How do rising geopolitical tensions influence foreign equity investments by US institutional investors?

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Abstract

This paper investigates how geopolitical risk and international political disagreements influence foreign equity investment decisions by US institutional investors. We find empirical evidence that rising geopolitical tensions adversely affect foreign equity investments and indirectly influence these investments based on the type of global supply chain participation between the destination countries and the US. Our comparative analysis reveals a heterogeneous impact of rising geopolitical tensions, with emerging markets experiencing sharper declines in foreign investments compared to advanced markets.

JEL Classifications:

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1. Introduction

Since the end of the Cold War, the global economy has become more integrated through increased trade, investment, and supply chains. However, the recent increase in geopolitical tensions, such as the China-US trade conflicts and Russia's invasion of Ukraine, highlights the risks to this integration. These events reveal the vulnerability of global integration to geopolitical challenges, yet studies on their impact on cross-border investment decisions remain limited.

Given this context, our paper seeks to uncover empirical evidence regarding the impact of geopolitical risk and international political discord on foreign equity investment decisions by US institutional investors. We have specifically chosen to focus on the US as the source of foreign investment due to its status as the largest contributor to foreign investments globally. By narrowing our scope to a single source country, we aim to streamline our empirical analysis, reducing potential heterogeneity that may arise from considering multiple source countries.

Geopolitical risk can impact foreign equity investment decisions through two key channels: financial and real (International Monetary Fund, 2023), as illustrated in Figure 1. Increased tensions between countries can directly influence financial decisions via the financial channel, such as the potential for financial restrictions or heightened risk and risk aversion among investors (Broner et al., 2013; Fratzscher, 2012). Additionally, increased tensions can alter economic relationships in real sectors, such as trade and supply chains, indirectly affecting investment decisions (Davis and Van Wincoop, 2018).

Figure 1. Key channels of transmission of geopolitical tensions
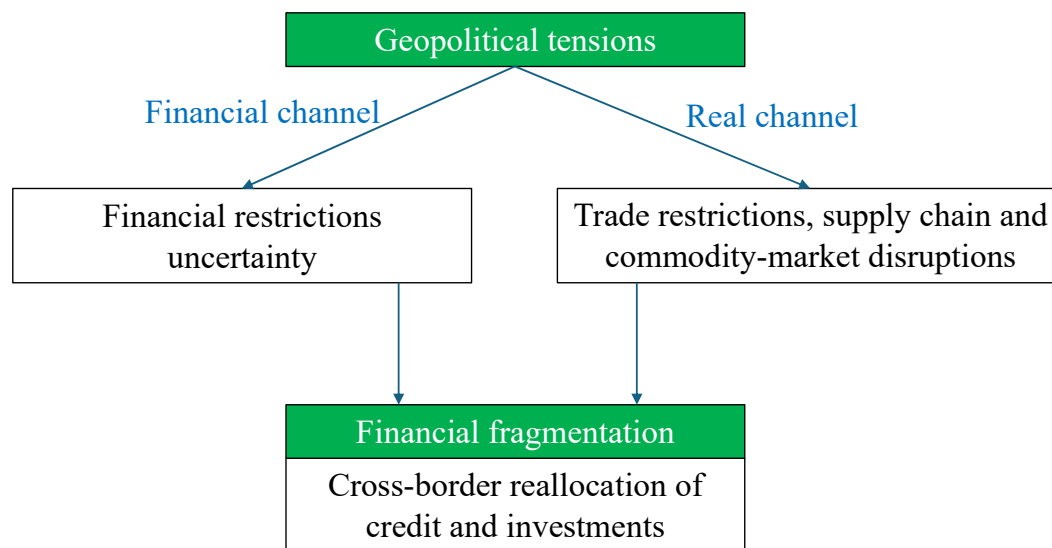
Source: International Monetary Funds (2023)

In our paper, we empirically analyze both the direct effects of geopolitical risk and political disagreements on foreign investment through the financial channel, as well as the indirect effects through global value chains (GVCs). Our paper contributes to the body of literature documenting the effects of geopolitical risk on the dynamics of international capital flows (Feng et al., 2023) by focusing on US institutional investors' equity allocations. Additionally, our paper extends the supply chain literature by examining how indirect trade linkages influence financial integration (Di Giovanni and Hale, 2022). Furthermore, we demonstrate that bilateral political distance significantly impacts decisions regarding cross-border equity investments.

