Why Geopolitics matters for Investments? And how?

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Why should investors care about Geopolitics? How it matters.

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The current state of international politics and geopolitics is historically unprecedented. The global effects of geopolitics transcend the major direct players in the global economy and are also being felt in smaller Emerging Markets and Developing Economies (EMDEs). We provide a summary analysis and discussion of the ***impact of geopolitics on trade, economic fragmentation, stock returns, sovereign risk premia, currencies, commodity prices, and the role of the dollar as a reserve currency***. Geopolitical Risks (GPR) affect the macro backdrop as well as investment fundamentals leading to lower returns, greater return volatility and higher macro uncertainty. If asset returns, trade, currency compositions, FDI and integration are affected as well as dollar dominance, **then each and every asset class is affected and every country is affected—**the magnitudes and the time horizons differ though**. Therefore, GPRs should be factored as a dynamic constraint in standard asset allocation models.**

1. Introduction

More than three decades ago, late Professor Sam Huntington of Harvard wrote the epic “The Clash of Civilizations: the making of a New World Order”[1]. He argued that wars would be a clash of cultures rather than a clash between countries. The late Henry Kissinger called it the best book on international affairs post the Cold-War. The book was prescient in laying out the thesis for a Changing World Order highlighting China, Russia vs Crimea, the Muslim Youth Bulge in the Middle East and Africa, the potential decline of the US and its influence. His ideas were controversial too as some considered his theory to be simplifying and ignoring some realistic interdependencies.

Jan Slavicek (2020)[2] applied Huntington’s methodology over 1995-2020 concluding that (i) large population growth was driven by African, Islamic and Hindu civilizations (ii) western civilizations superior economic growth has been declining with large growth in Confucian and Hindu civilizations (iii) three core countries remain superpowers (US, Russia and China) with India potentially being another (iv) most of the civilizations are economically compact with compactness increasing over last 25 years (v) Western, Hindu and Latin-American civilizations are highly compact politically whilst the others African, Islamic, Orthodox and Confucian civilizations are less compact. The Muslim civilization is least compact both economically and politically (vi) the superpowers (US, China, Russia and India) will remain or become the most important players in the multipolar 21st century.

Erik Reinfeldt (former Swedish PM speaking at the 2024 IPE Annual Conference, Prague) talked about the implications of the new “*strong man culture*” in global political leadership and its implications for Europe. However, it remains critical to understand the backdrop for the emergence of the strong-man leadership which creates greater uncertainty for the world in many dimensions, of which ***financial and economic integration*** remains one of the most important for investors and investments.

In “The Crisis of Democratic Capitalism”[3], Martin Wolf addressed why the relationship between democracy and capitalism is coming unstuck. The failings of democratic capitalism have resulted in slower growth, increasing inequality and widespread disenchantment with current regimes. This has provided incentives for the emergence of the “strong man leadership” trend. This remains in contrast to the classic essay “The End of History”[4] by Francis Fukuyama in 1989 where many

[1] S Huntington (1993) “The Clash of Civilizations—The Remaking of the Old Order”
[2] Jan Slavicek (2020), “S. P. Huntington’s Civilizations Twenty Five Years On”, Central European Journal of International and Security Studies
[3] Martin Wolf (2023), “The Crisis of Democratic Capitalism”, Penguin Books.
[4] Francis Fukuyama (1989) “The End of History” The National Interest

agreed that the western synthesis of liberal democracy with the free market had defeated other ideological paradigms. It was thought that freedom-political and economic- had won relative to totalitarianism and authoritarian regimes. *But nearly three and half decades later, neither liberal democracy nor capitalism are strong and victorious today*. Wolf maintains that democratic capitalism remains the best system for the world.

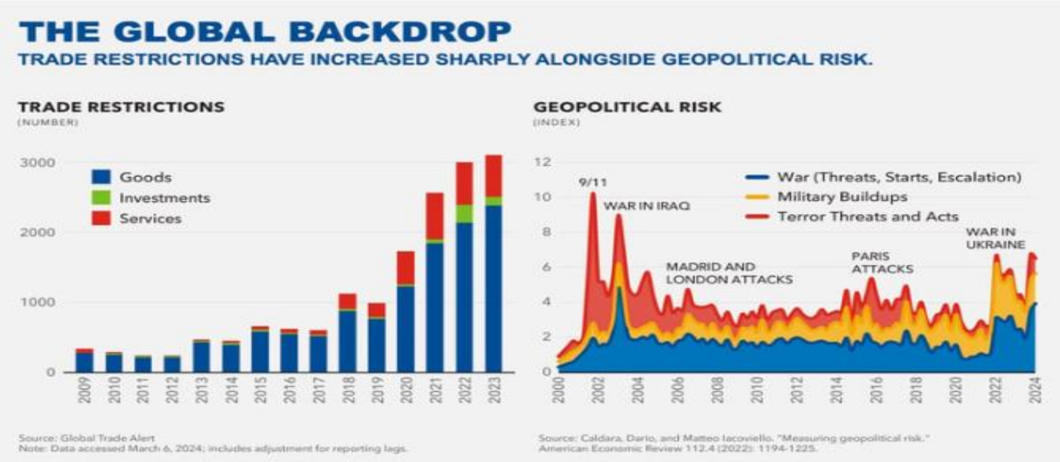
Danny Quah (2025)[5] argues that while bringing together nations to maintain peace and security and rising living standards was a utopian idea in 20th century, geopolitics, economics and world leader vision together helped shape that reality. After World War 2 economics started partnering with geopolitics to create a multilateral world. He asserts that economics and geopolitics are now working against multilateralism because that is an expensive good.

