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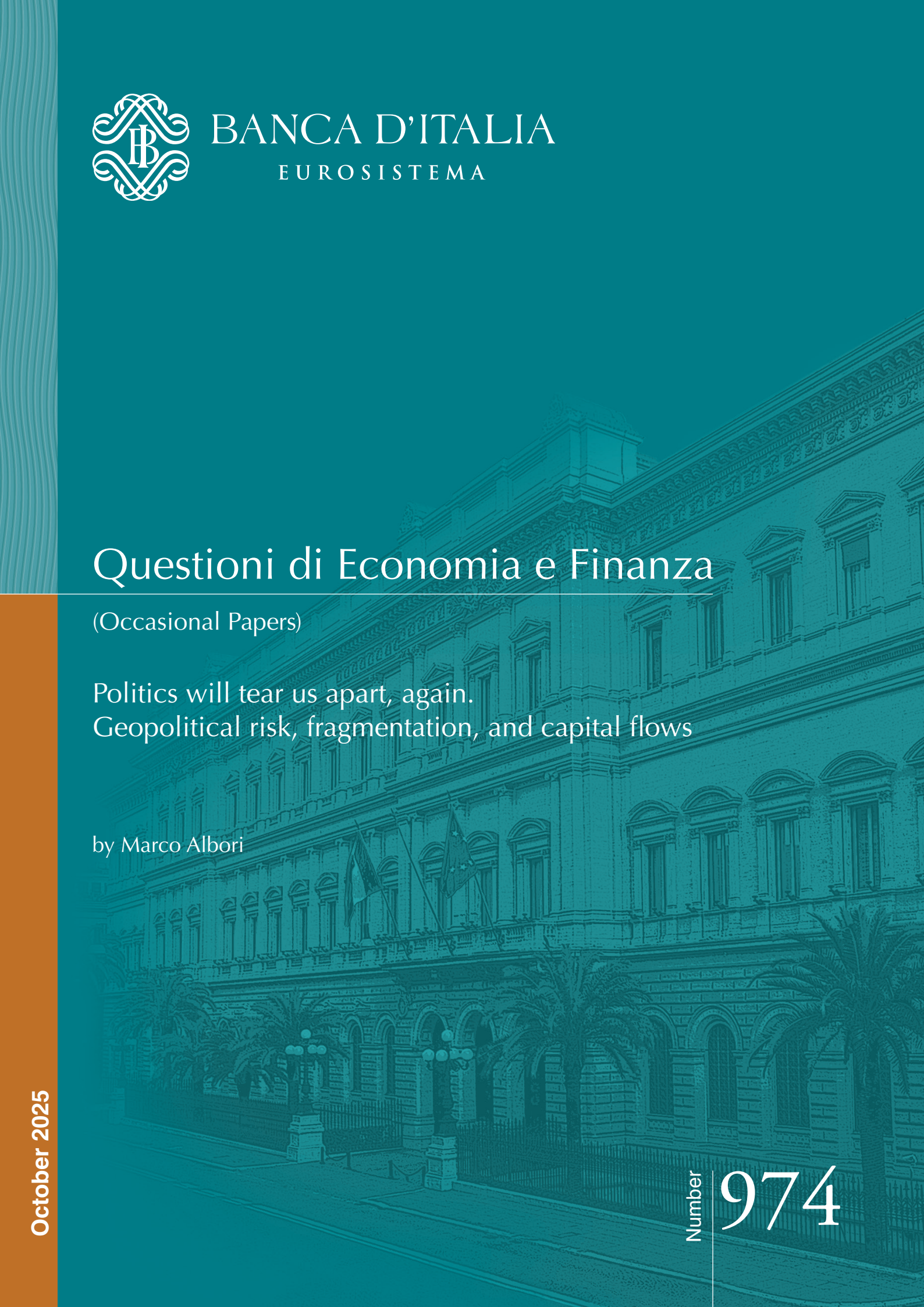

Questioni di Economia e Finanza

(Occasional Papers)

Politics will tear us apart, again. Geopolitical risk, fragmentation, and capital flows

by Marco Albori

October 2025

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POLITICS WILL TEAR US APART, AGAIN. GEOPOLITICAL RISK, FRAGMENTATION, AND CAPITAL FLOWS

by Marco Albori*

Abstract

This review summarizes empirical research on the impact that geopolitical risk and financial fragmentation have on cross-border capital flows. It distinguishes between event-driven geopolitical risk and structural political divides, showing that both affect international investment through retrenchment and alignment-based reallocation. Using gravity models, the literature documents how political distance increasingly shapes foreign direct investment and portfolio flows, particularly into emerging markets, strategic sectors, and, to some extent in the euro area following the invasion of Ukraine. Open questions include the macroeconomic consequences of financial fragmentation, its impact on the global financial cycle, and the implications for the role of reserve currencies.

JEL Classification: F21, F36, F52.

Keywords: foreign direct investment, portfolio investment, capital flows, geopolitics, globalization.

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Introduction [1]

The trade war between the United States and China during the first Trump administration, the invasion of Ukraine in 2022, the imposition of sanctions on Russia, the escalation in the Middle-East war, and rising trade tensions following Trump's announcement of "reciprocal tariffs" have all contributed to renew attention to the economic consequences of geopolitical divides. A central concern is that strategic policy choices may trigger a reversal of globalization, leading to a multidimensional process defined as *fragmentation* of the global economy by (Aiyar et al., 2023).[2]

In the financial sphere, such fragmentation implies that countries within politically aligned blocs increasingly engage in lending and borrowing among themselves, reducing exposure to counterparts in rival blocs (Bianchi and Sosa-Padilla, 2023). Recent research has rapidly expanded to investigate the implications of both geopolitical risk and geopolitical divides for international finance. These studies aim to identify how geopolitical factors are reshaping capital flows—adding new dimensions to the traditional "push" and "pull" framework (Koepke, 2019)—and to explore the potential risks to financial stability in a world where geopolitical risk shocks occur more frequently (Hodula et al., 2024) and economies that have long financed one another (Setser, 2023) may now be drifting apart.

