Cold War II? Preserving Economic Cooperation Amid Geoeconomic Fragmentation

DECEMBER 11, 2023

20TH WORLD CONGRESS OF THE INTERNATIONAL ECONOMIC ASSOCIATION

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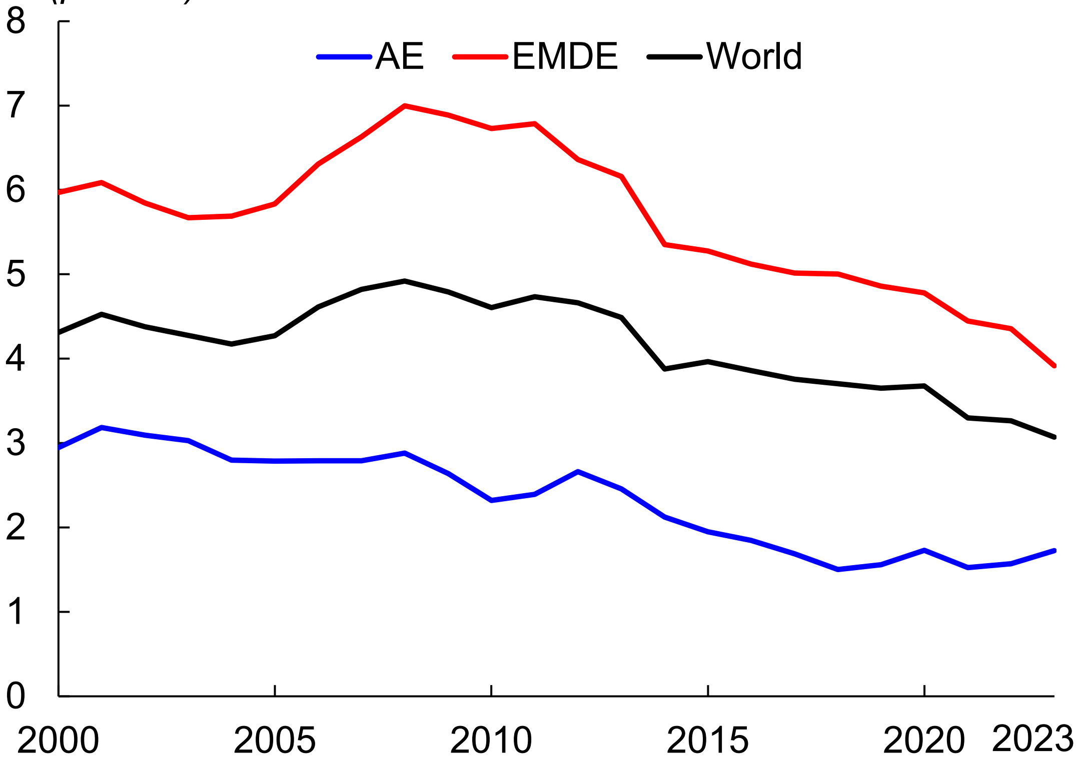
An unfavorable outlook

The threat of Cold War II is weighing on an already challenging outlook

Medium-term growth forecast

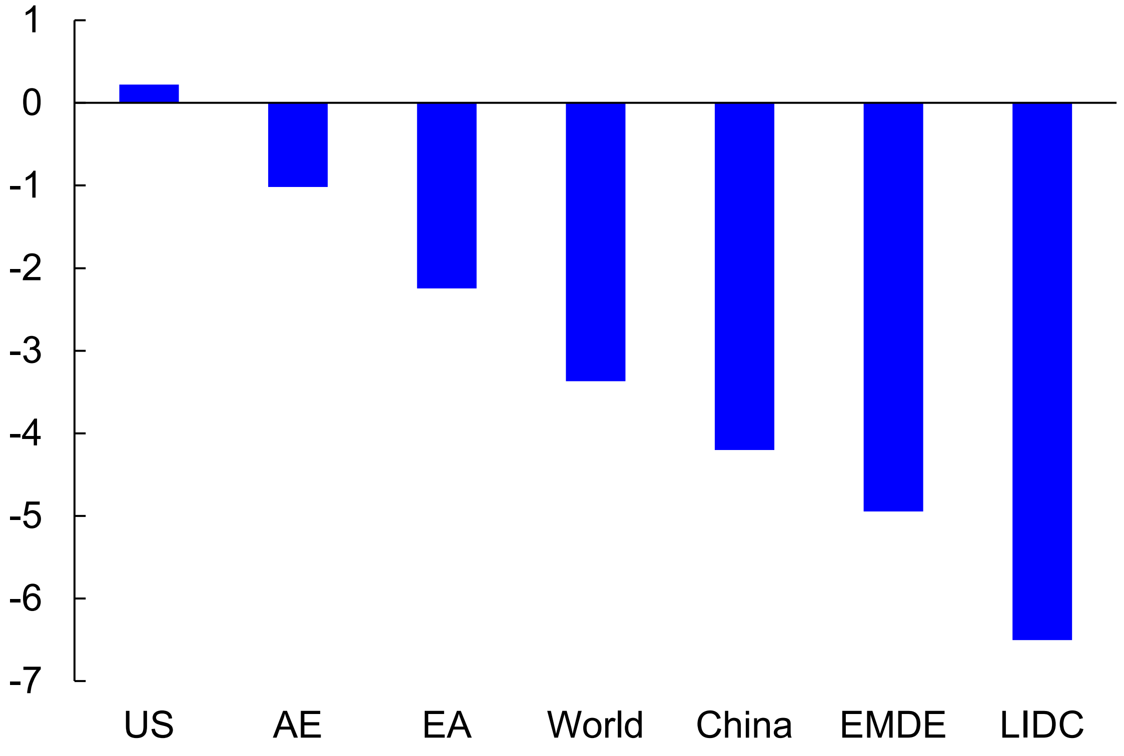
(percent)



Sources: IMF World Economic Outlook, and IMF staff calculations
Note: The years on the horizontal axis refer to the year for which a forecast is made. 2000-2022 use April World Economic Outlook vintages, and 2023 uses October vintage.

Scarring

(percent, real GDP deviation in 2023 from prepandemic projections)