2. Geopolitics: Impact on Trade and Dollar Dominance

Gita Gopinath (2025)[6], formerly of the IMF, highlighted that global economic ties are changing in ways different from the multilateral rules-based framework and the institutional framework created after World War 2. Post COVID and the Russian invasion of Ukraine, countries are re-assessing their trading partners based on both national security and economic concerns. Foreign Direct Investment (FDI) flows are following geopolitical priorities. There has been a **re-evaluation by many countries regarding their use of dollars as a reserve currency or as a medium of international trade**. She notes that policy makers are focused on building national economic resilience against geopolitical shocks and if this were to continue, she thinks we could see a broad *retreat from rules of global engagement and reversal of integration gains.*

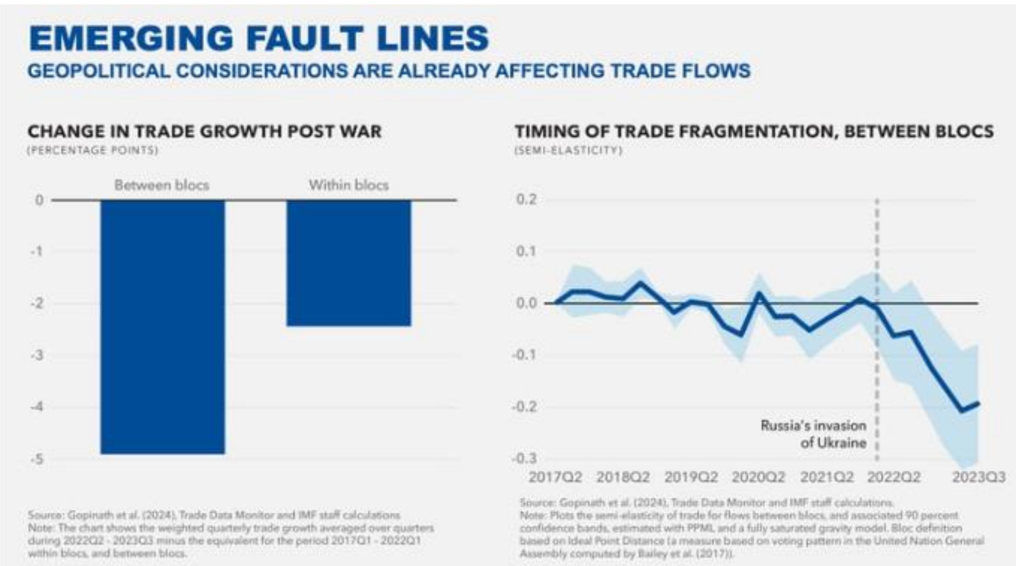
The Figure below shows that trade restrictions across goods, services and investments have tripled and the Geopolitical Risk Index (GPRI) has spiked post 2022 Russia-Ukraine war (right). The GPR geopolitical risk components: wars, military buildups and terror threats, are shown separately, and they sum up to the value of total GPRI.

[5] Danny Quah (2025),"Rethinking Multilateralism", IMF Finance & Development Podcast
[6] Gita Gopinath (2024), IMF speech at SIEPR, "Geopolitics and its Impact on Global trade and the Dollar"



Gopinath opines that in contrast to private sector concerns about fragmentation, there is a lack of evidence about deglobalization. We had also written[7] about the lack of evidence to support deglobalization based on increased movement of people, data and information, as well as global cross-border investment flows. Post the Global Financial Crisis (GFC) the ratio of goods traded to GDP has been roughly stable between 41-48%, not supporting the deglobalization view.

However, there are increasing signs of fragmentation with both trade and investment flows being redirected along geopolitical alignments. China's share in US imports declined by 8% over 2017-23, whereas the US share in Chinese imports declined by ~4%. IMF Head Kristalina Georgieva (2023)[8] highlighted that the cost of long-term fragmentation could reduce global GDP by 7% (equivalent to the sum of German and French GDPs). Gopinath asserts that geopolitics is already affecting trade flows and trade as fragmentation between blocs is evident as in the Figure below.



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7 LCP Blog (2025), Rethinking Degobalization: Migration, Mobility and Megacities"

8 Georgieva Kristalina (2023), "The Price of Fragmentation", Foreign Affairs (22 August 2023)

She notes the following for a 3-bloc world (a US-leaning, a China-leaning and a non-aligned bloc) (a) average weighted quarter on quarter trade growth between US bloc and Chinese bloc lower by 5% (comparing 2022Q2 -2023Q3 vs. 2017Q1-2022Q1) whereas intra-bloc trading growth was lower by 2% (b) after the Ukraine invasion by Russia, Trade and FDI between blocs declined by 12% and 20% more than intra bloc flows. ***These patterns are not driven by US or China and hold even without these two countries in the picture***. Gopinath asserts that the impact would have been even larger were it not for the effect of emerging connector countries like Mexico and Vietnam that have cushioned the effect of direct trade decoupling between US and China. Some trades are re-routed through these third-party connector countries.

Gopinath shows that today's ***economic fragmentation is not significantly different*** from the initial years of the Cold War. But compared to the intra-bloc trade shortfall during the Cold War period, the current fragmentation is an order of magnitude smaller. Trade fragmentation is likely to be costlier now than during the Cold War as currently world trade to GDP is nearly 45% whereas it was 16% during the Cold War. In addition, the non-aligned bloc currently is more economically important than it was during the Cold War.

