US-China tensions fragmenting trade and investment, IMF finds

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The global economy is showing signs of dividing between US- and China-centered blocs, though the dynamics differ from the Cold War with less overall fragmentation and a greater role for non-aligned economies, an International Monetary Fund study found.

Trade flows between a US-aligned group and another linked more closely to China have declined by about 12% more than trade between countries within the same bloc since Russia's full-scale invasion of Ukraine in 2022, according to a new working paper by IMF economists including First Deputy Managing Director Gita Gopinath.

Foreign direct investment projects fell by around 20% more between blocs than within blocs over the same period, it added. "The magnitude of the decline is both economically and statistically significant," the paper said.

Still, those declines are a fraction of the shortfall during the Cold War, when trade between the rival Western and Eastern blocs declined by two-thirds, relative to trade within those blocs, the study found.

"While the extent of fragmentation is still relatively small and we do not know how long-lasting it will be, the decoupling between the rival geopolitical blocs during the Cold War suggests it could worsen considerably should geopolitical tensions persist and trade restrictive policies intensify," according to the paper.

'Connector' Economies

Another contrast is that many of those non-aligned economies are benefiting from a new status as "connector" economies between the two blocs, it added.

"Global trade and investment have been resilient mostly because flows have been re-routed via connector countries. These non-aligned countries could benefit from rising geo-economic fragmentation," the paper said.

That's different from the Cold War, when neutral economies didn't step in to bridge the gap between the blocs because of factors like higher trade barriers and transport costs, it said.

The authors of the paper emphasized that economic fragmentation is different from deglobalization: The ratio of the world's goods trade to global gross domestic product increased significantly during the Cold War even as the competing blocs decoupled.

As strategic rivalry ramps up between the US and China, the IMF has warned about the economic damage from fragmentation, which it has estimated may sacrifice as much as 7% of global GDP in the long term, equivalent to the combined size of the French and German economies.