ID CHATTER – IMF VIEW ON GEOECONOMIC FRAGMENTATION

This chatter summarises IMF staff's current view on geoeconomic fragmentation and the future of multilateralism, based on a staff paper published today. Note that the staff view may differ from the IMF Executive Board's views.

The paper examines (i) signs of fragmentation so far, (ii) the channels by which fragmentation would affect the global economy and welfare, (iii) the implications for the International Monetary System (IMS), and (iv) the IMF's recommended approach for addressing fragmentation risks.

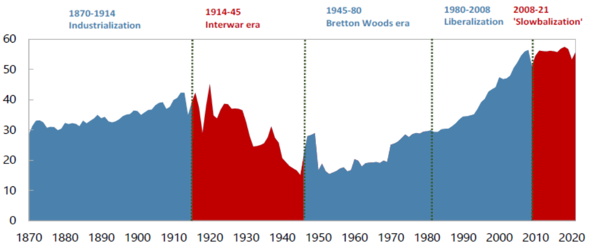
The paper is accompanied by additional analysis on debt reduction as self-insurance, fragmentation in the global payments system, ongoing trade initiatives, and a historical perspective on the IMS (see online annex).

After decades of increasing integration, the global economy is now at risk of fragmentation

Economic integration has plateaued since the GFC, and IMF staff believe it may now be on the brink of reversing.[1] As examples of this incipient fragmentation, they point to Brexit, the US-China trade tensions of 2018-19, and the proliferation of export restrictions in response to the pandemic (on medical goods and foodstuffs) and the war in Ukraine (on agricultural goods and fertilisers). The number of trade restrictions has spiked in the past five years (Graph 3), along with the use of trade measures for ostensibly national security reasons (Graph 4). IMF staff argue that strategic competition by governments around knowledge sharing is harming economic prospects and raising the risk of a high-tech decoupling.[2]

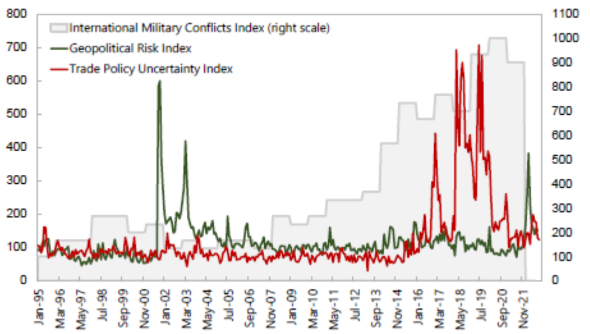
Graph 1

Figure 1: Trade Openness, 1870-2021
(Sum of exports and imports, percent of GDP)



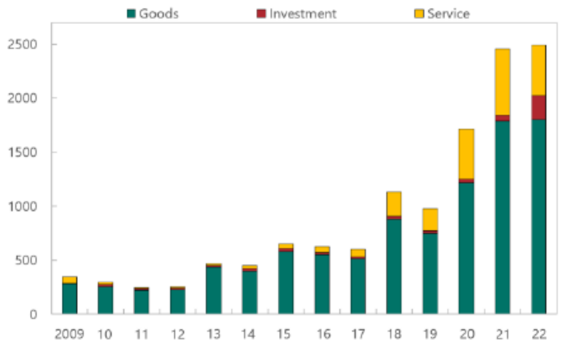
Graph 2

Figure 6. Geopolitical Risks, Military Conflicts and Trade Policy Uncertainty (1995 = 100)



Graph 3

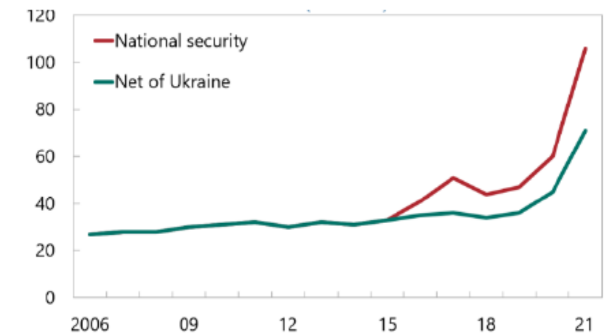
Figure 7. Trade Restrictions Imposed
(Number)



Sources: Global Trade Alert (2022), updated as of December 7, 2022

Graph 4

Figure 8. National Security Mentioned in IMF AREAR Reports
(Number)



Sources: 2022 IMF, Regional Economic Outlook: Asia and Pacific.

1 Internal RBA work argues that a material unwinding of global economic integration is unlikely, but is a risk worth monitoring (Bank 2022).

2 Recent measures highlighted by the IMF include the incentives for domestic producers in the US Inflation Reduction Act, the European Chips Act, and China's 'Made in China 2025' subsidy program, and US restrictions announced in October 2022 on sales to China of certain high-tech products.