She shows that geopolitics does not seem to have affected the ***dominant role of the US Dollar (USD)***: in both Trade Finance (80 %) and as a Reserve currency (~60%) despite newer alternative reserve currencies like the Australian Dollar, Canadian Dollar etc. In terms of the currency composition in trade for the Chinese bloc, the USD share of trade finance has declined since 2022 while the Renminbi (RMB) share has more than doubled from around 4% to 8%. Another important fact is that gold purchases by the China bloc for reserves has increased. China itself has increased gold holdings as reserves at the expense of US Treasury and Agency bonds. This is consistent with other IMF studies that find that FX Reserve managers tend to increase gold to hedge against economic uncertainty and sanctions risk.

In conclusion, the ***future geopolitical implications*** highlighted by Gopinath are (i) reduced efficiency gains and limited economies of scale (ii) fragmented payment systems and reserves system alongside reduced cross-border capital flows (iii) large economic costs in case of severe fragmentation (iv) disproportionate harm for EMDEs due to reliance on FDI, commodities and food security (v) investment in global public goods such as efforts to tackle climate change and AI may be impeded. Her ***advocated solutions*** include a robust rules-based global trading system and a resilient international monetary system complemented by trust, open communications, working in areas of common interest and working with groups of interested countries.

A Mattoo, M Ruta and R Staiger (2024)[9] study Geopolitics in the context of US-China rivalry and the current diminished status of the WTO. They state that the GATT/WTO system worked well in the past few decades until the start of this century. Economic research showed that if governments maximize the well-being of their own countries broadly defined, GATT/WTO principles would facilitate mutually beneficial cooperation over their trade policy choices. *The current heightened geopolitical rivalry seems to have undermined the WTO*. A simple transposition of the previous rationalization suggests that geopolitics and trade cooperation are not compatible. They show that this is only true if rivalry eclipses any consideration of own-country well-being. In all other circumstances, there are gains from trade cooperation even with geopolitics. The WTO's relevance is in question only if it adheres too rigidly to its existing rules and norms. It can continue to thrive as a forum for multilateral trade cooperation ***if it adapts in a measured way*** to current geopolitical strains.

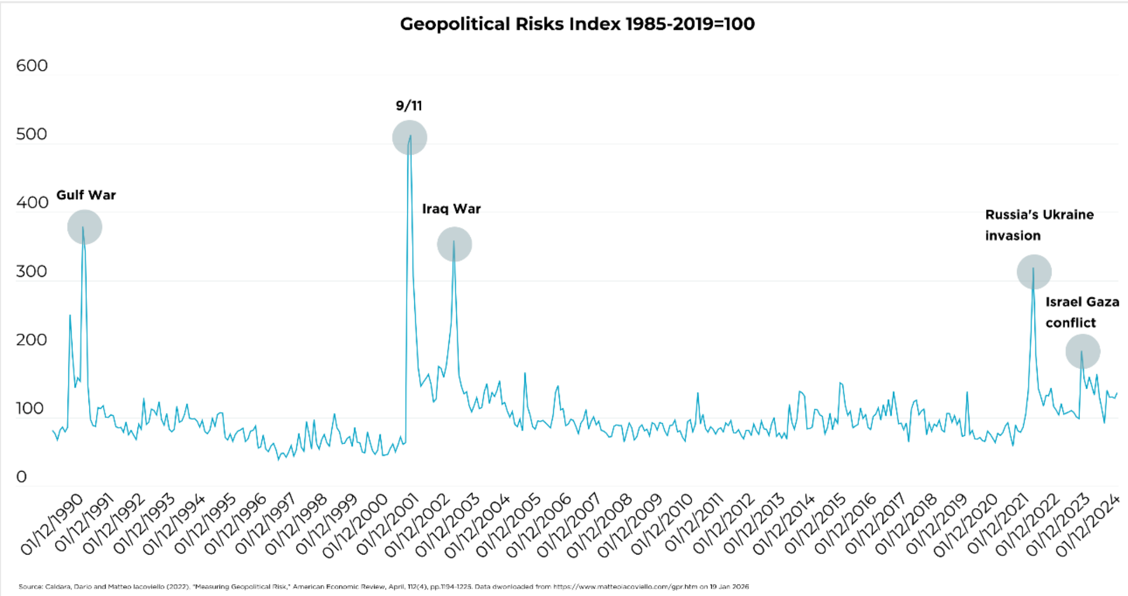
S Aiyar, D Malacrino and A.F Presbitero (2023)[10] assess the role of geopolitical alignment in FDI flows testing whether friendshoring helps to lessen the impact of geopolitical tensions. They show that slowbalization (slowdown in globalization, post GFC) resulted in FDI declines from 3.3% of GDP (2000s) to 1.3% (2018-2023). They state that while many factors like automation and technological change could be responsible, the emergence of ***fragmentation of capital flows*** along geopolitical lines and potential emergence of ***regional blocks*** are newer factors. Their model estimates show an economically significant role for ***geopolitical alignment*** in driving the geographical footprint of bilateral investments also in EMDEs. This result is robust to the inclusion of standard bilateral drivers of FDI—such as geographic distance and trade flows

