Geopolitical Risk and Extreme Capital Flow Episodes[*]

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Abstract

Do geopolitical risks affect the occurrence of "extreme capital flow episodes"? Using a panel of 57 economies from 1986Q1 to 2023Q4, we examine the effects of both global and country-specific geopolitical risks on the occurrence of the four types of extreme capital episodes ("surge", "stop", "flight", and "retrenchment"). We find no association between global geopolitical risks and the occurrence of extreme capital flow episodes for advanced economies and only a weak association for emerging economies. In contrast, country-specific geopolitical risks show no significant association for advanced economies but a significant association for emerging economies. Our results suggest that when country-specific geopolitical risk is high, an emerging economy is more likely to experience stop, flight, and retrenchment episodes and less likely to experience surge episodes, reflecting heightened risk perceptions among both domestic and foreign investors. For each episode, we further identify its key underlying flow type: banking flows for flight, direct investment flows for stop, and banking, debt, and equity flows for retrenchment. We also find that country-specific geopolitical risks became a more important driver of these episodes after the global financial crisis. These findings are robust to incorporating additional economic uncertainty indices, to excluding or adding certain control variables, to removing periods of dramatic global geopolitical risk fluctuations, and to employing alternative econometric methodologies.

Keywords: Global geopolitical risk; Country-specific geopolitical Risk; Extreme capital flow episodes; Emerging economies; Flight-to-safety; Flight-home effects;
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