https://doi.org/10.54318/eip.2025.vm.402

GEOPOLITICAL RISK AND ITS EFFECTS ON FINANCIAL STABILITY: CASE STUDY OF THE REPUBLIC OF SERBIA

Vesna Martin[1]**,** e-mail: martinv0803@hotmail.com

Abstract. *One of the biggest threats facing the world today is geopolitical risk. Apart from climate change and the increasing use of digitalization, geopolitical risk is a major issue for nearly every nation in the world. It is reflected in global capital markets, disrupts supply chains, impacts credit ratings and trust in all financial system participants, delays innovation and investment, and influences how monetary and fiscal policy is implemented. The aim of this paper is to examine how geopolitical risk affects financial stability, specifically focusing on the Republic of Serbia. Due to its foreign policy stance between regional interests and larger nations, Serbia is impacted by geopolitical risk. To reduce adverse effects on the prospects for the country, managing these risks calls for internal reforms, strategic diplomacy, and the creation of long-term political and economic policies. This suggests that the strategic resolve to pursue EU accession negotiations, cooperation with East and West nations, and adjustment to economic issues (such as high inflation, the energy crisis, and complex supply chains) will persist. Because of the economy's resiliency during the pre-coronavirus era, the analysis demonstrated that geopolitical concerns did not pose a threat to the Republic of Serbia's financial stability. Basic macroeconomic indicators, external position indicators, and important macroprudential indicators all point to this.*

Key words: geopolitical risk, financial stability, financial stress, geopolitical risk index.

GEOPOLITIČKI RIZIK I NJEGOVI EFEKTI NA FINANSIJSKU STABILNOST: STUDIJA SLUČAJA REPUBLIKE SRBIJE

Apstrakt. *Jedna od najvećih pretnji sa kojima se svet danas suočava je geopolitički rizik. Osim klimatskih promena i sve veće upotrebe digitalizacije, geopolitički rizik je glavno pitanje za skoro svaku zemlju u svetu. To se odražava na globalna tržišta kapitala, stvara zastoje u lancima snabdevanja, utiče na kreditni rejting i poverenje svih učesnika finansijskog sistema, odlaže inovacije i investicije i utiče na sprovođenje monetarne i fiskalne politike. Cilj ovog rada je analiza kako geopolitički rizik utiče na finansijsku stabilnost, sa posebnim osvrtom na Republiku Srbiju. Zbog svog spoljnopolitičkog položaja između regionalnih interesa i većih nacija, Srbija je pod uticajem geopolitičkog rizika. Da bi se smanjili negativni efekti na perspektivu zemlje,*

[1] Economists Association of Belgrade, Kneza Miloša 10, 11 000 Belgrade, Serbia. The views expressed in this paper are those of the author, and do not necessarily represent the official view of the Economists Association of Belgrade.

upravljanje ovim rizicima zahteva unutrašnje reforme, stratešku diplomatiju i kreiranje dugoročnih političkih i ekonomskih politika. Ovo sugeriše da će se strateška rešenost da se nastavi sa pregovorima o pristupanju EU, saradnji sa istočnim i zapadnim zemljama i prilagođavanju ekonomskim pitanjima (kao što su visoka inflacija, energetska kriza i zastoji u lancima snabdevanja) i dalje nastaviti. Zbog postignute otpornosti privrede u eri pre korona virusa, analiza je pokazala da geopolitički problemi ne predstavljaju pretnju po finansijsku stabilnost Republike Srbije. Na to ukazuje kretanje osnovnih makroekonomskih pokazatelja, pokazatelja eksterne pozicije i odabranih makropru-dencijalnih pokazatelja.

Ključne reči: geopolitički rizik, finansijska stabilnost, finansijski stres, indeks geo-političkog rizika.

JEL klasifikacija (classification): F51, G20, G32, H56

1. Introduction

Potential shifts in the political landscape brought about by international relationships, wars, governmental decisions, or pressures from the global political and economic sphere are referred to as geopolitical risk. Financial stability can be greatly impacted by such a risk on a national and international level. Global and local financial markets (e.g., declining share values and increased market volatility), international supply chains and trade disruptions (e.g., restricted market access), and fiscal and monetary consequences (e.g., increasing government spending on the military industry can increase the fiscal deficit and public debt) are just a few of the many important areas where geopolitical risks can have a complex and wide-ranging impact on financial stability. These points suggest that all economic agents and economic activities are impacted by geopolitical risk. As a result, countries have to develop buffers as a form of resistance against both internal and external geopolitical threats in order to lessen the impact of geopolitical risk.

The aim of this paper is to examine how geopolitical risk affects financial stability, specifically with regard to the Republic of Serbia. Finding out how external factors, political tensions, international relations, and global economic shocks can impact Serbia's economic stability — particularly in relation to financial markets, the banking sector, public finances, and investments — is the goal of the analysis of the impact of geopolitical risks on the country's financial stability. In addition to identifying potential threats, weaknesses, and challenges that Serbia encountered in the past, this study aims to anticipate potential threats in the future so that suitable measures can be developed to reduce these risks and maintain financial stability. State institutions, the central bank, regulators, and other actors make decisions to maintain the stability and growth of the national economy, manage debt, and maintain the confidence of investors and residents — decisions that are better understood thanks to this analysis.

