

BROOKINGS

International Fragmentation

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September 2023

A Break from the Past

- Long period of increasing economic integration
 - International trade
 - Global allocation of production
 - International finance
 - Labor movements
- First signs of backlash
 - Brexit
 - US-China trade tensions
 - Russia's external strategy 2014-onwards

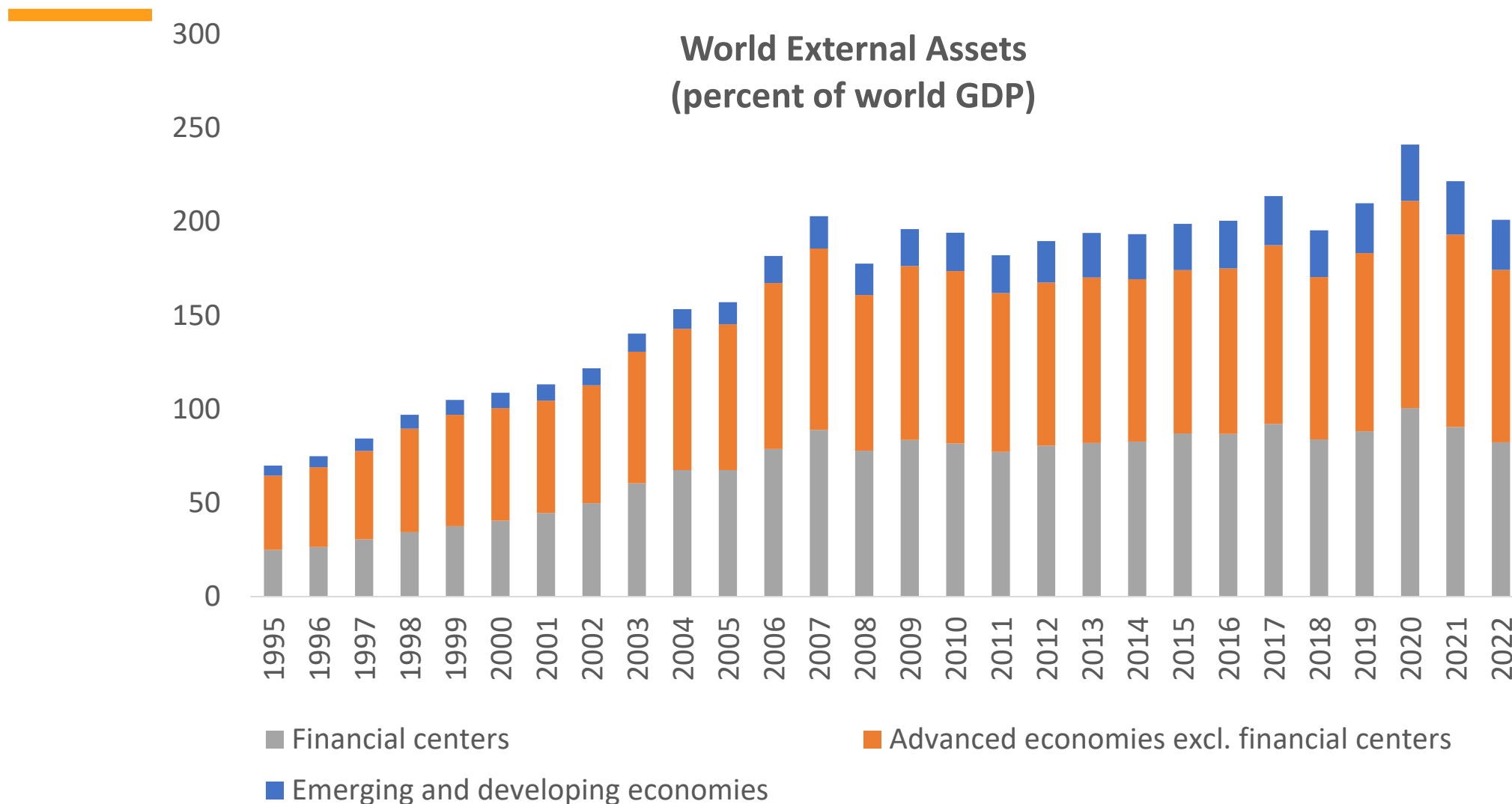
A Break from the Past (II)

- COVID-related trade frictions
- Increase in geopolitical tensions
 - China-US (and Europe)
 - Russia's invasion of Ukraine
- “Industrial policy” and trade restrictions
- Ongoing re-shaping of economic linkages—but will take time

