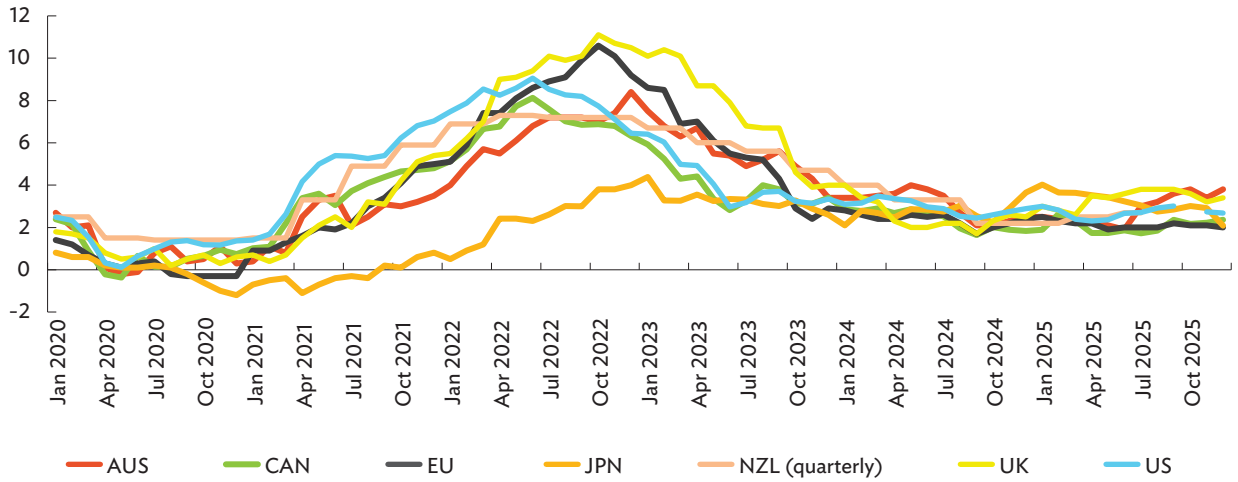
4 Financial Integration

Financial Resilience and Integration Amid Global Uncertainties

With Inflation Pressures Moderating, Policy Rate Differentials Influence Regional Capital Flows

Regional capital markets performed well in the first half of 2025, partly supported by the resumption of net nonresident portfolio inflows following net outflows toward the end of 2024. Following the central bank policy rate cut cycle in 2024, the United States (US) Federal Reserve maintained its policy rate at 4.37% throughout the first half of 2025. In September, it began lowering its policy rate, reaching a target range of 3.50%–3.75% in December after cutting the Fed Fund rate three times. With inflation gradually easing in advanced economies (Figure 4.1), the Reserve Bank of Australia, Bank of Canada, European Central Bank, Reserve Bank of New Zealand, and Bank of England also lowered benchmark interest rates. Central banks in developing Asia mirrored the easing trajectory, but at varying paces depending on domestic economic conditions and consideration of the potential impact of external economic uncertainties. This differentiated approach underscored the need for policymakers to balance internal economic objectives with external risks linked to global trade developments.

Figure 4.1: Inflation—Selected Advanced Economies *(%)*



AUS = Australia, CAN = Canada, EU = European Union (27 members), JPN = Japan, NZL = New Zealand, UK = United Kingdom, US = United States.

Note: Inflation refers to the year-on-year change of the consumer price index. US inflation data for October 2025 is not available.

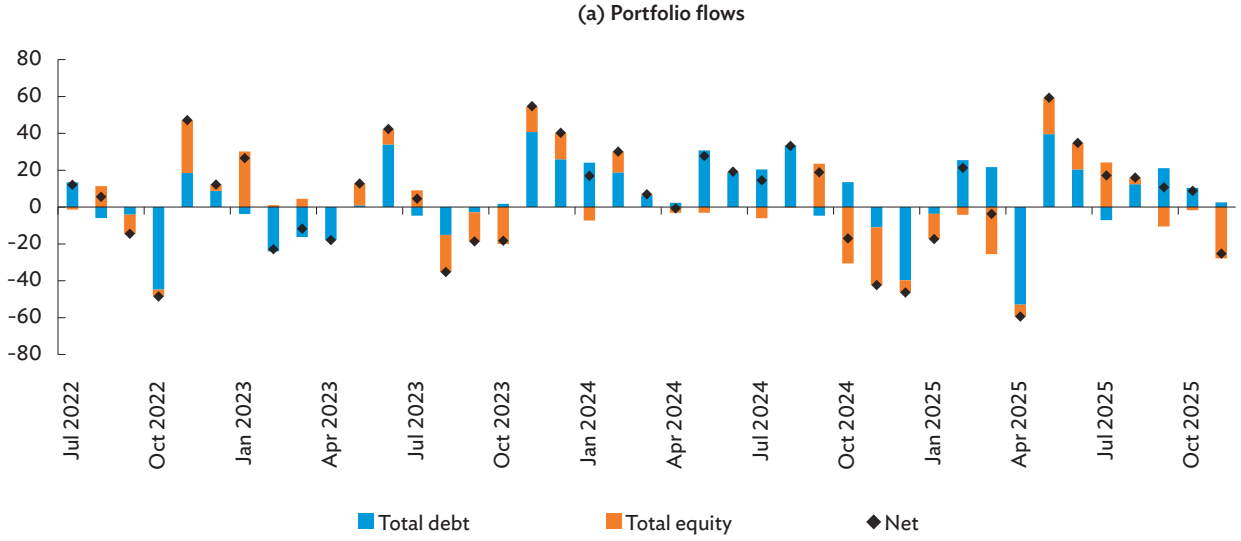
Source: CEIC Data Company (accessed January 2026).

Capital flows to Asia and the Pacific responded to changing policy uncertainties in global markets.[1] The region recorded portfolio outflows in the first quarter of 2025, given higher-for-longer interest rates in the US and elevated uncertainty around its trade policy. Portfolio inflows resumed in May 2025 with the announcement of a 90-day pause on the new US import tariffs introduced on 2 April, and as trade negotiations started. In the meantime, the Republic of Korea, the People's Republic of China (PRC), and Türkiye posted the region's highest net portfolio inflows until November 2025 (Figure 4.2a). Positive inflows into the PRC in the first half of 2025 were driven by foreign direct investment (FDI), while equity market sentiment improved following the government's stimulus package, including fiscal and monetary stimulus and capital-market support. These inflows were partly offset by outflows in the third quarter of 2025 (Figure 4.2b). Overall, positive policy rate differentials between the US and Asian economies continued to support the search for yield motive in Asia (Figure 4.3). The US dollar depreciated by 1.3% against a weighted average of Asian currencies in 2025 (ADB 2025). The depreciation supported local currency assets' rising valuations in US dollar terms, attracting capital inflows into the region although the recent strength of the US dollar has unwound the trend of strengthening local currency values in the region to some extent.