The structure of the paper is as follows: A review of the literature and an explanation of the research methodology come after the introductory presentation. The paper's middle section examines the influence of geopolitical risk on financial stability and an analysis of the Geopolitical Risk (GPR) index. Assessing the effect of geopolitical risk on the Republic of Serbia's financial stability is the goal of the paper's last section. We outline the key findings in the conclusion, along with suggestions for further research on this topic.

2. Literature review

Financial stability is significantly impacted by geopolitical risk, and an examination of the literature on this subject reveals that it crosses several academic fields, such as international relations, political science, and economics. Conflicts, terrorism, political and economic tensions between nations, shifts in international commerce, and other occurrences that have the potential to destabilize the world market are all considered forms of geopolitical risk. Indexes such as the GPR, which measures the volume of media coverage of geopolitical events, are frequently used to quantify geopolitical risk.

The global economy and financial markets are impacted by a variety of risks, many of which are impossible to diversify away. Numerous studies have examined a range of risk factors, such as geopolitical risk, and shown that local economic policies can have an impact on the global financial system. Lucchetta[2] points out that credit risk cannot be diversified if it is concentrated in the domestic and international banking sectors. Additionally, she notes that if all countries experience an economic downturn, this will lead to a significant increase in real interest rates. In its Global Financial Stability Report for April 2023[3], the International Monetary Fund (IMF) recommended that policymakers focus on identifying, controlling, and reducing financial stability risks associated with geopolitical risks. To lessen the impact of these geopolitical risks, the report emphasizes the need for financial institutions to maintain sufficient levels of capital and liquidity buffers. Multilateral efforts to diplomatically settle geopolitical conflicts and avoid economic and financial fragmentation should be bolstered in light of the serious threats to global macro-financial stability. The 2008 global financial crisis and the coronavirus epidemic have

[2] Lucchetta (2024), p.3
[3] IMF (2023), p. 81

shown that nations with larger foreign exchange reserves have less macroeconomic disruption as a result of capital disruptions[4].

Given the current state of unpredictability, geopolitical risks pose a serious threat to the world economy. These risks have the potential to seriously jeopardize stability in a variety of domains, such as politics, economics, and technology. Access to worldwide demand and increasing supply chain efficiency are the primary drivers of business internationalization in capital- and technology-intensive sectors[5]. Events from the domestic and global environment, such as trade disputes, terrorist attacks, climate change, cyber attacks, and the corona virus epidemic, can be the cause of geopolitical threats. Given the size and integration of the world economy, geopolitical risks have the potential to spread quickly and have serious repercussions on a global scale[6]. Having sufficient reaction strategies is essential to managing geopolitical risks, particularly when the financial markets exhibit high levels of stress. Because different industries respond differently to the effects of geopolitical risks, investors and authorities should implement distinct policies for each sector. International financial institutions, such as the World Bank and the European Bank for Reconstruction and Development, are steadfastly committed to preventing corporates from premature closure and providing them with another opportunity to regain stability through specific restructurings that may be jeopardized by geopolitical risks in order to assist corporations and households[7].

When making investment decisions and analyzing global financial market movements, representatives of central banks, corporations, and market participants carefully consider geopolitical concerns. In June 2016, former Bank of England Governor Mark Carney stated that economic performance is impacted by three different forms of uncertainty: political, economic, and geopolitical. According to Mr. Carney, global risk increased following 9/11 and continued to be unstable and high for years to come[8]. Indicating the interdependence of events in economic and financial frameworks, the conflict between Russia and Ukraine, which started in February 2022, contributed to the rise in geopolitical tensions on a global scale. Generally speaking, adverse geopolitical developments and threats from the local and global environment can have an impact on macroeconomic indicators in a number of ways, including higher military spending, fatalities, and the breakdown of social life[9].

[4] Kovačević (2022), p. 25
[5] Marković (2023), p. 37
[6] NguyenHuu and Örsal (2023), p. 217-218
[7] Lukić and Popović (2020), p. 62
[8] Bank of England (2016)
[9] Del Gaudio and De Luca (2024), p. 3

As geopolitical conflicts and financial development increase, more researchers are becoming interested in how these conflicts affect energy security, which is a crucial aspect of any nation's sustainable development. Therefore, to guarantee energy security in the future, it is essential to combine financial stability, economic growth, and geopolitical concerns[10]. If the shift to zero carbon emissions is not made, energy security will become a particularly significant issue in the years to come due to climate change[11]. Uncertainties brought on by geopolitical risk may have an impact on the nation's digital economy. Global events that can drastically disrupt digital supply chains and impact the movement of products and services include trade tensions, political crises, and regulatory changes[12]. The increase in geopolitical risk affects the increase in economic policy uncertainty, which in turn affects banks' decisions on loan approval and credit activity. This reduces the supply of loans and the competitiveness of the economy due to reduced sources of finance[13]. As noted in the literature, financial stability is very vulnerable to geopolitical shocks. Due to the international character of contemporary economies, no nation is totally immune to the effects of geopolitical risk, even though the repercussions differ depending on the region and business.

