



# Geopolitical Tensions and Economic Fragmentation: A Trade Policy Response

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## Executive Summary

**The policy challenge.** At a time when effective global co-ordination and action are desperately required, developments on the ground present several challenges. The shock from the COVID-19 pandemic elicited protectionist sentiment in some areas and continues to weigh on the global economy, despite the heroic response by the medical community. The war in Ukraine is tremendously costly to the adversaries. It has also proven very costly to third parties, especially those dependent on food and energy supply from the region. Tensions and bilaterally targeted trade restrictive actions by the US and China continue to the detriment of the two parties, with many others indirectly affected as well.

G20 leaders adopted a broadly conciliatory and constructive tone at their Bali summit (15-16 November 2022), concluding with a roughly 20-page Leaders' Declaration. That document included concrete actions to be taken in areas such as macroeconomic and financial stability, supply chain resilience,

food and energy security, and support for development.<sup>2</sup> Yet, real systemic risks persist with respect to growing economic fragmentation that is aggravated by the war in Ukraine and geopolitical tensions between China and the United States. Security considerations are spilling over to affect the international economy. The multilateral system remains distressed with respect to trade and investment.

**Some regional trade agreements such as the CPTPP and RCEP have a comparatively broad scope and complement trade policy efforts at the multilateral level, though still with gaps and limitations.**

The G20 Leaders' Declaration acknowledges the challenging situation, pointing to fragmentation in global health system governance; resilience shortfalls in areas such as food, finance, and the digital economy; and the compounding effect of geopolitical tensions on matters such as the climate emergency and energy crisis. A wide-ranging set of actions is endorsed. A central role for trade and investment is recognised as part of the solution. There is an affirmation of the importance of the multilateral trading system, but a statement of strategic approach to trade and investment is lacking. The G20 remains pragmatically oriented towards a more restricted mode of operation, building up its program from specific actions.

Likewise, the World Trade Organisation (WTO) has delivered some concrete results in specific areas. At the WTO's 12th Ministerial Conference (June 2022) the members reached accords such as disciplines on illegal fishing subsidies and continued duty-free treatment for



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## Introduction: A Hot War in Europe<sup>6</sup>

For the first time since the Cuban Missile Crisis (1962) the spectre of a nuclear confrontation between military superpowers is back. What started as President Putin's "special military operation" morphed into a war of attrition indirectly involving NATO countries through their support to Ukraine.

Russia has relied on a campaign of misinformation to influence perceptions about the invasion. On September 30th, Vladimir Putin organised an event in Moscow to announce that the referendums in Donetsk, Kherson, Luhansk and Zaporizhzhia had "unequivocally" confirmed the proposal to join the Russian Federation. Russia would be annexing roughly 15% of the Ukrainian territory. The decision to draft up to 300,000 military reservists to fight in Ukraine and Putin's reference to the use of nuclear weapons, suggest that the Kremlin is prepared to engage in a war of attrition and to use nuclear blackmail to limit external military support to Ukraine.

Winter, however, is an even more immediate threat to the Western alliance, constituting a test of its resilience. Russian history is marked by many episodes in which the outcome of military conflicts was influenced by the climate. The expression "General Winter" became popular in explaining past Russian military successes. In 1708/09, the Swedish troops of Charles XII faced one of the coldest winters in history helping Tzar Peter I win the battle of Poltava. In 1812, French troops, already retreating from Moscow, were decimated by the Russian army. Napoleon in a letter to Empress Marie Louise wrote: "The winter was our disaster. We became the victims of Russia's climate." And in World War II, the winter played an important role in the outcome of the battle for Stalingrad (1942-43).

A temporary stabilisation of the front could provide Russia with time to reorganise its forces and to train new conscripts. But the role of "General Winter" may also potentially have a significant impact, representing a point where security and economic considerations interact. The effect of the war on energy prices and availability – particularly natural gas, but also oil – may be a critical variable. The manipulation of energy exports has been a tactic used by Russia since 2014 in the aftermath of the annexation of Crimea.

digital products.<sup>3</sup> Some regional trade agreements such as the CPTPP and RCEP have a comparatively broad scope and complement trade policy efforts at the multilateral level, though still with gaps and limitations.<sup>4</sup>

Nonetheless, there remains a steady undercurrent of populism globally. This has been accompanied by the adoption of protectionist policies that distort trade, investment, and the digital economy.<sup>5</sup> In recent years, the number of economically costly trade policy actions have outpaced liberalising and trade facilitating measures by a wide margin. Collectively, such actions diminish our economic potential at a time when more resources are needed to respond to global challenges including the pandemic recovery and climate change.