In parallel, several studies highlight that trade fragmentation is already underway, including the reconfiguration of supply chains with a selective decoupling along geopolitical lines and the rise of friend-shoring (see, for example, Conteduca et al., 2025a), particularly since the invasion of Ukraine (Carluccio et al., 2025), and increased trade barriers between geopolitical rivals, with the potential to cause significant welfare and value added losses (Hakobyan et al., 2023, Moro and Nispi Landi, 2024; Panon et al., 2024; and Conteduca et al., 2025b). While this review focuses on the financial dimension of fragmentation, the literature on trade provides additional context for understanding the broader geoeconomic shift currently underway.[3]

As political tensions rise and the weaponization of trade and financial relations intensifies, understanding their impact on capital flows has become increasingly important. Consider, for instance, the anomalous behavior of the U.S. dollar following President Trump's announcement of tariffs: the disconnect between the dollar, interest rates, and global risk sentiment triggered a debate about the currency's central role in the global financial system and prompted a rush to assess whether investors were divesting from U.S. assets.[4]

Motivated by this evolving geopolitical landscape, this review focuses on the fragmentation of cross-border capital flows. The literature shows that geopolitical risk prompts not

[1] I thank Valerio Nispi Landi, Livia Ristuccia, Marco Taboga, and Giovanni Veronese for their valuable comments.

[2] For recent theoretical contributions, see Clayton et al. (2024a) and Clayton et al. (2024b). These papers highlight the strategic logic behind the weaponization of economic interdependence, developing a formal model in which hegemonic powers exploit deep economic integration to exert coercion, leading to fragmentation as countries seek to reduce their vulnerability.

[3] For a broad introduction to the field of geoconomics, see Mohr and Trebesch (2025).

[4] See for instance Panetta (2025).

only a retrenchment from directly affected countries but also broader spillovers to neighboring economies. Drawing on an established methodological framework, namely the use of gravity models to control for bilateral confounding factors, recent studies have provided consistent evidence of the increasing role of political alignment in shaping cross-border investment decisions. This effect is particularly strong in emerging economies and strategic sectors, and contributes to explaining euro area investment following Russia's invasion of Ukraine.

The work is organized as follows: Section 1 discusses how researchers measure geopolitical risk and fragmentation; Section 2 summarizes the existing evidence on the impact of geopolitical risk on capital flows; Section 3 reviews findings on the effects of geopolitical divides on international investment. The conclusion highlights key takeaways and identifies several potential avenues for future research.

1 Measuring geopolitical risk, political affinity, and fragmentation

Before turning to the findings on how geopolitical tensions and divides affect financial flows, it is essential to clarify how such tensions are measured, how countries can be objectively grouped, and—more ambitiously—how geopolitical fragmentation can be quantified.

A key distinction must be made between geoeconomic fragmentation and geopolitical risk, two related but -at least in this literature- conceptually distinct phenomena. While, as noted, geoeconomic fragmentation refers to a multifaceted, policy-driven process that potentially affects all dimensions of international economic relations, geopolitical risk is defined by Caldara and Iacoviello (2022) as "the threat, realization, and escalation of adverse events associated with wars, terrorism, and any tensions among states and political actors that affect the peaceful course of international relations."

Although these categories are analytically distinct, in reality they often overlap and mutually reinforce. Rising diplomatic tensions may escalate into military threats or outright conflict, constituting realizations of geopolitical risk as defined in this literature, which in turn deepen ideological divides and geoeconomic fragmentation. However, the studies reviewed in this section do not explicitly investigate the causal relationship between geopolitical shocks and political realignments, or vice versa.

Geopolitical risk - local perception matters.

The most widely used indicator of geopolitical risk is the GPR index developed by Caldara and Iacoviello (2022). This news-based index measures the share of newspaper articles that discuss adverse geopolitical events and associated threats, using a sample of ten newspapers (six from the United States, three from the United Kingdom, and one from Canada). In addition to a global index, the authors provide country-specific versions that capture the share of articles mentioning both geopolitical risk terms and the name of a specific

country. Additionally, they construct a measure of firm-level geopolitical risk by looking at mentions of geopolitical risks in the transcripts of earnings calls (Hassan et al., 2019), obtaining a complement to news-based metrics.[5] Country-level GPR indexes are often used to construct firm-level measures of exposure to geopolitical risk, by weighting them according to the geographical distribution of a bank's assets (Niepmann and Shen, 2025; Dieckelmann et al., 2025), a fund's portfolio allocations (Converse and Mallucci, 2025), or a firm's revenues (similarly to D'Orazio et al., 2024).[6]

The GPR index has since become a standard tool in both academic research and policy analysis. Numerous studies have documented its impact on key macroeconomic variables, including economic activity, inflation, and investment (Caldara and Iacoviello, 2022; Caldara et al., 2024; see also Pinchetti, 2024 for differentiated effects based on the nature of the shock—particularly its link to energy disruptions).

Despite its influence, the GPR index has some limitations. As noted by Bondarenko et al. (2024), it relies exclusively on English-language sources and reflects a Western-centric perspective. Using Russia as a case study, the authors construct an alternative GPR index based on Russian-language media. They find that spikes in this local GPR measure have substantial negative effects on the Russian economy—effects that are not captured by shocks to the global GPR index, highlighting the importance of local perceptions.[7]

Building on this insight, Alonso-Alvarez et al. (2025) create bilateral, country-specific GPR indices for the U.S., U.K., Germany, France, Russia, and China, using domestic news sources. Their indices are bilateral, meaning that for each of the listed countries, they also reflect the regional or country-specific origin of the perceived risk. The findings show that the source of risk is significant for macroeconomic outcomes and that these effects vary across countries.

In a similar vein, Agarwal et al. (2024) construct local sentiment and risk perception indicators toward China using national newspapers. They find that these perceptions have measurable effects on investors' portfolio allocations to Chinese assets, further illustrating how domestic narratives and geopolitical sentiment shape financial decisions.

Ideals and blocs

The political distance between any pair of countries is most commonly proxied by the Ideal

[5] Niepmann and Shen (2025) use corporate earnings calls to build country-level geopolitical risk indexes used in a robustness exercise. Moreover, using this method, they are able to distinguish perceptions of risk specific to financial sector firms.

[6] D'Orazio et al. (2024) construct revenue-weighted measure of firm-level geopolitical risk to study how (real) exposure to geopolitical risk affects corporate financial performance. To proxy for geopolitical risk, they use International Country Risk Guide (ICRG) scores for twelve indicators related to government stability, conflicts, and institutional quality. The larger coverage of the ICRG data as compared to Caldara and Iacoviello (2022)'s country-level GPR allows them to better map firms' revenues to political risk.