Regional Financial Markets Remain Resilient

Variations in equity and bond returns reflected greater sensitivity to global than regional shocks (Figure 4.4). The US tariff announcement on 2 April triggered losses in regional markets of 10.4% for equities and 1.24% for bonds on a market-weighted basis. As investor

Figure 4.2: Nonresident Capital Flows—Selected Asian Economies ($ billion)

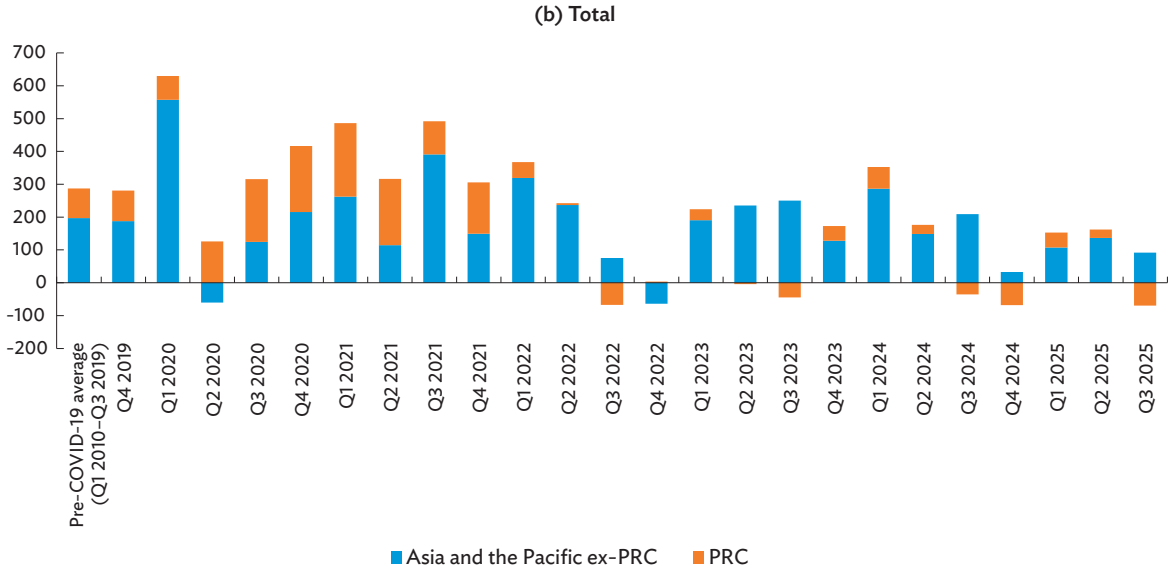


Notes: Positive values denote net inflows, negative values denote net outflows. Selected Asian economies include India; Indonesia; the Republic of Korea; Malaysia; Mongolia; Pakistan; the Philippines; Sri Lanka (equity only); Taipei,China; Thailand; Türkiye; and Viet Nam (equity only).

Source: ADB calculations using data from the Institute of International Finance. Capital Flows Tracker. https://www.iif.com (accessed January 2026).

[1] Asia and the Pacific (or Asia) refers to the 50 regional members of the Asian Development Bank (ADB), comprising 47 developing economies as well as three advanced economies—Australia, Japan, and New Zealand. The composition of economies for Central and West Asia, East Asia (including Japan), the Pacific (developing economies plus the advanced economies of Australia and New Zealand), South Asia, and Southeast Asia are outlined in ADB. Asia Regional Integration Center. Economy Groupings. https://aric.adb.org/integrationindicators/groupings. Beginning with this year's edition of the *Asian Economic Integration Report*, Türkiye is included among the developing member economies. For further details, refer to the note in Chapter 6: Statistical Appendix.

Figure 4.2: continued



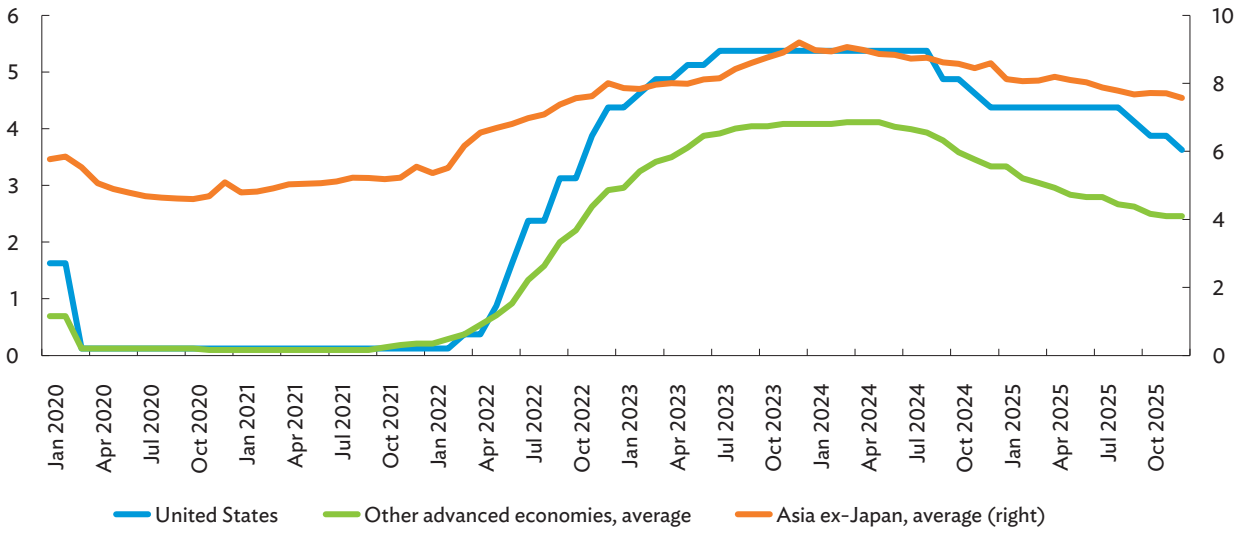
PRC = People's Republic of China, COVID-19 = coronavirus disease, Q = quarter.

Notes:

(i) Nonresident capital flows are composed of foreign direct investment, portfolio equity and debt flows, and other investment flows. Other investment flows include currency and deposits; insurance, pension, and standardized guaranteed schemes; loans; other accounts payable; other equity; special drawing rights; and trade credit and advances.
(ii) Positive values denote net inflows; negative values denote net outflows.
(iii) Selected Asian economies refer to Armenia; Azerbaijan; Bangladesh; Cambodia; the People's Republic of China; Fiji; Georgia; Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; Malaysia; Pakistan; the Philippines; Samoa; Tajikistan; Taipei,China; Thailand; and Uzbekistan.

Source: ADB calculations using data from the International Monetary Fund. Balance of Payments and International Investment Position Statistics. Accessed from CEIC Data Company (accessed January 2026).