In this note, we focus on the implications for the trading system of two symptoms of the current malaise: the conflict in Eastern Europe – in particular, with respect to energy – and the disruption to international trade arising from geopolitical tensions in Asia. It is evident that this poisonous "cocktail" is affecting not only growth

prospects, but also the capacity of multilateral institutions to function and to uphold the rules of the game – particularly, with respect to international trade and peace.

**The policy response.** We argue that trading nations need to renew the value proposition that underpins the multilateral system for trade and investment. An economically compelling, succinct, and clear restatement of the core principles endorsed by leading economies may help to elicit popular buy-in for the revitalisation of multilateralism and against fragmentation. A formal affirmation may also motivate greater policy consistency among member countries. The idea is to advance trade governance using a high standard approach that offers market access and trade facilitation, but also includes elements such as labour standards and environmental protection. It could draw on existing agreements but could go beyond in a new more inclusive manner to address concerns and unlock economic opportunity including for developing countries.



Western sanctions have imposed costs on Russia; however, if Russia can find other outlets (China, India, Turkey...) for its exports the economic impact of the sanctions is attenuated.<sup>7</sup> At the same time, Russian gas export restrictions are imposing significant costs upon the European economies. During 2022, wholesale prices for gas and electricity increased up to fifteen times in some markets compared to 2021, though with some recent moderation.<sup>8</sup> The European Commission (EC) proposed measures that will stimulate demand reduction for both electricity and gas, while protecting vulnerable consumers. This is a step in the right direction but may not be enough.<sup>9</sup> The alleged sabotage of the Nord Stream pipelines in the last week of September added to the uncertainty.

Prices of natural gas have now fallen 80% from their peak in 2022, but they remain elevated (double their pre-crisis level).<sup>10</sup> Russia believes that the military and economic support to Ukraine will become increasingly unpopular in European countries. Some countries (e.g., The Netherlands) have been issuing waivers to sanctions against Russia and some fear this practice may become widespread. In the end, the effectiveness of the Russian strategy – including its destruction of the energy infrastructure in Ukraine – will depend on the strength of “General Winter.” So far, the winter has been 30% warmer than the 30-year average. Moreover, gas inventories are currently at high levels, diminishing the chances of major spikes in the price of energy in the coming months.<sup>11</sup>