2. Research methodology

This paper's research methodology is based on a combination of a thorough literature review, an analysis of the GPR, and an examination of how geopolitical risk affects the Republic of Serbia's financial stability. The foundation of desk research is the examination of a variety of sources, including working papers, reports from major financial institutions, and case studies that take into account how geopolitical conflicts affect different activities.

Created by Caldara and Iacoviello[14], the GPR is a metric that quantifies the likelihood of unfavorable geopolitical events and associated risks by counting the frequency of news stories that discuss geopolitical tensions. A greater degree of geopolitical risk is associated with decreased employment, decreased investment, and stock price declines. Additionally, a high likelihood of economic catastrophes and a greater risk to the global economy might be indicated by the strong presence of geopolitical risk. By examining fundamental macroeconomic, external position, and macroprudential indicators, this paper will provide a comprehensive analysis of how geopolitical risk influences the

[10] Aslam et al. (2024), p. 19
[11] Hoffart et al. (2022), p. 5
[12] Mohammedi et al. (2025), p. 2
[13] Lu et al. (2020), p. 103
[14] Caldara and Iacoviello (2022), p. 1194

financial stability of the Republic of Serbia. The following are the main research hypotheses:

Hypothesis 1: Geopolitical risk negatively affects financial stability.

Hypothesis 2: The methodology for calculating the GPR is based on the analysis of textual data from relevant sources.

Hypothesis 3: The financial stability of the Republic of Serbia has not been threatened as a result of geopolitical tensions.

3. Influence on financial stability

Global financial markets are greatly impacted by geopolitical events and wars, which raise uncertainty among investors, the economy, and politicians[15]. There are two channels through which geopolitical conflicts might cause financial instability: the financial channel and the real channel[16]. The foundation of the financial channel is either heightened investor uncertainty and risk aversion to possible future restrictions, conflict escalation, or expropriation, or it is based on limitations on capital flows and payments (such as capital control measures, financial sanctions, and international asset freezes). As a result of the above, there may be a decrease in the funds placed by the banks, which may consequently lead to financial fragmentation and a decrease in asset prices. By raising borrowing costs, capital reallocation also increases liquidity and solvency stress in both the financial and non-financial sectors. The real channel problem may amplify the financial channel's impact on financial stability. In particular, heightened geopolitical tensions may have an indirect impact on financial instability through the real channel, resulting in disruptions in supply chains and commodities markets, as well as limitations on international trade and technology transfer. Inflationary pressures might result from such developments, which would also affect economic growth and international trade flows. All of the above factors would undermine the profitability and liquidity of the non-financial sector, which would contribute to an increase in banks' credit risk and threaten the stability of the macro-financial system.

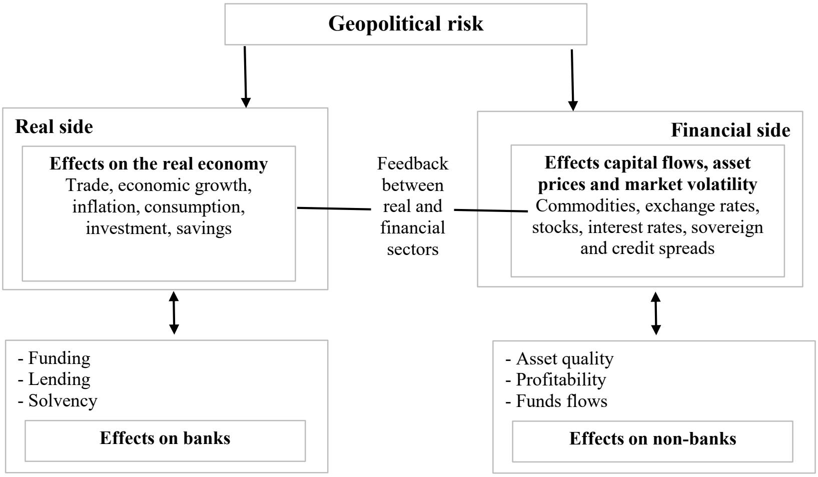
According to the IMF's October 2024 Global Financial Stability Report[17], there are three main channels through which macroeconomic uncertainty might impact financial stability at the macro level. The first is the market channel, whereby investors may be more affected by negative shocks due to macroeconomic uncertainty, raising the possibility of unrealized future