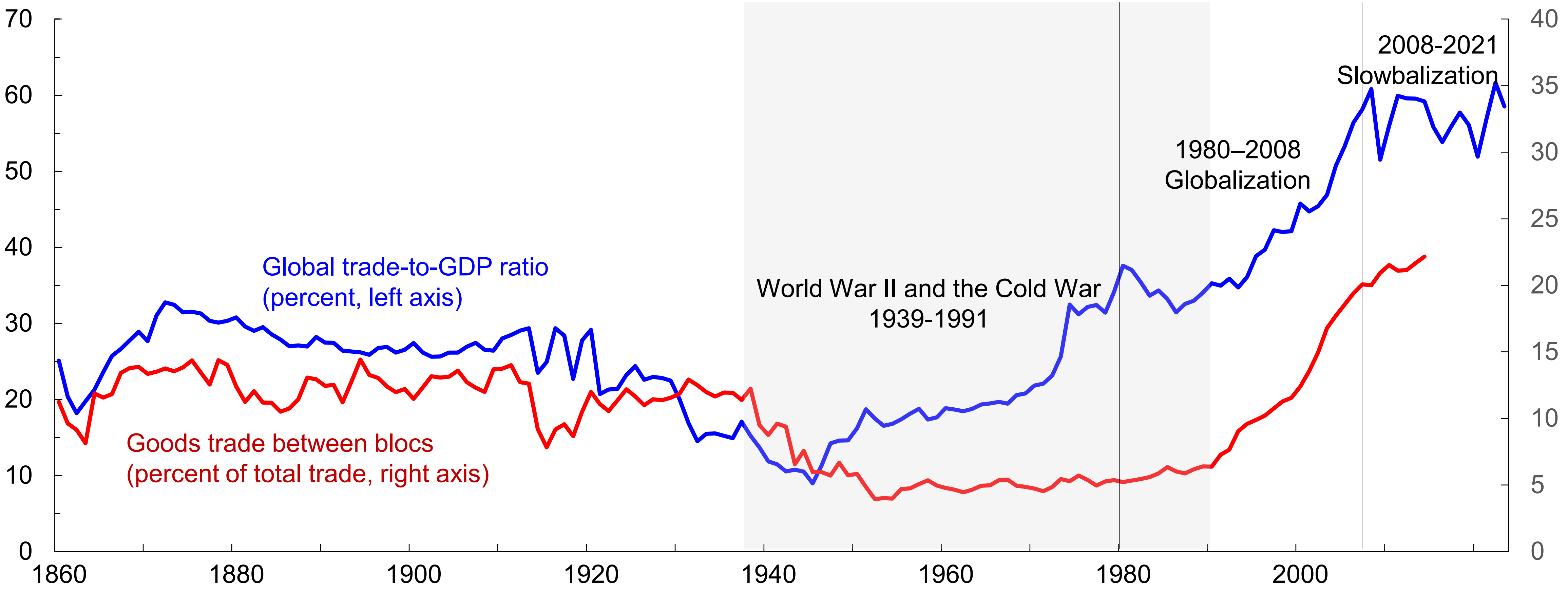
Sources: IMF World Economic Outlook, and IMF staff calculations
Note: "Prepandemic projections" refers to those in the January 2020 World Economic Outlook Update. AE=advanced economies, EA=euro area; EMDE=emerging market and developing economies; LIDC=low income developing countries.

#1. Some historical perspective

Not the first time globalization under threat

During the Cold War, trade-to-GDP rose but trade was heavily shaped by geopolitical considerations

Trade openness and trade between rival geopolitical blocs
(percent)

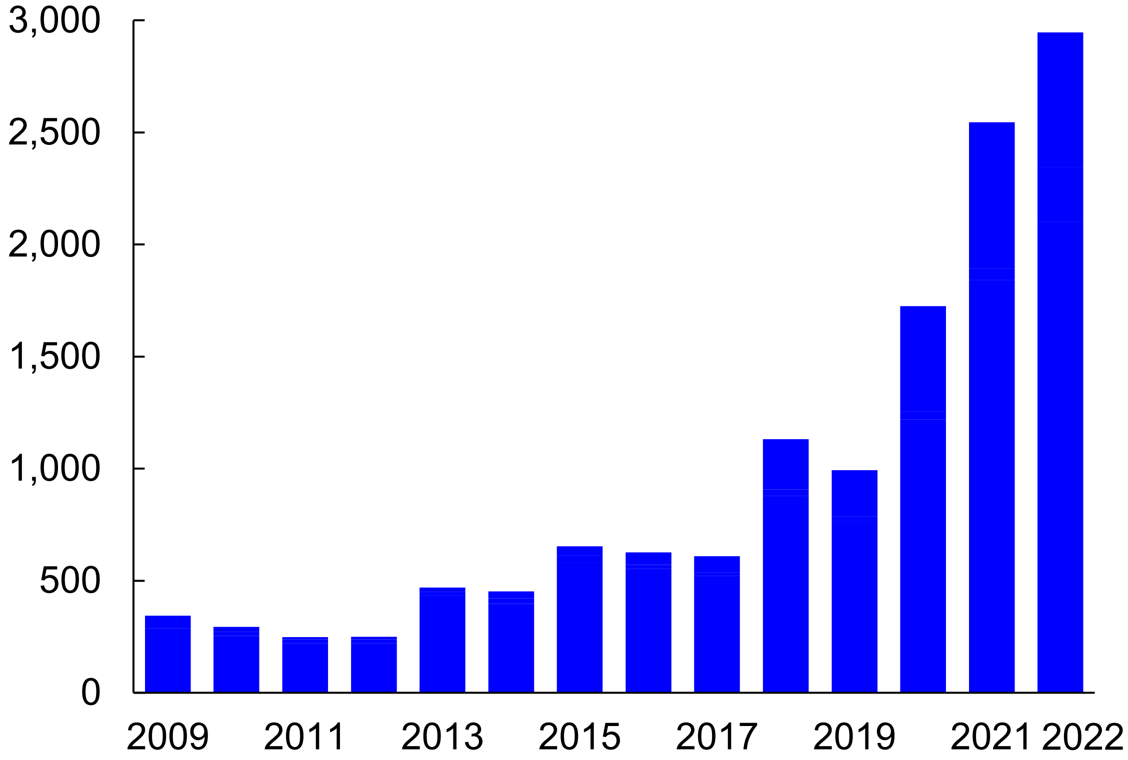


Sources: Fouquin and Hugod (2016), CEPII; Gokmen (2017); Jordà-Schularick-Taylor Macrohistory Database; IMF World Economic Outlook; and IMF staff calculations
Note: Rival geopolitical blocs during the Cold War are defined based on Gokmen (2017).

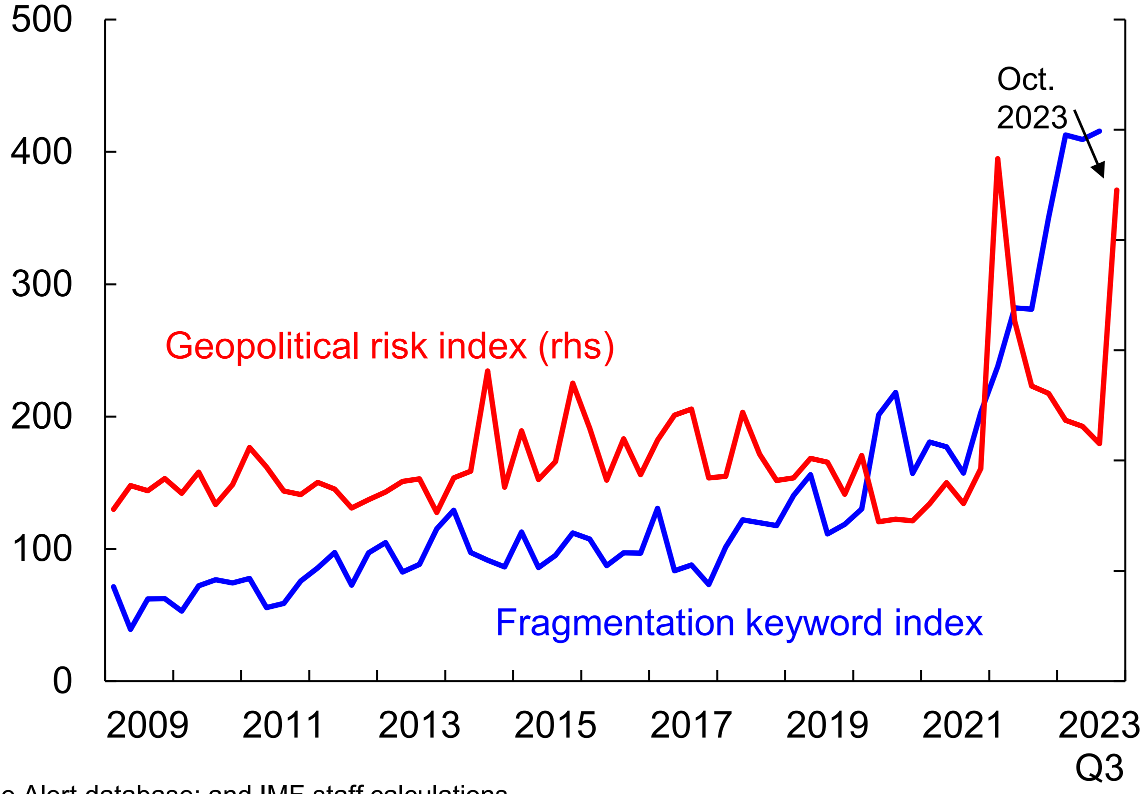
Fragmentation forces on the rise

Geopolitical risks have increased and protectionist measures are surging

Measures distorting trade and investment
(number)