[7] In this work, the authors construct also local news-based indicators for the countries included in the Caldara and Iacoviello (2022) measure (Canada, the U.K., and the U.S.), Germany, and Ukraine. They show that the Russian index evolves differently from both the Anglosphere GPR and the German and Ukrainian measures, highlighting how the degree of involvement in a conflict and its media coverage can diverge substantially across countries. In a follow-up, they extend the approach to the euro area (Bondarenko et al., 2025).

Point Distance (IPD), as developed by Bailey et al. (2017). This measure is derived from voting behavior in the United Nations General Assembly (UNGA). For each vote, countries can cast one of three responses: yes, no, or abstain. The estimation framework models these responses by identifying two latent thresholds (cut-points) for each vote, which delineate the ranges of latent ideal points associated with each voting outcome. Each country occupies a specific position along a single ideological dimension.

Every UN resolution is also assigned a discrimination parameter, capturing how effectively it differentiates countries along a latent geopolitical alignment dimension. Votes with high discrimination parameters are considered more informative and thus carry greater weight in the estimation of a country's ideal point. In contrast, votes that do not clearly distinguish between countries receive less weight.

Ideal points are estimated using Bayesian methods, which produce posterior distributions that reflect the uncertainty surrounding each country's ideological position. The posterior mean of these distributions is typically used as the point estimate of a country's ideal point for a given year. The IPD between two countries is then calculated as the absolute difference between their respective ideal points. In the empirical works reviewed below, IPDs are used either as control variables in regressions explaining bilateral capital flows or to classify countries into different geopolitical blocs, typically based on their proximity to the U.S. or China, for example, by assigning countries in the top quartile of proximity the U.S. to a U.S.-aligned bloc, and analogously for the China-aligned bloc.

The widespread use of the IPD measure is not without criticism. Airaudo et al. (2025) highlight how the construction of IPDs can be sensitive to methodological choices, such as the historical sample period used or the categorization of UN votes (e.g., focusing solely on economic issues). These choices significantly influence both the identification of geopolitical blocs and the resulting estimates of fragmentation. The authors find that these differences matter particularly for trade flows, where IPDs based on more recent voting data—and thus reflecting contemporary geopolitical shifts—yield significantly stronger fragmentation effects. In contrast, IPDs constructed exclusively from economic-related votes tend to produce more moderate estimates of fragmentation. For financial flows, the sensitivity to such methodological variations appears less pronounced.

A measure of fragmentation

While most of the literature uses the geopolitical measures discussed above as explanatory variables to assess their influence on economic outcomes, Fernández-Villaverde et al. (2024) take a different approach by directly estimating a composite index of global fragmentation. Their measure is derived from a dynamic hierarchical factor model with time-varying parameters and stochastic volatility, and incorporates several indicators spanning various dimensions of fragmentation. In addition to the overall fragmentation index, the model produces group-specific factors, isolating fragmentation dynamics across trade, finance, mobility, and politics. Notably, the financial fragmentation component exhibits a

particularly strong comovement with the common factor, suggesting it plays a central role in driving global fragmentation trends.

The analysis finds that rising fragmentation has a significantly negative impact on global economic activity, with emerging market economies suffering more severe consequences than advanced economies—an asymmetry that recurs across the literature. Moreover, the authors highlight that the effects are not symmetric: fragmentation leads to immediate economic losses, whereas the gains from reintegration materialize only gradually. A sectoral breakdown further reveals that the most exposed industries—those highly integrated into global markets—are the hardest hit, while more domestically oriented sectors are largely shielded from the adverse effects.

2 Retrenching: the impact of geopolitical risk on capital flows

A growing number of studies examine the effects of geopolitical risk on capital flows using the GPR index. Their findings are briefly summarized in Table 1 and discussed in greater detail below.

Geopolitical risk triggers retrenchment and flight to safety

One of the earliest studies, Feng et al. (2023), analyzes the impact of global GPR on official (balance of payments) financial flows. The authors find that increases in global GPR reduce both inflows and outflows, with stronger effects in emerging markets. Regarding outflows, they report a negative impact on other investment—primarily banking flows—in both advanced and emerging economies, as well as on reserve assets in EMEs. Interestingly, advanced economies appear to experience slightly larger outflows in reserve assets. On the inflow side, the study finds that geopolitical risk significantly reduces direct investment, portfolio investment, and other investment in emerging economies. While banking inflows also decline in advanced economies, the contraction is milder than in EMEs. In contrast, geopolitical risk has a positive effect on FDI inflows to advanced economies, consistent with the idea that multinational firms may redirect investments toward safer destinations during times of heightened geopolitical tension.

FDI are the specific focus of Bussy and Zheng (2023), who find that an increase in (destination) country-level GPR deters flows into emerging economies. They show that stronger governance, as measured by the World Bank's Worldwide Governance Indicators (WGIs) of Kaufmann et al. (2011), mitigates this negative effect. In contrast, a greater proximity between investors and host countries —being it geographical, cultural, or economic— amplifies the adverse impact, likely because closer and experienced multinational investors are more aware of local risks.[8] At the sectoral level, FDI in research- and development-intensive industries is less sensitive to GPR.

[8]Economic proximity, which the authors name *experience*, is proxied by cumulative FDI from sample start.

The significance of institutional quality and governance is also emphasized by Caporale and Menla-Ali (2024) and Choi and Havel (2025), although their focus is on a different type of investment—U.S. monthly portfolio flows (Treasury International Capital - TIC data). In particular, Choi and Havel (2025) present evidence closely aligned with Bussy and Zheng (2023): U.S. investors withdraw from emerging market economies (EMEs) when geopolitical risk rises, reducing their purchases of local long-term bonds and equities. However, this reaction is absent when risk increases in advanced economies (AEs). They argue that this heterogeneity—leading to insignificant GPR effects in aggregate samples—is largely driven by weaker institutional quality (measured by WGIs) and, to a lesser extent, by shallower financial markets in EMEs. Notably, they also identify a contagion effect: U.S. investors reduce their exposure to an emerging market when geopolitical risk rises in neighboring EMEs. [9]