3. Geopolitics and Asset Prices

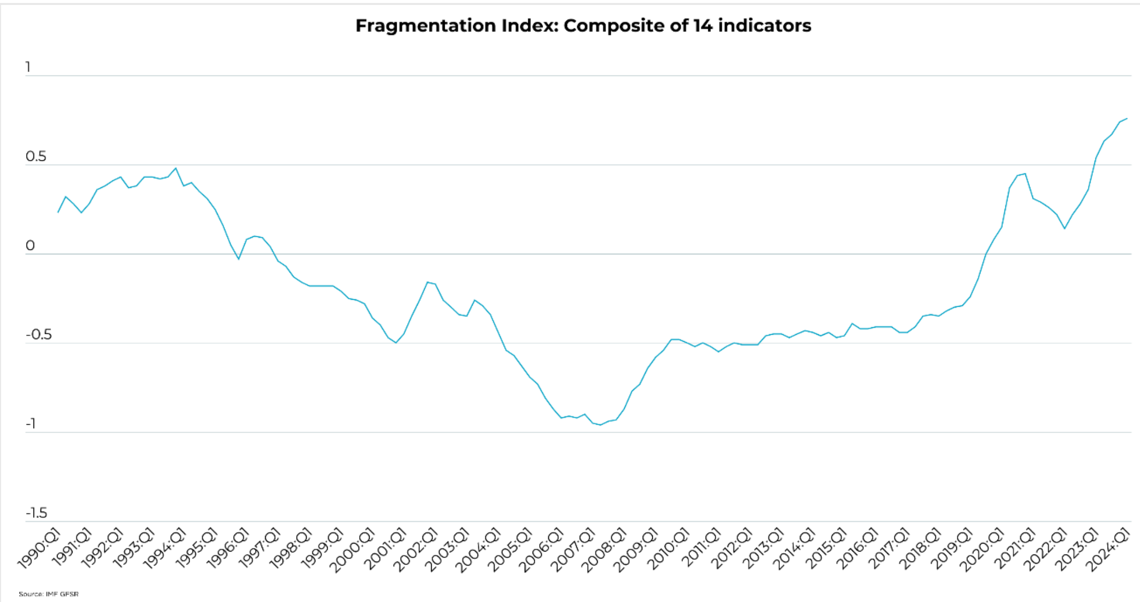
This section draws on the April 2025 Global Financial Stability Report (GFSR) of the IMF[11] which find that geopolitics affects asset prices and caution needs to be adopted by emerging markets in a world with geopolitical risks. The graphic below from the GFSR summarises (i) the *rise of geopolitical risk* as measured by the global geopolitical risk index of Caldera and Iacoviello (2022) (ii) *increased military expenditures* by many countries relative to the median (iii*) increased financial and trade sanctions* and (iv) increase in the fragmentation index.

[9] A. Mattoo, M. Ruta and R.W. Staiger (2024), NBER WP33293, "Geopolitics and the World Trading System"
[10] S. Aiyar, D Malacrino and A.F. Presbitedro (2023), "Investing in Friends: the Role of Geopolitical Alignment in FDI Flows", American Economic Association.
[11] IMF (2023, 2024 & 2025), "How Rising Geopolitical Risks Weigh on Asset Prices"

The Geopolitical Risk Index (GPRI)[12] captures the realization as well as the perception of risks that matter for asset prices. The Figure below illustrates a 35-year history of geopolitical risks during major events and shows that the GPRI has increased over the last 4-5 years.

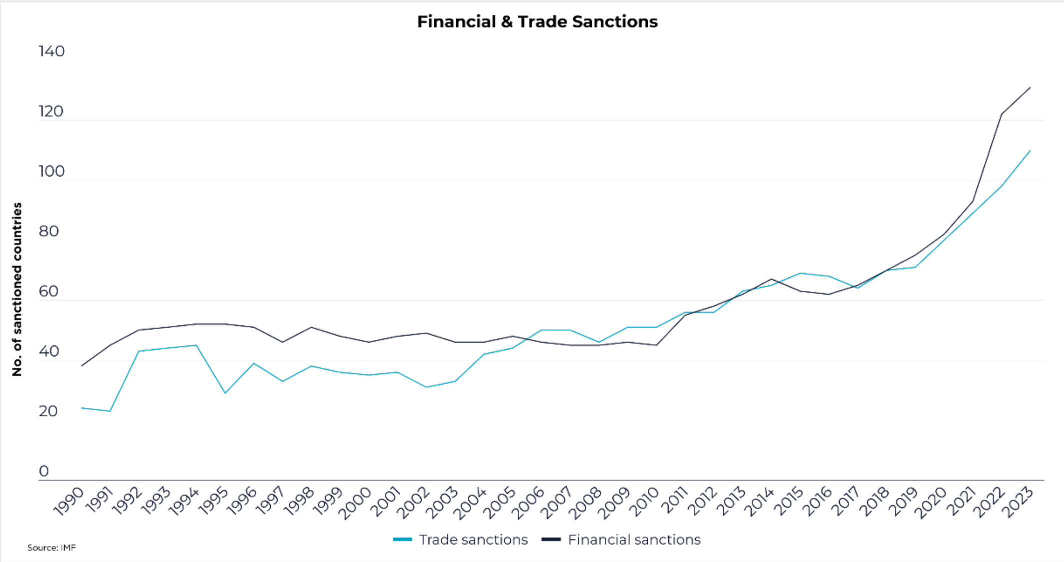


The Fragmentation Index (a composite of 14 geopolitical indicators) has been rising as seen in Figure below. This attests to the fact that integration (financial and economic), a trusted and established paradigm is in reverse gear—alongside the rise of country blocs, connector countries and a multipolar world.



12 Caldara, Dario and Matteo Iacoviello (2022), "Measuring Geopolitical Risk," American Economic Review, April, 112(4), pp.1194-1225.