Fragmentation is likely to involve significant economic costs via multiple channels, especially for EMDEs

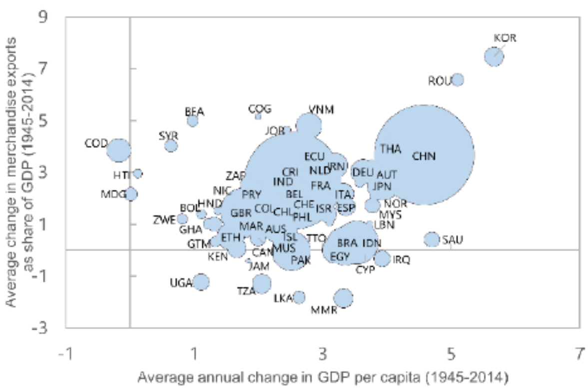
IMF staff outline several transmission channels for fragmentation:

- *Trade:* Fragmentation in trade would especially harm (i) lower-income countries, due their greater reliance on trade, their thin policy buffers, and the role of trade in driving income convergence (Graph 5); and (ii) low-income households in AEs, due to higher import prices.[3] In the transition period, supply chain adjustments could lead to repeated temporary supply shortages and higher inflation.
- *Technology diffusion:* Fragmentation would slow the expansion of the technological frontier and widen the technological gap between countries.
- *Cross-border labour flows:* A reduction in migration would exacerbate demographic trends in AEs, reduce remittance flows to origin countries, hinder knowledge diffusion across migrant diaspora networks, and limit productivity gains from a more efficient allocation of labour.
- *Cross-border capital flows:* A decline in international capital flows could slow capital accumulation, limit opportunities for consumption smoothing and risk-sharing, distort global resource allocation, hinder productivity gains from knowledge transfer, and make it difficult for EMDEs to deepen their domestic financial sectors.
- *Uncertainty:* Economic and policy uncertainty could lead firms to delay investment and R&D,[4] and drive further global demand for safe assets.
- *Global public goods:* The provision of global public goods – e.g. climate change mitigation, pandemic preparedness – relies on global cooperation, technology diffusion, and trade in critical goods.

Quantitative projections of the long-run output losses from fragmentation range from 0.2–1 percent in a limited fragmentation scenario, to 8–12 percent in the case of full technological decoupling (Graph 6). EMDEs are likely to be most affected, because they are furthest from the technological frontier. Actual welfare losses could be substantially higher than these estimates, which do not account for all transmission channels, interactions between channels, transition costs, or the political economy implications of fragmentation.

Graph 5

Figure 10. Growth of GDP and Trade, 1995–2014
(Average annual change in real GDP per capita vs. average annual change in exports as share of GDP, percent)



Sources: Fouquin and Hugot (2016); and Maddison Project Database 2020.
Note: Dot size is proportional to population.

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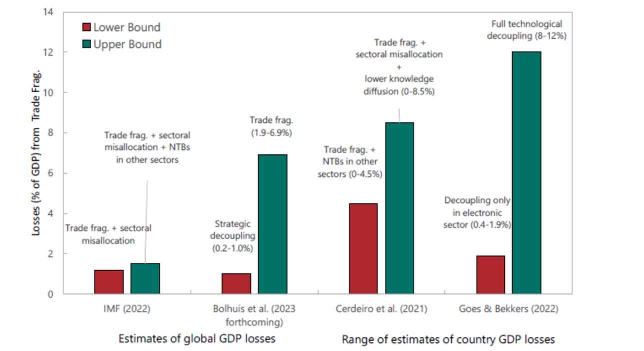
Figure 1.1: Long-Term Losses, Percent of GDP, from Global Trade Fragmentation



Fragmentation could exacerbate weaknesses in the International Monetary System (IMS)

IMF staff point to several implications of fragmentation for the IMS:

- *Less international risk-sharing:* Financial exposures might become concentrated within country blocs, where shocks are more correlated.
- *Less frequent but more severe crises:* While crises would be more frequent during the transition period, due to heightened volatility and policy uncertainty, fragmentation might reduce crisis frequency in the

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new steady state, by dampening the transmission of shocks across blocs. However, crises would likely be more severe when they did occur, due to less risk-sharing and access to external finance, reduced policy coordination across countries, and a fragmented global liquidity backstop.[5]

- *Less efficient global payments system:* As countries seek to reduce their reliance on international payments infrastructure and standards for geopolitical reasons, the emergence of new parallel systems lacking interoperability could raise transactions costs. In particular, this kind of fragmentation could undercut the benefits from current efforts to digitalise payments systems.
- *Potential changes to reserve composition and currency usage:* Fragmentation might reduce the transactional demand for certain dominant currencies, and thus reduce their share in reserve holdings. That said, there are currently no alternatives to existing reserve currencies. At least in the near term, changes in reserve composition are likely to be limited, and potentially tilted towards gold.[6]
- *A more fragmented global financial safety net (GFSN):* The middle two layers in the GFSN – bilateral swap arrangements and regional financial arrangements – are likely to increase in importance, while being reconfigured along geopolitical bloc lines. Countries might also seek to self-insure against the greater severity of crises by increasing reserve holdings. Multilateral institutions dominated by one geopolitical bloc could lose legitimacy, while those with balanced representation might become ineffective due to an inability to reach agreements. Overall, these changes could result in a GFSN that is more uneven in coverage, and with a potentially inadequate supply of liquidity.