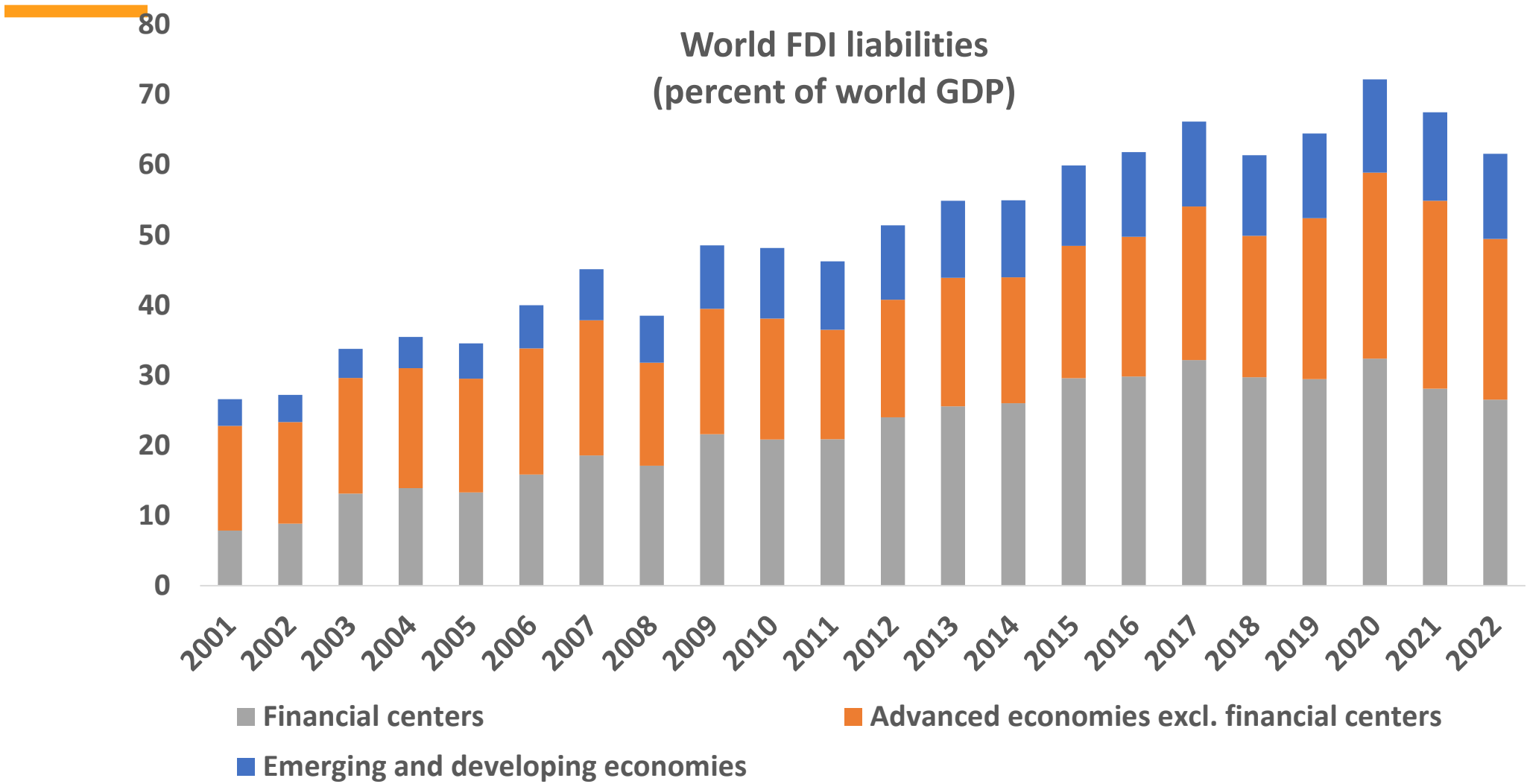
Rapidly Growing Literature

- IMF conference (May 2023)—forthcoming CEPR E-Book
- Goldberg-Reed (2022 BPEA)
- WEO Ch. 4 (Spring 2023) — FDI
- GFSR Ch. 3 (Spring 2023) — international finance
- Aiyar et al (2023) (geopolitical fragmentation)
- Freund et al (2023) (US trade policy and supply chains)
- Alfaro-Chor (2023) Jackson Hole paper