Geopolitical risk and fragmentation keywords in earnings calls
(index, 2013-15=100)

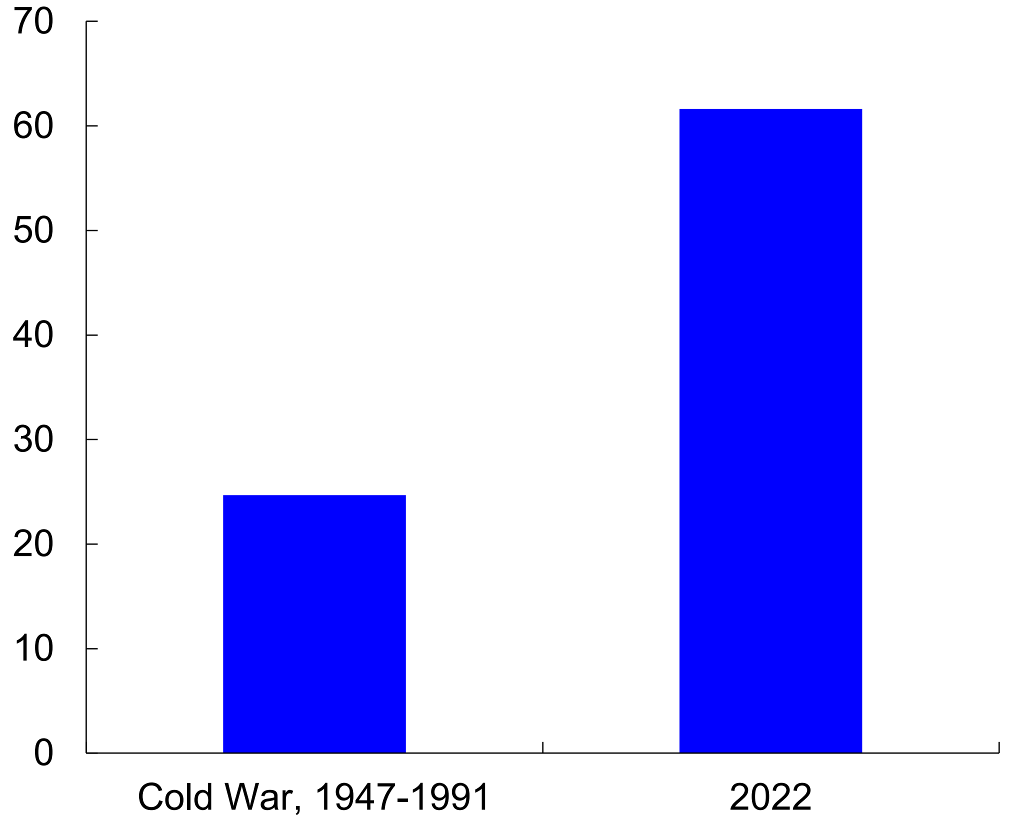


Sources: Caldara and Iacoviello (2022); Hassan and others (2019); NL Analytics, Inc.; Global Trade Alert database; and IMF staff calculations.
Note: Fragmentation indices measure the average number of sentences, per thousand earnings calls, that mention at least one of the following keywords: *deglobalization, reshoring, onshoring, nearshoring, friend-shoring, localization, regionalization.* New trade and investment distorting measures are defined per the classification from the Global Trade Alert database.

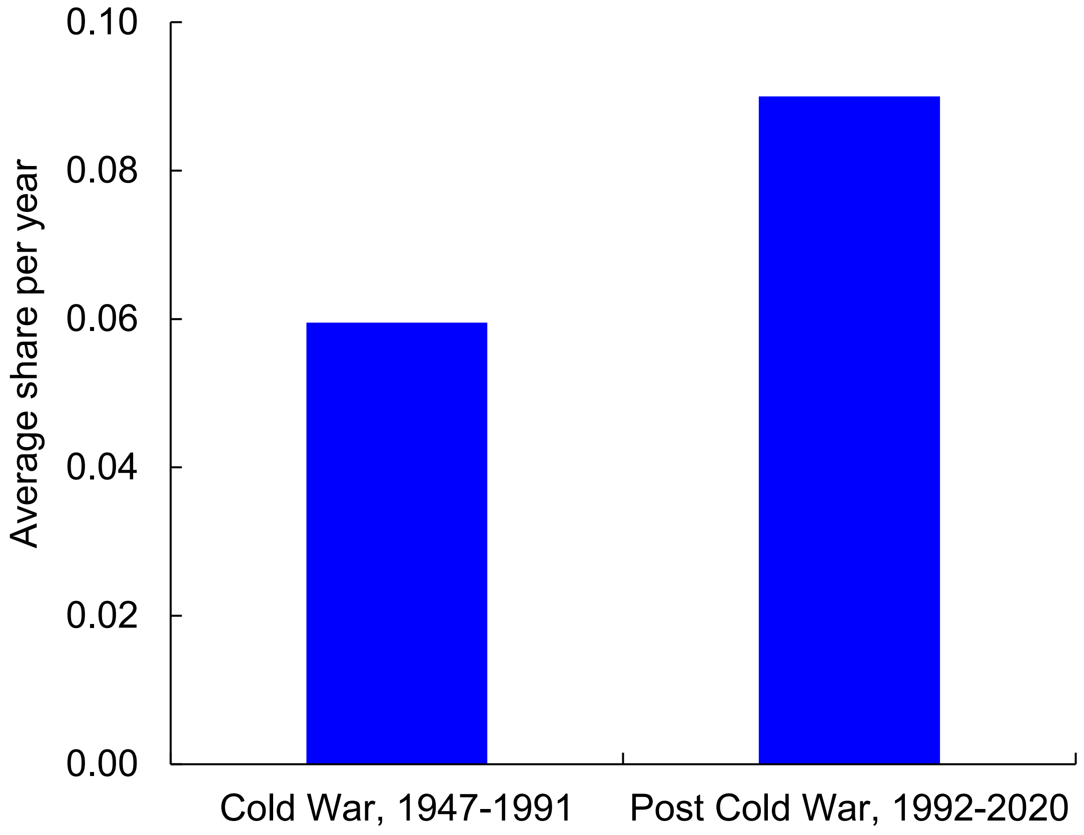
But this time could be different (1)

A more integrated world, higher uncertainty about countries' ideology and political allegiances

Global trade-to-GDP ratio
(percent)



Change in government ideology over time
(percent)