To address the risk of fragmentation, the IMF proposes a pragmatic approach

Given the current geopolitical environment, the IMF suggests using different kinds of engagement to break deadlocks and rebuild trust.

1. In areas of common interest (e.g. climate change, food security, pandemic preparedness), multilateral efforts remain the best approach.
2. Where preferences are not aligned and multilateral action is not feasible, open and non-discriminatory plurilateral initiatives are a practical approach.[7]
3. Where preferences are not aligned and countries are resorting to unilateral actions, 'guardrails' should be used to mitigate global spillovers. These guardrails could include establishing multilateral consultation frameworks, which provide a forum for identifying spillovers of unilateral actions and considering whether alternative measures could achieve the same objectives, and developing common norms of conduct, e.g. agreeing on 'safe corridors' for critical goods and services such food, medicine, and energy.

For example, the IMF suggests applying this approach to the digitalisation of cross-border payments. Countries could start with plurilateral initiatives, then unify them in a multilateral system. Developing international guidelines/standards to ensure interoperability could be used as a 'guardrail' in this situation.

What the IMF can do

The IMF believes it can help address fragmentation risks by using its convening powers to support discussion and agreement on common policy approaches, and by monitoring and advising on spillovers from policy actions through its surveillance activities. They could also spearhead the creation of a multilateral consultation framework on cross-border restrictions motivated by national security.

With respect to its own governance, IMF staff note the importance of successfully completing the 16th General Review of Quotas by the end of 2023. They also say that EMDEs need a greater voice in the institutions governing the IMS.

Further reading

- The IMF's paper also includes annexes on:
  - Debt Reduction as Self-Insurance
  - Risks of Fragmentation of the Global Payment System

5 Sovereign debt crises in EMDEs have already become more difficult to resolve due to the heterogeneous preferences of creditors.
6 Central bank gold purchases increased dramatically in 2022Q3.
7 The IMF uses 'multilateral' to refer to agreements that are close to universal (e.g. among all WTO members), and 'plurilateral' for agreements among smaller groups of countries.

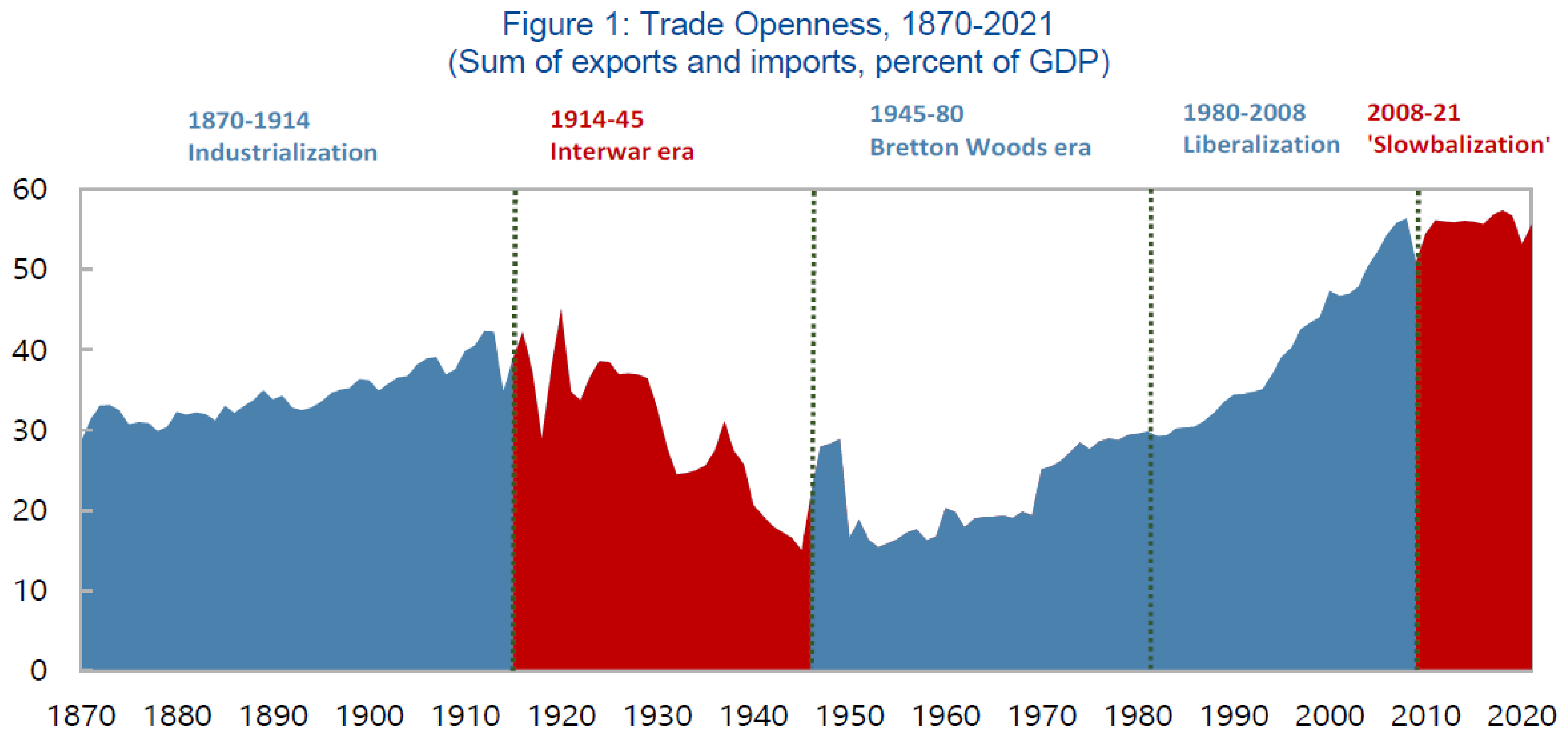
    - Multilateral and Plurilateral Initiatives to Advance the Trade Agenda
    - International Frameworks for Consideration of Policy Measures Imposed for Security Reasons.
- The online annexes include:
    - Future-Proofing the International Monetary System: Historical Perspective
    - Literature Review for Transmission Channels of Geoeconomic Fragmentation.