A Quick Look at the Past 25 Years: (I) International Finance



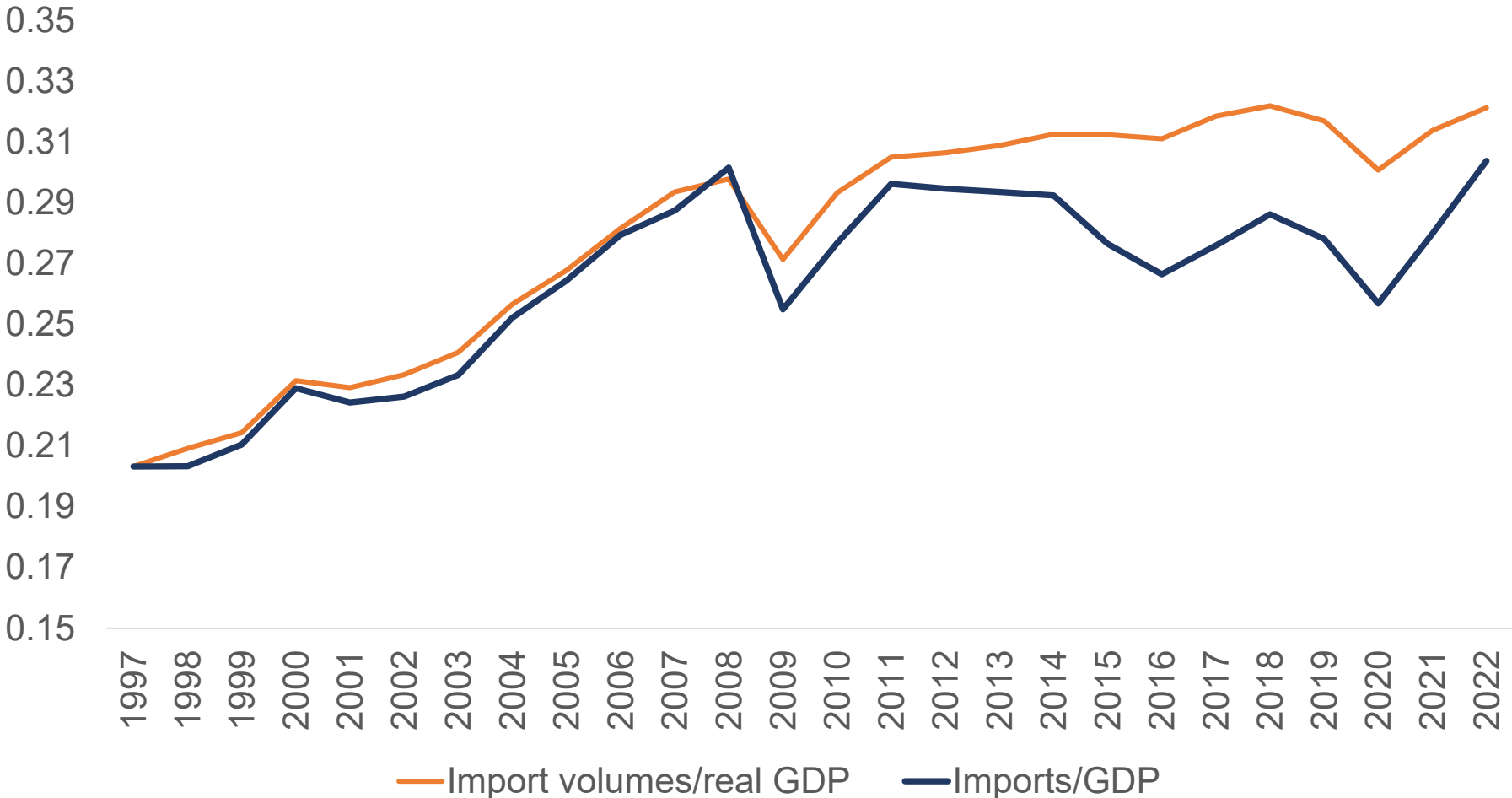
A Quick Look at the Past 25 Years: (II) International Finance: FDI