2. Empirical Framework and Data

To analyze the relation between the geopolitical tensions and US institutional cross-border equity investments, we employ the following panel regression framework:

$$Holdings_{it} = \alpha_1 Political\ Distance_{it} + \alpha_2 GPRC_{it} + \alpha_3 GPRUS_t + \alpha_4 Forward\ GVC_{it} + \alpha_5 Backward\ GVC_{it} + X'\theta + \gamma_i + \varepsilon_{it}. \qquad (1)$$

The variable $Holdings_{it}$ is the logarithm of the ratio of the market value of equities held by US institutional investors to the total market value of all equities in in a destination country i in year t. The holdings data of US institutional investors in non-US equities are sourced from FactSet Ownership[1] and aggregated based on the domicile countries of the firms whose equities are held by the investors. Constructing the holdings data as the ratio described above has the advantage of making the holdings independent of country-wide price changes.

$Political\ Distance_{it}$ is the bilateral political relations between the destination country i and the United States, estimated by state ideal points that reflect state positions toward the US-led liberal order based on the United Nations General Assembly (Bailey et al., 2017).

$GPRC_{it}$ and $GPRUS_t$ represent the country-level geopolitical risks of destination country i and the United States, respectively, as constructed by Caldara and Iacoviello (2022). The destination countries are chosen based on the availability of Geopolitical Risk (GPR) index.

$Forward\ GVC$ and $Backward\ GVC$ denote the shares of a country's GVC-related exports derived from Inter-Country Input-Output (ICIO) data in the OECD TiVA database, following the source-based approach in Borin and Mancini (2023). $Forward\ GVC$ refers to the domestic value added in exported intermediate goods that will contribute to the international sharing of production (GVC) going forward. $Backward\ GVC$ represents the portion of exports that have already been part of the GVC before export, essentially the import content of GVC-related exports.

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[1] We process the FactSet Ownership data following the methodologies of Bartram, Griffin, Lim, and Ng (2015).

We also include a vector of control variables X to control for other factors influencing cross-border equity investment. VIX is included to control for global financial uncertainty. Trade volume defined by the sum of exports and imports between the destination country and the United States is included to control for the relationship between trade and international investment. γ_i denotes country-fixed effects. Our sample period extends from 2000 to 2020, encompassing 40 destination countries. This timeframe is selected due to the comprehensive coverage of FactSet ownership data commencing from 2000.

3. Empirical Results

Our main estimation results are presented in Table 1. The significant negative relationship between the geopolitical risk of the destination country (GPRC) and Holdings indicates that increased geopolitical risk in the destination country correlates with decreased investment by US investors in that country. Additionally, we observe that greater political distance between the US and the destination country is associated with reduced US investor investments in the destination country. These findings suggest that rising geopolitical tensions adversely impact cross-border equity investments, aligning with our financial channel hypothesis.

Both forward GVC participations by the destination country and the U.S. show statistically significant relationships with Holdings. This implies that an increase in forward GVC participation between the US and the destination country corresponds to higher equity investments in the destination country by US investors. Comparing the coefficients for forward GVC participation of the destination country and the US, we find that forward GVC participation by the destination country is approximately five times more influential on US investor investments compared to forward GVC participation by the US. Moreover, the inclusion of GVC variables and the resulting insignificance of our trade variable suggest that the relationship between investment and trade may be explained by relationships within the global value chain.

Table 1. Main results

VARIABLES	(1) Holdings	(2) Holdings	(3) Holdings	(4) Holdings	(5) Holdings
VIX	-0.014**	-0.0128**	-0.014**	-0.010***	-0.015**
	(0.0055)	(0.0052)	(0.0055)	(0.0035)	(0.0067)
Trade	0.185**	0.165*	0.219**	-0.0509	0.0198
	(0.0711)	(0.0927)	(0.0975)	(0.0763)	(0.111)
Political Distance	-0.346***	-0.273*	-0.344***	-0.169	-0.312**
	(0.118)	(0.143)	(0.115)	(0.135)	(0.129)
GPRC	-0.212**		-0.223**	-0.264***	-0.221**
	(0.0856)		(0.0986)	(0.0912)	(0.0984)
GPRUS		-0.131	0.0609	-0.0667	0.0828
		(0.0878)	(0.130)	(0.122)	(0.141)
Forward GVC (Destination)				21.36***	11.20***
				(3.289)	(3.402)
Forward GVC (US)				4.338***	3.797***
				(0.823)	(0.498)
Backward GVC (Destination)				0.807	
				(1.176)	
Backward GVC (US)				-12.39***	
				(2.447)	
Constant	0.864	0.801	0.452	1.949*	1.104
	(0.846)	(1.133)	(1.171)	(1.073)	(1.221)
Observations	775	775	775	775	775
Adjusted R-squared	0.817	0.809	0.817	0.837	0.825

Clustered standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

In Table 2, we examine the relationship between GVC participation variables and our measures of geopolitical tensions. Our regression results show that the coefficient for political distance is significantly negative for forward GVC participation by the destination country. This suggests that heightened political tensions between the US and the destination country could lead the US to decrease imports intended for further processing and re-export. Regarding country-level geopolitical risks, GPRUS is negatively associated with all GVC participation variables, whereas destination country-specific geopolitical risks are less important.

