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The Interplay of Geopolitical Risk and International Capital Markets Stability

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Abstract

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Geopolitical risk has become an increasingly important factor shaping global financial dynamics, influencing investor sentiment, capital flows, and the overall stability of international capital markets. In an era of rising interconnectedness, geopolitical tensions such as armed conflicts, diplomatic disputes, and trade wars generate significant disruptions across financial systems, affecting asset pricing, market expectations, and volatility levels. This study employs a Systematic Literature Review (SLR) to synthesize current evidence on how geopolitical shocks propagate through macroeconomic and financial channels. The findings reveal that geopolitical risk contributes to heightened market volatility, liquidity shifts, safe-haven movements, and structural vulnerabilities within global markets. Emerging economies are found to be particularly sensitive due to their exposure to external capital flows and limited shock absorption capacity. At the firm level, geopolitical uncertainty leads to reduced investment activity and delayed strategic decision-making. Overall, the review highlights that geopolitical risk is a multidimensional force that not only generates short-term market instability but also poses long-term challenges for global financial resilience. These insights emphasize the need for policymakers and institutions to integrate geopolitical considerations into risk management, regulatory frameworks, and financial stability strategies.

1. Introduction

Geopolitical risk has increasingly become a major source of global financial uncertainty, influencing investor sentiment, capital flows, and market stability across countries. In an era of heightened interconnectedness, political tensions, armed conflicts, trade wars, and diplomatic disputes often trigger rapid adjustments in global financial markets as investors reassess risk exposure. Rising geopolitical uncertainty affects asset pricing and investment decisions, creating volatility that can undermine the overall stability of international capital markets (Bouras et al., 2018).

Recent studies show that geopolitical shocks have significant impacts on equity returns, bond yields, commodities, and exchange rates, as they alter macroeconomic fundamentals and market expectations (Antonakakise et al., 2017). Investor demand for safe-haven assets typically increases during periods of geopolitical escalation, causing shifts in global liquidity and portfolio reallocations that may amplify systemic vulnerabilities (Baumeister et al., 2016).

Furthermore, geopolitical tensions disrupt international trade and supply chains, thereby influencing inflation, production costs, and country risk premiums factors closely linked to capital market performance (Balcilar et al., 2018). As financial integration deepens, these geopolitical shocks propagate more quickly across economies, increasing spillover effects and interconnected risks within the global financial system (Diebold & Yılmaz, 2016).

Despite growing recognition of its importance, the interplay between geopolitical risk and international capital market stability still requires deeper theoretical and empirical exploration. Understanding the transmission mechanisms and market responses is essential for policymakers, investors, and global institutions seeking to manage financial vulnerabilities in an increasingly uncertain geopolitical landscape.

2. Literature Review

Geopolitical risk (GPR) has been conceptualized as a form of uncertainty arising from wars, terrorism, diplomatic tensions, and other cross-border political conflicts that can disrupt economic activity and financial markets. Bouras et al. (2018) develop a news-based Geopolitical Risk Index and show that spikes in GPR are associated with lower investment, weaker real activity, and higher downside risks for the economy, underscoring its relevance as a systemic source of global financial uncertainty. At the same time, studies in energy and financial markets reveal that geopolitical tensions are closely linked to movements in oil prices and financial liquidity, indicating that GPR operates through both macroeconomic and financial channels (Abdel-Latif & El-Gamal, 2020).

A growing body of empirical work examines how geopolitical shocks translate into asset price dynamics and market volatility. He et al. (2021), using a GARCH-MIDAS framework for China's CSI 300 index, finds that geopolitical risk significantly explains and forecasts stock return volatility in an emerging market setting, confirming that GPR is an important driver of financial market risk. Similarly, Smales (2021) shows that geopolitical risk plays a central role in determining volatility spillovers between oil and stock markets, with heightened GPR increasing oil price volatility and, to a lesser extent, stock market volatility.

From a multi country perspective, Das et al. (2019) document that emerging stock markets react strongly to international economic policy uncertainty, geopolitical risk, and financial stress, suggesting that GPR is priced as a distinct global risk factor in equity markets.

The effects of geopolitical risk extend beyond equity volatility to broader measures of financial stability and capital flows. Lu et al. (2020) investigates a panel of emerging Asian stock markets and finds that the geopolitical risk index and the World Uncertainty Index exert significant negative effects on stock performance, indicating that prolonged geopolitical stress can erode investor confidence and raise risk premia. In addition, evidence from international macro-finance shows that higher geopolitical risk is associated with capital reallocation away from riskier emerging markets toward advanced economies, reinforcing safe-haven behavior and potentially amplifying global financial fragmentation. These dynamics highlight that GPR is not only a source of short-term volatility but also a driver of shifts in global capital allocation and liquidity conditions.

