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The Impact of Geopolitical Risk on Abnormal Cross-Border Capital Flows

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Abstract: Geopolitical risk has become an important factor affecting global financial stability and a key source of risk for cross-border capital movements. When geopolitical tensions intensify, international capital flows may exhibit abnormal patterns, including surges, sudden stops, flight, and retrenchment. This paper develops a conceptual analysis of the channels through which geopolitical risk influences these extreme flow episodes. Four transmission mechanisms are identified: uncertainty and real options, sanctions and asset freeze, safe haven rebalancing, and financial decoupling. Each mechanism is linked to specific flow abnormalities, temporal characteristics, and degrees of reversibility. The mechanisms are organized into a classification, and illustrative episodes are provided alongside policy considerations.

Keywords: Geopolitical risk, Abnormal capital flows, Sanctions, Financial decoupling.

1. Introduction

Over the past decade, geopolitical tensions including military conflicts, strategic rivalries, and financial sanctions have elevated geopolitical risk (GPR) as a major factor in international capital movements [1, 2]. When GPR rises, cross-border capital flows can deviate sharply from normal patterns, generating extreme episodes often classified as surges, sudden stops, flight, and retrenchment [3].

Existing empirical studies frequently include GPR indices in regression models and treat geopolitical risk as a general uncertainty proxy. Although a statistical association has been established, these studies offer limited insight into the specific pathways connecting a geopolitical shock to a particular type of abnormal flow. The same event may cause a sudden stop in one country and a surge in another. Furthermore, financial sanctions operate through legal compulsion rather than uncertainty alone [4]. Recent work confirms that global uncertainty increases the likelihood of extreme flow episodes [5], yet the geopolitical dimension deserves separate conceptual attention.

This paper provides a conceptual examination of how GPR affects abnormal cross-border capital flows. It addresses three questions: how abnormal flow episodes can be characterized when geopolitical disturbances are the primary trigger; what transmission mechanisms lead GPR to surges, sudden stops, flight, and retrenchment; and how these mechanisms can be organized into a practical classification. The remainder of the paper is organized as follows. Section 2 reviews the conceptual background. Section 3 identifies the transmission mechanisms and presents a classification. Section 4 discusses several recent episodes from the perspective of the proposed framework. Section 5 considers policy implications, and Section 6 concludes.

2. Geopolitical Risk and Abnormal Capital Flows

Cross-border capital flows encompass foreign direct investment, portfolio flows, and bank lending. Under normal conditions, they respond to interest rate differentials and growth prospects. Geopolitical events, however, can cause extreme deviations. The literature classifies such extreme episodes based on gross flows [3]: a surge is a period of unusually large gross inflows; a sudden stop is a sharp contraction in gross inflows; flight is a sharp increase in gross outflows by residents; and retrenchment is a sharp decline in gross outflows by foreigners. These episodes are identified when flows exceed a threshold relative to their historical mean and standard deviation.

In a geopolitical context, “abnormal” also implies that the disturbance is driven by a non-economic shock that alters perceived property rights security, payment system continuity, and institutional stability. Geopolitical shocks can simultaneously stop inflows and accelerate outflows, creating hybrid episodes that do not fit a single category. Some geopolitical events permanently change the baseline level and volatility of capital flows, making purely statistical detection less reliable. A conceptual understanding that accounts for the nature of the trigger is therefore necessary.

Geopolitical risk is defined as the threat, realization, and escalation of adverse events related to wars, terrorism, and tensions among states. For investors, GPR introduces concerns about expropriation, contract enforcement, and payment infrastructure access. Assets in a country facing geopolitical tensions may lose value through legal restrictions or asset freezes beyond normal market channels. This tail risk produces nonlinear reactions: investors may hold assets until a certain threat threshold is crossed, then withdraw rapidly. The GPR index developed by Caldara and Iacoviello captures newspaper-based perceptions but does not directly reflect structural shifts such as payment system fragmentation or new investment screening regimes.

3. Transmission Mechanisms and Classification

Four main mechanisms through which GPR influences cross-border capital flows and generates abnormal episodes are identified below.

3.1. Uncertainty and the Real Options Mechanism

Geopolitical shocks increase uncertainty about future policies, asset returns, and contract enforceability. When investment is partially irreversible, higher uncertainty raises the value of delaying commitments [6]. The theoretical logic underlying this mechanism draws on the real options literature, which emphasizes that the opportunity to wait for new information becomes more valuable when the future environment is highly unpredictable. For foreign direct investment, the sunk costs of establishing physical operations and navigating host country regulations imply that exiting during a crisis can be costly. Similarly, for portfolio investments, fire sales and market illiquidity during periods of stress make rapid position adjustments expensive. Consequently, foreign investors faced with an uncertain geopolitical environment are likely to postpone planned investments, leading to a sudden stop in inflows. Domestic residents, confronting an equally unpredictable home environment, may also transfer wealth abroad as a precaution, contributing to flight. The duration of such disruptions is closely tied to the persistence of uncertainty. If credible policy measures restore investor confidence by clarifying the rules of the game, the process is partially reversible. However, in cases where the geopolitical situation remains fluid for an extended period, the wait-and-see attitude can persist for years, depressing capital formation and external financing.