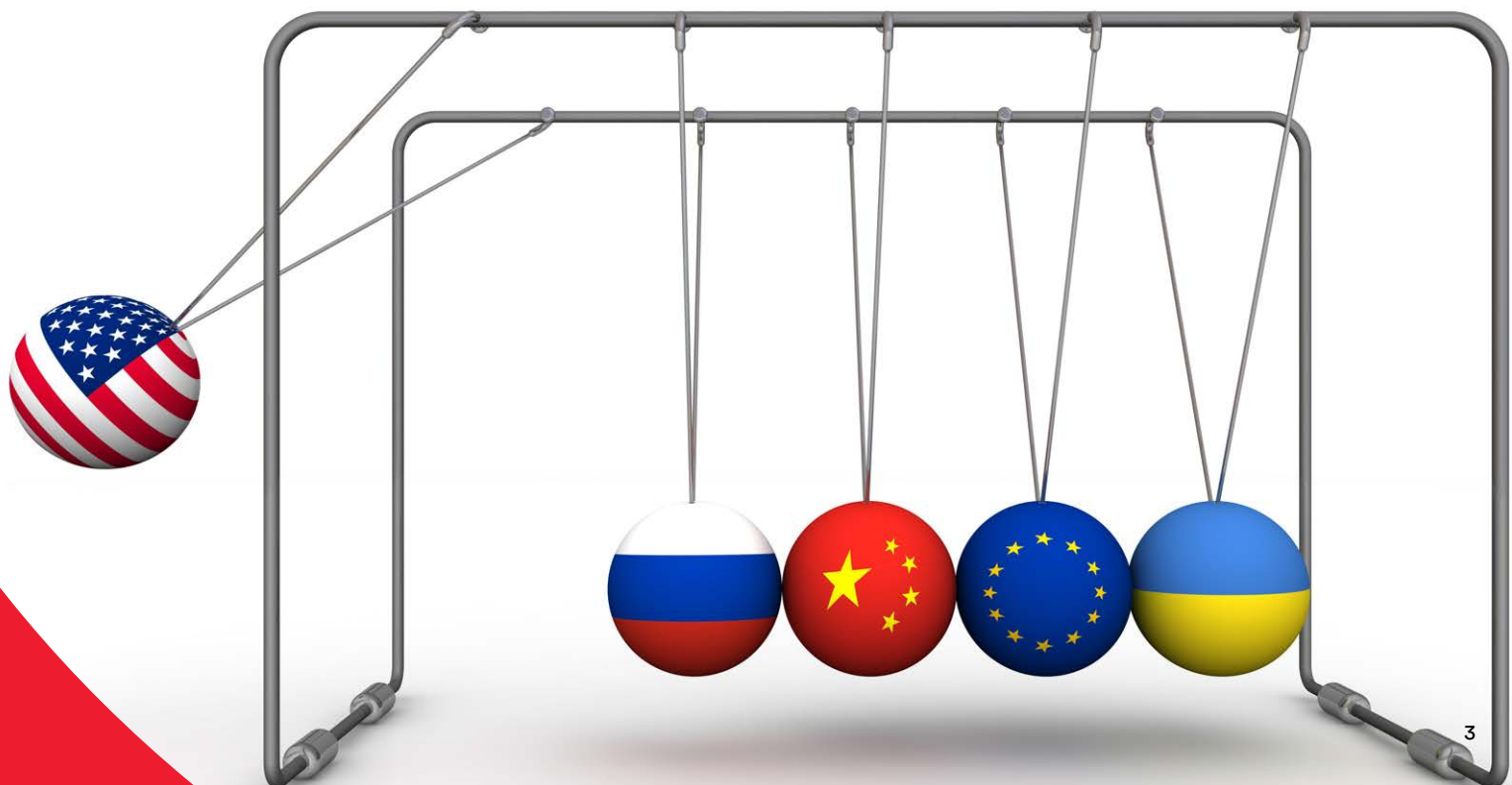
Germany’s position will be a key variable in the stability of the Western Alliance. It faces criticism for delays in providing weapons to Ukraine.<sup>12</sup> And, substantial concerns have arisen with respect to Chancellor Olaf Scholz’s announcement of a massive package of energy subsidies (200 billion euros, roughly 5% of Germany’s GDP) to shield the German economy from the increase in energy prices.<sup>13</sup> Germany has the fiscal space to adopt such a policy, but the same does not apply to many other EU countries. Reactions from Poland and the European Commission underscore the potential for these subsidies to distort markets. Such points of contention raise doubts about the cohesion of EU countries in confronting the Russian threat over time.

The US mid-term elections added a new variable to this geopolitical game. The Republican Party, now in control of the US House of Representatives, is less willing to write a blank cheque to Ukraine. A recently leaked report suggests that the Biden administration would be in favour of Ukraine opening negotiations with Russia.<sup>14</sup> If this report truly reflects the evolving position of the US government, then the Russian strategy of betting on cracks in the Western alliance over time may become even more effective. Of course, such a strategy would also depend on the Kremlin sustaining adequate Russian domestic support for the war for as long as necessary to split the Western Alliance.<sup>15</sup>

## And a Cold War in Asia

Geopolitical tensions are not limited to the Ukraine war. The commercial and geopolitical tensions between China and the USA, which increased during the Trump administration, are not expected to abate.<sup>16</sup> Although President Xi and President Biden appear to have launched a constructive dialogue in the margins of the Bali G20 meeting, the underlying conflict of strategic interests will require on-going management. The Biden administration has not only maintained the tariff increases imposed by Trump against Chinese products, but also introduced a series of new regulatory restrictions that affect access to US technology by Chinese companies. Of particular concern are the new controls to limit the development and production in China of advanced node semiconductors, semiconductor production equipment, advanced computing items, and supercomputers.<sup>17</sup>

Trump’s trade war significantly weighed on imports of semiconductors from China, with the imposition of a new 25 percent tariff imposed in mid-2018. By 2021, US import volumes had declined 50 percent below the pre- “war” levels and 22 percent in dollar terms.<sup>18</sup> This caused significant disruptions since China’s semiconductors are typically legacy chips, less sophisticated products that are less profitable. US domestic supply of such chips is limited and import substitution from alternative suppliers is proving difficult, as the market is not attractive to technologically advanced





Australia's Deputy Trade Minister Tim Ayres (third from right).

semiconductors producers in economies such as Taiwan and South Korea. This situation illustrates well the economic costs of the decoupling fostered by the cold war between China and the USA.