---

[15] Hodula et al. (2024), p. 6
[16] IMF (2023), p. 85
[17] IMF (2024), p. 56-57

returns on assets invested. By raising the possibility of output cuts, the realization of market risk may have an impact on the overall economy. Second, uncertainty may affect consumers and businesses, delaying spending and investment, which would slow down the economy and raise credit risks for financial institutions. The credit channel is the final channel via which macroeconomic uncertainty can have an impact. It may result from a decrease in lending to financial intermediaries since it is more difficult to assess a debtor's creditworthiness. Economic uncertainty can have a greater impact on macro-financial stability if all three channels act concurrently and reinforce one another. The use of artificial intelligence in the financial industry and other technological advancements may make market volatility even more likely. Even if innovation has many advantages, it can also lead to systemic issues that might hasten the spread of shocks and increase the impact of macroeconomic uncertainty on financial stability. In times of high macroeconomic uncertainty, policymakers should enact appropriate fiscal and macroprudential measures to reduce the risks to financial stability resulting from high macro-financial vulnerabilities. Policymakers should proactively implement macroprudential regulations to limit macro-financial vulnerabilities, as high uncertainty can worsen their negative impacts, such as excessive borrowing by the private sector. This is particularly crucial in times of loose financial conditions that do not seem to be connected to the high level of uncertainty in the overall economy. In these situations, the central bank may respond by implementing restrictive monetary policy in addition to strict macroprudential measures, if doing so is consistent with its goal of maintaining price stability. In order to limit the detrimental impacts of excessive public debt on borrowing costs that run the danger of jeopardizing macro-financial stability, fiscal policy should also place a high priority on debt sustainability. Based on the above, we can accept the first hypothesis and conclude that geopolitical risk negatively affects financial stability.

Figure 1. Transmission channels of geopolitical risk to financial stability



Source: European Central Bank, Financial Stability Review, May 2024, https://www.ecb.europa.eu/press/financial-stability-publications/fsr/html/ecb.fsr202405~7f212449c8.en.html

Financial instability and adverse effects on the global economy can result from geopolitical risk. Geopolitical risk can harm the economy through the real economy by adversely influencing trade flows, inflation, gross domestic product growth, investments, savings, and consumption (see Figure 1). From the standpoint of the financial channel, geopolitical risk can have an impact on interest rates, interest spreads, asset prices, and capital flows. The process of sharing direct information can have a direct impact, given the interdependence of the financial industry and the real economy. The solvency, asset quality, financing sources, credit activity, and profitability of banks and the non-banking sector may all suffer as a result of these detrimental effects on the real economy and financial markets. Because geopolitical risk increases uncertainty, it can have a negative effect on the economy by affecting investor and consumer confidence, which in turn affects economic growth. Additionally, trade bans and limitations may result in a decline in global commerce. For instance, Middle Eastern geopolitical developments have in the past triggered supply chain and commodity market disruptions, such as the oil shock of the 1970s.

According to the European Central Bank's (ECB) Financial Stability Review, May 2024[18], global geopolitical risk may have an impact on macro-economic variables. For example, inflation will rise by nearly 0.1 percentage points, while industrial production will fall by roughly 0.15% in six months following the realization of the geopolitical shock. In some cases, these trends would need tighter monetary policy, which would negatively affect the population's and the economy's financing conditions. By influencing the macroeconomic outlook and raising uncertainty, geopolitical risks have the potential to disrupt financial markets. The outlook for the company's profitability may be impacted by expectations of weaker macroeconomic growth and a higher rate of inflation. A tightening of financial conditions may result from such occurrences and the rise in credit risk, which may raise interest rates that banks charge on loans. Investors may decide to shift their portfolios toward safer investment options and decrease their holdings in riskier assets as a result of increased financial market volatility. Since the US dollar is regarded as a safe-haven currency in situations of increased geopolitical risk, this is most frequently maintained through its appreciation. A systemic crisis cannot be brought on by a recent history of geopolitical threats alone, but it certainly highlights the need for greater attention to detail. Even in the countries that were directly affected, extreme geopolitical risk, such as the September 11 attacks, did not instantly result in a financial crisis. If geopolitical shocks combine with pre-existing vulnerabilities, including the possibility of another large shock or a high degree of uncertainty, they can serve as a catalyst for systemic stress. Geopolitical risk should be continuously monitored by policymakers, who should also evaluate any possible effects on financial stability. By evaluating these risks, political leaders will be better equipped to spot weaknesses, comprehend how geopolitical events can spread throughout the financial system, and take proactive measures to address heightened vulnerability. This would increase the financial system's overall resilience and allow for a prompt and coordinated policy response when necessary. To address geopolitical risk, financial institutions should use a mix of risk management and business diversification techniques. First, in order to survive shocks, particularly those brought on by potential geopolitical risk events, financial institutions must manage liquidity and preserve capital adequacy. For ongoing geopolitical development monitoring, institutions should also employ expert services or create specialized teams. They might foresee risks and modify their plans in response with such a proactive strategy. Finally, in order to minimize operational disruption and respond swiftly to unforeseen circumstances, financial institutions should create strong contingency plans.