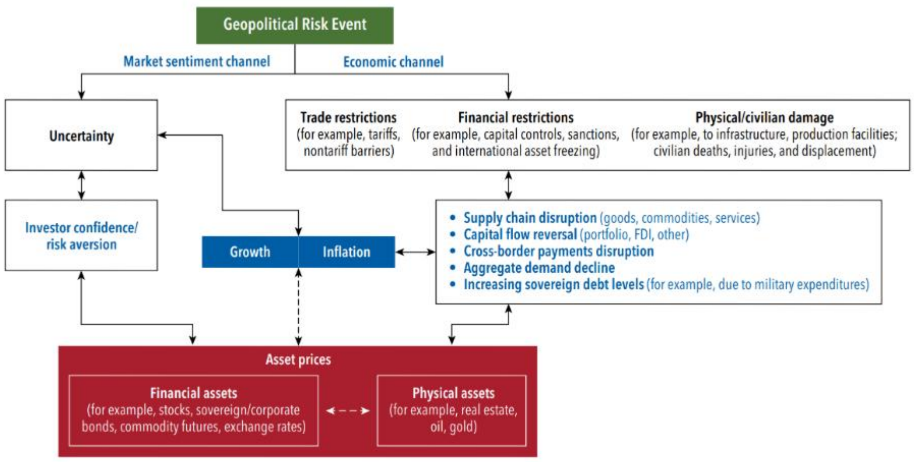
Similarly, we note that the IMF documents that the Financial and Trade sanctions have been increasing as the Figure below shows.



IMF research (2025) identified about 450 major geopolitical risk events across countries over 1985-2004 and events are defined as **major** if index scores are at least 2 standard deviations above the average score for the country where they occurred. About one sixth of events classified as major are *international military conflicts* with others involving diplomatic tensions, domestic political unrest, terrorism etc.

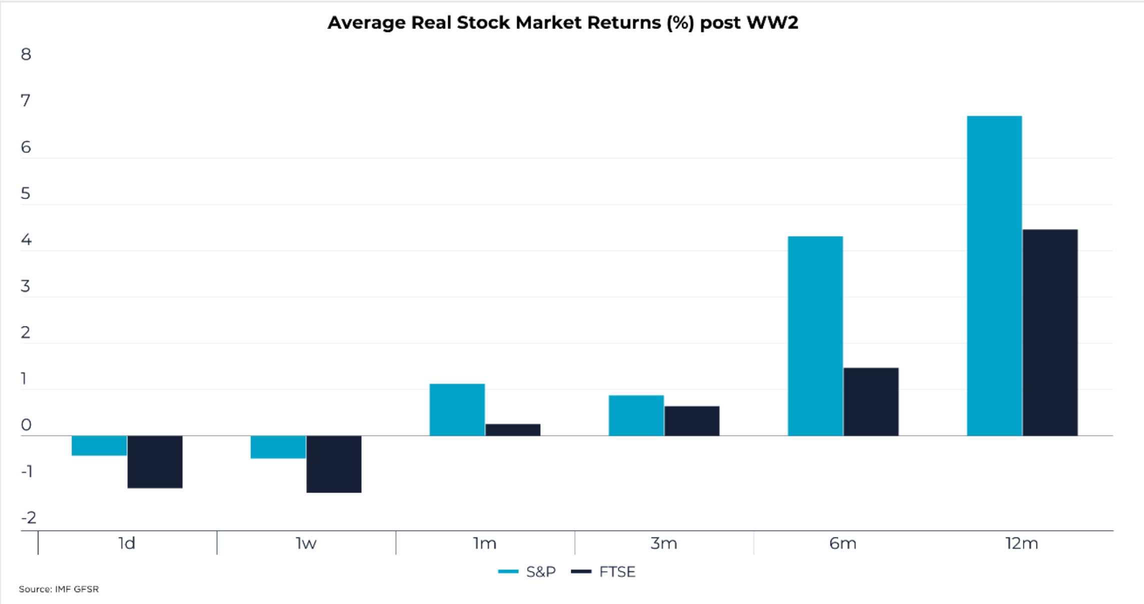
IMF's GFSR research (April 2025) outlines the ***transmission of geopolitical tension via the Financial and the Real channels*** on to asset prices and financial stability in both the short and the long term. Market sentiment and economic channels are the two channels through which both financial and physical assets are affected by geopolitics.

An increase in geopolitical risk can have an impact on prices of financial assets through two key channels.

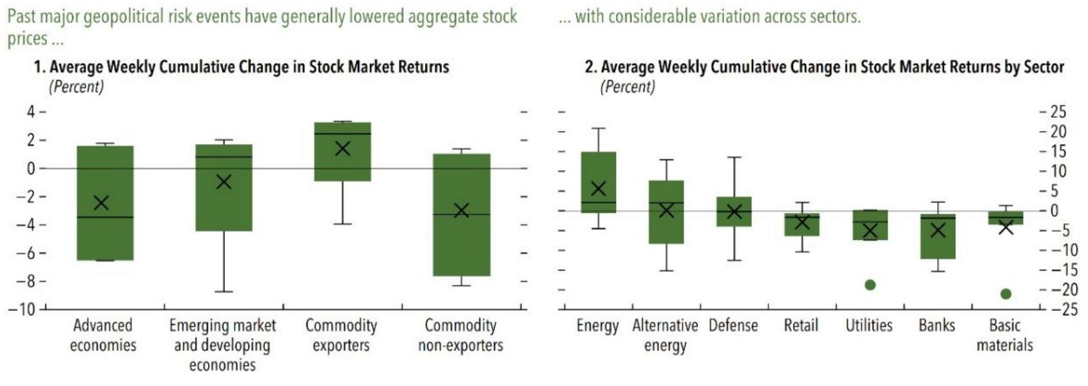


Source: IMF staff.
Note: FDI = foreign direct investment.