International Policy & Engagement
16 January 2023

RESERVE BANK OF AUSTRALIA

The IMF View on Geoeconomic Fragmentation

IMF: integration might be on the risk of reversing



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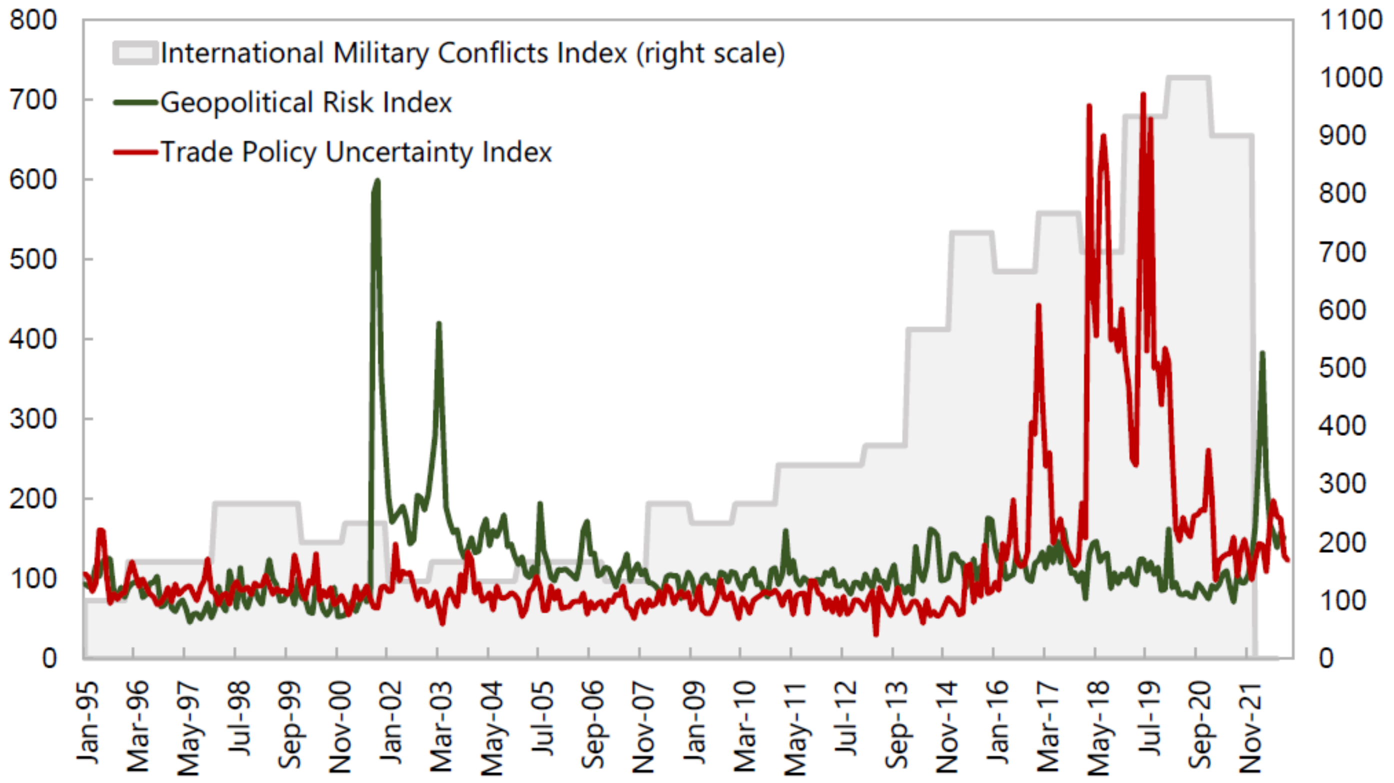