[18] ECB (2024), p. 93-94

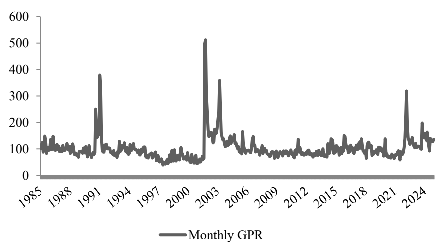
4. Geopolitical risk (GPR) index

Caldara and Iacoviello's GPR index is one indicator of geopolitical risk; high values of the index suggest a decline in employment and investment, which is taken as a high likelihood of unfavorable geopolitical occurrences[19]. The definition, measurement, and validation of the GPR index serve as the foundation for its construction. According to Caldara and Iacoviello, geopolitical risk is the possibility, occurrence, and intensification of a bad event including terrorism, war, or any conflicts between nations and political actors that may have an impact on world peace. In order to create the index, the authors gathered a sample of roughly 25 million journalistic articles that were published in English-language newspapers from 1900 to the present. This amounts to roughly 30,000 articles per month for the recent sample and 10,000 articles per month for the historical sample. The number of publications discussing negative geopolitical developments and associated threats was counted by the authors each month. An automated search of journalistic articles from ten newspapers—the Wall Street Journal, Washington Post, New York Times, USA Today, Chicago Tribune, the Los Angeles Times, the Daily Telegraph, the Financial Times, the Guardian, and the Globe and Mail—forms the basis of the most recent GPR index, which has been in publication since 1985. The desire to cover events with a worldwide dimension is reflected in the newspaper source's construction, with six newspapers from the USA, three from the UK, and one from Canada. The indicator divides the total number of published articles by the number of journalistic fragments that discuss the increasing geopolitical dangers each month. A review of historical articles from three newspapers—the Chicago Tribune, the New York Times, and the Washington Post—serves as the foundation for the historical GPR index, which has a collection of data going back to 1900. Two-word groups are used to create a query when looking for journalistic articles. While the group of words comprises activities categorized into three groups (starting of war, escalation of war, and terrorist acts), another group of words contains threats grouped into five groups: war threats, peace threats, military buildup, nuclear threats, and terrorist threats. There are three stages involved in validating the acquired GPR index data. In the first, the GPR index's ability to accurately quantify geopolitical threats in terms of geography and history is examined. The index is compared with comparable geographic and economic data in the second phase, and the correctness of the data gathered is further checked in the third phase. Based on the methodology presented, we can accept the second hypothesis, which states that the methodology for calculating the GPR is based on the analysis of textual data from relevant sources.

[19] Caldara and Iacoviello (2022), p.1194

For international investors, governments, and both developed and developing nations, the GPR index can be seen as a crucial metric[20]. We have included the major negative geopolitical events that took place between January 1985 and December 2024 in Figure 2, together with the movement of the monthly recent GPR index. The USA's invasion of Afghanistan in October 2001 caused the index to reach its maximum value (512.5) over the given time period. This was followed by the Gulf War (Operation Desert Storm) in January 1991 (index value of 379.3) and the beginning of the Iraq War in March 2003 (index value of 358.7).

Figure 2. Recent Geopolitical Risk Index (GPR) and major events



Period	Major events
April 1986	U.S. Bombing of Libya
January 1991	Gulf War - Operation Desert Storm
October 2001	U.S. Invades Afghanistan
September 2002	Bush Seeks UN Approval for Iraq War; Putin Threatens War with Georgia
February 2003	War Fears U.S./Iraq; Terrorism in UK; Tension with North Korea
March 2003	Beginning of the Iraq War
August 2004	Terrorist Threats in New York and Washington
July 2005	London Bombings 7/7
November 2015	Paris Terrorist Attacks
January 2020	U.S. / Iran Tensions Escalate
February 2022	Russia / Ukraine Tensions

Source: https://www.matteoiacoviello.com/gpr.htm [Accessed: 16/01/2025]

In the past, the realization of unfavorable geopolitical events has frequently led to a concern that similar incidents may occur in the future. A terrorist attack, for instance, may lead to threats of more attacks or possibly the outbreak of war. Both realized unfavorable geopolitical events and threats of future ones are included in the GPR index's computation. According to Trinh and Tran's analysis[21], the global financial stability of the banking system and the GPR index have a significant negative correlation. According to statistics, banking stability declines with each unit increase in the GPR index.

5. Case study of the Republic of Serbia

Following the analysis of the possible avenues through which geopolitical concerns could impact financial stability in the last section, we will use the Republic of Serbia as an example to demonstrate this influence in this

[20] Demirkale and Ojaghlou (2024), p. 14
[21] Trinh and Tran (2024), p. 14

section. Serbia is vulnerable to changes and threats from the global environment, like other small and open economies. The coronavirus epidemic, the Russian-Ukrainian conflict, the energy crisis, and a period of high inflation have all affected Serbia since 2020. More recently, US sanctions on Surgutneft, Gazpromneft, and its subsidiaries have caused geopolitical difficulties. In particular, the US Treasury Department decided to impose sanctions on Russian energy businesses and their subsidiaries on January 10, 2025, in an effort to lower Moscow's earnings from the sale of energy items that support the conflict in Ukraine. The Russian corporation Gazpromneft is the principal owner of the Serbian Oil Industry, one of the sanctioned businesses.