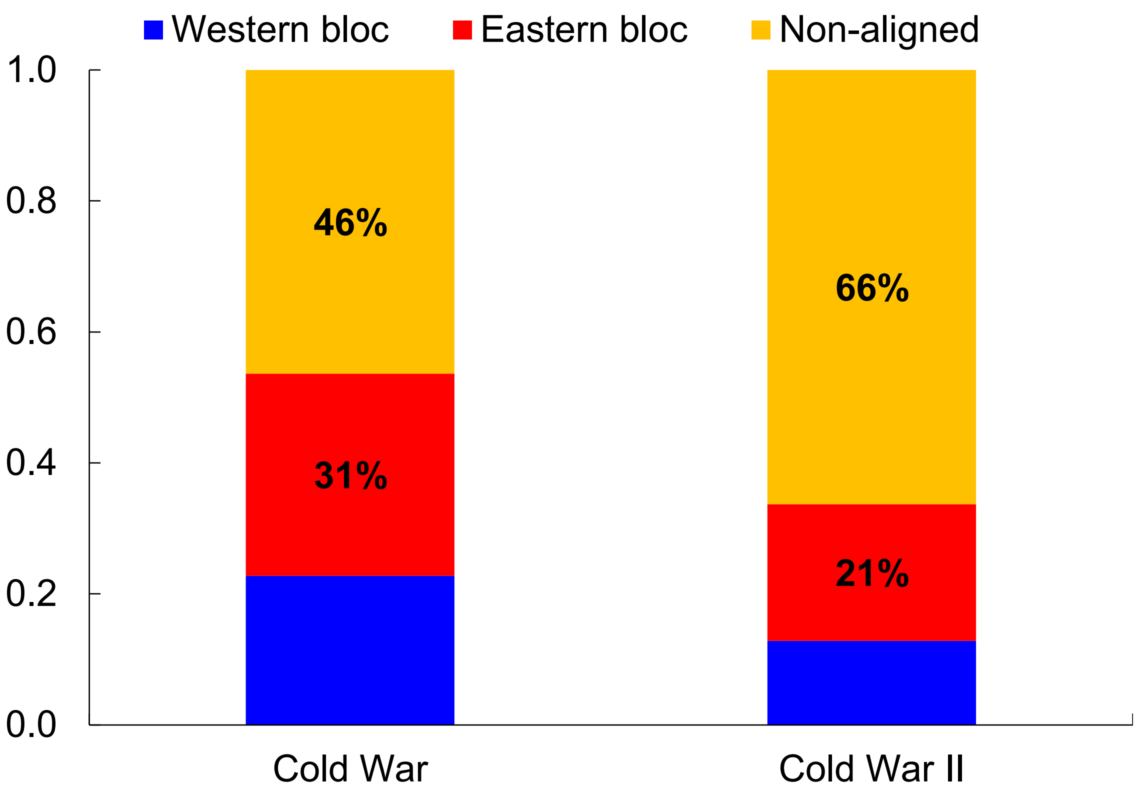


Sources: Fouquin and Hugod (2016), CEPII; Global Leader Ideology dataset; Jordà-Schularick-Taylor Macrohistory Database; IMF World Economic Outlook; and IMF staff calculations.

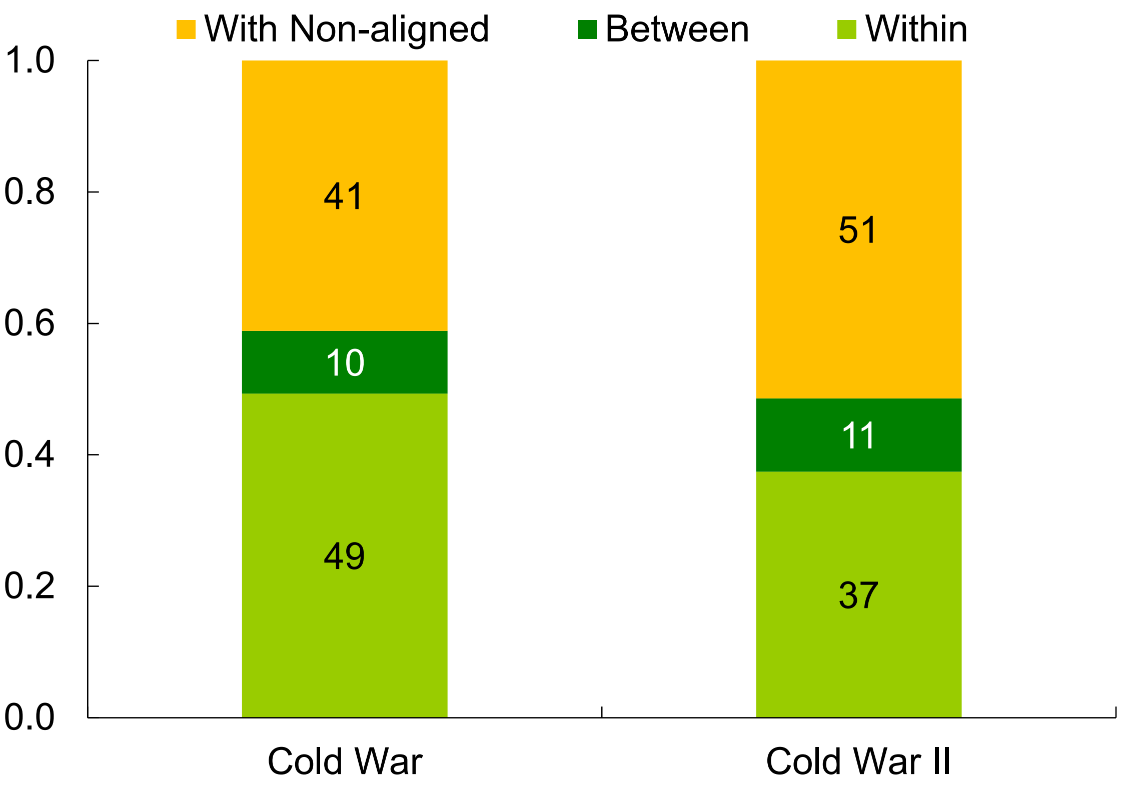
But this time could be different (2)

Greater economic heft and integration with rival blocs of non-aligned countries

Relative bloc size during the Cold War and currently
(share of total population)



Trade between, within blocs and with non-aligned
(share of total trade)



Sources: Fouquin and Hugod (2016), CEPII; Gokmen (2017); IMF World Economic Outlook; Trade Data Monitor; and IMF staff calculations
Note: Western bloc, Eastern bloc and non-aligned economies are defined based on Gokmen (2017) for the Cold War period. For the current period, a hypothetical Western bloc includes US, Europe, Canada, Australia and New Zealand. The hypothetical Eastern bloc comprises Belarus, China, Mali, Nicaragua, Russia, and Syria, with the rest of the countries considered "Non-aligned."