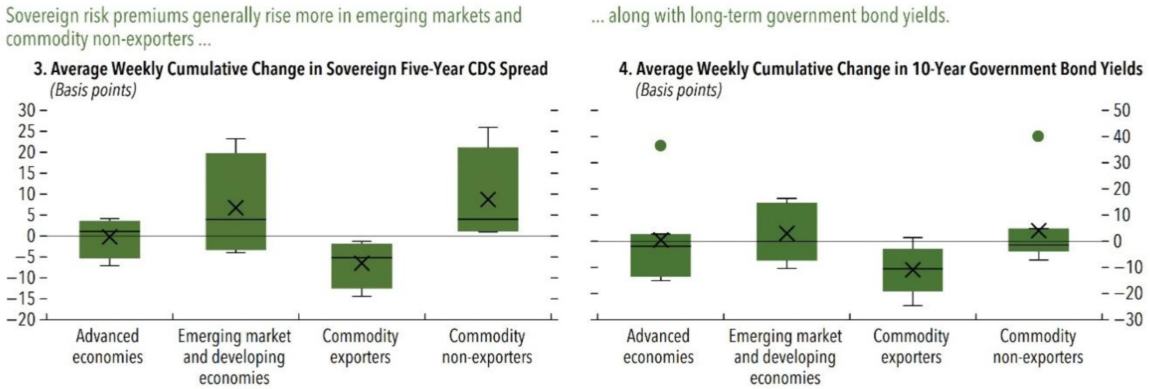
The IMF researchers found that stock prices tend to decline significantly during major geopolitical risk events as measured by more frequent news stories mentioning adverse geopolitical issues. The average monthly drop in stock prices is 1% across countries, but is much larger with 2.5% stock price drops in EM economies. Figure below shows the average real stock market returns after major geopolitical risk (GPR) events.



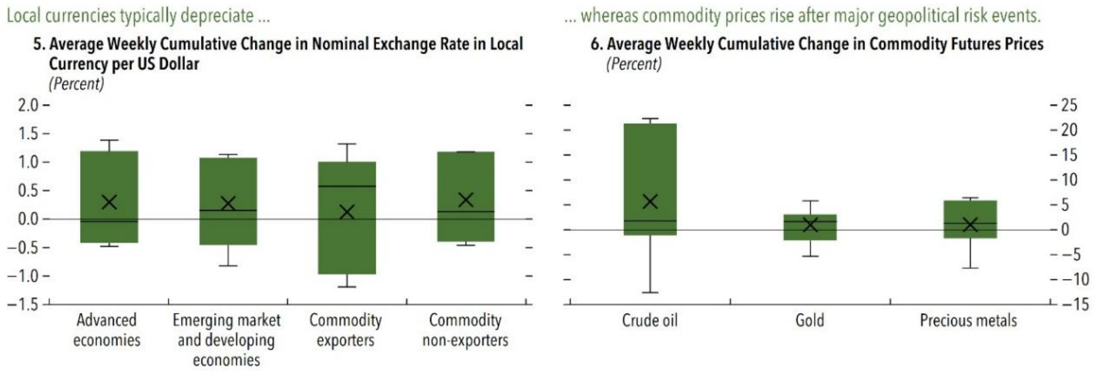
The IMF research (GFSR April 2025) found varying impact of GPR across countries and asset classes as below.



They record similar results of GPR impact on sovereign risk premia and government bond yields.



The IMF Research team also demonstrate the differences in GPR's impact on rising commodity futures prices and nominal exchange rate depreciations.



On average, aggregate asset prices exhibit a ***modest reaction*** to major geopolitical risk events, but the ***impact can be notable in some instances***. For example, aggregate stock prices across economies have generally declined in the immediate aftermath of major global GPR events. Although the average impact has been moderate, about 3 percent, some events have caused a substantially larger negative impact, up to 9 percent on average across countries. **The effects also vary based on country-specific factors.** Commodity-importing countries tend to suffer more, whereas commodity exporters often experience positive stock returns after major GPR events. Firm-level panel data analysis found that, in general, stock prices react more to international military conflicts than to other types of risk events, particularly in EM economies.

IMF's GFSR (April 2025) analysis further showed that stock prices reacted negatively to tariff announcements by China and the US during 2018–24. After announcements of tariffs on China by the US, the stock prices of Chinese firms declined by nearly 4 percent, on average. This decrease affected firms in both the directly impacted sectors and those in other sectors. The magnitude of the effect is notable, as the average stock return in these firms in the two-year period prior to the imposition of these tariffs was about 0.1 percent. Moreover, some US tariff announcements had an even larger impact on Chinese firms. For example, average stock returns declined by almost 8 percent on May 6, 2019, when the US announced tariff increases on Chinese products amounting to $200 billion.

4. Geopolitics and Financial/Economic Fragmentation

The term “economic and financial fragmentation” refers to the breakdown of integrated global or regional markets into smaller, isolated segments or blocs. This process, often driven by geopolitical tensions, regulatory divergence, and technological shifts, reverses decades of economic integration and carries significant potential costs for the global economy. It has gained popularity amongst policy makers and the multilateral institutions since the China-US trade war and the Russian invasion. GPRs are undermining the financial integration of the world post Bretton Woods in terms of multilateralism and also the future of institutions (WHO, WTO, World Bank, IMF etc). Building institutions has taken the global order a few decades, ongoing threats of dismantling and downsizing them are affecting the current operations of these globally operating multilateral institutions.