## Against the background of a hot war in Eastern Europe and an evolving cold war, and in the context of nations' mutual economic interests, a question arises as to the status of the multilateral trading system.

The current stage of the conflict, however, raises the stakes for the world economy. Semiconductor production is a globalised industry and could be characterised as the poster child for the operation of global value chains. The supply-chain of the industry is quite complex, involving an upstream

segment (R&D activities), a middle segment (encompassing chip design, manufacturing, assembly, testing and packaging) and a downstream segment (the use of semiconductors in electronic equipment). The reality is that all major semiconductor producing countries rely on each other for different types of chips, as well as key production inputs.<sup>19</sup> Any attempt to pursue a strategy of self-sufficiency would entail significant efficiency costs.<sup>20</sup>

Geopolitical tensions, however, have shifted development strategy in favour of onshoring in the US and in China. US restrictions have fostered Chinese government support for local chipmakers. And the US CHIPS and Science Act was signed into law (9 August 2022), with new funding of roughly US\$ 52.7 billion to support domestic research and manufacturing of semiconductors in the USA.<sup>21</sup> These initiatives (and the related subsidies embedded in these efforts) underscore the trend toward growing geopolitically driven fragmentation in this critical industry.

Adding to the challenges associated with this technological confrontation, the tensions between the US and China have increased the danger of a possible military confrontation over Taiwan, which hosts the

largest and most advanced semiconductor foundries. The Taiwan Semiconductor Manufacturing Company (TSMC) produces roughly 90% of the world's most advanced semiconductors (e.g., 5 nanometre chips; with the expectation that 3 nm chips will be available in 2023). A potential ratcheting up of militarised incidents or possibly an open conflict could generate major disruptions across many industries owing to their reliance on imports of advanced semiconductors from Taiwan.

Against the background of a hot war in Eastern Europe and an evolving cold war, and in the context of nations' mutual economic interests, a question arises as to the status of the multilateral trading system. Can the relevant institutions serve to defend the principles of an open, rules-based approach to governance of trade? Can we further promote trade integration to deliver gains for the global economy in terms of welfare and resilience? Might efforts to improve global governance help diminish the danger of economic fragmentation? In sum, can multilateralism be revived?

## The Policy Response: Trade Multilateralism – an updated affirmation

In looking ahead, it may be helpful to look back. The current multilateral trading system arose from the ashes of World War II based on an evolving economic vision among certain wartime allies and their former adversaries. The United States and the United Kingdom laid down a starting point in the Atlantic Charter (1941).<sup>22</sup> Among 8 principles, this document highlighted 2 concerning the post-war economy and trade:

- [The US President and the UK] will endeavour, with due respect for their existing obligations, to further the enjoyment by all States, great or small, victor or vanquished, of access, on equal terms, to the trade and to the raw materials of the world which are needed for their economic prosperity.
- [The US and the UK] desire to bring about the fullest collaboration between all nations in the economic field with the object of securing, for all, improved labour standards, economic advancement, and social security.

The Atlantic Charter principles were endorsed by 26 allied governments in the “Declaration by United Nations” in January 1942. Then, in 1947, 20 Atlantic Charter signatories together with 3 former British holdings (Burma, Ceylon, and Southern Rhodesia) agreed to enter into the **General Agreement on Tariffs and Trade (GATT)**.<sup>23</sup> This served as the foundation for the evolving post-war multilateral trading system and the eventual founding of the World Trade Organisation in 1995.

The GATT framework established disciplines to limit discrimination in trade policy through principles of most-favoured-nation (MFN) treatment<sup>24</sup> and national treatment.<sup>25</sup> Negotiated schedules of commitments established the terms of market access among the contracting parties for covered products, though subject to some exceptions.

A grand bargain emerged that supported trade-led economic development over subsequent decades. In exchange for submission to GATT disciplines, contracting parties could be assured of the agreed liberal treatment for their mutual trade with respect to covered matters. As further rounds of negotiations were held and as new members joined, the participating parties benefitted from increasing mutual

market openness and enhanced disciplines on trade-related policies.

**The success of this approach remains relevant** in the light of conditions in 2023. In response to the turbulence of geopolitical tensions and economic fragmentation, a renewed commitment to the rules-based trading system by leading members may provide ballast. A succinct restatement of core principles for multilateral governance of trade by leading economies could provide reassurance in a time of uncertainty and guidance for next steps in trade policy.