3.2. Sanctions and Asset Freeze Mechanism

Financial sanctions operate through legal compulsion rather than voluntary portfolio choice. When a country or its nationals are sanctioned, foreign investors may be legally compelled to divest their holdings, and assets can be frozen or made nontransferable. This generates an immediate and often irreversible capital flight by non-residents, along with a sudden stop of new inflows. The scope of sanctions matters considerably: primary sanctions directly target the sanctioned state and its entities, while secondary sanctions threaten third-country investors with penalties if they continue financial relationships with the target, thereby widening the circle of forced divestment. Domestic agents, anticipating the broadening of sanctions, may also engage in preemptive flight, moving assets to jurisdictions beyond the reach of current and anticipated restrictions. The freezing of central bank reserves, as witnessed in recent episodes, adds a sovereign dimension to the mechanism by undermining the country's ability to defend its currency or provide liquidity support, which further accelerates outflows. Because the driving force is the legal framework of foreign governments, domestic policy alone cannot easily reverse these flows, and the resulting hybrid sudden stop and flight episode tends to be long lasting, persisting until the sanctions regime is dismantled.

3.3. Safe Haven Rebalancing Mechanism

Rather than uniformly reducing capital flows, GPR redirects them. When tensions rise in certain regions, global investors rebalance portfolios toward economies perceived as geopolitically safe. A safe haven in this context is defined by jurisdictional security and the absence of sanctions exposure, not solely by credit quality or market depth. Currencies such as the US dollar and Swiss franc typically appreciate during geopolitical crises, while emerging market currencies face depreciation pressures regardless of their individual fundamentals. This flight-to-safety dynamic can create a self-reinforcing cycle: currency depreciation in exposed countries erodes the local-currency value of foreign investments, which prompts additional outflows and further depreciation. At the same time, capital surges into sheltered destinations, generating appreciation pressures and potential asset market overheating in recipient economies. Gold and certain sovereign bonds also attract substantial inflows, reinforcing their status as stores of value during periods of elevated geopolitical uncertainty. The rebalancing mechanism thus produces a markedly asymmetric pattern of capital redistribution, which has little connection to conventional macroeconomic fundamentals.

3.4. Financial Decoupling Mechanism

Persistent geopolitical rivalries can lead to the gradual decoupling of financial systems through investment screening, technology transfer restrictions, and the development of parallel payment infrastructures. The fragmentation of global payment systems, exemplified by the emergence of alternatives to SWIFT and the expansion of bilateral currency swap lines among allied nations, represents a structural barrier to capital mobility that is distinct from cyclical fluctuations in risk appetite. Over time, these measures reduce cross-border flows between rival blocs and cause a structural retrenchment of gross outflows. Investment in strategic sectors such as semiconductors, artificial intelligence, and energy becomes subject to national security reviews, effectively closing certain channels of cross-border equity and direct investment. Capital markets also exhibit segmentation, as firms from targeted sectors shift their fundraising activities toward domestic or bloc-aligned exchanges. Unlike episodic stops or flights, financial decoupling reflects lasting institutional change with low reversibility. It alters long-term global capital allocation, reduces international risk sharing, and contributes to a more fragmented international financial landscape in which capital circulates primarily within politically homogeneous corridors.

3.5. Classification

The four mechanisms differ in their temporal patterns and policy sensitivity. The uncertainty and real options mechanism tends to produce protracted, state-dependent disruptions that respond moderately to confidence-building measures. The sanctions and asset freeze mechanism is abrupt and structural, with low responsiveness to domestic policy. Safe haven rebalancing is episodic and can be rapid, while its effects can be partially managed through macroprudential tools. Financial decoupling is secular and gradual, with very limited policy reversibility once institutional changes are in place. Table 1 maps geopolitical triggers to expected abnormal flow outcomes and the dominant mechanism at work.

Table 1. Geopolitical triggers and abnormal capital flow types

Flow Type	Brief Definition	Typical Triggers
Sudden Stop	Sharp decline in gross inflows	Sanctions threat, military escalation, political turmoil
Flight	Sharp rise in resident outflows	Sanctions imposition, asset freeze, armed conflict
Surge	Sharp rise in gross inflows	Conflict elsewhere enhancing safe haven status
Retrenchment	Sharp decline in gross outflows	Financial decoupling, investment screening
Hybrid Stop-Flight	Simultaneous inflow stop and outflow surge	Comprehensive sanctions, major war

Source: Authors' elaboration.

4. Illustrative Episodes

The classification presented above can be used to examine several recent geopolitical developments. The three episodes discussed below are interpreted through the lens of the transmission mechanisms identified in Section 3. They are intended as conceptual applications, illustrating how the framework helps make sense of observed capital flow dynamics.