Figure 7. Trade Restrictions Imposed
(Number)

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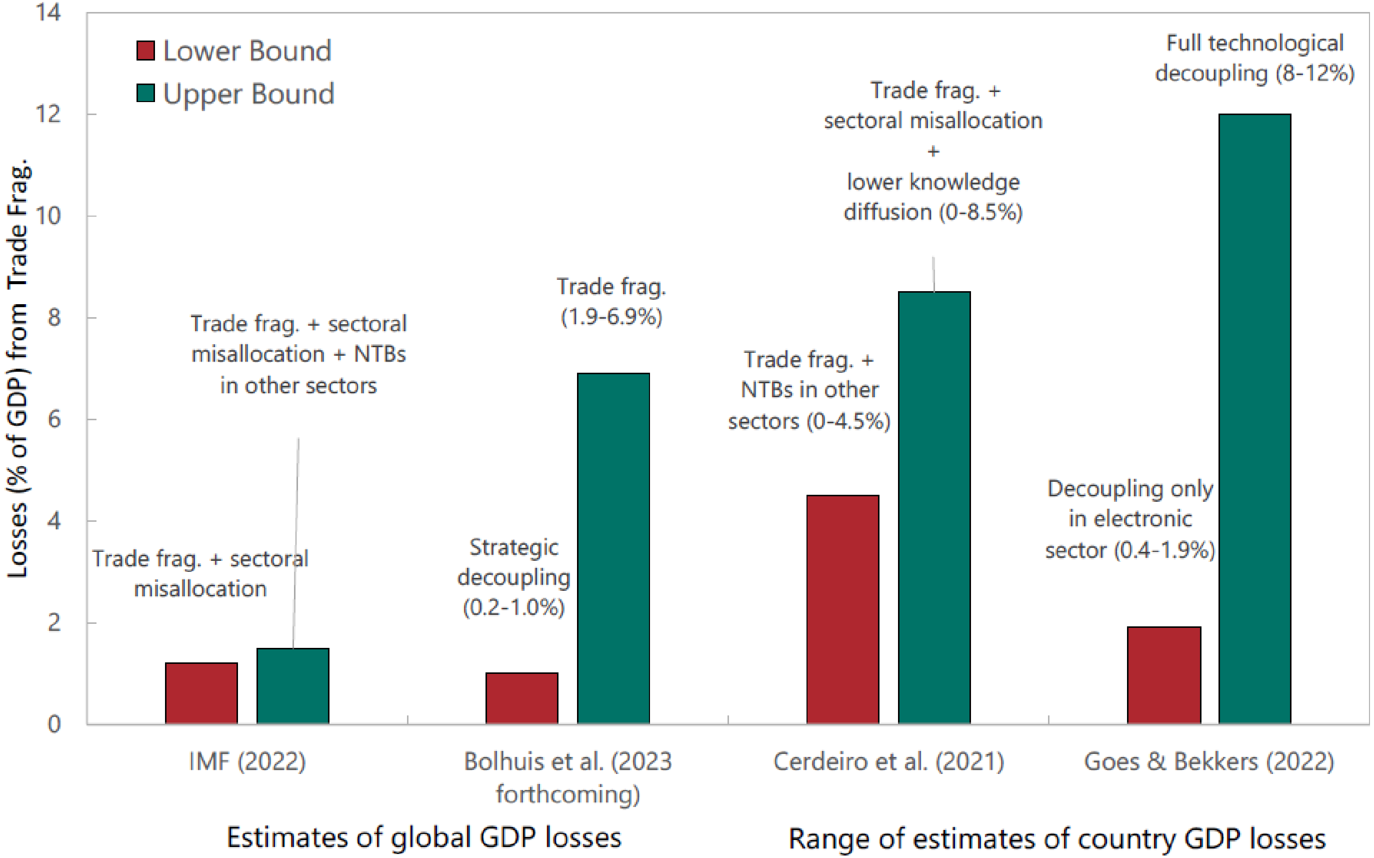
Transmission channels of fragmentation