Caporale and Menla-Ali (2024), also using TIC data, examine both U.S. inflows and outflows. Differently from Choi and Havel (2025), they find that rising local geopolitical risk (GPR) in emerging market economies (EMEs) prompts these countries to reduce equity investment in the U.S. and increase domestic equity holdings. They interpret this as evidence of a *flight home* effect, in which investors repatriate funds rather than reallocating them to perceived safe havens, in contrasts with the established *flight to safety*, where capital typically moves toward safer assets. The short-term decline in flows into the U.S. is primarily driven by developed countries (or those with high institutional quality), while the long-term effect is more pronounced for emerging markets (or countries with weaker institutions, as captured by ICRG indicators). Unlike Bussy and Zheng (2023) and Choi and Havel (2025), they thus do not identify a clear moderating role for institutional quality, rather an effect on short vs. long-term flows. Additionally, the retrenchment is stronger in financially open economies and those with flexible exchange rate regimes, and the effects of GPR appears to be non-linear, stronger when GPR is above its median.[10]

Differently from the studies discussed so far, Hudecz et al. (2024) combine descriptive analysis and standard panel regressions with macroeconometric estimates to assess the impact of geopolitical risk shocks on euro area portfolio flows. Using Bayesian Vector Autoregression (BVAR) models, they uncover evidence supporting the safe-haven role of euro area assets. Specifically, following a global geopolitical risk shock, euro area investors tend to retrench from foreign assets, both debt and equity, while foreign investors increase their purchases of euro area instruments.[11] However, the strength and direction of these ef-

[9] A similar pattern is observed in Ferriani et al. (2023), who study the impact of natural disasters. They find that such events not only reduce net investment flows into the affected country if it is an emerging economy with high climate risk, but also lead to a decline in inflows to other high–climate-risk EMEs in the same region, suggesting that investors respond to heightened perceptions of regional risks, not just to localized events.

[10] Brignone et al. (2024) document that the macroeconomic effects of geopolitical risk shocks are nonlinear. Heightened uncertainty, an important transmission channel, becomes active only in the case of substantially large shocks.

[11] The shock is identified using the Cholesky decomposition, with the index by Caldara and Iacoviello (2022) ordered first within the system.

fects depend on the prevailing risk environment. Applying Markov regime-switching BVAR models, the authors show that portfolio debt inflows into the euro area are more fragile under high-risk conditions. In low-risk regimes, a geopolitical risk shock leads to increased foreign purchases of euro area debt. In contrast, under high-risk regimes, the same shock results in net outflows from euro area debt securities, highlighting potential risks to the euro area' external financing.

Mutual funds and global banks adjust their portfolios in face of risk

Portfolio flows are also the focus of Converse and Mallucci (2025), who examine how geopolitical risk influences mutual fund portfolio allocations. Using local projections (Jordá, 2005), they show that a rise in geopolitical risk in a given country causes only an initial modest reduction in its portfolio weight, which is however persistent and grows over time. Static panel regressions reveal more information about when geopolitical risk matters for (contemporaneous) allocations. Country-level risk is a decisive factor when it is high, or when global geopolitical risk is elevated, and high country-specific geopolitical risk affects portfolio weights more strongly than high global geopolitical risk. Furthermore, as in other studies, the effect is heterogeneous and significantly more pronounced for emerging markets. Among EMEs, the few NATO member countries appear less sensitive to geopolitical risk. The authors also find that rising global geopolitical risk contributes to financial fragmentation: mutual fund portfolios become less diversified, with increased concentration, a reduced number of destination countries, and higher cash holdings. In addition, fund-specific exposure to geopolitical risk (the portfolio-weighted average of country-level risks) amplifies the effect of global GPR. They further document that end investors aggressively redeem funds with greater geopolitical risk exposure. Notably, this is the only study to propose a simple theoretical model of delegated portfolio management that rationalizes these empirical patterns.

Investors and funds are not alone in adjusting their behavior in response to geopolitical risk: banks, too, revise their operations under such conditions. Niepmann and Shen (2025) document that U.S. global banks reduce cross-border lending to countries with elevated geopolitical risk, yet continue to serve those markets through their foreign affiliates.[12] This pattern is specific to geopolitical risk and differs from the response to other types of country risks, such as macroeconomic instability or sovereign risk.[13] The structure of banks' foreign lending produces spillovers to domestic credit supply. Because capital requirements are applied at the consolidated level, continued lending through foreign affiliates in high-risk countries raises the banks' risk-weighted assets. This tightens capital constraints and leads U.S. global banks to reduce lending to domestic firms when geopolitical risk in-

[12] They construct bank-specific measures of geopolitical risk by calculating a weighted average of country-level GPR indices from Caldara and Iacoviello (2022), using each bank's exposure to those countries as weights.

[13] Banks adopt this strategy to mitigate expropriation risk, as lending via foreign affiliates is partially backed by local deposits, which do not require repayment in the event of expropriation.

creases abroad.[14]

Geopolitical risk amplifies the international transmission of other shocks

Lastly, there is a strand of the literature that investigates the interaction between geopolitical risk and other sources of shocks. Agoraki et al. (2024) use a unified regression framework to compare the effects of various uncertainty and risk measures on capital flows. Specifically, they contrast geopolitical risk with Economic Policy Uncertainty (EPU; Baker et al., 2016) and the World Uncertainty Index (WUI; Ahir et al., 2022). Their findings show that GPR reduces equity and bond fund flows, as measured by EPFR data, while it has no significant effect on official flows.[15] Consistent with other studies, emerging market economies experience the largest decline in fund investments. Furthermore, they find that high levels of GPR amplify the negative impact of EPU on these flows, highlighting an interaction between different sources of uncertainty.

According to Pradhan et al. (2025), the effects of a monetary policy tightening are also amplified during periods of acute geopolitical distress. Geopolitical tensions not only directly reduce cross-border bank lending but also strengthen the international transmission of monetary policy. [16] Notably, the interaction between monetary policy and geopolitical tensions accounts for nearly as much variation in bilateral lending flows as monetary policy alone.

Instead, Ambrocio et al. (2024) documents an amplification effect of geopolitical ties on the spillovers of the global financial cycle, proxied by the VIX, to the stock markets of developing economies, an effect which becomes stronger in periods of low, rather than high, geopolitical risk.[17] They postulate this may indicate a hedging or insurance benefit of US political ties during periods of high geopolitical risk, but they do not provide an exhaustive explanation on how this might operate.

In summary, geopolitical risk has a heterogeneous impact on capital flows. Advanced economies are generally less affected—and may even experience increased inflows due to a *flight to safety*. In contrast, emerging economies are more severely impacted. However, stronger institutional frameworks can help partially shield these countries from capital outflows. As with other shocks, rising geopolitical risk in one country can spill over to

[14] Using a similar measure constructed combining the Caldara and Iacoviello (2022) country GPR with ECB confidential data on banks' exposure, Dieckelmann et al. (2025) document that an increase in this exposure-weighted bank-level geopolitical risk index is significantly associated with an increase in CDS spreads and a decline in stock prices

[15] Collecting investment fund portfolio data, EPFR only represents a subset of Balance of Payment flows. For an extensive review of capital flows data, see Koepke and Paetzold (2024).