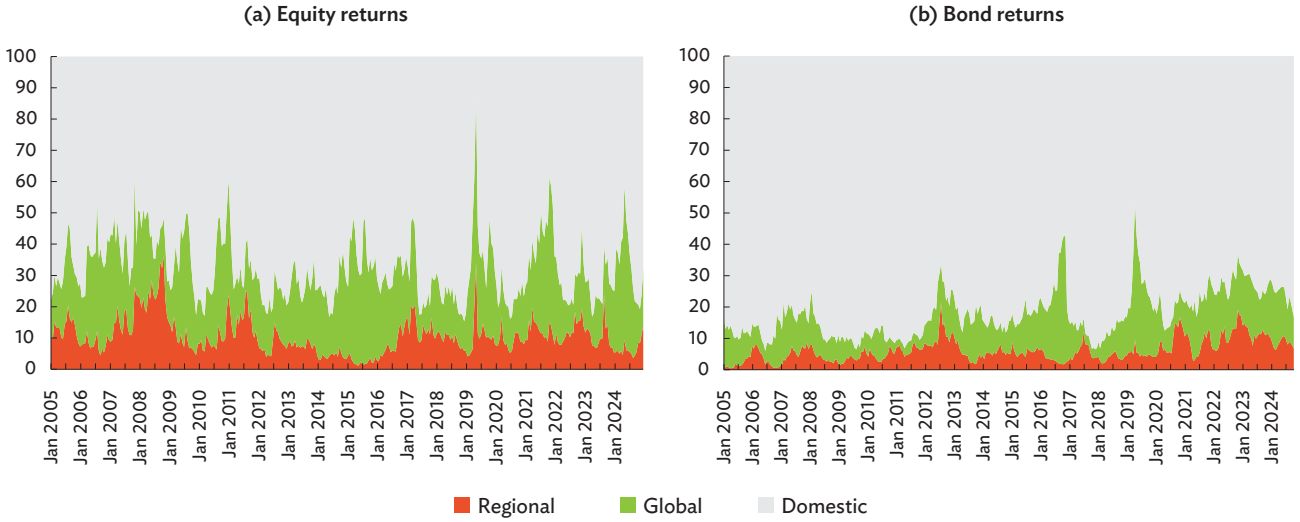
Figure 4.3: Monetary Policy Rates *(%)*



Notes: Advanced economies include Australia; Canada; euro area; Japan; New Zealand; and the United Kingdom. Asian economies include Armenia; Azerbaijan; Bangladesh; the People's Republic of China; Georgia; Hong Kong, China; India; Indonesia; Kazakhstan; the Republic of Korea; the Kyrgyz Republic; the Lao People's Democratic Republic; Malaysia; Mongolia; Nepal; Pakistan; the Philippines; Singapore; Sri Lanka; Taipei,China; Tajikistan; Thailand; Türkiye; Uzbekistan; and Viet Nam.

Source: ADB calculations using data from CEIC Data Company (accessed January 2026).

Figure 4.4: Variance Decomposition of Equity and Bond Returns—Asia *(%)*



Notes: Asia includes Australia; Bangladesh (equities only); Cambodia (equities only); the People's Republic of China; Georgia (equities only); Hong Kong, China; India; Indonesia; Japan; Kazakhstan; the Republic of Korea; the Kyrgyz Republic (equities only); the Lao People's Democratic Republic (equities only); Malaysia; Mongolia (equities only); Nepal (equities only); New Zealand (equities only); Pakistan (equities only); the Philippines; Singapore; Sri Lanka (equities only); Taipei,China; Thailand; Uzbekistan (equities only); and Viet Nam.

Sources: ADB calculations using data from Bloomberg; CEIC Data Company (both accessed January 2026); and methodology by Lee and Park (2011) using 1-year rolling window estimations.

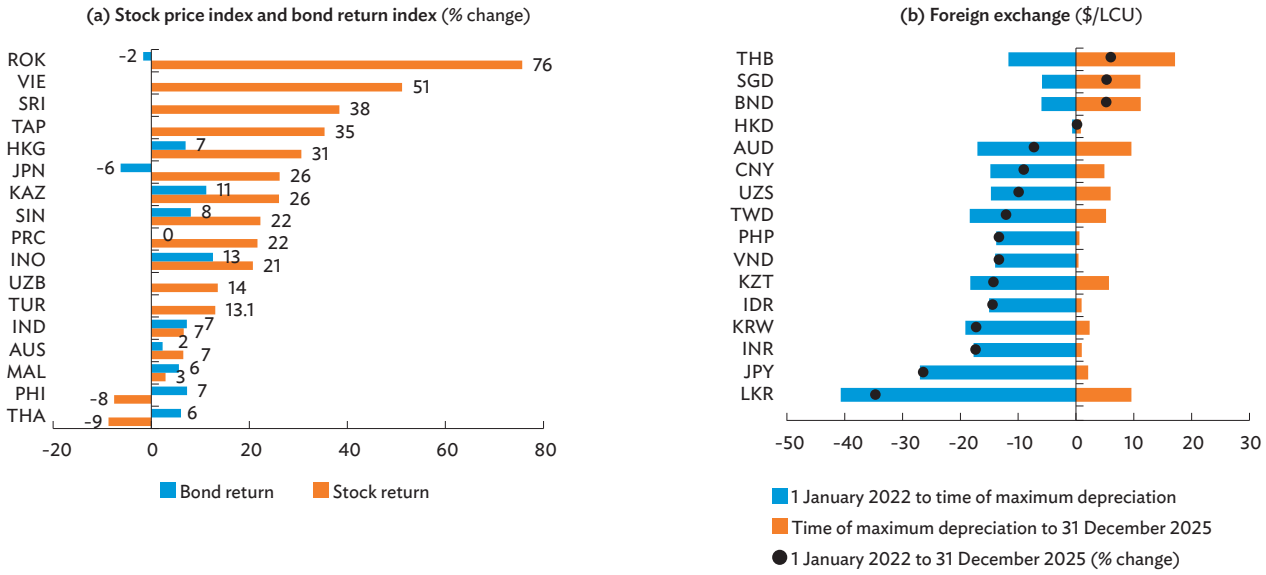
sentiment improved with the announcement of a 90-day pause in tariff implementation, markets recovered such that average regional stock prices gained 22.0% and bond prices increased by 5.0% by the end of the year. Stock price gains were the highest in the Republic of Korea, Viet Nam, and Sri Lanka (Figure 4.5a). The heightened trade uncertainty initially weakened local currencies in the first half of 2025, which was followed by a swift recovery in the second half of the year, led by the Thai baht and the Singapore dollar. Many currencies, however, have struggled to recover from the broad-based depreciation against the US dollar even after the US Fed began lowering the benchmark interest rate in 2024. Meanwhile, domestic economic pressures drove the depreciation of local currency values in some economies, such as the Sri Lankan rupee and the Philippine peso (Figure 4.5b). On the price front, the impact of global factors on equity returns intensified in 2024, while the impact of regional factors increased toward the end of the year. Meanwhile, bond returns became less sensitive to both regional and global factors while in terms of magnitude, the impact of regional factors does not lag far behind that of global factors, as depicted in the variance decomposition exercise in Figure 4.4 (see Box 4.1 for a detailed explanation of the methodology).

Intraregional Exposures Increased Slightly in 2024

Asia's intraregional share of cross-border assets remained at 36%, while the share for cross-border liabilities rose by 1 percentage point to 37%. On the assets side, the intraregional share of portfolio debt posted a modest increase by 0.5 percentage points to 22.2% in 2024. Portfolio equity followed a similar pattern, increasing from 21.1% in 2023 to 21.5% in 2024. In absolute terms, estimates show that intraregional portfolio debt expanded from $1.1 trillion in 2023 to $1.2 trillion in 2024. Likewise, portfolio equity grew by $0.2 trillion to $1.6 trillion over the same period (Figure 4.6). On the liabilities side, the intraregional share of both portfolio debt and equity rose by 2 percentage points, reaching 31% and 22% in 2024, respectively. A slight increase in absolute values was also recorded, with portfolio debt rising to $1.2 trillion and portfolio equity to $1.6 trillion in 2024 (Figure 4.7).