- Trade
- Technology diffusion
- Cross-border labour flows
- Cross-border capital flows
- Uncertainty
- Global public goods

Box Figure 1.1: Long-Term Losses, Percent of GDP, from Global Trade Fragmentation

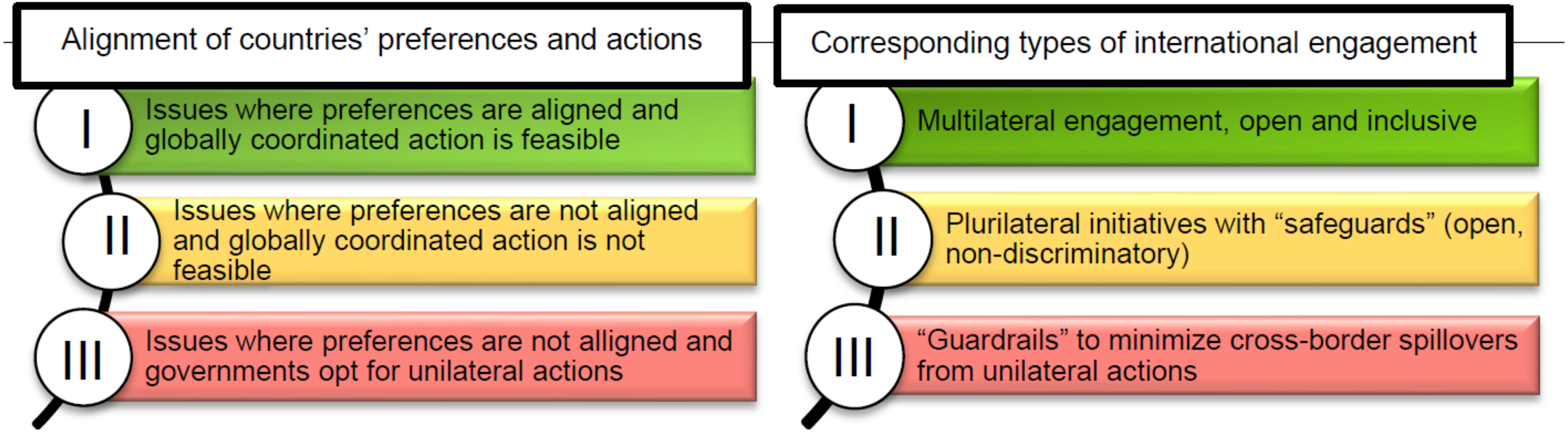


Implications for International Monetary System

- Less international risk-sharing
- Less frequent but more severe crises
- Less efficient global payments
- Possible changes to reserve composition and currency usage
- Fragmented global financial safety net

IMF recommends a multipronged approach

Figure 16. Pragmatic Approach to International Cooperation



Questions

- Are fragmentation concerns overhyped? Underhyped?
- How costly will it be? IMS implications?
- Does it matter for the RBA?

From:
Sent: Friday, 20 January 2023 9:54 AM
To:
Subject: RE: ID Chatter - The IMF View on Geoeconomic Fragmentation [SEC=OFFICIAL]

Thanks That's exactly right – in the papers that the IMF survey, the largest quantitative effects of fragmentation generally come from low-income countries losing the productivity benefits of technology transfer.

From:
Sent: Friday, 20 January 2023 3:20 AM
To:
Subject: RE: ID Chatter - The IMF View on Geoeconomic Fragmentation [SEC=OFFICIAL]

I thought this was a very interesting read thanks Surprising to see the outcome of full tech decoupling versus other forms of fragmentation discussed no doubt this is because it would impede productivity gains and low income economy catch up right?

European Representative Office
RESERVE BANK OF AUSTRALIA | Level 2, 53 New Broad St, London EC2M 1JJ
w: www.rba.gov.au

From:
Sent: Monday, 16 January 2023 2:02 AM
To: ID Chatter
Subject: ID Chatter - The IMF View on Geoeconomic Fragmentation [SEC=OFFICIAL]

For word version, see D23/12266.