[16] The authors suggest that this amplification may stem from geopolitical risk exacerbating existing financial constraints faced by banks, thereby increasing their cost of accessing liquidity. However, unlike Niepmann and Shen (2025), they do not propose a formal model to explicitly characterize the interaction between monetary policy and geopolitical risk. Concerning the proposed channel, it is worth noting that, due to the identification strategy, bilateral lending is denominated in core currencies, and therefore foreign to the currency of the lending country's banking system.

[17] The mechanisms through which the amplification effect may operate are discussed in greater detail in Section 3.

neighboring economies, as heightened investor attention and increased risk aversion amplify negative effects across the region. Finally, geopolitical risk may amplify the effects of other shocks, being them related to economic policy uncertainty, monetary policy, or financial interlinkages.

3 Fragmenting: political differences and cross-border investment

There are some general methodological differences between studies on geopolitical fragmentation and those examining the effects of heightened geopolitical risk. First, while the latter typically focus on capital flows, the studies reviewed in this section primarily analyze bilateral investment stocks, largely due to the limited availability of comprehensive flow data at the country-pair level. Second, the identification strategies in the fragmentation literature tend to be less diverse, with most studies relying on gravity regression models as their primary empirical framework.

Some papers focus on a specific type of cross-border investment: foreign direct investment (Aiyar et al., 2024, Boeckelmann et al., 2024a, and Boeckelmann et al., 2024b); portfolio investment (Catalan et al., 2024, Lugo and Montone, 2024, and Airaudo et al., 2025); others examine more than one type (Kempf et al., 2023 and Gopinath et al., 2025); while a few cover multiple types of investment broadly (Aiyar and Ohnsorge, 2024 and Hudecz et al., 2024). What all these studies agree on is that financial fragmentation is actually occurring, with ideological distance increasingly shaping cross-border investment. They are summarized in Table 2.

FDI increasingly target friends, particularly in strategic sectors

Aiyar et al. (2024) provides the first systematic evidence on the role of geopolitical considerations in shaping FDI flows. In an event-study framework, it shows that following key UN resolutions - specifically, the 2014 resolution on the annexation of Crimea and the 2017 resolution on the deterioration of human rights in Syria—FDI flows from countries that supported these resolutions were significantly lower toward countries that opposed them, compared to flows toward countries that also voted in favor. The core empirical analysis employs a gravity model and finds that greater geopolitical distance, measured using the ideal point distance developed by Bailey et al. (2017), is associated with lower bilateral greenfield FDI. Importantly, this negative relationship has strengthened since 2018, coinciding with escalating tensions between the United States and China. The effect is particularly pronounced when the host country is an emerging market or when the investment is in a strategic sector, stressing how national security concerns, and the policies they inform, are becoming central in guiding cross-border investment decisions.[18]

Using the same dataset and settings, Boeckelmann et al. (2024a) confirm that aggregate greenfield FDI flows are increasingly exhibiting signs of fragmentation along geopo-

[18]Additional non-parametric evidence points to the the growing importance of geopolitical distance in shaping FDI flows, especially in strategic sectors.

litical fault lines. Their descriptive analysis divides countries in three blocs (U.S.-centric, China-centric, non-aligned) according to the geopolitical alignment index developed by den Besten et al. (2023)[19] and shows that Western firms are progressively engaging in friend-shoring and near-shoring of production, in line with the growing use of these terms in corporate earnings calls.[20] Outward greenfield investment from the euro area has followed a similar trajectory, increasingly directed toward geopolitically aligned countries—most notably, the United States. In parallel, the euro area has also experienced a rise in greenfield inflows from the U.S. Finally, the authors provide evidence that Chinese firms have adapted their production structures in response to U.S. trade restrictions, relocating manufacturing operations in the euro area to circumvent these barriers.

Their formal econometric analysis also relies on a gravity model and rolling-window estimates reveal that, in the three years leading up to early 2024, FDI flows within geopolitical blocs were nearly three times larger than flows between blocs. Turning to the use of IPD, they further show that overall geopolitical divides exert a negative effect on FDI flows, and that this effect has intensified for the euro area since the onset of the war in Ukraine, more so than for the rest of the world. For example, they find that the increase in the geopolitical distance between the euro area and China during the same period is associated with a 20% drop in the value of flows between the two areas. An extension of their analysis, presented in Boeckelmann et al. (2024b), indicates that the global trend is not driven solely by investment involving China, Russia, and major Western countries, but reflects a broader pattern.

The reallocation of FDI across geopolitical partners is also documented by Gopinath et al. (2025). The authors begin by computing a modified version of the Lilien Index—a standard measure of structural change—for each country, and regress it on year and country fixed effects. Their findings indicate that FDI reallocation has intensified in recent years, particularly among advanced economies, relative to the 2003–2021 average. To assess the role of geopolitical divisions more formally, they estimate a gravity model in which countries are grouped into three blocs based on their IPD: a U.S.-leaning bloc (top quartile in proximity to the U.S.), a China-leaning bloc (top quartile in proximity to China), and a set of non-aligned countries (the remainder). The key variables of interest are interactions between indicators for cross-bloc and bloc-to-non-aligned investment and a post-invasion dummy marking the period after Russia's invasion of Ukraine. The results reveal a significant decline in FDI holdings between blocs relative to within-bloc investment, with a differential drop of 12% after the invasion. Applying the same empirical framework to

[19]This index is constructed from four components: (i) the difference between the number of times a country has been sanctioned by China and Russia versus the United States; (ii) the difference in the share of military imports from Russia and China compared to the U.S.; (iii) an indicator for participation in the Belt and Road Initiative; and (iv) the country's vote on the UN General Assembly resolution of 2 March 2022 condemning Russia's invasion of Ukraine. Each component is normalized, and the average forms the index, with higher values indicating alignment with China and Russia over the United States.