The larger increase in intraregional shares for portfolio liabilities relative to portfolio assets indicates the growing role of regional markets for financing. Further

Figure 4.5: Year-to-Date Change—Selected Asian Economies (as of 31 December 2025)



AUD = Australian dollar; AUS = Australia; BND = Brunei dollar; PRC = People's Republic of China; CNY = yuan; HKD = Hong Kong dollar; HKG = Hong Kong, China; IDR = rupiah; IND = India; INO = Indonesia; INR = Indian rupee; JPN = Japan; JPY = yen; KAZ = Kazakhstan; ROK = Republic of Korea; KRW = won; KZT = tenge; LCU = local currency unit; LKR = Sri Lanka rupee; MAL = Malaysia; PHI = Philippines; PHP = peso; SGD = Singapore dollar; SIN = Singapore; SRI = Sri Lanka; TAP = Taipei,China; THA = Thailand; THB = baht; TUR = Türkiye; TWD = NT dollar; UZB = Uzbekistan; UZS = sum; VIE = Viet Nam; VND = dong.

Source: ADB calculations using data from Bloomberg and CEIC Data Company (both accessed in January 2026).

Box 4.1: Methodology for Variance Decomposition

Regional and the global variance decompositions are computed using the following formulas:

$$VR^{EA}_{c,t} = \frac{\left(\beta^{EA}_{c,t}\right)^2 \sigma^2_{EA,t}}{\sigma^2_{c,t}} \quad VR^{G}_{c,t} = \frac{\left(\beta^{G}_{c,t}\right)^2 \sigma^2_{G,t}}{\sigma^2_{c,t}}$$

where $VR^{EA}_{c,t}$ and $VR^{G}_{c,t}$ are the regional and global variance of economy c, at time t, respectively. $\beta^{EA}_{c,t}$ and $\beta^{G}_{c,t}$ are the economy-specific sensitivity to the regional and global beta at time t, respectively. These were obtained from the following equation:

$$\varepsilon_{c,t} = \alpha_{c,t} + \beta^{EA}_{c,t}\varepsilon_{EA,t} + \beta^{G}_{c,t}\varepsilon_{G,t}$$

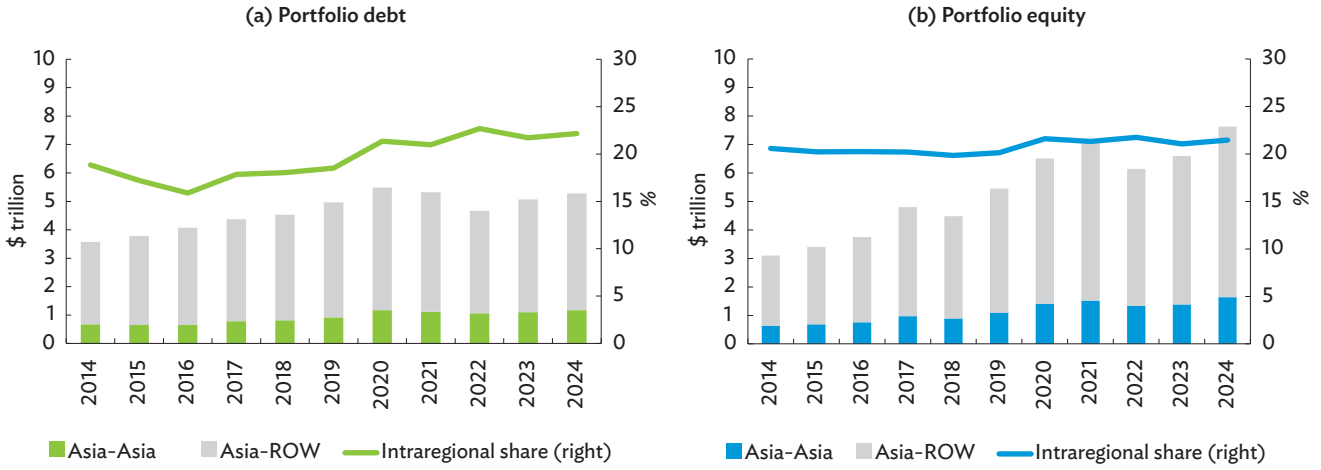
The formula was applied on a rolling basis, with 52 weekly data points. $\sigma^2_{EA,t}$ and $\sigma^2_{G,t}$ are the regional conditional variance and global conditional variance, estimated from the equation above. They are assumed to follow a standard asymmetric GARCH (1, 1) process. $\varepsilon_{EA,t}$ and $\varepsilon_{G,t}$ are the unexpected components of equity (bond) market returns, which are proxied by the error terms obtained from the regression equation where $r_{c,t}$ is the weekly equity (bond) returns of each individual economy.

$$r_{c,t} = \delta_{0\,c,t} + \delta_{1\,c,t-1} r_{c,t-1} + \varepsilon_{c,t}$$

The "Asia index" or regional component of each economy is created using the weighted sum of the index of individual economies, excluding the economy considered. Current gross domestic product in United States dollars is the weight for the Asia indexes.

Source: Lee and Park (2011).

Figure 4.6: Cross-Border Assets—Asia and the Pacific, by Type

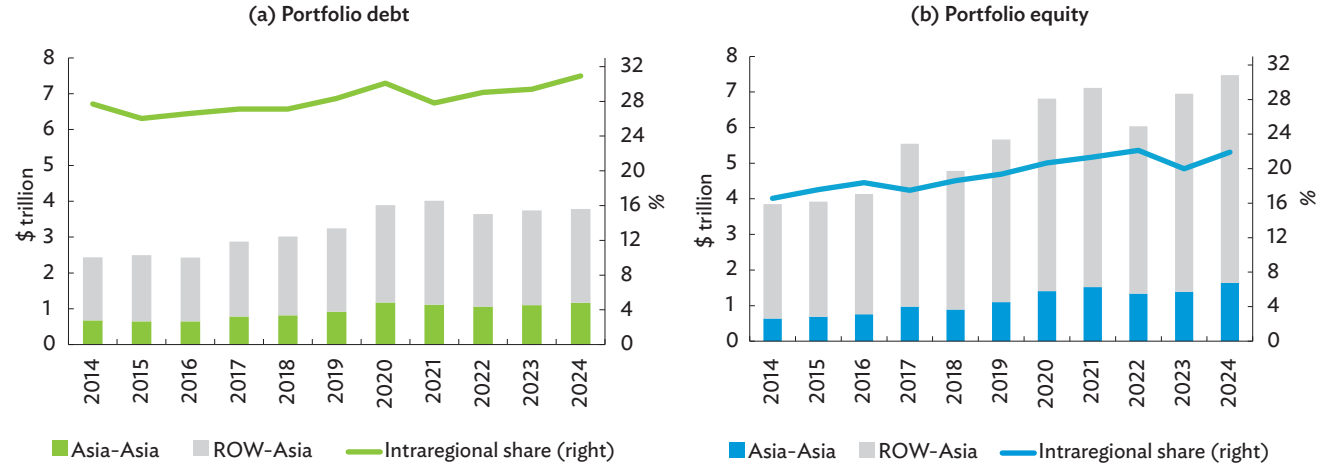


ROW = rest of the world.

Notes: Estimates are as of December 2025. Asia refers to Asia and the Pacific, which includes ADB regional members for which data are available. The gray bars represent actual values of portfolio debt and equity from Asia to the rest of the world, while the colored bars (green and blue) show the actual values of intraregional assets. The lines indicate the intraregional shares of Asia relative to the total.

Source: ADB calculations using data from International Monetary Fund. Portfolio Investment Position. https://data/imf.org/en/datasets/IMF.STA:PIP (accessed November 2025).

Figure 4.7: Cross-Border Liabilities—Asia and the Pacific, by Type



ROW = rest of the world.