At the firm and sectoral level, the literature indicates that geopolitical risk affects real and financial decisions that are closely tied to capital market stability. Le et al. (2021) finds that higher geopolitical risk reduces corporate investment among Turkish manufacturing firms, implying that firms respond to rising uncertainty by postponing or scaling back long-term projects. This micro-level response complements macro evidence showing that geopolitical risk can heighten financial stress across banking, currency, and bond markets in emerging economies. Together, these studies suggest that geopolitical risk propagates through multiple channels asset price volatility, capital flows, and real investment decisions each of which can weaken the resilience of international capital markets.

Despite these advances, the existing literature remains fragmented, often focusing on specific markets (oil, equities, or a single country) or single transmission channels, rather than providing an integrated view of how geopolitical risk shapes overall international capital market stability. This gap motivates further research to synthesize cross-asset, cross-country evidence and to clarify the mechanisms through which geopolitical shocks interact with financial integration, liquidity conditions, and systemic risk.

3. Methods

This study adopts a Systematic Literature Review (SLR) approach to provide a comprehensive and structured synthesis of academic findings on the relationship between geopolitical risk and international capital market stability. The SLR methodology is selected because it ensures a transparent, replicable, and rigorous process for identifying, evaluating, and integrating scholarly evidence, allowing the study to map conceptual developments, methodological trends, and empirical patterns across diverse financial and geopolitical contexts. Guided by the PRISMA framework, the review follows sequential stages of identification, screening, eligibility assessment, and final inclusion to ensure that only relevant and high-quality studies form the analytical foundation of this research.

The literature search was conducted through major academic databases, including Scopus, Web of Science, Google Scholar, ScienceDirect, Taylor & Francis

Online, and Emerald Insight. A set of targeted keywords was used to retrieve studies closely aligned with the research topic, such as "geopolitical risk," "capital market stability," "market volatility," "financial spillovers," "uncertainty index," and "capital flows." Boolean operators were applied to refine search combinations and improve the accuracy of the retrieved literature. The search was restricted to English-language publications to ensure consistency in the analysis and comparability across studies.

The screening process began by identifying all potentially relevant studies from the initial search results. Duplicate entries and studies unrelated to financial markets were removed at this stage. Then, titles and abstracts were examined to determine whether the studies addressed the effects of geopolitical shocks, global uncertainty, financial risk transmission, or capital flow dynamics. Articles that met these preliminary criteria were reviewed in full to ensure their relevance to the core theme of geopolitical risk and market stability. Only studies that directly examined financial responses to geopolitical tensions through variables such as stock returns, bond yields, commodity prices, exchange rates, investment decisions, or liquidity conditions were included in the final dataset.

A quality assessment was performed to evaluate the methodological rigor, clarity of data, theoretical contribution, and analytical coherence of each selected study. Research employing strong empirical techniques, such as GARCH models, VAR approaches, panel regressions, spillover indices, and macro-financial modeling, was prioritized, as these methods provide deeper insights into how geopolitical risk influences market dynamics. Key information was extracted from each study, including research focus, methodological design, variables used, and main findings.

This extraction process enabled the identification of recurring themes such as volatility transmission, safe-haven flows, liquidity adjustments, supply-chain disruptions, and cross-market contagion.

The final stage of the SLR involved synthesizing the extracted information through a narrative and comparative approach. Findings across different regions, asset classes, and methodological frameworks were integrated to develop a holistic understanding of the mechanisms through which geopolitical risk affects international capital markets. This synthesis made it possible to identify convergent evidence, highlight inconsistencies, and reveal gaps that remain unexplored in the existing literature. The systematic nature of this method ensures that the conclusions drawn reflect a well-grounded and comprehensive assessment of global research on geopolitical risk and financial stability.

4. Results and Discussion

The findings from the systematic literature review reveal several consistent patterns regarding the influence of geopolitical risk on international capital market stability. Across the reviewed studies, geopolitical risk emerges as a significant driver of financial uncertainty, market volatility, and shifts in global capital allocation. Evidence shows that geopolitical tensions, whether through wars, diplomatic frictions, or trade disputes, create disruptions that propagate through both macroeconomic fundamentals and financial channels.