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After decades of increasing integration, the global economy is now at risk of fragmentation

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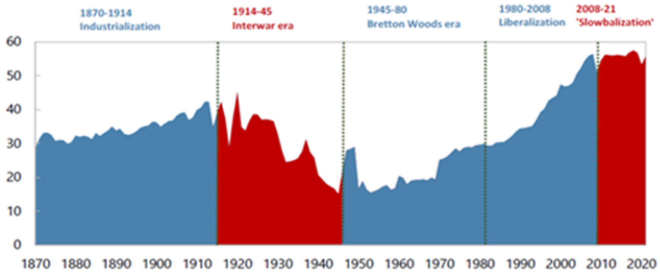

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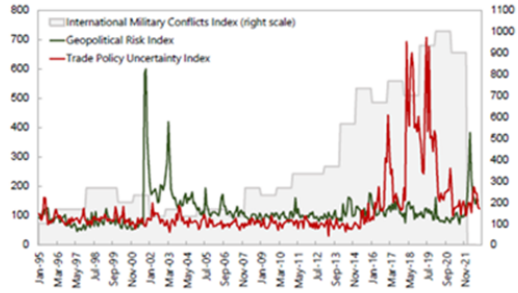

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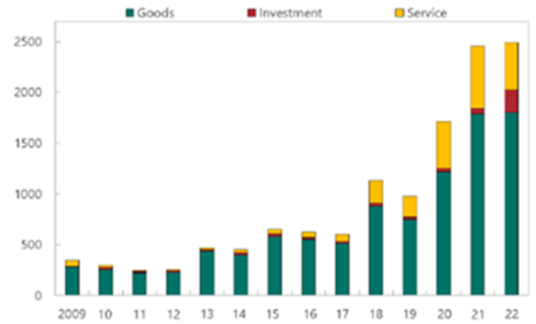

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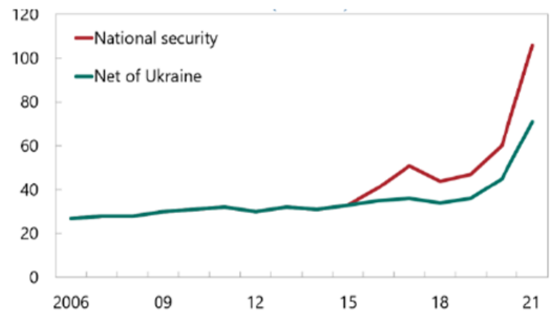

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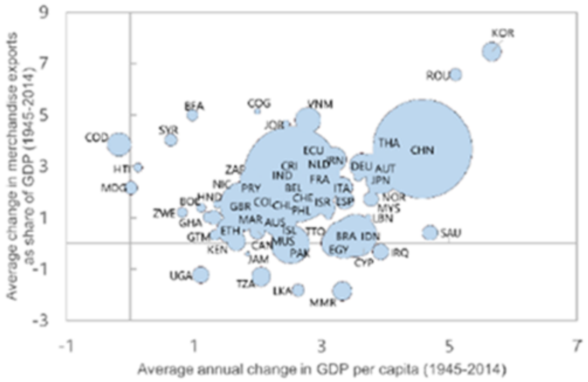

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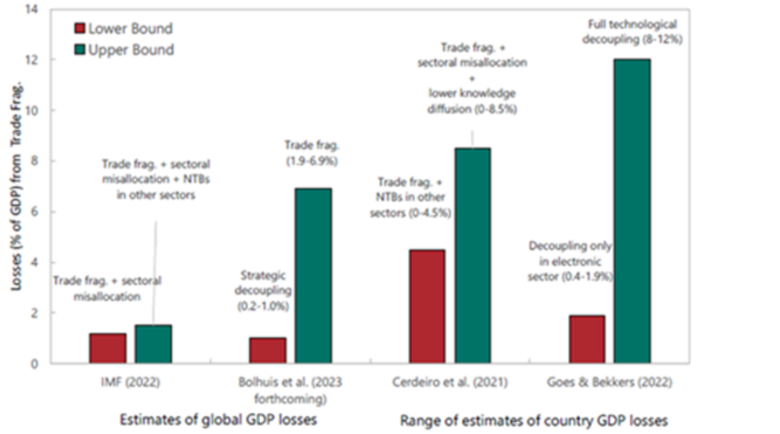

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- *Potential changes to reserve composition and currency usage:* Fragmentation might reduce the transactional demand for certain dominant currencies, and thus reduce their share in reserve holdings. That said, there are currently no alternatives to existing reserve currencies. At least in the near term, changes in reserve composition are likely to be limited, and potentially tilted towards gold.[6]
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reconfigured along geopolitical bloc lines. Countries might also seek to self-insure against the greater severity of crises by increasing reserve holdings. Multilateral institutions dominated by one geopolitical bloc could lose legitimacy, while those with balanced representation might become ineffective due to an inability to reach agreements. Overall, these changes could result in a GFSN that is more uneven in coverage, and with a potentially inadequate supply of liquidity.

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Further reading

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From:
Sent: Thursday, 18 May 2023 5:21 PM
To:
Cc:
Subject: IMF material on financial implications of geoeconomic fragmentation [SEC=OFFICIAL]

Hi

mentioned you were looking for some IMF material on the financial implications of geoeconomic fragmentation. They've published three papers on it this year: I've copied some notes below and linked to them.

This is largely from pre-existing IPE material, but I'd be happy to provide more info on anything if that would be useful.