Notes: Estimates are as of December 2025. Asia refers to Asia and the Pacific, which includes ADB regional members for which data are available. The gray bars represent actual values of portfolio debt and equity from the rest of the world to Asia, while the colored bars (green and blue) show the actual values of intraregional liabilities. The lines indicate the intraregional shares of Asia relative to the total.

Source: ADB calculations using data from International Monetary Fund. Portfolio Investment Position. https://data/imf.org/en/datasets/IMF.STA:PIP (accessed November 2025).

improvements in financial infrastructure should underpin the progress in financial integration. Existing impediments to regional cross-border financial flows include regulatory heterogeneity and underdeveloped payment and settlement linkages, among others.

FDI accounts for the largest share of cross-border assets and liabilities for Asia.

The share of FDI in cross-border assets and liabilities has remained broadly stable. As FDI is less sensitive to short-term global capital market gyrations, it could help reduce capital flow volatility. The share of Asian investors' regional FDI out of total intraregional assets slipped marginally from 39% in 2023 to 38% in 2024 (Figure 4.8a). Meanwhile, the share of FDI from regional investors out of total intraregional liabilities remained unchanged at 44% over the same period (Figure 4.8b). Meanwhile, the share of portfolio debt and bank flows in cross-border assets and liabilities has declined over time since 2024, whereas that of portfolio equity has been increasing gradually.

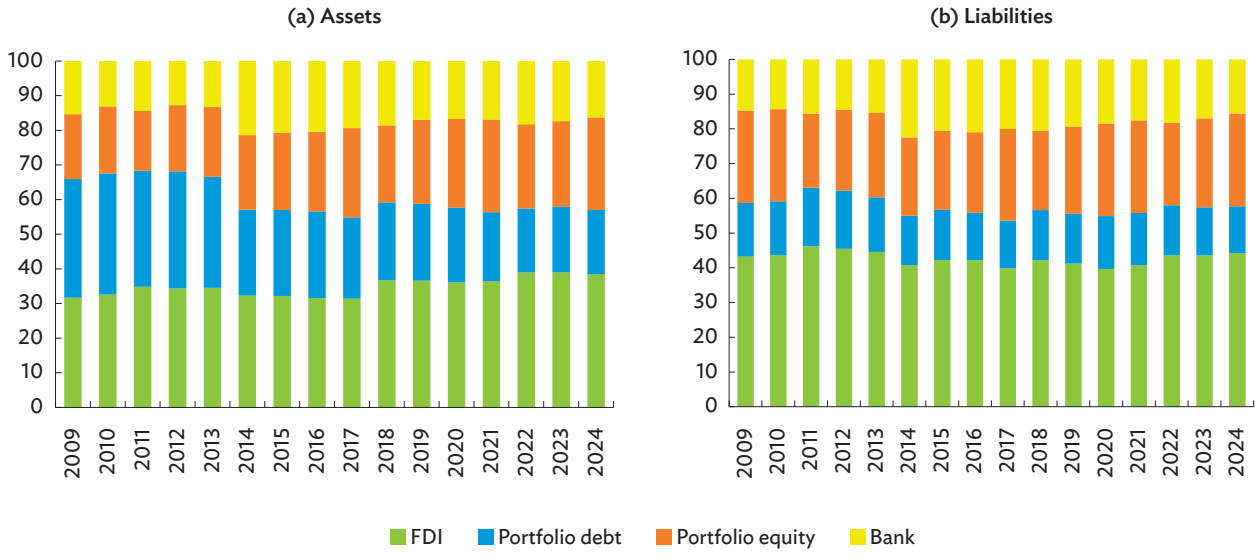
Geopolitical Risks and Investment Flows

Geopolitical Risks Affect Investment Fund Flows and Economy-Level Portfolio Allocations

Geopolitical risks (GPR) weigh on economic activities by undermining the predictability of economic prospects. In finance, rising geopolitical risks are also expected to be factored into investor sentiment, expected rates of return, and pursuant portfolio adjustments of investment. Whether this holds true, and if so to what extent, remains an empirical question. This section attempts to open up discussion based on two empirical exercises; one on how investment funds adjust their portfolios, and the other on the flow of investment between economies.

Fund flows analysis shows that stock markets have been largely resilient to the impact of higher GPRs. Using monthly frequency data, the model estimates the growth

Figure 4.8: Intraregional Cross-Border Investment—Asia and the Pacific, by Type (% of total)



FDI = foreign direct investment.

Notes: Estimates are as of December 2025. FDI assets refer to outward FDI holdings, while FDI liabilities refer to inward FDI holdings. Bank claims and liabilities are limited to bank loans and deposits. Asia and the Pacific includes ADB regional members for which data are available.

Sources: ADB calculations using data from Bank for International Settlements. Locational Banking Statistics. https://www.bis.org/statistics/bankstats.htm; CEIC Data Company; International Monetary Fund (IMF). Direct Investment Positions. https://data/imf.org/en/datasets/IMF.STA:DIP; IMF. Portfolio Investment Position. https://data/imf.org/en/datasets/IMF.STA:PIP; United Nations Trade and Development. UNCTADstat Data Centre. https://unctadstat.unctad.org/datacentre/dataviewer/US.GDPTotal; and World Bank. World Development Indicators. https://databank.worldbank.org/source/world-development-indicators (all accessed January 2026).

in an investment fund's portfolio shares in terms of firm-level GPR exposures. The study identifies more risk-taking investment behaviors by investment funds, as higher GPR induces funds to load up on greater risks through increased investments into more GPR-exposed firms. This reallocation is unrelated to the industry a firm belongs to or the location of the firm. The key motivation of this portfolio reallocation turns out to be a search for yield as the pivot into GPR-exposed firms is mainly driven by the opportunity to buy their stock at cheaper prices (Box 4.2).

Box 4.2: Geopolitical Risks and Investment Funds—Security-Level Evidence

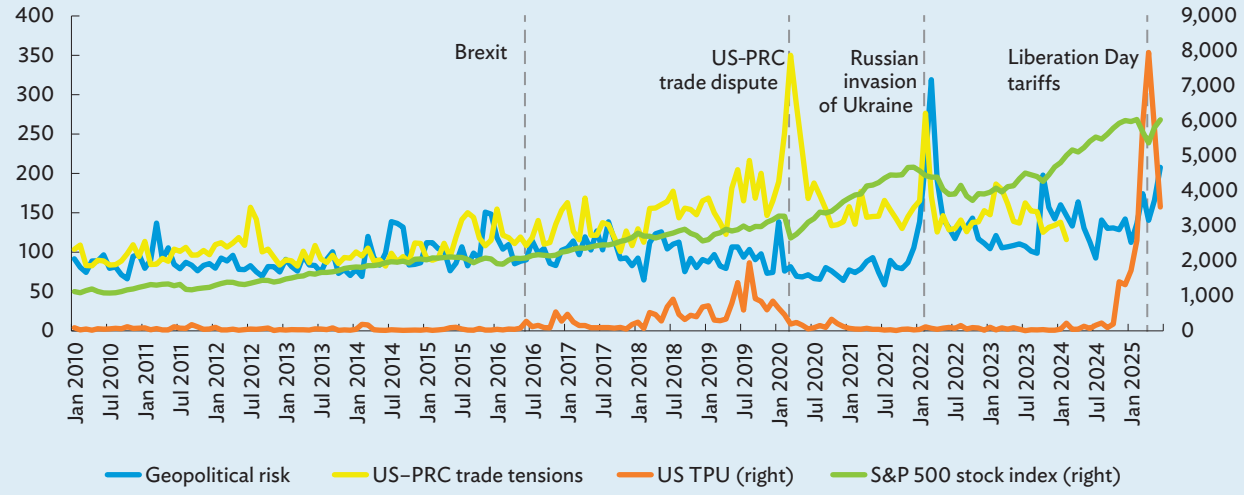
Geopolitical risks (GPR) have risen markedly in recent history, with the most prominent shocks occurring after the Russian invasion of Ukraine and the United States (US) Liberation Day on tariffs. However, stock markets hardly reacted to increases in GPR, as shown in the first box figure.