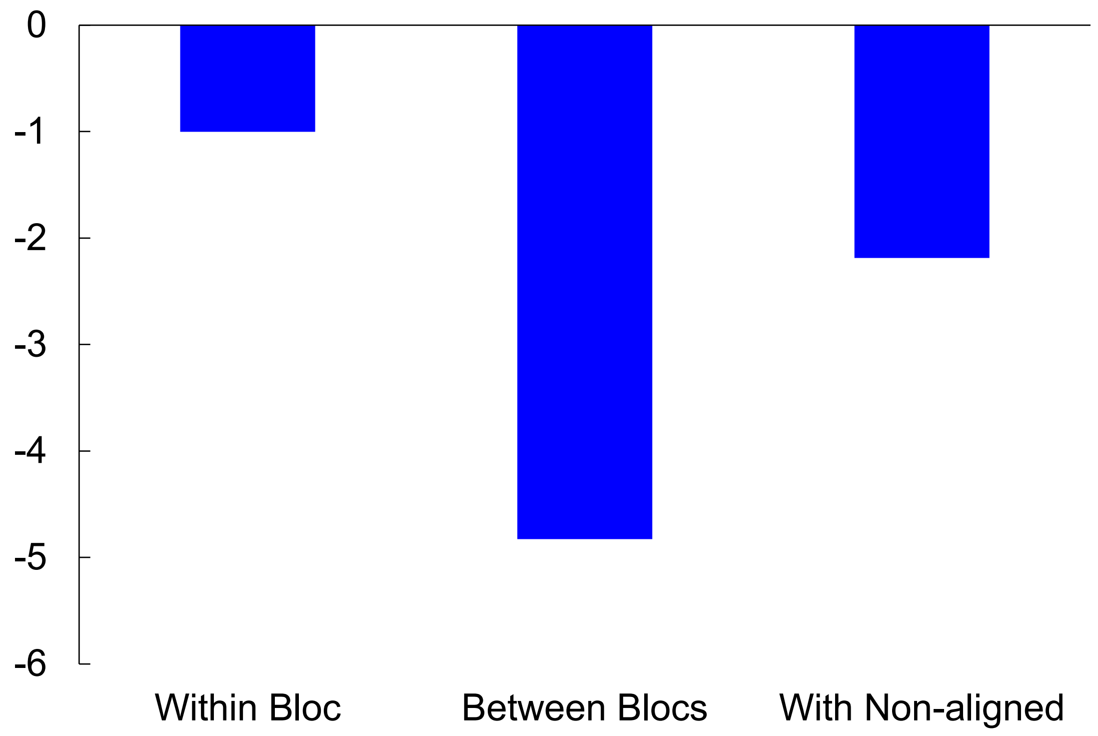
#2. Growing fault lines

Emerging fault lines

Geopolitical considerations are already affecting trade and investment

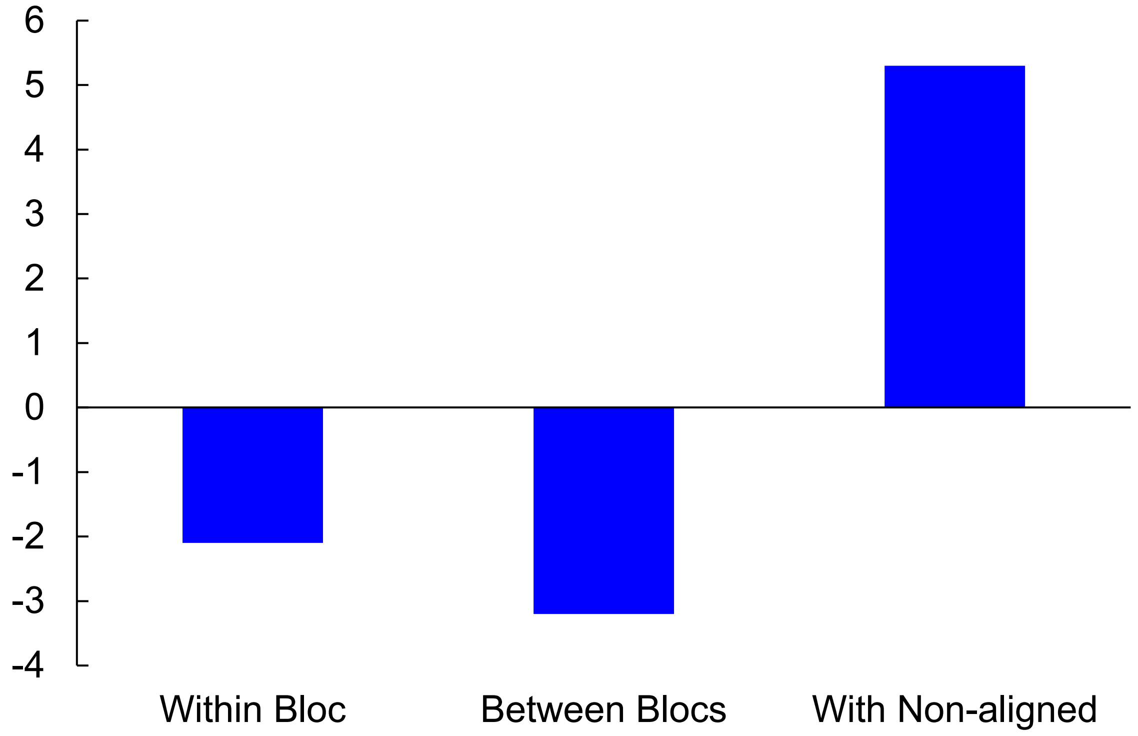
Change in trade growth post war

(percentage points)



Change in FDI shares post war

(percentage points)

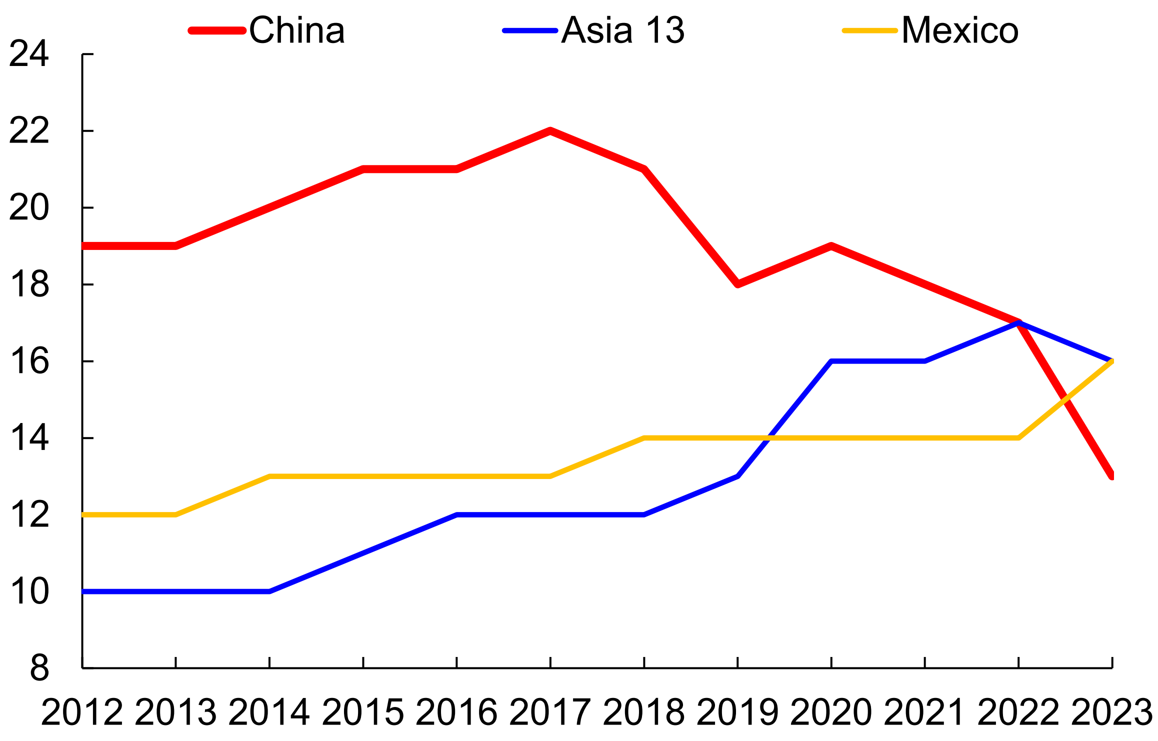


Sources: fDi Markets; Trade Data Monitor; and IMF staff calculations.
Note: In the right chart, bilateral quarterly growth rates are computed as the difference in log bilateral trade, which are then aggregated using bilateral nominal trade as weights. The chart on the left plots the change in the number of FDI (measured as a share of the total number of FDI) between 2022Q2-2023Q2 and 2018Q1-2022Q1 within and between blocs and with non-aligned countries. In both charts, the hypothetical Western bloc includes US, Europe, Canada, Australia and New Zealand. The hypothetical Eastern bloc comprises Belarus, China, Mali, Nicaragua, Russia, and Syria. The rest of the countries are considered “Non-aligned.”