These findings indicate that heightened political tensions, whether stemming from increased disagreement or greater geopolitical risks in the US, significantly dampen GVC participation, particularly affecting forward GVC participations. Given the significance of forward GVC variables on cross-border equity investments as shown in Table 1, we infer that as political tensions manifest through forward GVC participation, persistent effects on cross-border investments may ensue.

Table 2. GVC participation and geopolitical tensions

VARIABLES	(1) Forward GVC (Destination)	(2) Forward GVC (US)	(3) Backward GVC (Destination)	(4) Backward GVC (US)
Political Distance	-0.0164***	0.0019	-0.0019	-0.0010
	(0.0038)	(0.0067)	(0.0082)	(0.0070)
GPRC	0.0005	0.0012	0.0047**	-0.0032*
	(0.0008)	(0.0018)	(0.0018)	(0.0017)
GPRUS	-0.0090**	-0.0146***	-0.0292***	-0.0180**
	(0.0033)	(0.0032)	(0.0044)	(0.0072)
Constant	0.101***	0.201***	0.252***	0.119***
	(0.0085)	(0.0163)	(0.0196)	(0.0180)
Observations	799	799	799	799
Adjusted R-squared	0.843	0.914	0.927	0.570

Clustered standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Next, we examine whether our main results differ between developed and emerging economies. According to IMF market classifications, 18 countries are categorized as developed markets and 22 as emerging markets.

Table 3 presents the results of our main regression analysis, using separate samples for advanced and emerging economies. We find several interesting differences between the two groups. Trade volume is significantly associated with foreign equity investments in advanced markets, consistent with the findings by Lane and Milesi-Ferretti (2008). However, this association is not as significant in emerging markets. Regarding political tensions, equity investments in emerging markets are significantly associated with our measures of political tensions. In advanced markets, however, these measures are not as important, except for the geopolitical risk associated with the US.

The coefficient on forward GVC participation by emerging markets is highly significant and large in magnitude, indicating that being a GVC supplier in emerging markets to the US is associated with larger equity investments by US institutional investors. This is not true for advanced markets, where the same coefficient is not significant. Forward GVC participation by the US is significant in both groups, indicating that being a GVC-related customer of the US is associated with larger equity investments in both emerging and advanced markets.

Table 3. Comparison of advanced and emerging economies

VARIABLES	Advanced		Emerging	
	(1) Holdings	(2) Holdings	(3) Holdings	(4) Holdings
VIX	-0.006**	-0.007**	-0.020***	-0.021**
	(0.0028)	(0.0026)	(0.0066)	(0.0091)
Trade	0.601***	0.289***	0.139	-0.097
	(0.0726)	(0.0695)	(0.106)	(0.122)
Political Distance	-0.012	-0.049	-0.552***	-0.564***
	(0.0850)	(0.0650)	(0.156)	(0.176)
GPRC	0.0604	0.0663*	-0.311***	-0.314***
	(0.0361)	(0.0317)	(0.109)	(0.108)
GPRUS	-0.160**	-0.204***	0.235	0.256
	(0.0638)	(0.0540)	(0.163)	(0.187)
Forward GVC (Destination)		4.183		15.14***
		(2.597)		(3.579)
Forward GVC (US)		4.782***		2.859***
		(0.449)		(0.833)
Constant	-4.197***	-1.899**	1.705	2.704*
	(0.857)	(0.726)	(1.385)	(1.438)
Observations	359	359	416	416
Adjusted R-squared	0.784	0.811	0.793	0.803

Clustered standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

4. Conclusion

In this paper, we investigate the impact of geopolitical tensions, using measures of geopolitical risks and international political disagreements, on foreign equity investments by US institutional

investors. We find empirical evidence that geopolitical risk plays a significant role in foreign equity investment decisions, especially for investments in emerging markets, contributing to the rapidly growing literature on geopolitical risk.

Additionally, we demonstrate that economic linkages via global supply chains play crucial roles in foreign equity investment allocations. Our findings indicate that traditional international trade alone may not suffice to explain foreign equity investment allocations and that forward GVC participation can be an important factor for foreign investments by US investors, particularly for investments in emerging market equities. The importance of forward GVC participation is especially noteworthy because it is highly sensitive to our measures of geopolitical tensions.

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