The National Bank of Serbia acted responsibly, and during the corona virus pandemic it adopted a large number of measures with the aim of preserving the achieved level of stability and further strengthening the financial system. In March 2020, and then in August of the same year, measures were adopted that enabled a moratorium (suspension of repayment) of obligations based on loans, loan products, and leasing[22]. Additionally, a 10% down payment, rather than the usual 20% down payment, is required for first-time residential real estate buyers in order to be approved for a housing loan, which is prescribed by Decision on measures for safeguarding and strengthening stability of the financial system[23]. The National Bank of Serbia's prompt and effective action stopped the internal banking industry from being negatively impacted by the external shocks brought on by the escalation of the conflict in Ukraine. A few days after the conflict in Ukraine began, the National Bank of Serbia granted permission to the Agro Industrial Commercial Bank, AIK Banka a.d. Belgrade, to purchase 100% of Sberbank Srbija a.d. Belgrade in order to maintain the seamless operation of the entire financial system. The takeover was finalized on March 1, 2022, incorporating the bank into a robust domestic group with high capitalization, liquidity, and profitability and avoiding any possible risk spillover to the domestic banking sector.

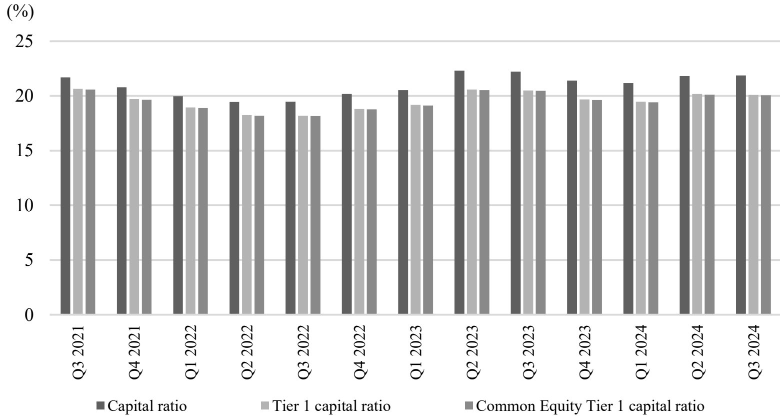
The Republic of Serbia has managed to maintain macroeconomic and financial stability and strengthen its resilience to external shocks even during the turbulent period of economic challenges in the last five years, as evidenced by positive domestic macroeconomic developments, easing external inflationary pressures, more favorable prospects for global economic growth, and demonstrated greater resilience to adverse geopolitical developments. Key indicators that have been preserved for protection against both internal and external shocks, including the exchange rate's continued relative stability, the foreign exchange reserves' record level, the financial system's strong

[22] Martin (2020), p. 71
[23] Republic of Serbia (2011)

capitalization and high liquidity, and the decline in the non-performing loans ratio to the lowest level ever recorded, show that the National Bank of Serbia has managed to preserve stability even during the period of pronounced uncertainties. By the end of December 2024, the National Bank of Serbia's gross foreign exchange reserves had increased by EUR 4.4 billion from the end of December 2023 to a new high of EUR 29.3 billion. With a public debt level of 46.8% of GDP in November 2024—a 5.2 percentage point drop from the end of 2023—public finances are manageable and stable. Positive labor market trends persisted, and in Q3 2024, the unemployment rate was 8.1%, down 0.9 percentage points from the same period in 2023. After real GDP growth of 3.8% was achieved in 2023, economic growth continued in 2024. In the third quarter of 2024, the real gross domestic product grew by 3.1% compared to the corresponding period of the previous year. In the first eleven months of 2024, the current account deficit was around EUR 4.3 billion, which was entirely offset by EUR 4.6 billion in foreign direct investment. The evaluation of top rating agencies confirms positive macroeconomic improvements. Standard & Poor's upgraded Serbia's credit rating to investment grade (BBB-) in October 2024. Furthermore, Serbia's credit rating was confirmed by Fitch and Moody's in August 2024 at BB+ and Ba2, respectively, with an improved outlook to positive. In May 2024, following a period of high inflation from September 2021 to April 2024, inflation returned to the target range of 3±1.5%, reaching 4.3% year-on-year in December 2024. Forecasts indicate that the ongoing tight monetary circumstances, which are influenced by the ongoing drop in inflation expectations, as well as reduced import inflation, will be the main causes of this year's inflation deceleration. The key policy rate was lowered by 25 basis points in June, July, and September 2024 to 5.75% due to the anticipated and actual movement of key inflation factors, mainly the continued decline in global inflationary pressures, and the disinflationary effect of restrictive monetary measures thus far. Regarding financial sector trends, the Republic of Serbia's banking sector, which at the end of Q3 2024 accounted for 90.4% of the financial sector, continued to run steadily and profitably.

High levels of profitability indicators were recorded in the first half of 2024, which is a result of both the maintained asset quality and the prior global increase in interest rates. In November 2024, the banking sector's return on equity was 21.3% and its return on assets was 3.0% as a result of the attained profitability. In September 2024, the banking industry was well-capitalized, with capital ratios of 21.9%, tier 1 capital ratios of 20.1%, and common equity tier 1 capital ratios of 20.0%, which is above the regulatory minimums (8%, 6% and 4.5%, respectively) (see Figure 3).