The way investors react to GPR shocks could explain the muted response of markets: Stock prices have been shown to fall in response to such shocks (Hirshleifer, Mai, and Pukthuanthong 2024; IMF 2025; Yilmazkuday 2024). Given lower valuations of assets susceptible to such shocks—e.g., due to disrupted supply chains—investors may recognize an opportunity to acquire these otherwise healthy assets at a low cost. The higher demand for GPR-exposed assets would swiftly stabilize valuations, leaving financial markets seemingly calm. This increased demand for GPR-exposed assets should be detectable in investor portfolios pivoting toward GPR-exposed assets as shocks materialize.

te Kaat, Liu, and Raabe (forthcoming) confirm this hypothesis for professional investors' reaction to GPR shocks, notably for investment fund managers. They model the growth in an investment fund's portfolio shares in stocks as a function of (i) an index measuring global GPR intensity by Caldara and Iacoviello (2022), interacted with (ii) the GPR exposure of the firm issuing the stocks. For this, the authors use detailed data covering some 10,000 investment funds' holdings in about 45,000 stocks at monthly frequency from 2011 to the end of the first quarter of 2025 (January 2011 to March 2025), obtained from the data provider Emerging Portfolio Fund Research. Firm-level GPR exposure is approximated by the share of relevant keywords in firms' earnings call reports. The empirical framework further controls for fund size, past performance, and valuation changes. These metrics are important for identifying investment funds' active portfolio reallocations. A rich set of fixed effects absorbs potential confounders.

The study shows that investment funds pivot into stocks issued by more GPR-exposed firms as GPR shocks realize (depicted in the box figure below). A two-standard deviation increase in the GPR index leads funds to raise the portfolio shares in stocks of relatively more GPR-exposed firms by 3 basis points. This impact corresponds to one-fifth of the median portfolio share in the sample. During exceptionally high GPR risk spikes such as the 2 April 2025 US Tariff "Liberation Day," the effect can reach 4 to 5 basis points.

Muted Market Reaction to Geopolitical Risks and Policy Uncertainty



PRC = People's Republic of China, TPU = trade policy uncertainty, US = United States.

Source: Baker, Bloom, and Davis (2016); Caldara and Iacoviello (2022); and Rogers, Sun, and Sun (2024).

continued on next page

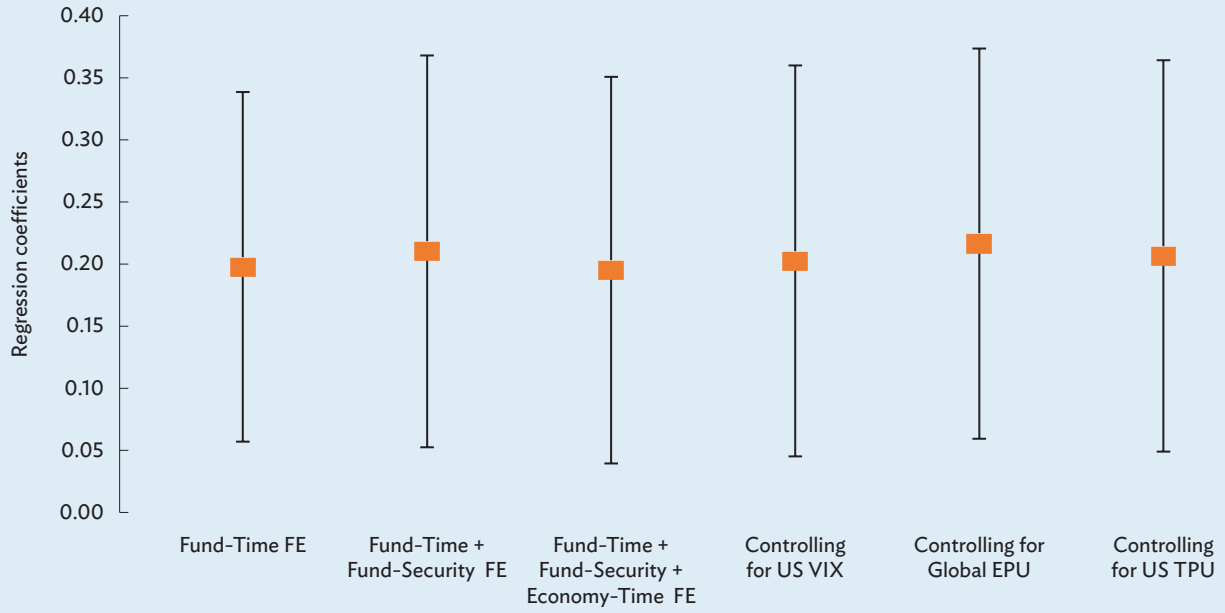
Box 4.2: continued

Results hold even when accounting for financial and macroeconomic risk as measured by financial market volatility (the VIX), global economic policy uncertainty, and US trade policy uncertainty. Results are also robust to a range of fixed effects absorbing variation within fund-stock pairs as well as time-varying factors for each economy that firms are located in. Dynamics in specific industries such as defense or the manufacturing of dual goods—which may see higher demand due to GPR shocks—do not drive the results. Large fund domiciles like the US and Luxembourg, firms headquartered in any particular economy or funds belonging to large asset management companies do not account for the results either.

The authors further corroborate that funds' pivot into GPR-exposed stocks is indeed driven by falling stock prices as GPR shocks unfold, promising higher returns in the future. Less performing investment funds are more likely to chase higher returns by investing in GPR-exposed stocks. Higher risk-taking capacity, measured by fund size, cash buffers, and increased inflows prior to GPR shocks, also induces funds to allocate into GPR-exposed stocks.

The study suggests that investment funds can help stabilize stock markets after GPR-injected volatility. While this may make markets seem calm, funds' portfolio reallocations can still trigger significant cross-economy spillovers. In fact, economies with higher concentrations of highly GPR-exposed firms may experience larger increases in funds' portfolio allocations, and thus capital inflows. Inversely, economies with lower concentrations can experience sudden outflows.

Effect of Firm-Level Geopolitical Risk Exposure on Investment Fund Portfolio Shares



EPU = economic policy uncertainty, FE = fixed effects, TPU = trade policy uncertainty, US = United States, VIX = Volatility Index.

Notes: This figure plots the coefficients from a regression of the 1-month change in investment funds' portfolio shares on firm-level geopolitical risk exposure interacted with the Caldara and Iacoviello (2022) global geopolitical risk index, controlling for stock price changes and fund-security, fund-time, and economy-time FE depending on the specification. Selected specifications control financial market volatility (the VIX), global EPU, and US TPU.

Source: ADB calculations using data from Emerging Portfolio Fund Research (accessed August 2025).

Source: te Kaat, Liu , and Raabe (forthcoming).