This section draws summarily from the Geneva Report 28[13] (2025). The report re-examines the impact of the recent rise in geopolitical fragmentation on the international financial landscape, the potential repercussions of further fragmentation, and the policy measures that could avert or mitigate its economic consequence.

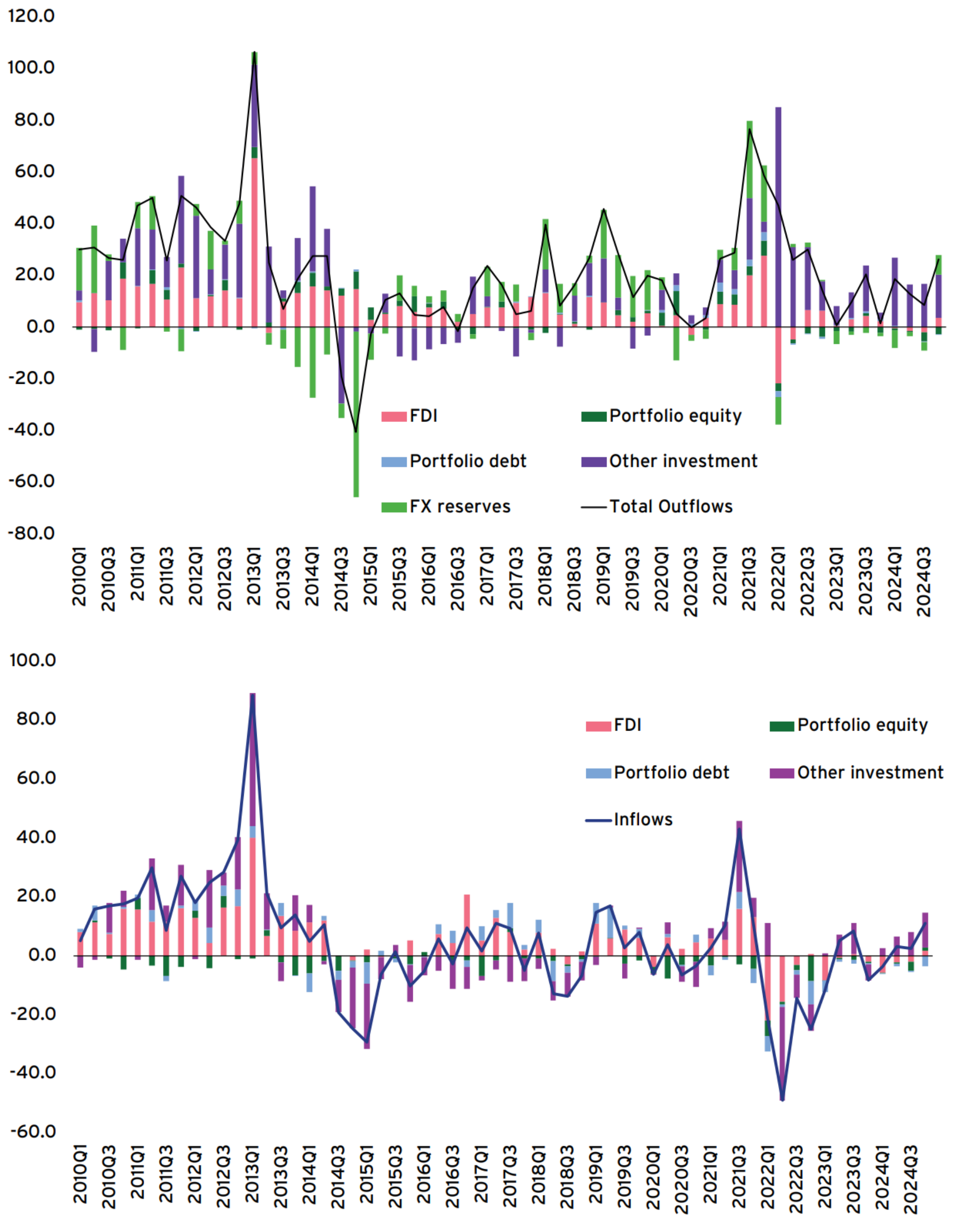
The benefits of international financial integration in play since the 1980s are widely known. While measures to strengthen resilience can reduce vulnerabilities to external shocks, *geoeconomic fragm*entation would adversely impact allocative efficiency, disrupting international risk sharing, weakening the global financial safety net, hampering international coordination and financial responses when crises were to occur. Moreover, **geopolitical tensions increase the frequency of real and financial shocks and through transmission mechanisms raise the cost of external finance, particularly for more financially vulnerable countries**.

At the end of 2013, the Russian economy was becoming increasingly integrated with global financial markets. Benefiting from high oil prices, Russia was running substantial current account surpluses, which made it a net creditor vis-à-vis the rest of the world, despite an undercount of asset accumulation by residents abroad due

[13] A. Chari, N Converse, A Mehl, G M Milesi-Ferretti & I. Vansteenkiste (2025), “Geopolitical Tensions and international Fragmentation: Evidence and Implications”

to historically large capital flight. This pattern changed sharply starting in 2014 as shown below.