These could be issued by the leading economies of the G7 or by a larger grouping of WTO members such as the economies participating in the Indo-Pacific Economic Framework for Prosperity proposed by the United States.<sup>26</sup> This is not about establishing new institutions, but rather about providing guidance and reference points for the operation of existing trade institutions from the WTO to regional trade groupings, to national-level trade policies. It is about reviving public awareness of the benefits and terms of the bargain. In a system lacking a single guarantor (or hegemon), it is about establishing a shared understanding of direction in trade governance that has a broader, more inclusive basis.<sup>27</sup>

**A new value proposition for international trade cooperation could be issued** as a declaration serving as a benchmark for reference as the multilateral system evolves. The principles would show that leaders have heard concerns about the multilateral trading system and are responding with a reformulated approach. Though the elements remain to be negotiated, they could usefully retain an affirmation of the MFN and national treatment principles, market openness, and the objective of continued rules-based incremental progress towards reduced discrimination and increased trade integration. There could also be a recognition that trade has implications for development, labour markets and the environment. The declaration could recognise that there is a place for these issues to be treated in the trade policy context as part of a progressive, holistic approach to responding to challenges.<sup>28</sup> It might also underscore the mutual interest and benefit of pursuit of such policy orientations.

## Final Considerations

There is a saying, attributed to Mark Twain that “history doesn’t repeat itself but it often rhymes.” Eighth-four years ago (September

30, 1938) the Munich Agreement was imposed upon Czechoslovakia as Germany, the United Kingdom, France and Italy agreed on the cession of the Sudeten territory to Germany. This was initially welcomed in France and the UK as a concession that would avoid war. What came next was proof of the dangers of appeasement to an aggressive military power. The post-war response of the allies provides an illustration of an alternative approach. This was based on an economic framework of cooperation underpinned by enlightened self-interest, including with respect to trade.

The response to present day trade challenges requires cooperation and enlightened self-interest. A piecemeal response to the risks from geopolitical tensions and economic fragmentation may not prove adequate. For example, the tensions between China and the USA will not be easily resolved if both sides do not see gains from cooperation.<sup>29</sup> The complexity of the pressing challenges for trade merits a reflection on first principles. A renewed statement of the value proposition for multilateral trade may underscore what is at stake, promote buy-in, and provide guideposts for a way forward, and counter-acting the “deglobalisation” narrative. This could potentially serve as a prelude to a concerted WTO reform agenda. It is important to underscore that global economic fragmentation will have non-trivial economic costs for all countries and may further debase the value of the multilateral trade regime. In short, the concept of “friendshoring” – i.e., the focus on integration among democracies with similar values – would not only require a major restructuring of global governance, but it may also foster economic fragmentation and geopolitical conflict.

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2. The [US] White House 2022. 'G20 Bali Leaders' Declaration', Briefing Room Release, 16 November. While the document reflects broad alignment on most key elements, it notes divergent views on some issues including the war in Ukraine; <https://www.whitehouse.gov/briefing-room/statements-releases/2022/11/16/g20-bali-leaders-declaration/>.
3. The WTO's 12th Ministerial Conference offers a counterpoint in that it delivered a number of positive steps as summarized in: WTO 2022. 'MC12 Outcome Document', WT/MIN(22)24, 22 June; <https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/MIN22/24.pdf&Open=True>.
4. CPTPP has relatively limited economic scale (about 13.5% of global GDP), whereas RCEP has significant exceptions (e.g., in relation to self-determined essential security matters). CPTPP = The Comprehensive and Progressive Agreement for Trans-Pacific Partnership, an 11 member accord with Japan as its largest member. It entered into force in December 2018. RCEP = The Regional Comprehensive Economic Partnership, a 15-member accord with China as its largest member and ASEAN as the host. It entered into force in January 2022.
5. Global Trade Alert 2022. 'G20 Trade Policy Factbook', St. Gallen Endowment for Prosperity Through Trade, November; <https://www.globaltradealert.org/reports/99>.
6. This section relies upon Primo Braga, C.A., 2022, 'Winter is Coming: The Ukraine Shock', IAC Newsletter, Fundação Dom Cabral, (November).
7. It is also worth noting the growing role of Greek tanker ships in transporting Russian oil in 2022. See @RobinBrooksIIIF.
8. See Heussaff, C et al 2022. 'An assessment of Europe's options for addressing the crisis in energy markets', Bruegel Policy Contribution no. 17/22 (September); <https://www.bruegel.org/policy-brief/assessment-europes-options-addressing-crisis-energy-markets>.
9. See EC, 2022. 'Council Regulation on an emergency intervention to address high energy prices,' COM (2022) 473 final, September 14; <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022PC0473&from=EN>.
10. Since October last year one has observed a significant decline in gas prices, influenced by imbalances in the available storage capacity for natural gas in Europe. Prices in Spain, for example, have been impacted by a growing queue of ships waiting to off-load their cargo outside Spanish LNG ports. See AndreasSteno.substack.com.
11. See Blas, J 2023. 'Europe is Winning the Winter War by Sheer Luck', Bloomberg Opinion (January 18th).The complexity of decisions concerning the provision of weapons is mind-boggling. For example, Switzerland – claiming its neutrality – blocked the transfer of Swiss made ammunition for Gepard anti-aircraft tanks that Germany is providing to Ukraine.
12. There are estimates that 71% of energy-intensive products imported by Germany face competition in the German market from firms that benefit from subsidies. See Evenett, S.J., 2022, 'Deep Pockets, Revising EU State Aid Rules and the Single Market,' Zeitgest Series, Briefing #7 (December 5); <https://www.globaltradealert.org/reports/104>.