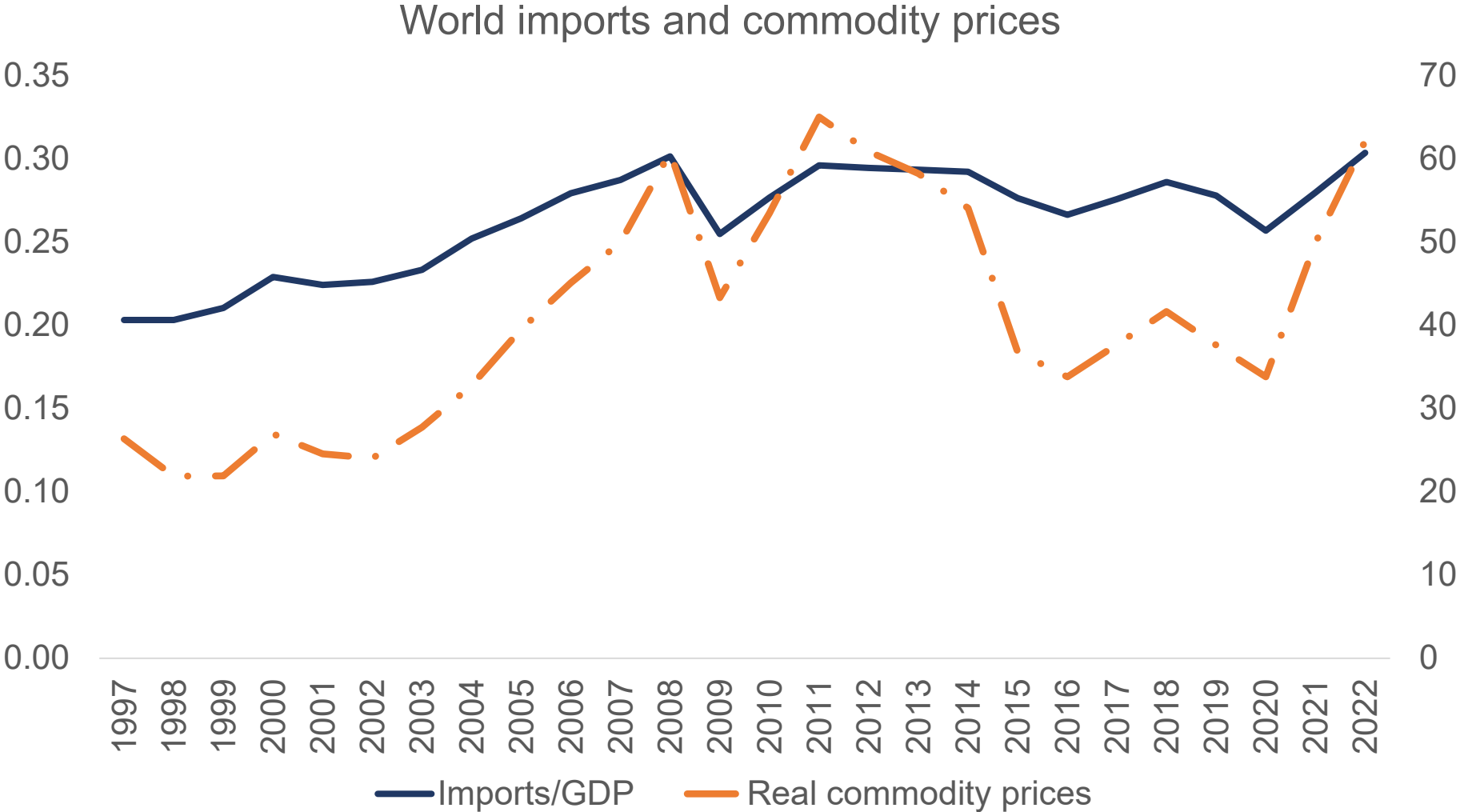
A Quick Look at the Past 25 Years: (II) Trade Volumes and Values



World imports: values and volumes



A Quick Look at the Past 25 Years: (II) Trade Volumes and Values



Evidence so far: International Trade

- United States: changes in import origin
 - China's share of US imports ↓ (esp. goods subject to tariffs)
 - Increase in shares of Vietnam, Taiwan, Mexico....
- Countries increasing US exports have rapid trade growth with China in the same categories
- Weak evidence of “reshoring”
- No decline in the share of euro area imports coming from China

Evidence so far: Production Allocation

- Reduction in FDI flows to China (and from China to US)
- Higher FDI among countries that are more geopolitically aligned
- Harder to find direct evidence on reshaping supply chains given data availability....
- ...but anecdotal evidence clearly pointing in that direction

Evidence so far: Portfolio Allocation

- Countries tend to allocate a larger share of their portfolio to countries with closer geopolitical preferences
- **Russia:** rapid reduction in portfolio investment in the US after 2014 (direct holdings of US bonds virtually disappeared by 2018)
- **China:** reduction in the share of US bonds held directly
- Hard to interpret data because of volume of investment intermediated by financial centers

Holders of U.S. Portfolio Instruments

Holdings in the U.S. as a Percentage of Total Foreign Holdings in the U.S.

	Jan 2012		June 2017		June 2023	
	Debt	Equity	Debt	Equity	Debt	Equity
Russia	1.8%	0.0%	0.9%	0.0%	0.0%	0.0%
China	17.5%	5.3%	13.1%	2.7%	9.4%	2.3%
Advanced Asia	26.5%	12.1%	24.2%	12.6%	24.2%	14.0%
Other Advanced Econ.	8.3%	26.2%	9.9%	27.4%	14.0%	29.3%
Small Financial Centers	9.4%	17.7%	9.5%	17.1%	8.4%	14.3%
Large Financial Centers	24.9%	30.6%	31.8%	33.2%	32.3%	33.1%

Assessing Economic Implications

- Fiendishly difficult! We do not know the end-point
- Negative effects on productivity, more severe for affected EMs (less trade and technology transfer). But subsidies/decline in competition take a toll on AEs as well
- International finance/centrality of the dollar
 - Financial market weight of AEs (especially US) still dominant
 - Hard to envisage large switch away from US\$ as store of value
- Repercussion of tensions on international cooperation (eg debt restructuring agreements)