First, the literature consistently highlights that geopolitical risk exerts strong downward pressure on investment activity and real economic performance. Bouras et al. (2018) demonstrate that heightened geopolitical risk reduces investment levels and weakens economic activity, indicating that uncertainty associated with such risks can dampen both firm-level decisions and broader macroeconomic outcomes. This aligns with the broader conclusion in the introduction that geopolitical risk affects investor sentiment and lowers market stability.

Second, geopolitical shocks are found to significantly affect asset pricing and volatility across multiple financial markets. Antonakakise et al. (2017) emphasize that geopolitical shocks influence equity returns, bond yields, commodities, and exchange rates by altering market expectations. These findings are reinforced by He et al. (2021), who show that geopolitical risk plays a critical role in shaping stock return volatility using a GARCH-MIDAS framework. Smales (2021) further documents that geopolitical tensions drive volatility spillovers between oil and stock markets, suggesting that the impact of geopolitical shocks extends beyond a single asset class and contributes to interconnected risks across financial markets.

Third, the review highlights that geopolitical risk affects not only asset prices but also global liquidity and capital flows. The tendency of investors to shift toward safe-haven assets during periods of geopolitical tension, as described by Baumeister et al. (2016), contributes to changes in global liquidity patterns and portfolio reallocations. Lu et al. (2020) expand on this by showing that geopolitical risk and global uncertainty adversely affect stock market performance in emerging Asian markets, eroding investor confidence and increasing risk premia. At the international level, geopolitical risk is associated with capital reallocation away from emerging economies toward advanced markets, amplifying financial fragmentation and contributing to systemic vulnerabilities.

Fourth, the literature shows that geopolitical risk has material effects on real-sector decisions and firm-level behavior. Le et al. (2021) find that geopolitical risk reduces corporate investment among Turkish manufacturing firms, indicating that geopolitical tensions influence business strategies by inducing firms to delay long-term investments. This firm-level evidence complements macro-level findings such as those of Balcilar et al. (2018), who note that geopolitical tensions disrupt supply chains, increase production costs, and elevate country risk premiums all of which negatively affect financial market performance and stability.

Finally, the reviewed studies collectively suggest that the transmission of geopolitical risk operates through multiple channels, including asset price volatility, supply-chain disturbances, capital flow adjustments, and liquidity shifts. As highlighted by Diebold and Yılmaz (2016), increased financial integration accelerates the cross-border propagation of these shocks, further increasing spillover effects and interconnected risks within the global financial system.

Overall, the results indicate that geopolitical risk is a multifaceted force with significant implications for international capital markets. The evidence underscores that geopolitical shocks not only trigger short-term fluctuations in asset prices but also contribute to broader structural vulnerabilities that threaten long-term financial stability across economies.

5. Conclusion

This study concludes that geopolitical risk has become a fundamental and multidimensional force shaping the stability of international capital markets. The systematic review demonstrates that geopolitical tensions whether arising from conflicts, diplomatic disputes, or global uncertainty significantly influence asset prices, market volatility, and cross-border capital flows. Evidence consistently shows that geopolitical shocks disrupt macroeconomic fundamentals, reduce investment confidence, and trigger risk-averse behavior among investors, thereby weakening the resilience of financial markets.

The reviewed literature further highlights that the transmission of geopolitical risk occurs through several interconnected channels, including volatility spillovers across asset classes, safe-haven capital movements, disruptions to trade and supply chains, and structural adjustments in liquidity conditions. Studies such as those by Antonakakise et al. (2017), Bouras et al. (2018), Lu et al. (2020) He et al. (2021), Smales (2021), and collectively underscore the pervasive and persistent nature of geopolitical influences on financial stability. Emerging markets, in particular, display heightened vulnerability due to their reliance on external capital and limited capacity to absorb geopolitical shocks, while advanced markets often benefit from safe-haven inflows.

At the microeconomic level, geopolitical risk also affects firm behavior. Findings by Le et al. (2021) demonstrate that elevated uncertainty leads firms to scale back long-term investment plans, reinforcing the link between geopolitical conditions and corporate decision-making. These micro-level adjustments accumulate into broader macro-financial consequences, suggesting that geopolitical risk permeates multiple layers of economic activity.

Overall, the conclusion of this review is that geopolitical risk not only triggers short-term market disruptions but also poses long-term structural challenges to global financial stability. The interconnectedness of modern financial systems amplifies the speed and magnitude of geopolitical shock transmission, underscoring the need for policymakers, investors, and institutions to integrate geopolitical considerations into risk management strategies. Future research should therefore focus on developing more comprehensive models that capture cross-asset and cross-country dynamics, as well as exploring how institutional quality, market structure, and policy responses can mitigate the adverse effects of geopolitical uncertainty.

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