Figure 3. Capitalization of the banking sector



Source: National Bank of Serbia

Despite the present geopolitical tensions, the banking sector remains stable and adequately capitalized, which was confirmed by the results of macroprudential stress tests. Based on the conducted macroprudential stress tests, on the basis of data from December 2023, capital ratios remain above the regulatory minimum according to the central projection (20.0%), the moderate scenario (18.49%), and the worst scenario (17.09%).

Even in the circumstances of the multifaceted crises we have been facing in recent years, a systemic approach to resolving non-performing loans, coupled with the prompt execution of appropriate actions, has contributed to a significant drop in the ratio of non-performing loans in total loans. In November 2024, the non-performing loans ratio accounted for 2.7%, reaching its historical minimum. In order to maintain and further strengthen the Republic of Serbia's achieved financial stability and thereby contribute to overall macroeconomic stability, the National Bank of Serbia will continue to implement an effective macroprudential policy. It does this by closely and consistently monitoring and analyzing domestic and international markets as well as developments in the financial system. The indicators presented demonstrate that we can accept the third hypothesis that financial stability of the Republic of Serbia has not been threatened due to geopolitical tensions.

Concerns in relation to the geopolitical environment in the coming period stem from the anticipated fluctuations in food and energy costs, which may lead to a return of inflation. Interest rates on dinar loans would rise as a result of the National Bank of Serbia boosting the key policy rate in response to heightened inflationary pressures. The stability of public finances would be in jeopardy if public debt increased as a result of increased liabilities for the resolution of geopolitical crises. Increased international tensions may jeopardize the steady flow of foreign direct investments that are essential to the growth of the overall economy. Continued investment in renewable energy sources is required to attain energy independence, which would then reduce the budget deficit through the use of fiscal restraint. Meanwhile, more investment in education would boost productivity and further solidify stability. All of the aforementioned would help to improve financial stability, which is particularly crucial while geopolitical risks are profound.

6. Conclusions

Given their influence on all economic activity, geopolitical risks provide a challenge to nearly all economic participants. As a result, geopolitical risk encompasses both security risks that can negatively affect the stability, growth, and development of specific countries as well as difficulties and threats resulting from international interactions, economic instability, and political shifts. Geopolitical risk for the Republic of Serbia can result from a number of causes, including the nation's historical links, economic interests, and strategic location in the Balkans, as well as from its relationships with powerful nations.

Financial stability around the world might be seriously disrupted by geopolitical risk. Politicians, investors, and business owners should all be aware of these risks and create plans to mitigate them. By reducing adverse impacts on financial and economic institutions, effective geopolitical risk management can boost stability and resilience during tumultuous times. The financial channel and the real channel are the two main channels through which geopolitical risks can impact financial stability. The real channel is sustained by supply chain interruptions and trade restrictions, but the financial channel shows up as heightened investor uncertainty and risk aversion. The Geopolitical Risk index, GPR, was created by Caldara and Iacoviello[24] to gauge the degree of geopolitical risk. A higher GPR index value denotes a decline in investment and unemployment as well as a higher likelihood of unfavorable geopolitical events occurring. Higher values of this index are typically observed at the onset of conflicts and terrorist attacks.

Financial stability and geopolitical risk in Serbia are linked to the political and economic environment in which geopolitical issues can have a major impact on investments, financial flows, and the nation's overall economic security. During times of elevated geopolitical risk (e.g., the corona virus

[24] Caldara and Iacoviello (2022), p. 1194

epidemic and the conflict between Russia and Ukraine), the Republic of Serbia was able to maintain and even improve its financial stability, according to the above analysis. This is maintained through the preserved stability of public finances, key macroeconomic indicators, as well as external imbalance indicators. In order to preserve financial stability in the future, it is necessary for the Republic of Serbia to develop and actively implement strategies that will reduce its vulnerability to external influences, thereby achieving sustainable economic growth and development. Suggestions for future research on this topic relate to examining the impact of geopolitical risks on price stability, bearing in mind that price and financial stability are the main goals of central banks.

References:

Aslam, A., Ghouse, G. and Ali, M. (2024), "Can Financial Development and Geopolitical Risks Ensure a Sustainable Energy Future?" https://ssrn.com/abstract=5078624 or https://doi.org/10.2139/ssrn.5078624

Caldara, D. and Iacoviello, M. (2022). "Measuring Geopolitical Risk", *American Economic Review*, Vol. 112, No. 4, Pp. 1194–1225, https://doi.org/10.1257/aer.20191823

Bank of England (2016), "Uncertainty, the economy and policy – speech by Mark Carney", Governor of the Bank of England and Chairman of the Financial Stability Board, Bank of England, London, https://www.bankofengland.co.uk/speech/2016/uncertainty-the-economy-and-policy [Accessed: 20/1/2025]