4.1. The 2022 Russia Ukraine Conflict

The 2022 escalation and the subsequent imposition of comprehensive financial sanctions on Russia triggered a severe capital flow shock. The sanctions package included the removal of major Russian banks from SWIFT, a freeze on approximately half of the Bank of Russia's foreign reserves, and asset freezes targeting Russian individuals and entities. These measures left foreign investors with no legal pathway to repatriate funds, resulting in a near-total cessation of portfolio inflows and a scramble for exits. Fund flow data indicated unprecedented redemptions from emerging market funds with Russian exposure in the weeks following the invasion. The freezing of central bank reserves directly impaired the authorities' capacity to provide foreign currency liquidity, intensifying the outflow pressure. The outcome was a hybrid sudden stop and flight episode with near-zero reversibility. Simultaneously, capital surged into US dollar-denominated assets, gold, and Swiss franc instruments, and selected neutral jurisdictions also received inflows, consistent with the safe haven rebalancing mechanism.

4.2. US China Financial Decoupling

Since 2018, strategic rivalry has led to gradual financial decoupling between the United States and China. The US administration issued executive orders restricting investments in certain Chinese technology sectors, and the audit inspection dispute raised the risk of forced delistings for Chinese firms listed on US exchanges. In parallel, Chinese authorities accelerated the liberalization of domestic bond markets and expanded stock connect programs with Hong Kong, encouraging a shift toward onshore and offshore renminbi-based fundraising. As a result, the share of US institutional holdings in Chinese equities declined steadily, and Chinese issuers increasingly turned to Shanghai, Shenzhen, and Hong Kong for capital. These developments contributed to a structural retrenchment of bilateral portfolio and direct investment flows. The long-term trend reflects the financial decoupling mechanism, with policy measures on both sides reshaping the bilateral investment landscape and lowering the probability of a return to previous levels of integration.

4.3. The 2014 Crimea Sanctions

Sectoral sanctions imposed on Russia following the 2014 Crimea annexation illustrate the anticipatory nature of the sanctions mechanism. The restrictions targeted Russia's energy, financial, and defense sectors, limiting major state-owned banks' and energy firms' access to Western capital markets. In the quarters following the initial sanctions, Russia experienced a sudden stop in portfolio inflows and a significant increase in resident capital outflows. Domestic agents, expecting the scope of sanctions to widen, shifted assets abroad preemptively, often through offshore financial centers such as Cyprus and Switzerland. Balance of payments data showed a surge in errors and omissions, a pattern commonly associated with unrecorded capital flight. Although the initial shock was severe, some flows gradually returned after the situation stabilized and sanctions were partially priced in, indicating the relatively higher reversibility that characterizes threat-driven as opposed to comprehensive asset freeze-driven episodes.

A comparison of the three episodes reveals distinct patterns. The Russia Ukraine war case features a hybrid flow outcome driven jointly by sanctions and uncertainty, with extremely low reversibility. The US China decoupling case is characterized by structural retrenchment with similarly low reversibility but operating on a longer time scale. The Crimea sanctions case involves a mixture of flight and sudden stop, with somewhat greater sensitivity to the evolution of the sanctions regime. Across all three, the dominant mechanism aligns closely with the nature of the geopolitical trigger, supporting the practical relevance of the classification.

5. Policy Considerations

For uncertainty-driven episodes, policies that reduce institutional ambiguity can help restore inflows. Transparent policy frameworks, multilateral guarantees, and clear property rights communication may shorten waiting periods. Macroeconomic stabilization programs can also reinforce credibility.

For sanctions-induced episodes, domestic policy options are limited because flow reversals result from foreign legal actions. Diplomatic efforts to secure stability exemptions and the development of alternative financial channels are more relevant. Larger reserve buffers and diversified reserve currencies provide self-insurance.

When safe haven surges occur, the main challenge is managing the macroeconomic effects of large inflows. Countercyclical macroprudential tools, such as higher reserve requirements on non-resident deposits, can mitigate appreciation pressures and financial vulnerabilities.

Where financial decoupling is dominant, policymakers face longer-term adjustment. Reduced foreign capital access necessitates deeper domestic capital markets and strengthened regional financial integration within blocs. The costs of decoupling in diminished risk sharing and lower investment should be weighed against perceived stability gains.

For multilateral surveillance, incorporating geopolitical indicators into early warning systems would help identify emerging risks. The classification and mechanism characteristics presented here can serve as a reference.

6. Conclusion

This paper has presented a conceptual analysis of the impact of geopolitical risk on abnormal cross-border capital flows. By distinguishing four transmission mechanisms—uncertainty and real options, sanctions and asset freeze, safe haven rebalancing, and financial decoupling—the study offers a structured understanding of how GPR affects surges, sudden stops, flight, and retrenchment. The analysis indicates that specific flow outcomes depend on the geopolitical trigger and the dominant mechanism.

The classification and illustrative episodes serve as practical tools for interpreting capital flow events and guiding preliminary policy assessment. The framework yields testable propositions, such as the expectation that sanctions-driven flight is less reversible than uncertainty-driven flight, or that safe haven surges concentrate in geopolitically aligned economies. In an environment where geopolitical factors increasingly influence financial decisions, a clear conceptual understanding complements empirical analysis and encourages further investigation into the geopolitical dimensions of global capital flows.

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