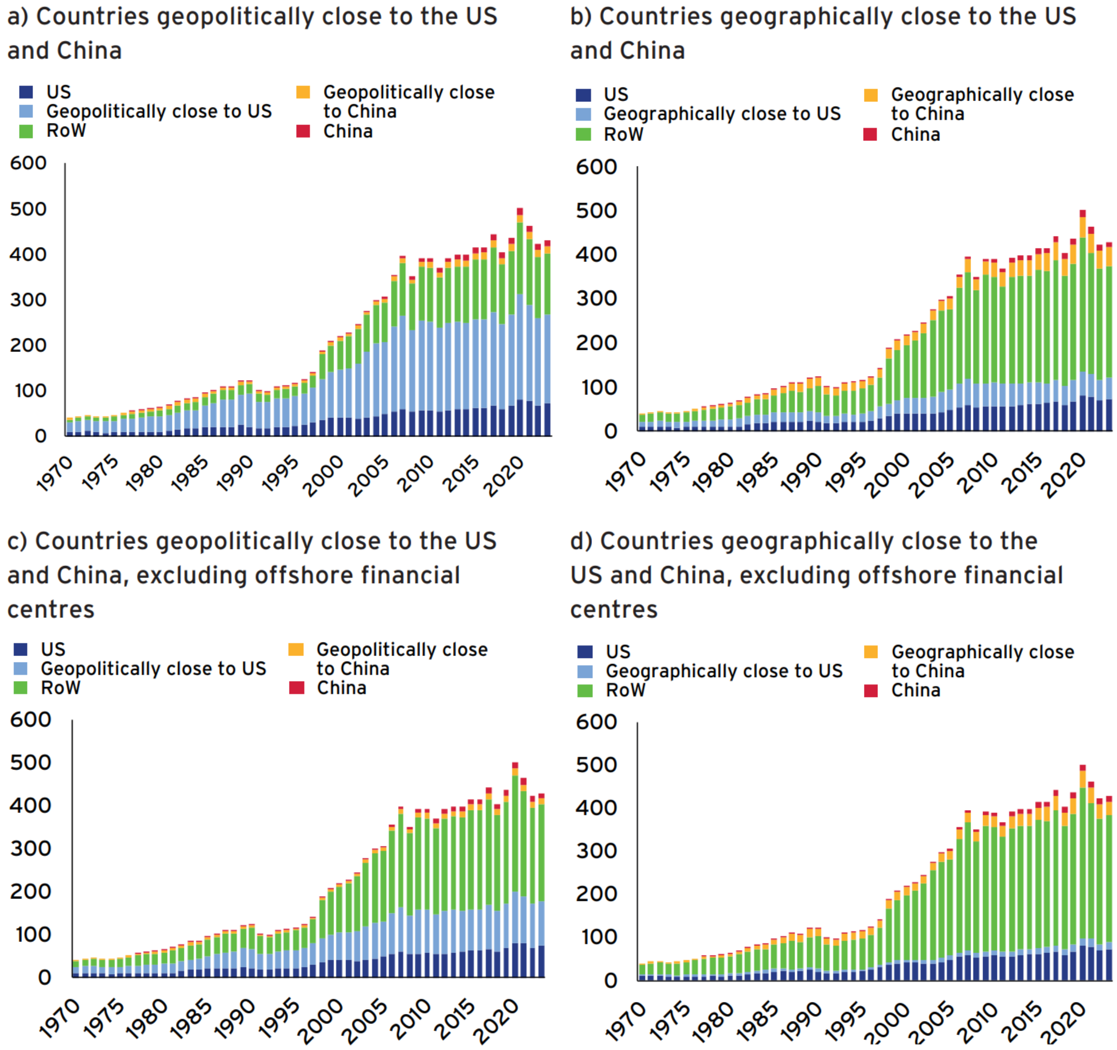
FIGURE 1.1 **RUSSIA: FINANCIAL INFLOWS (TOP) AND OUTFLOWS (BOTTOM), 2010-24 (US$ BILLIONS)**



Source: IMF, Balance of Payments Statistics and Central Bank of Russia.

Foreign financial inflows into Russia remained very modest in subsequent years, as Russian policymakers sought to increase financial autarky, including by repaying a sizeable portion of external debt (declined by over $200 billion between 2013 and 2015). In subsequent years inflows remained very low – total external liabilities at the end of 2020 were some $300 billion below those at the end of 2013. Financial claims increased with a rapid buildup of foreign exchange reserves, which exceeded $600 billion by the end of 2021. During this period, the reserves composition changed sharply, with the share of the euro and the dollar falling and the share of gold as well as the renminbi rising. The figures below which illustrate international financial integration as percent of world GDP,show how dominant the US and countries geopolitically close to US are in global finance (~ 65%) whereas China and Chinese geopolitical allies accounted for 3%. In contrast, we note that China accounts for 15% of global GDP and 13% of global trade.

Figure 11. International Financial Integration (% of World GDP)



Source: External Wealth of Nations and ECB staff calculations.

Notes: International financial integration ratio is the sum of stock of total gross external financial assets and liabilities. Latest observation: 2023

5. Conclusions

Historically unprecedented geopolitical risks have changed the international financial and investment landscape. We summarise academic and policy research evidence showing a world with greater geoeconomic and financial fragmentation, increasing geopolitical risks and their components, USD dominance in trade finance and as reserve currency continues. In addition, we show how geopolitical risks lead to adverse stock returns, increased sovereign risk premia (CDS and 10-year bond yields), weakened currencies and higher commodity prices. Emerging Market Developing Economies (EMDE) face disproportionately higher risks and vulnerabilities due to GPR's impacts on global trading system and payment systems.

Every asset class, every country and every investor is impacted in different ways by the ever-evolving dynamics of GPR in the current milieu of global international relations. All investors and of all types (individual or institutional, short or long term, real money or absolute return) need to understand these linkages to plan and invest accordingly. GPR affects portfolio returns and risk. We believe that it would be prudent to consider geopolitical risk as a dynamic constraint in asset allocation models.

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The views expressed are those of the author and do not necessarily reflect those of Lane Clark & Peacock LLP (LCP).

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