the new U.S. regime and continued trade-related tensions not only with China, can create new types of risks associated with financial ties to the U.S.

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