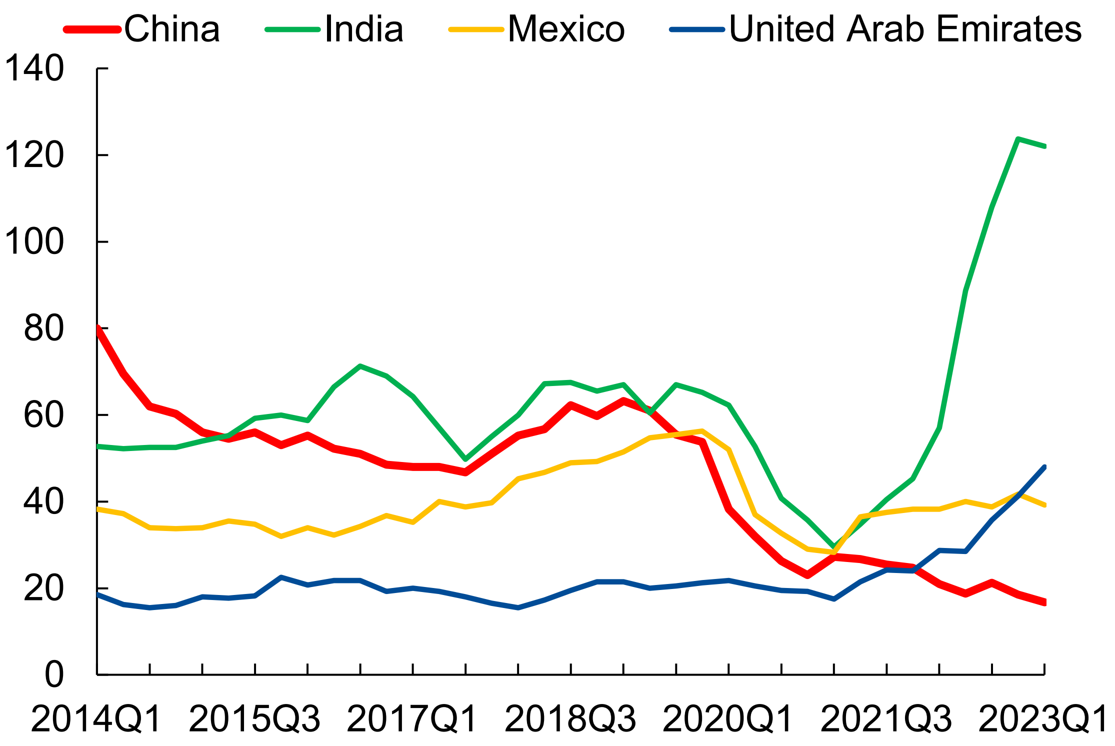
Severing direct links with China

China has lost ground as a source of US imports and destination for US investment

US imports
(percent of total)



US FDI
(count; 4-quarter moving average)

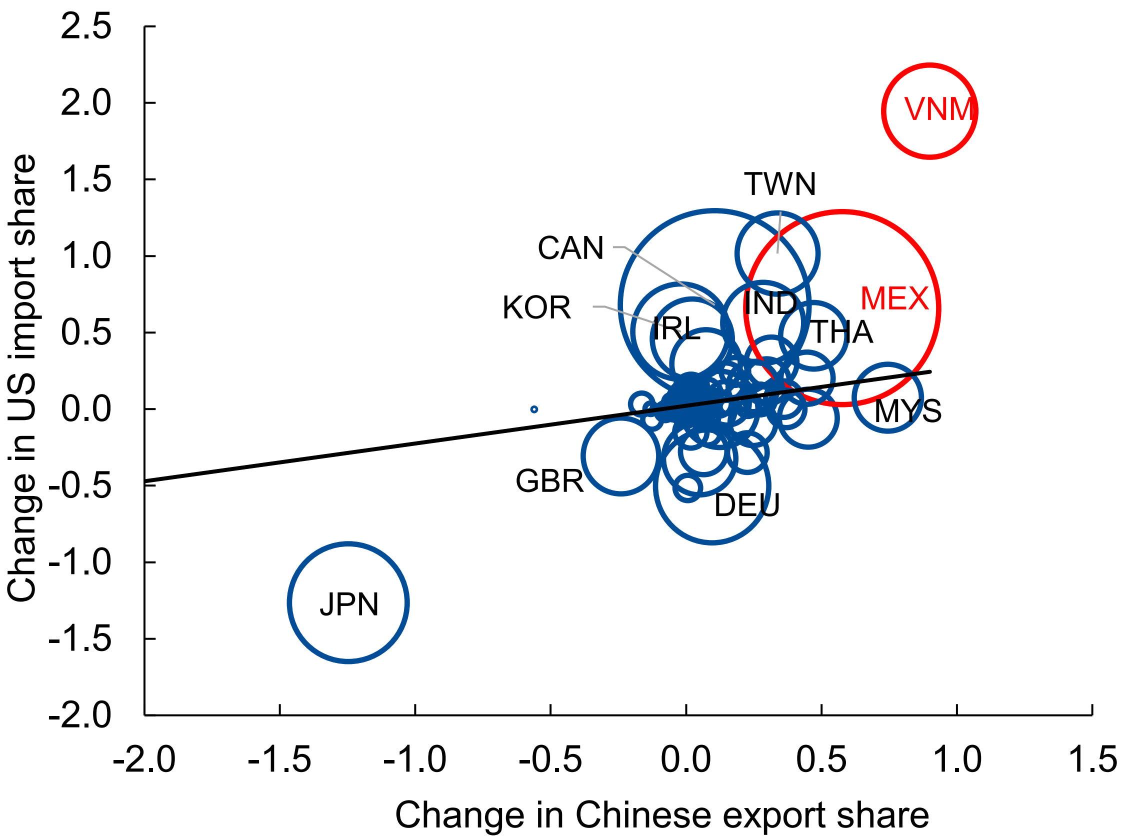


Sources: fDi Markets; and Trade data monitor; and IMF staff calculations.

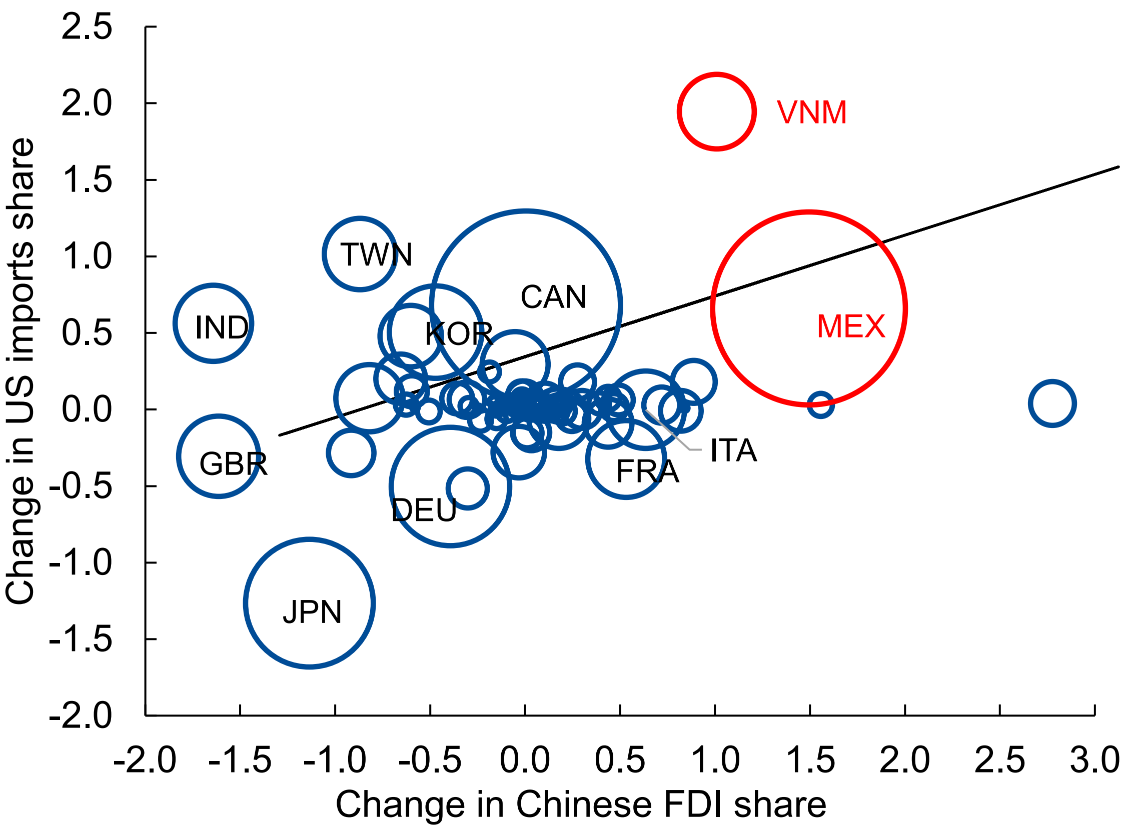
Exposure to China reduced?