Del Gaudio, B. L. and De Luca, G. (2024), "Geopolitical Risk and Financial Stress", https://ssrn.com/abstract=4814598 or https://doi.org/10.2139/ssrn.4814598

Demirkale Ö. and Ojaghlou, M. (2024), "Is There A Relationship Between Financial Development And Geopolitical Risk Indices And Sustainable Development Goals? A Study on E3 Countries", *Panoeconomicus*, Pp. 1-33, https://doi.org/10.2298/PAN240802002D

European Central Bank (2024), *Financial Stability Review*, May 2024, https://www.ecb.europa.eu/press/financial-stability-publications/fsr/html/ecb.fsr 202405~7f212449c8.en.html [Accessed: 14/1/2025]

Hodula, M., Janků, J., Malovaná, S. and Ngo, N. (2024), "Geopolitical Risks and Their Impact on Global Macrofinancial Stability: Literature and Measurements", Bank of Finland Institute for Emerging Economies (BOFIT), Helsinki, BOFIT Discussion Papers, No. 9/2024, Pp. 1-59

Hoffart, F. M., D'Orazio, P. and Kemfert, C. (2022), "Geopolitical and Climate Risks Threaten Financial Stability and Energy Transitions", *Energy Proceedings*, Vol. 29, Pp. 1-23, https://doi.org/10.46855/energy-proceedings-10325

https://www.matteoiacoviello.com/gpr.htm [Accessed: 16/01/2025]

International Monetary Fund (2023), *Global Financial Stability Report: Safeguarding Financial Stability amid High Inflation and Geopolitical Risks*, April 2023, https://www.imf.org/en/Publications/GFSR/Issues/2023/04/11/global-financial-stability-report-april-2023 [Accessed: 20/01/2025]

International Monetary Fund (2024), *Global Financial Stability Report: Steadying the Course: Uncertainty, Artificial Intelligence, and Financial Stability*, October 2024, https://www.imf.org/en/Publications/GFSR/Issues/2024/10/22/global-financial-stability-report-october-2024 [Accessed: 23/01/2025]

Kovačević, R. (2022), "Finansijske krize i devizne rezerve zemalja u tranziciji i zemalja u razvoju", *Ekonomske ideje i prakse*, Vol. 46, Pp. 13-29, https://doi.org/10.54318/eip.2022.rk.330

Lu, Z., Gozgor, G., Huang, M. and Lau, C. K. M. (2020), "The Impact of Geopolitical Risks on Financial Development: Evidence from Emerging Markets", *Journal of Competitiveness*, Vol. 12, No. 1, Pp. 93-107, https://doi.org/10.7441/joc.2020.01.06

Lucchetta, M. (2024), "International Aggregate Risk: Effects on Financial Stability", *Economics Letters*, Vol. 240, 111773, https://ssrn.com/abstract=4792615 or https://doi.org/10.2139/ssrn.4792615

Lukić, V. and Popović, S. (2020), "Sistematska kriza problematičnih kredita i ekonomska politika – analiza iskustava nakon globalne finansijske krize", *Ekonomske ideje i prakse*, Vol. 37, Pp. 53-78

Marković, D. (2023), "Uticaj Covid-19 pandemije na finansijske performanse auto-dobavljača u Srbiji", *Ekonomske ideje i prakse*, Vol. 48, Pp. 37-51, https://doi.org/10.54318/eip.2023.dm.341

Martin, V. (2020), "The Response of the Monetary and Fiscal Policies on COVID 19 in Serbia", *Bankarstvo*, Vol. 49, Issue 2, Pp. 70-114, https://doi.org/10.5937/bankarstvo2002070M

Mohammedi, W., Mgadmi, N., Abidi, A. and Moussa, W. (2025), "The Impact of the Digital Economy on Sustainable Development in the Face of Geopolitical Risks", *Digital Economy and Sustainable Development*, Vol. 3, Pp. 1-21, https://doi.org/10.1007/s44265-024-00050-5

NguyenHuu, T. and Örsal, D. K. (2023), "Geopolitical Risks and Financial Stress in Emerging Economies", *World Economy*, Vol. 47, Pp. 217-237, https://doi.org/10.1111/twec.13529

NguyenHuu, T. and Örsal, D. K. (2024), "Geopolitical Risks: A Significant Challenge for the Global Financial Stability", *International Network for Economic Research*, Vol. 1, Pp. 1-3

Republic of Serbia. (2011), "Decision on Measures for Safeguarding and Strengthening Stability of the Financial System", *RS Official Gazette*, No. 34/2011, 114/2017, 84/2020 and 102/2024

Trinh, H. H. and Tran, T. P. (2024). "Global Banking Systems, Financial Stability, and Uncertainty: How have Countries Coped with Geopolitical Risks?", *International Review of Economics and Finance*, Vol. 96, Pp. 1-30, https://doi.org/10.1016/j.iref.2024.103647

Primljen (Received): 30.1.2025.
Prihvaćen (Accepted): 31.3.2025.
Pre štampe (Online First): 12.5.2025.