[20]They also highlight that industrial policy may be a contributing factor in the recent evolution of FDI patterns. For instance, the Inflation Reduction Act (IRA) may have bolstered greenfield FDI inflows into the U.S., particularly in IRA-related sectors, by offering incentives for firms to relocate production domestically.

portfolio holdings yields a similar pattern: cross-bloc portfolio shares declined by 0.5 percentage points more than within-bloc shares—a sizable shift, given the average portfolio share of just 1.5% in the sample.[21]

Political alignments influence also portfolio allocations

Portfolio investment is the specific focus of Catalan et al. (2024), who investigate how investment funds allocate smaller shares of their equity and bond portfolios to recipient countries that are geopolitically distant from their country of origin. Using a gravity framework and the (negative of the) S score of Signorino and Ritter (1999) as a measure of geopolitical distance, they find that the effect is economically significant: a geopolitical distance equivalent to the divergence in UN voting patterns between the U.S. and China since 2016 is associated with a 25% reduction in portfolio allocation.[22] Consistent with the findings of Bussy and Zheng (2023), Caporale and Menla-Ali (2024), and Choi and Havel (2025) regarding geopolitical risk, the adverse effect of political distance on cross-border portfolio allocations is attenuated for recipient countries with stronger institutional quality, proxied by ICRG scores. Furthermore, the authors identify an additional transmission mechanism: a cross-border investment diversion effect, whereby a recipient country benefits from increased capital inflows when geopolitical distance rises between its source countries and third-party financial partner countries.

Airaudo et al. (2025) analyze total bilateral portfolio holdings using the method of Gopinath et al. (2025) but armed with a revised set of political distance indicators and find that financial fragmentation appears generally weaker than in trade, with results more sensitive to the specific definition of these indicators. While this suggests that global financial linkages may be more resilient to geopolitical tensions, the authors also interpret it as evidence of the mediating role played by third countries, including financial centers, which can obscure direct financial interconnections between countries with divergent ideological alignments.

Still focusing on portfolio holdings but with a narrower scope and leveraging more granular data, Lugo and Montone (2024) examine the impact of increased IPD on equity holdings at the firm level. They find a negative effect that is stronger for firms with greater exposure to geopolitical risk—measured by the sensitivity of stock returns to increases in the Caldara and Iacoviello (2022) GPR index—as well as for dividend-paying and less liquid firms. Their panel covers foreign institutional equity holdings from nine investing countries to 23 host countries, with the euro area treated as a single entity in both cases.

[21] Gopinath et al. (2025) also examine in detail the effects of political distance on trade, also drawing comparisons with the Cold War period. These results are not reported here, as this review focuses specifically on the financial dimensions of geopolitical fragmentation. However, one is worth mentioning; they find that direct links between the U.S. and China are being replaced by indirect ones, and there is a robust association between the number of Chinese greenfield FDI in a country and the increase in the country trade with the U.S.

[22] The S score is 1 minus the ratio between the sum, over voting session in a given year, of the squared differences between the votes of two countries (where yes=1, abstain=2, and no=3), over half the sum of squared maximum possible distances between the countries in a given session.

Although they do not use the IPD, it is worth citing Crosignani et al. (2025), who examine how U.S. investment funds respond to a specific manifestation of political tensions, namely, the U.S.-China decoupling. Their study focuses on the response to the imposition of export controls on U.S. firms to restrict the sale of advanced technology to China. They find that U.S. funds divested from firms directly targeted by the export restrictions and also reduced holdings in other companies exporting to China, even if those firms were not explicitly sanctioned.

As with FDI, portfolio investment into the euro area also shows signs of fragmentation. Specifically, Beck et al. (2025) document that euro area government debt held by the official sector in non-aligned countries has slightly declined since Russia's invasion of Ukraine, while holdings by aligned countries have remained large and have grown further since 2022.[23] Following Gopinath et al. (2025), the authors define aligned (non-aligned) countries as those in the top quartile of political proximity to the United States (China), excluding Russia. A formal econometric analysis—adapting the framework of Gopinath et al. (2025)—shows that Russia's invasion of Ukraine increased the differential in official sector holdings of euro area sovereign debt along geopolitical lines, although the estimates are sample-sensitive and suggest that the effect materialized gradually.

As for sovereign euro bonds, portfolio investments to and from the euro area appear particularly sensitive to geopolitical dynamics, based on the gravity model estimates in Hudecz et al. (2024). This report presents a wide range of descriptive and formal analyses, with a focus on investment patterns in ASEAN economies and the euro area and the influence of geopolitical divides. Using a gravity regression framework similar to that of Aiyar et al. (2024), the authors confirm that geopolitical proximity significantly influences bilateral FDI flows and that the U.S.–China trade war has intensified this effect. A distinctive feature of the analysis is the differentiation between immediate and ultimate investor-based FDI.[24] When using immediate investor data, the authors find a statistically significant negative relationship between political distance and FDI into China. However, this relationship becomes statistically insignificant when using ultimate investor data—indicating that politically distant countries may still invest in China, but often channel these investments through intermediary jurisdictions. [25]

Another broader comparison of the intensity of fragmentation across different types of investment and trade is presented in Aiyar and Ohnsorge (2024). Their work offers valuable insights into both the patterns of fragmentation and countries' exposure to it. Using the econometric framework of Aiyar et al. (2024) across various asset classes and trade categories, they find that greater geopolitical distance—as measured by the IPD—is consistently associated with reduced cross-border transactions. However, the magnitude of the effect varies considerably across categories: it is strongest for foreign direct investment

[23] Non-aligned foreign countries account for approximately 6% of the outstanding government debt.
[24] FDI positions are reallocated based on the methodology outlined in Casella (2019).
[25] This pattern is also evident in FDI from China to the euro area. While China accounts for only 0.3% of immediate investors in the euro area, it represents 2.3% of ultimate investors, suggesting substantial routing of Chinese FDI through third countries.

(FDI), while more muted for capital goods exports and portfolio investment liabilities. [26]

In a second step, the authors construct two additional indicators: geoeconomic vulnerability and geoeconomic connectedness. The former is defined as the transaction-weighted average IPD of a country's partners; higher values indicate greater misalignment between a country's geopolitical stance and that of its trading partners or creditors. The latter is the standard deviation of the IPD of a country's partners, capturing the extent to which a country is connected to ideologically diverse blocs—thereby formalizing the idea of "connector" countries that maintain economic ties across geopolitical divides.

Their results show that emerging market economies (EMEs) are significantly more geoeconomically vulnerable than advanced economies, particularly in financial liabilities as opposed to exports. Among capital flows types, EMEs liabilities to banks and portfolio liabilities are significantly more vulnerable than FDI. [27] EMEs also tend to be more geoeconomically connected across most international linkages, especially in trade and to a lesser extent in finance—likely due to the more centralized structure of global financial markets. The countries identified as most vulnerable are also those that have been reducing both their vulnerability and connectedness the most since 2016. Last, open capital accounts and efficient financial markets improves a country attractiveness to all sources of capital (FDI, portfolio, bank loans).