This suggests that commercial incentives to maximize investment returns could help ease GPR-led market volatility. Investment funds' adjustment in the portfolio, weighing more on GPR-exposed firms could help soften the market jitter or blow to the market from GPR-induced volatility and help safeguard the stability of the stock market under the recurring GPR-related risks. However, the funds' portfolio reformulation could also lead to significant cross-economy capital flows, depending on how much an economy is exposed to the concentration of GPR-prone firms amid heightened GPRs. Potential market-stabilizing effects, notwithstanding, a deeper and prolonged impact of GPR could upend this channel, leading to negative impacts on the overall market sentiment and performance.

Geopolitical Affinities Drive Investment Reallocation During Shocks

Using monthly data on investment funds' allocations, funds' portfolio shares across economies are estimated in terms of global GPR intensity and an economy's geopolitical bloc alignment, where geopolitical alignment is characterized into US-aligned, PRC-aligned, and non-aligned, with the categorization determined by an economy's latent foreign policy preferences derived from roll-call votes at the United Nations General Assembly (Box 4.3). The analysis shows that investment funds reallocate portfolios in alignment with geopolitical blocs when GPR rises.

Economies' geopolitical affinity seems to affect investment capital reallocations in response to GPR shocks. Reallocation of the funds largely tilt toward PRC-aligned economies relative to US-aligned economies as GPR rises. This effect is more pronounced for equity funds and for the funds domiciled in US-aligned economies. Unlike investment fund reallocations, however, there seems to be no clear evidence for price discount as a potential channel for the reallocations as the prices in PRC-aligned markets do not fall much around GPR shocks. The results also do not support the notion of a global fragmentation of financial flows through an increase in intra-bloc investments.

Both fund-level and economy-level reallocation of investments indicate a significant impact of GPR on global financial flows

Although stock markets have sizable resilience to the shocks from GPRs, changing patterns of investment flows warrant attention from policymakers. Depending on the concentration of GPR-prone firms or characteristics of geopolitical alignment, different economies may experience different types of capital flow changes, which require close monitoring of the capital flow trends and assessing their impact on macroeconomic performance and financial markets. The heightened level of GPRs recently and more frequent incidences of such risks call for policymakers in the region to stay vigilant regarding the financial market situation.

Strengthening Financial Safety Nets

No Economy Is Immune to Spillover Effects of Financial Crises

Most economies rely on their own international reserves as a first line of defense against financial crises. When domestic resources prove insufficient, nations have traditionally turned to the International Monetary Fund (IMF), the global lender of last resort. While IMF support can provide critical financial assistance, it typically comes with significant policy conditions such as requiring substantial fiscal reforms.

In the wake of the 2007 global financial crisis, bilateral central bank swap lines gained importance as an additional layer of financial safety. This was particularly important for the economies facing dollar shortages (Koosakul and Miksjuk 2024). These arrangements allow central banks to exchange currencies and provide much-needed liquidity to ease market stress. For example, when the US Federal Reserve established a swap line with the Bank of Korea in 2008, it quickly eased funding pressures and restored market confidence, even though the facility was not fully utilized. However, access to swap lines is often limited to close political or economic partners, or to economies with strong fundamentals—often excluding those most in need during a crisis.

Box 4.3: Geopolitical Risks and Investment Funds—Economy-Level Evidence

Rising geopolitical risk (GPR) may reshape established global economic structures. As investors become more attuned to such risks (as discussed in Box 4.2), markets are likely to reallocate capital globally, with profound repercussions for financial stability. Zooming in on portfolio capital, Ciminelli, Raabe, and Zhao (forthcoming) investigate how investment funds reallocate capital across economies in response to GPR shocks. In particular, the authors study whether such shocks lead investment funds to align portfolios along the geopolitical blocs identified by United Nations (UN) voting patterns.

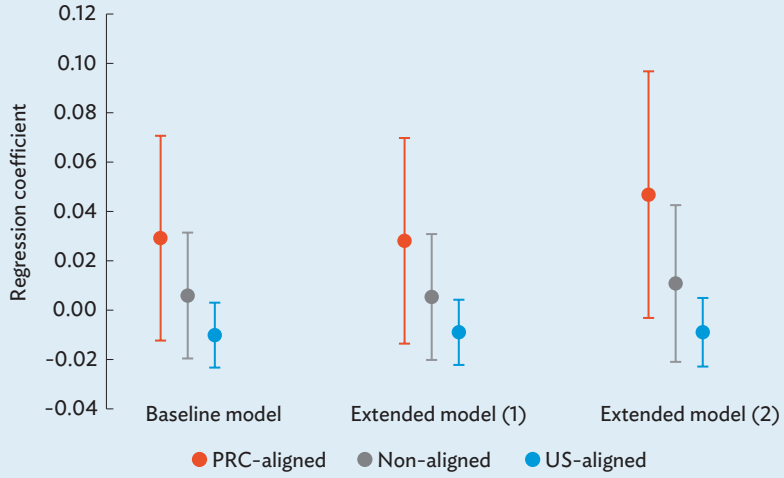
The study draws on monthly data on some 30,000 investment funds' allocations across economies from Emerging Portfolio Fund Research over the period July 2017 to June 2025. The authors model funds' portfolio shares in various economies as a function of (i) a measure of global GPR intensity, interacted with (ii) an economy's geopolitical bloc alignment, controlling for past portfolio allocations, fund size, and performance as well as macroeconomic developments. Fixed effects absorb potential confounders within fund-economy pairs.

The authors use the BlackRock Geopolitical Risk Indicator (BGRI) to measure GPR intensity, summarizing markets' attention and sentiment to geopolitical shocks as extracted from brokerage reports and financial news. Geopolitical alignment is categorized into United States (US)-aligned, People's Republic of China (PRC)-aligned, and non-aligned, and based on ideal points, which score an economy's latent foreign policy preferences as derived from UN General Assembly roll-call votes (Bailey, Strezhnev, and Voeten 2017). Sorting into these three blocs is based on the difference between any economy's ideal point and the ideal point of the US and the PRC. Following Gopinath et al. (2024), economies in the top quartile closest to the US and the PRC are labeled US-aligned and PRC-aligned. Non-aligned denote the remainder. Bloc assignments are time-varying, allowing to capture shifts in alignment.

The study shows that investment funds reallocate portfolios in alignment with geopolitical blocs as GPR shocks materialize. Specifically, as GPR rises, fund portfolios tilt toward PRC-aligned economies, relative to US-aligned economies. A one-standard deviation increase in GPR raises portfolio shares in PRC-aligned economies by 3.7 basis points (box figure below). Portfolio shares in non-aligned economies do not rise. Effects are stronger for equity funds and those domiciled in US-aligned economies, suggesting increased inter-bloc investments.

The findings suggest that economies' geopolitical affinities affect portfolio capital reallocations as GPR shocks occur. However, the results do not support the notion of a global fragmentation of financial flows through an increase in intra-bloc investments. This contrasts with trade flows, which have been shown to intensify within geopolitical blocs (Alfaro and Chor 2023; Qiu, Xia, and Yetman 2025). The study underscores how geopolitical blocs are increasingly shaping cross-border capital allocation.

Effect of Economies' Geopolitical Alignment on Investment Fund Portfolio Shares



BGRI = BlackRock Geopolitical Risk Indicator, PRC = People's Republic of China, US = United States.

Notes: This figure plots the coefficients from a regression of investment funds' portfolio shares at the economy-level on economies' geopolitical bloc alignment interacted with the BGRI index, controlling for past portfolio allocations, fund size and performance, and fund-economy fixed effects. The three coefficient sets differ by the scope of controls. The baseline model controls for fund assets and returns, and the dependent variable lagged by one period; the first extended model adds the dependent variable lagged by two periods; and the second extended model adds real gross domestic product growth, inflation, unemployment rate, the sovereign rating and the volatility index.