April GFSR chapter on *Geopolitics and Financial Fragmentation: Implications for Macro-Financial Stability*

- Geopolitical tensions could lead to macro-financial instability through:
    - Restrictions placed on capital flows and payments.
    - An increase in uncertainty and investors' risk aversion to future restrictions, the escalation of conflict or expropriations.
    - Restrictions on international trade and technology transfer, and disruptions to supply chains and commodity markets.
- An increase in geopolitical tensions with major partner countries could cause a sudden reversal of cross-border capital flows, with the effect more pronounced for EMDEs than AEs.
- These could cause liquidity and solvency stress in banks and non-financial corporations through reduced profitability, increased funding costs, and lower provision of credit to the private sector.
    - The effects are likely to be disproportionately larger for banks with lower capitalisation ratios.
- To mitigate macro-financial stability risks arising from geopolitical tensions, policymakers should**:**
    - Devote resources to identifying, managing, and mitigating financial stability risks stemming from geopolitical tensions.
    - Take a systematic approach to supervision, using stress testing and scenario analysis to quantify geopolitical shock transmission to financial institutions.
    - Ensure banks and NBFIs have adequate capital and liquidity buffers to manage rising geopolitical risks.
    - Ensure the adequacy of the GFSN, using (i) international reserves, (ii) bilateral and regional financial arrangements, and (iii) precautionary credit lines from international financial institutions.
    - Strengthen international cooperation by promoting convergence in financial regulations and standards (e.g. frameworks to enhance the interoperability of payment systems).
    - Use diplomacy to try to resolve geopolitical tensions and prevent fragmentation.
- The chapter also has two boxes, these include:
    - *Geopolitical Tensions and Cross-Border Payments: A Case Study of Remittances*
    - *Financial Fragmentation: Loss of Diversification Benefits*

Paper on *Geoeconomic Fragmentation and the Future of Multilateralism* (summarised in this IPE chatter)

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April WEO chapter on *Geoeconomic Fragmentation and FDI*

- The recent slowdown in FDI has been characterised by divergent patterns across host countries, particularly when considering investment in strategic sectors, like semiconductors. FDI flows are increasingly concentrated among countries that are geopolitically aligned. Efforts to preserve a multilateral dialogue are needed to keep FDI fragmentation from increasing.
- Analyses of vulnerability to FDI relocation suggests that, on average, EMDCs are more vulnerable than advanced economies. Countries could mitigate their exposure to FDI relocation by introducing policies and regulations to promote private sector development.
- A further contraction in FDI and a shift in its geographic distribution would likely have large negative effects on host countries, through lower capital accumulation and technological deepening.
- Illustrative model-based scenarios suggest that FDI fragmentation could substantially reduce global output, by about 2% in the long term. These losses are likely to be unevenly distributed, with EMDCs with reduced access to advanced economies being particularly effected, through both lower capital formation and reduced productivity gains.

Cheers

International Policy & Engagement | International Department
RESERVE BANK OF AUSTRALIA | 65 Martin Place, Sydney NSW 2000
w: www.rba.gov.au

[1] Sovereign debt crises in EMDEs have already become more difficult to resolve due to the heterogeneous preferences of creditors.

[2] Central bank gold purchases increased dramatically in 2022Q3.

From: JONES, Bradley
To:
Subject: Chart from IMF [SEC=OFFICIAL]
Date: Wednesday, 11 October 2023 5:25:00 PM
Attachments: image002.png
image003.png

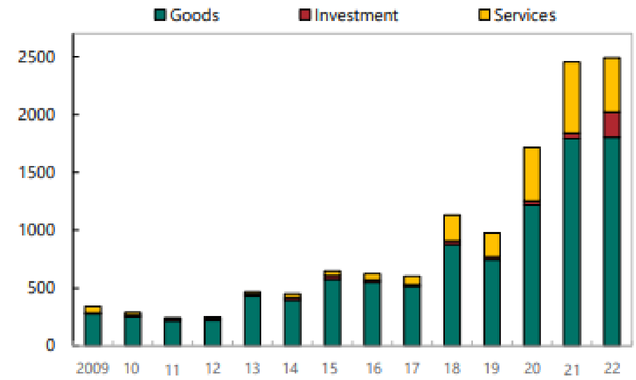
Hi

Could I please trouble you to track down the data so we can reproduce Figure 7 (p.11) from this IMF paper: https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2023/01/11/Geo-Economic-Fragmentation-and-the-Future-of-Multilateralism-527266.

The contact authors are below (unfort I don't know any of them). Mention that we would like to reproduce the chart for a speech (with their permission).

@imf.org; @imf.org; @imf.org;
@imf.org; @imf.org

Figure 7. Trade Restrictions Imposed
(Number)



Sources: Global Trade Alert (2022), updated as of December 7, 2022

Thanks and let me know if any issues.

Brad

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