Geopolitical tensions dampen cross-border bank lending

As already mentioned, Pradhan et al. (2025) finds that rising geopolitical tensions directly dampen cross-border bank lending and amplify the international transmission of monetary policy. It is worth recalling their result in this Section as the documented amplification is more pronounced in the presence of materialized geopolitical tensions—captured through UN voting disagreement (as in Bailey et al., 2017) and the imposition of bilateral sanctions—than in cases of unrealized tensions, which are proxied by either differences in the geopolitical risk index of country pairs or the GPR level in borrower countries.

Political differences matters even in abscence of acute tensions

Finally, it is worth noting that the influence of political proximity extends beyond episodes of acute geopolitical tension. Even in more tranquil periods, ideological distance from a host country can shape capital allocation decisions, as shown by Kempf et al. (2023). Following foreign elections that increase ideological distance from the U.S., American banks reduce both the volume and number of loans extended to the newly governed country and simultaneously raise loan spreads—relative to banks experiencing a decrease in political distance. This effect is driven by cross-partisan heterogeneity in expectations about economic conditions under ideologically distant administrations. Similarly, fund managers

[26] Interestingly, the effect on banking liabilities to BIS-reporting banks is positive. This likely reflects the geographic concentration of BIS-reporting banks in advanced economies that are geopolitically aligned but distant from many of the emerging markets to which they lend.

[27] Their detailed trade-related findings are not discussed in this review.

adjust their portfolio allocations in response to increased ideological distance. [28]

Local narratives—shaped by domestic media—can reinforce sovereign political divides and significantly affect international capital flows. Agarwal et al. (2024) show that changes in sentiment and perceived risk toward China, as conveyed by national newspapers, influence the portfolio allocation decisions of institutional investors. Importantly, this effect is asymmetric: capital flows into China are more responsive to negative narratives than to positive ones. The sensitivity to media-driven sentiment diminishes with investor experience—those with a longer history of investing in China are less affected, likely due to superior access to information and greater familiarity with the market, and is larger in times of heightened stock market volatility.

Political proximity may influence also the transmission of international financial shocks, as shown by Ambrocio et al. (2024).[29] They find that stronger political ties with the United States are associated with larger and more persistent spillovers from U.S. financial volatility to stock returns in non-OECD economies—echoing broader findings on the heightened sensitivity of emerging markets to geopolitical factors.[30] Unlike most studies, their measure of political proximity is based solely on voting alignment with the U.S. in United Nations General Assembly resolutions deemed important by the U.S. State Department. Importantly, political ties with the U.S. amplify the global financial cycle primarily in countries with unbalanced geopolitical alignments—those showing asymmetries in political ties with the U.S., EU, and China, a condition the authors refer to as fragmentation. In contrast, countries maintaining a more balanced geopolitical stance experience less pronounced transmission of U.S. financial shocks to their domestic markets.[31]

Last, Cao et al. (2023) find that belonging to a political alliance can increase cross-border capital flows. They show that the formation of a military alliance between two countries is associated with greater cross-border M&A activity and confirm their results using the 1999 and 2024 NATO enlargements as case studies. In line with other studies that find fragmentation to be deleterious for emerging market economies (EMEs), the positive effect of military alliances on cross-border deals is stronger for countries with weaker institutions. Beyond the increase in activity, at the deal level, the presence of military alliances reduces the offer premium and increases the likelihood of bidding for full control of the target company.

[28] Ideological distance from newly elected foreign governments is calculated using data from the Manifesto Project, which quantifies parties' policy stances based on electoral manifestos. Political affiliations of banks are inferred from PAC contributions, while those of fund managers are derived from voter registration records.

[29] Their sample ends before the COVID-19 pandemic and predates recent major geopolitical tensions.

[30] The authors identify three channels through which this amplification may operate. First, countries with stronger political ties to the United States tend to be more financially integrated, and thus more exposed to international comovements in equity markets. Second, political proximity attenuates the adverse effects of geographical distance on bilateral investment involving the U.S., potentially reducing information frictions. Third, there may be a sentiment amplification channel. The latter is supported by regressions showing that IMF growth forecast revisions depend negatively on the interaction between the VIX and political ties with the U.S. Moreover, when global financial conditions are tighter, news sentiment about foreign firms is disproportionately more pessimistic for firms located in countries with strong political alignment with the U.S.

[31] The authors do not put forward a hypothesis to explain this result.

Overall, the emerging evidence suggests that geopolitical divides are becoming an increasingly relevant determinant of cross-border investment. Alignment-based reallocation is documented across different types of cross-border investment, including FDI, portfolio holdings, and bank lending. Most contributions rely on gravity-type models in which political distance between countries, or bloc affiliation based on the same, enters as the explanatory variable of interest. Although this body of work points to a systematic incorporation of geopolitical considerations into international investment decisions, the evidence remains relatively recent, and further research is needed to assess its scope and long-term implications.

4 Conclusions

This review has summarized the growing body of literature on the effects of geopolitical risk and geopolitical fragmentation on international finance. The findings consistently show that political tensions and divides have become significant determinants of cross-border capital flows, shaping both the volume and direction of international investment.

First, geopolitical risk triggers a widespread retrenchment in global capital flows, especially from emerging market economies. While advanced economies may benefit from a flight to safety, EMEs are more vulnerable to sudden stops and reallocations, though stronger institutional quality can help buffer the impact. Moreover, geopolitical risk interacts with other economic forces, such as monetary policy and economic uncertainty, amplifying their transmission across borders.

Second, rising geopolitical divides are contributing to structural shifts in international capital allocation. The established use of gravity models has provided consistent results across different works and asset classes; political distance influences all kinds of cross-border investment, with a clear tendency toward bloc-based investment patterns. This fragmentation is particularly evident in strategic sectors, and appears to be more pronounced in FDI than in portfolio flows. Investments into and from the euro area have shown signs of sensitivity to political alignment following the Russian invasion of Ukraine.

While the literature has mostly examined geopolitical shocks and ideological distance as separate factors, their interconnected and mutually reinforcing nature deserves greater recognition. For instance, the growing significance of political distance in empirical results, particularly following Russia's invasion of Ukraine, illustrates how geopolitical events can deepen blocs divides, in turn affecting cross-border financial flows. The two literatures, rather than two different phenomena, may actually be investigating short-term versus more structural responses to the same underlying international relations dynamics.