Source: ADB calculations using data from Emerging Portfolio Fund Research (accessed August 2025).

Source: Ciminelli, Raabe, and Zhao (forthcoming).

Importance of Regional Response and Arrangements

Regional financial arrangements (RFAs) have emerged as an important source of emergency liquidity. This layer of the global financial safety net is typically anchored by deep regional expertise. By pooling financial resources, RFAs can provide timely crisis support with any conditionality tailored to the region's needs, allowing for greater flexibility and willingness to provide liquidity support. The European Stability Mechanism for the euro area and the Chiang Mai Initiative Multilateralisation (CMIM) for the Association of Southeast Asian Nations Plus the People's Republic of China, the Republic of Korea, and Japan (ASEAN+3) are examples of RFAs. Although the RFAs play a crucial role in safeguarding regional financial stability and resilience, such arrangements also raise questions about their long-term sustainability and the equitable sharing of risks and responsibilities among participating members. To maintain the credibility and effectiveness of these regional safety nets over time, it is important to ensure robust governance and clear rules for resource mobilization and disbursement.

Multilayered Regional Responses Safeguard Stability

Regional financial safety nets are crucial for safeguarding economic stability in times of heightened economic risks and the buildup of vulnerabilities. When shocks hit, timely and decisive action can prevent localized problems from escalating into broader instability. Often, the mere presence of robust financial backstops—demonstrated by visible, pooled resources—can reassure markets and deter speculative attacks, reducing the likelihood that emergency measures will need to be deployed.

Well-designed RFAs offer several key advantages over the other components of the global financial safety net. By pooling resources, economies can secure access to international capital on better terms and benefit from countercyclical financing during periods of stress, helping them avoid the pitfalls of limited market access, fire-sale asset losses, and prohibitively high borrowing costs in a crisis. Importantly, RFAs can provide rapid support with fewer constraints than global mechanisms, helping economies weather shocks before they deteriorate into full-scale crises (Baran 2020). Another key strength of RFAs is their grounding in the local context, which makes support more tailored and responsive to economy-specific circumstances.

Evolution of Regional Financing Arrangement in ASEAN+3

In strengthening the regional financial safety net, two recent advances deserve emphasis. First, members of ASEAN+3 agreed to develop more flexible, faster-deploying instruments, notably a rapid financing facility (RFF) as a new component of CMIM to provide quickly disbursing liquidity. The RFF is designed to help members cover urgent balance of payments needs caused by exogenous shocks (e.g., pandemics, physical hazard-driven disasters, commodity price spikes, or sharp reversals of capital inflows) without the long lead times and heavy conditionality typical of standard crisis programs.

Second, ASEAN+3 policymakers endorsed the exploration of a paid-in capital structure to complement the current commitment-based model of the CMIM. Under paid-in capital, resources could be pre-positioned, shortening activation time, improving market credibility, and allowing more flexible instruments. Both steps directly address long-standing operational bottlenecks and would improve the CMIM's ability to deliver timely support during regional shocks. They are expected to enhance regional resilience by offering members timely access to emergency financing during urgent balance of payments needs.

Swap Arrangements Need Broadening

In addition to reforming the CMIM, Asia should also enhance the other pillars of global financial safety nets. It is critical to expand multicurrency and local currency swap arrangements so as to enlarge the size and effectiveness of regional financial safety nets. The 2007 global financial crisis demonstrated the critical role that

central bank swap lines can play in calming markets and providing timely liquidity. However, the experience since then has shown that such arrangements are typically concentrated among economies with strong fundamentals, leaving more vulnerable economies with limited or no access to these crucial backstops. This is not only the case for swap lines established with leading central banks such as the US Federal Reserve and the European Central Bank, but also within the region. Despite substantial growth in bilateral swap lines within ASEAN+3, access remains concentrated among stronger, larger economies, while smaller and lower-income members are largely excluded. This concentration leaves the most vulnerable economies without reliable liquidity backstops. Further efforts are necessary to make the swap arrangements more inclusive, and—crucially—ensure they can be activated quickly and reliably when financial stress emerges, giving all members greater confidence in their regional safety net.

Local Currency Bond Markets Enhance Stability

To strengthen Asia's regional financial safety net, it is essential to develop deep and liquid local currency bond markets. The Asian Bond Markets Initiative (ABMI), which was launched in December 2002 and adopted in August 2003 at the ASEAN+3 Finance Ministers' Meeting, aims to foster the development of local currency bond markets and also aims to recycle vast savings within the region to support needed infrastructure investments. Through market development, ABMI promotes regional financial cooperation and integration to reduce the region's vulnerability to the sudden reversal of capital flows and to strengthen its financial resilience and stability.[2] Well-functioning local currency bond markets in fact are a cornerstone of the region's financial stability. They reduce reliance on volatile external finance, lower currency-mismatch risk, and give governments room to respond when global liquidity recedes. This should entail expanding local currency issuance and building out the market infrastructure: active market makers, reliable benchmark yield curves, robust repo and hedging tools, and a broader domestic and regional investor base. With this ecosystem in place, funding would remain resilient when global conditions tighten, and regional safety nets can deliver support that is better aligned with members' actual currency exposures. By promoting the issuance and active trading of local currency bonds, policymakers can reduce the region's vulnerability to external shocks. Deep regional bond markets provide governments and firms with more stable financing options, support countercyclical policy, and make it easier to mobilize resources quickly in a crisis.

Regional Financial Cooperation: A Cornerstone of Financial Stability and Resilience

Vigilance to Geopolitical Risks Requires Well-Coordinated Action

Rising geopolitical tensions and uncertainties are fundamentally reshaping the global financial landscape. As a result, the coverage and effectiveness of existing financial safety nets could face unexpected challenges. Financial turbulence has underscored that the economies most in need often struggle to access prompt and adequate support, while regional mechanisms confront challenges from scale, risk-sharing, and currency mismatches. For Asia—now a central node in global trade and finance—this shift is a call to action: adapt safety nets to a changing financial environment by strengthening regional arrangements, building local currency capacity, and coordinating more closely with global backstops.

Geopolitical risks, a potential slowdown of the global economy, and changes from accelerating digital finance could all produce volatility in financial markets. While digital finance offers greater opportunities for economic efficiency and inclusiveness, it also poses growing challenges to putting in place appropriate regulatory regimes, narrowing the digital divide, and addressing new types of financial vulnerability. Geopolitical risks

[2] Asian Development Bank. AsianBonds Online. https://asianbondsonline.adb.org/about.php (accessed December 2025).

will likely continue to be the potential shock factor to the financial market. Depending on the trajectory of the global economy, the solvency and liquidity conditions of some businesses might worsen, with a negative impact on the asset quality of banks and nonbank financial institutions. Detecting potential signals of looming risks, employing proper macroprudential policies, and exercising timely actions to resolve the sources of strains through appropriate policy measures cannot be overemphasized.

It is important for Asian economies to work together to enhance regional cooperation and strengthen cross-border financial systems. A more resilient multicurrency framework and deep, liquid regional capital markets are critical components of Asia's economic development. Looking ahead, policymakers should prioritize the strengthening of regional safety nets. ADB can serve as a key partner, supporting resource mobilization, technical capacity building, and the development of innovative financial solutions along with other international organizations.

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