13. See Friedman, G., 2022. 'Negotiations', Geopolitical Futures (November 5); <https://geopoliticalfutures.com/negotiations/>.
14. Kimmage, M., and M. Lipman, 2023. 'Wartime Putinism', *Foreign Affairs*, 13 January;
15. <https://www.foreignaffairs.com/ukraine/wartime-putinism>.
16. See Primo Braga, C.A 2021. 'Cold War 2.0: Implications for Middle Powers', Policy Brief 11, Institute for International Trade, University of Adelaide (February); <https://iit.adelaide.edu.au/news/list/2021/02/02/cold-war-20-implications-for-middle-powers>.
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18. See Bown, C.P., 2022. 'Four years into the trade war, are the US and China decoupling?', *PIIE Realtime Economics* (October 20); <https://www.piie.com/blogs/realtime-economics/four-years-trade-war-are-us-and-china-decoupling>.
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20. See Hufbauer, G.C & Hogan, M 2022. 'CHIPS Act Will Spur US Production but Not Foreclose China', *PIIE Policy Brief* (October); <https://www.piie.com/sites/default/files/2022-10/pb22-13.pdf>.
21. See White House, 2022. 'FACT Sheet: CHIPS and Science Act Will Lower Costs, Creates Jobs, Strengthen Supply Chains, and Counter China', (August 9).
22. VanGrasstek, C 2019. *Trade and American Leadership*, Cambridge University Press, p. 49ff; and History.com editors 2021. 'Atlantic Charter', online article, A&E Television Networks; <https://www.history.com/topics/world-war-ii/atlantic-charter>.
23. The Soviet Union was notably not among the initial GATT signatories.
24. Concessions granted to one member would be applicable to all.
25. In certain matters covered by the GATT, treatment of imported products should be no worse than for domestic products and should not amount to protectionism.
26. Office of the United States Trade Representative, 2022. 'Indo-Pacific Economic Framework for Prosperity', Agreements under negotiation; <https://ustr.gov/trade-agreements/agreements-under-negotiation/indo-pacific-economic-framework-prosperity-ipef>.
27. Ikenberry, G.J 2011. *The Future of the Liberal World Order: Internationalism After America*, *Foreign Affairs*, May/June; and VanGrasstek, C 2019, *Trade and American Leadership*, Cambridge University Press.
28. It is important to recognize, however, that the role of trade agreements in advancing non-trade objectives has yet to prove its effectiveness. See Francois, J, Hoekman, B, Manchin, M & Santi, F 2022. 'Pursuing Environmental and Social Objectives through Trade Agreements', *EUI RSC Working Paper #73*, (November); [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4285646](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4285646).
29. Indeed, the current tensions between China and the US are sometimes characterized as a harbinger of a future conflict, as foreseen by adepts of the Thucydides Trap. This is seen by some as a rivalry between declining and rising economic powers and the main geopolitical challenge of this age. See Allison, G 2017. *Destined for War: Can America and China Escape Thucydides's Trap?* Boston: Houghton Mifflin Harcourt.

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