Countries gaining market share in US imports received more FDI and exports from China since 2017

Change in US import shares vs Chinese export shares
(percentage point)



Change in US import shares vs FDI from China
(percentage point)

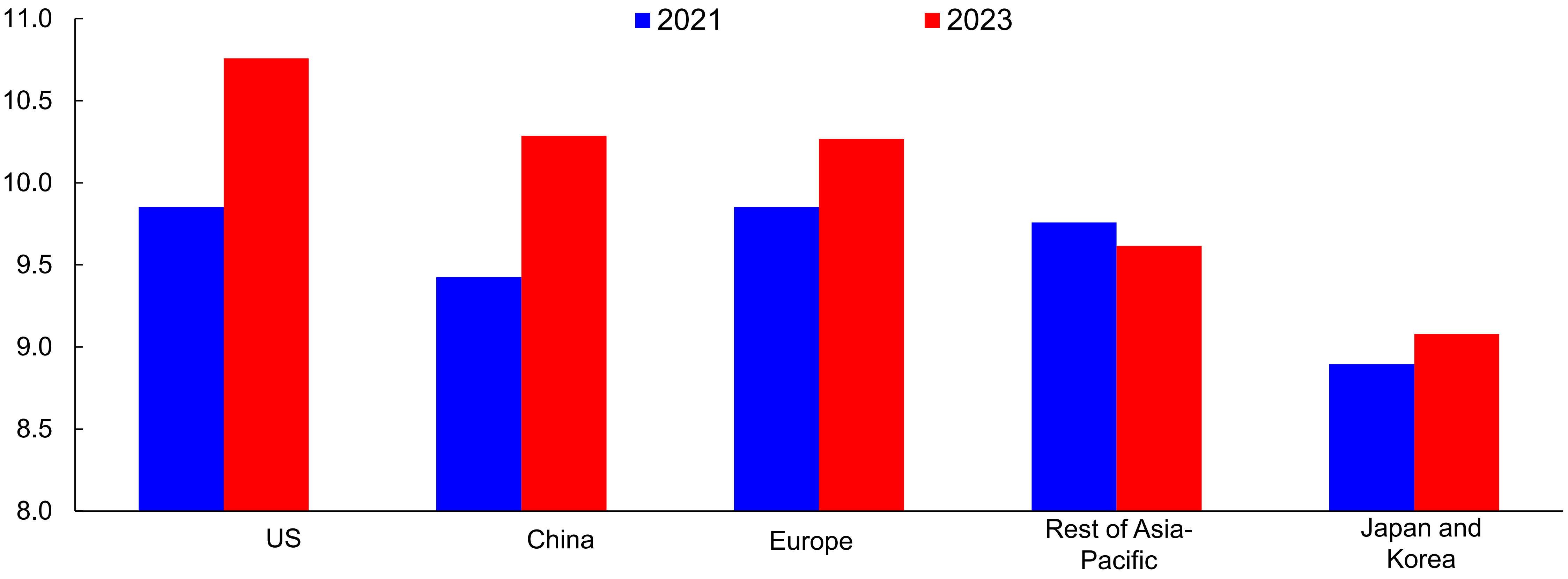


Sources: Trade Data Monitor; fDi Markets; and IMF staff calculations.

Lengthening supply chains

Trade flows are now making additional stops, especially those from China to the US

Distance by location of supplier
(number)



Sources: Qiu, Shin and Zhang (2023). “Mapping the realignment of global value chains.” BIS Bulletin No. 78.

#3. The costs of fragmentation

Fragmentation: the channels of transmission

- **Trade** restrictions imply less economies of scale, efficiency gains from specialization, resource reallocation, technological diffusion, and competition
  - Fragmented commodities trade could make the green energy transition harder
- **Capital flows** (FDI, portfolio and bank flows) restrictions may lead to lower capital accumulation and increased risks and macro volatility
- Barriers to **labor flows** could hinder innovation and worsen demographic trends

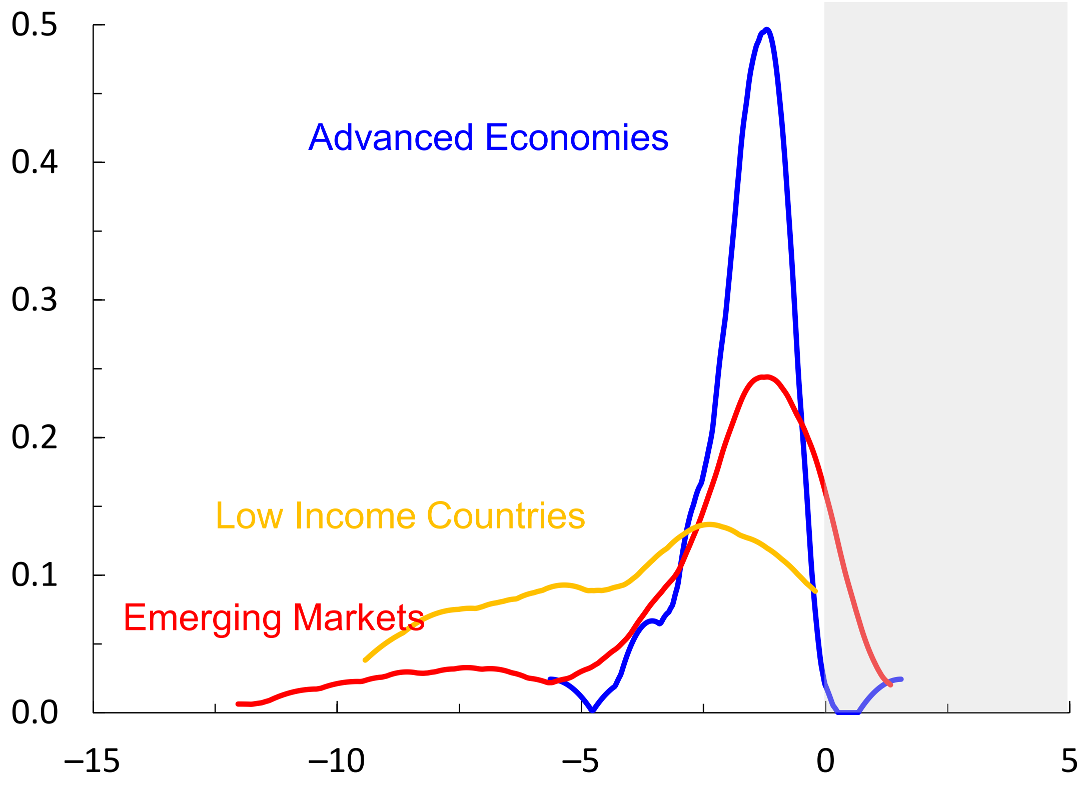
Temporary adjustments: price pressures and supply shortages