As fragmentation is an ongoing and evolving process, further research is needed to assess the scale and consequences of the reconfiguration of international financial relationships.

A challenge common to other strands of the literature persists: the role of offshore financial centers (OFCs) in shaping the geography of international investment (Coppola et al., 2021; Albori et al., 2024), and the relative scarcity of comprehensive official statistics on a ultimate investor basis. This has important implications for empirical analyses based on immediate-investor-based capital flow data (Damgaard et al., 2024), which may obscure the true origin and destination of investments. Although many studies exclude (or are robust to the inclusion/exclusion of) offshore countries, a clearer mapping of ultimate investors remains essential to determine whether observed reallocations reflect genuine shifts in financial relationships or merely the use of third countries as intermediaries.

While continued efforts to measure the effects of fragmentation on capital flows are essential, several broader and interrelated questions warrant attention. For instance, are the documented trade and financial reallocation coupled, or, within blocs, do they involve different partners? More broadly, what are the macroeconomic implications of financial fragmentation? How might it reshape the structure and stability of the international financial system? What are the consequences for the role and valuation of reserve currencies in a world divided into geopolitical blocs? And how might it affect the global demand for safe assets—will it rise due to heightened uncertainty, or decline due to diminished trust in shared financial anchors? How will fragmentation alter the transmission of monetary policy across borders and, more broadly, the correlation of financial cycles across countries?

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Table 1: **Effects of geopolitical risk on cross-border investment**

Author(s)	Type of investment	Sample	Type of risk	Main findings
Feng et al. (2023)	All (BoP data); Advanced and emerging economies	2005–2019	Global	Geopolitical risk has a negative effect on capital outflows and inflows in both advanced and emerging countries. Negative effect on direct investment inflows of emerging economies; positive effect on those of advanced economies.
Bussy and Zheng (2023)	FDI; Emerging economies	2003–2019	Country-specific	Geopolitical risk deters FDI in EMEs. Effective governance and institutional quality soften impact; proximity worsens it. R&D-intensive FDI is less responsive to risk.
Choi and Havel (2025)	Portfolio; US outward investment	1994–2022	Country-specific	U.S. investors react to geopolitical risk in EMEs, not in AEs. Impact influenced by institutional quality and capital market openness. Contagion effect among neighboring EMEs.
Caporale and Menla-Ali (2024)	Portfolio; U.S. inward and outward investment	1992–2022	Country-specific	US investors reduce equity investments in EMEs when geopolitical risk rises. Foreign investors repatriate capital when their country's risk increases. Nonlinear effects, stronger under high risk.
Hudecz et al. (2024)	Portfolio; Euro area inflows and outflows	2000–2023	Global	In geopolitical shocks, euro area investors sell foreign equities/debt; foreigners buy euro area assets. In low-risk regimes: increased foreign purchases. In high-risk: possible outflows.
Converse and Mallucci (2025)	Portfolio; Funds domiciled in 8 countries	2002–2024	Country-specific and global	Mutual funds reduce exposure to countries with rising geopolitical risk. Stronger effect in EMEs; milder for NATO members. Global risk increases concentration; political distance narrows.
Niepmann and Shen (2025)	Bank loans; US global banks	1986–2022	Country-specific	U.S. global banks reduce lending to high-risk countries but maintain presence via affiliates. Domestic credit spillovers.
Agoraki et al. (2024)	Portfolio; Aggregate BoP data—Advanced and emerging economies	1996–2022	Global	Equity and bond flows negatively impacted by geopolitical risk. Stronger effect in EMEs. High geopolitical risk magnifies impact of economic policy uncertainty.

Table 2: **Effects of political distance on cross-border investment**

Author(s)	Type of investment	Sample	Main findings
Aiyar and Ohnsorge (2024)	All; Advanced and emerging economies	2002–2023	Increasing geopolitical distance diminishes bilateral transactions. Largest effect for FDI, capital goods exports and portfolio investment. EMEs are more vulnerable.
Aiyar et al. (2024)	FDI; Advanced and emerging economies	2003–2022	Countries invest less in geopolitically distant countries. The effect has been increasing, is more pronounced for EMEs recipients and in strategic sectors.
Boeckelmann et al. (2024a)	FDI; Advanced and emerging economies	2003–2024	The negative effect of geopolitical distance on euro area FDI intensified after the war in Ukraine.
Gopinath et al. (2025)	FDI, portfolio; Advanced and emerging economies	2003–2024	FDI reallocation has intensified, especially among advanced economies. Cross-bloc FDI and portfolio holdings declined after the Russian invasion of Ukraine.
Catalan et al. (2024)	Portfolio; Advanced and emerging economies	—	Investment funds allocate smaller portfolio shares to geopolitically distant countries. The effect is milder for countries with strong institutions. Cross-border investment diversion effect.
Hudecz et al. (2024)	All; Advanced and emerging economies	2005–2023	Political alignment negatively linked to FDI, especially following the U.S.-China trade conflict. China still attracted FDI from politically divergent countries, via intermediaries. Euro area portfolio investments sensitive to geopolitics.
Lugo and Montone (2024)	Portfolio (equity); Advanced economies	2005–2020	Increased geopolitical distance reduces foreign institutional equity holdings, particularly in geopolitically sensitive, dividend-paying, and illiquid stocks.
Beck et al. (2025)	Portfolio (sovereign bond); Euro area	2017–2024	Russia's invasion of Ukraine has widened the geopolitical divide in foreign official holdings of euro area sovereign debt.
Airaudo et al. (2025)	Portfolio; Advanced and emerging economies	2015–2023	Financial fragmentation appears weaker than trade fragmentation.
Pradhan et al. (2025)	Bank loans; Advanced and emerging economies	2012–2023	Geopolitical tensions dampen cross-border bank lending and amplify monetary policy transmission internationally.
Kempf et al. (2023)	Bank loans, portfolio; Advanced and emerging economies	2000–2018	U.S. banks reduce loans to countries with politically distant new governments. Fund managers adjust portfolios in response to ideological distance following foreign elections.
Ambrocio et al. (2024)	Advanced and emerging economies	1990–2019	Stronger U.S. political ties are linked to larger and more persistent spillovers from U.S. financial volatility to stock returns in non-OECD countries.