Global cooperation: harder to tackle challenges transcending geopolitical blocs

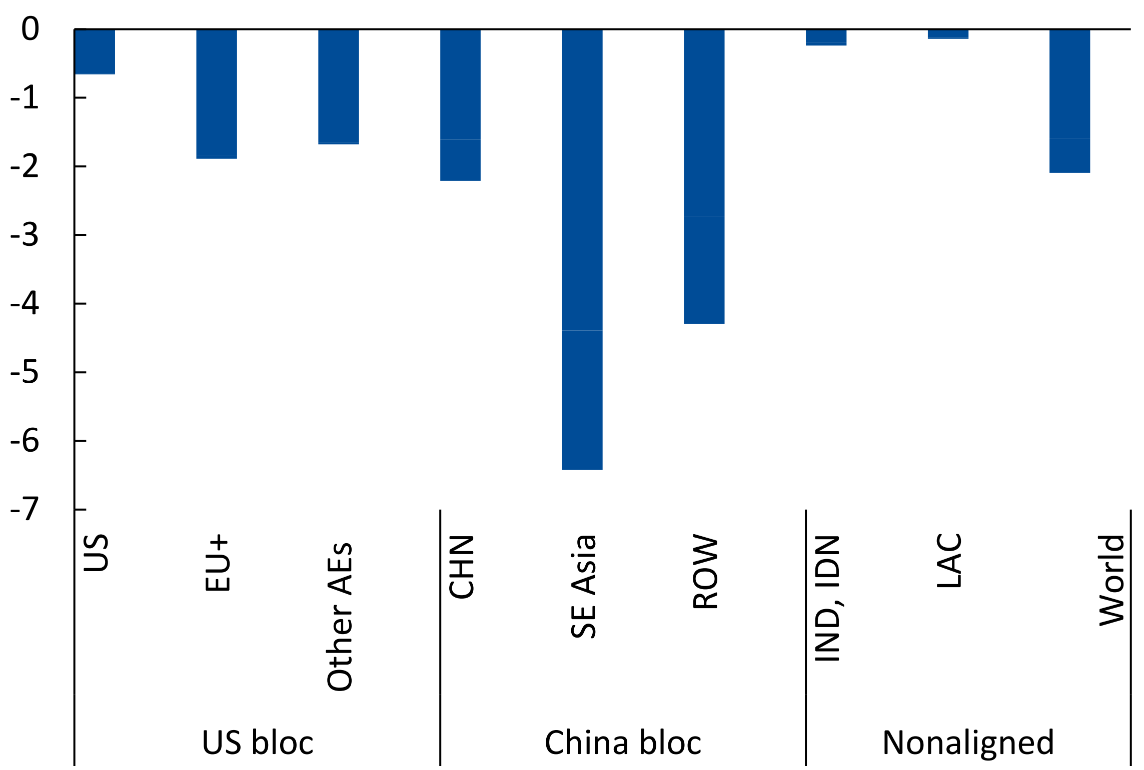
Fragmentation costs could be large

Output losses could be particularly severe for emerging market and developing economies

Trade fragmentation: impact on GDP
(density of percent deviation from baseline by country groups)



FDI fragmentation: impact on GDP
(percent deviation from no-fragmentation scenario)

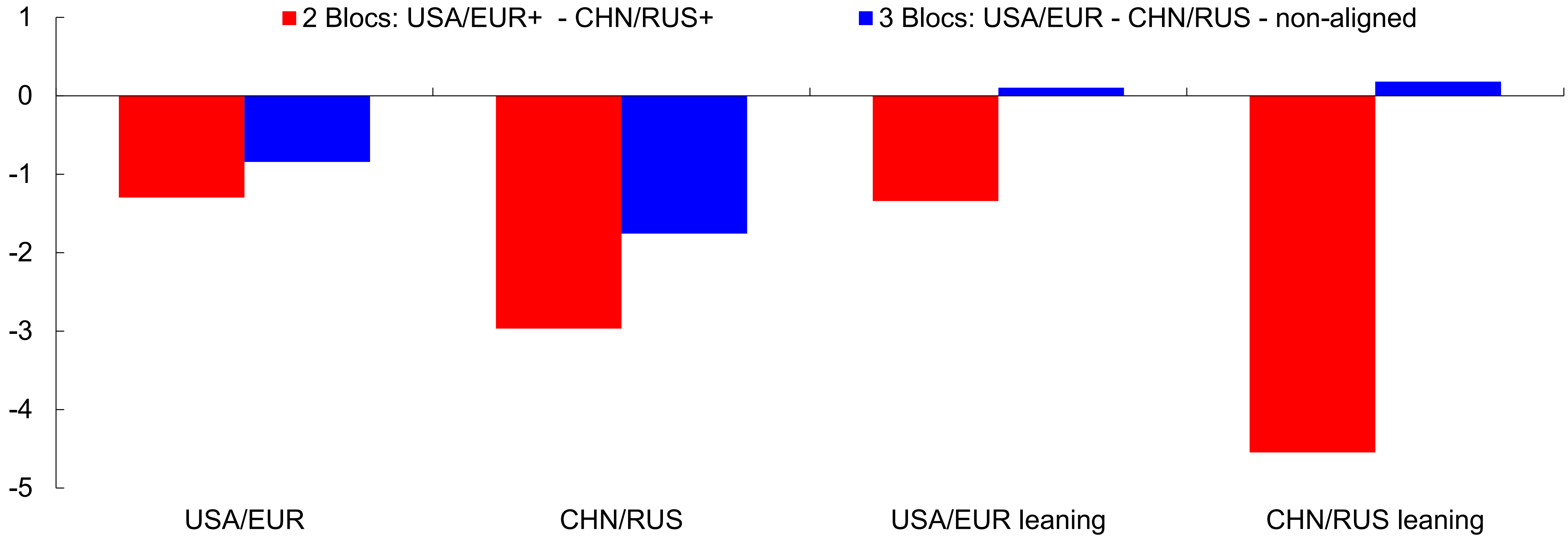


Sources: Bolhuis, Chen, and Kett (2023); Chapter 3 of the October 2023 World Economic Outlook; Chapter 4 of the April 2023 World Economic Outlook; and IMF staff calculations.
Note: In the right chart, country-level losses are aggregated using weights based on GDP at purchasing power parity.

Non-alignment a winning strategy?

Non-aligned economies could cushion the negative effects of fragmentation and benefit in some cases

Trade model simulations: alternative scenarios
(percent deviation of GDP from baseline) 1/



Sources: Bolhuis, Chen, and Kett (2023); Chapter 3 of the October 2023 World Economic Outlook; and IMF staff calculations.
Note: Country-level losses are aggregated using weights based on GDP at purchasing power parity. In the **2-bloc scenario**, countries are allocated across the two blocs based on their UN vote on Russia's invasion of Ukraine, as in Chapter 3 of the October 2023 WEO. In the **3-bloc scenario**, all trade between China/Russia and USA/EUR is eliminated, while the remaining countries continue to trade with all.

#4. Three principles for policy action

Three principles

To minimize fragmentation costs, achieve national objectives and tackle global challenges

1. Seek a multilateral approach for areas of common interest (e.g. climate change, regulation of new technologies)

2. Deploy a plurilateral approach that deepens economic ties with a broad set of partners and targets only a narrow set of products and technologies on economic security grounds (e.g. RTA, JSI)

3. Restrict the use of time-bound unilateral policy actions (e.g. IP) to address externalities and market distortions

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