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Win, Lose or Draw: Estimating the Impact of Trade Disengagement on APEC Trade

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KEY MESSAGES

- Globalisation and multilateralism have brought profound benefits to the APEC region over the past three decades. Macroeconomic data show that they have been a net positive for participating economies. However, despite their benefits, there are loud calls for economic and trade disengagement, to retreat back to a fragmented world of exclusive economic blocs last seen in the 1980s.
- Trade disengagement and geoeconomic fragmentation involve the increasing adoption of targeted economic and trade policies and the division of the global economy into blocs driven by geopolitical preferences. Certain economies may choose to disengage economically from some partners while facilitating ties with others. This is antithetical to the principles of globalisation and to multilateralism, which seeks to treat all trade partners the same. While this is an evolving situation, the effects are starting to be seen and measured.
- What are the consequences of outright fragmentation? Who stands to win or lose in a regional economy characterised by exclusive economic blocs? Using data spanning over three decades, the APEC Policy Support Unit (PSU) estimates the impacts of trade disengagement policies on APEC trade flows. Specifically, we categorise economies into three blocs – A, B and C – and consider the scenario where blocs A and B impose trade-restrictive policies against each other. We also consider the alternative where blocs A and B implement trade-facilitating policies for their respective members. Bloc C remains neutral in all situations.
- Our findings show that, generally, cross-bloc trade restrictions negatively impact APEC trade for all blocs and almost all sectors, the exceptions being in the food and digital sectors. Even member economies that stay neutral suffer losses in terms of trade, indicating potential unintended repercussions of targeted restrictive policies. An analysis by geographical region shows adverse effects across APEC, with varying degrees of impact, highlighting the pervasive nature of the negative impacts on trade.
- Conversely, intra-bloc facilitative policies benefit trade for all blocs, including member economies belonging to the neutral bloc, benefiting most goods. The analysis by geographical region confirms overall positive trade trends across APEC.
- Geoeconomic fragmentation is not a done deal; it could still be reversed. Economies first need to avoid actions or policies that lead to an erosion of trust among trading partners. Commitments to economic integration and multilateralism need to be maintained. Now, more than ever, strengthening multilateral institutions of economic integration and trade, such as APEC, is paramount to bolstering cross-border cooperation and rebuilding trust in the multilateral trading system.

Globalisation and multilateralism: A win-win

Globalisation and multilateralism have brought significant economic benefits over the past three decades. They have contributed to lifting billions out of poverty, generating unprecedented levels of output, and driving technological change in all aspects of life. Macroeconomic data overwhelmingly show that globalisation has been a net benefit for participating economies. It has linked together diverse economies, transforming them into an integrated world that thrives on mutual cooperation. Multilateralism, serving as a cornerstone of this interconnected framework, reinforces collaborative efforts among economies and collective problem-solving on a global scale.

This intricate network of interconnectedness and interdependence among economies has created multiple opportunities for cross-border trade and investment, expanding access to global markets and increasing consumer choice. At the same time, globalisation has spurred competition among economies across the globe, incentivising businesses to innovate and improve the goods and services on offer.

Over the past half-century, the rapid surge in international trade and investment has been a catalyst for global economic growth. By fostering deeper economic integration, globalisation has enabled economies to capitalise on their strengths, specialise in their comparative advantages, and engage in mutually beneficial trade relations with one another. As a result, the global economy has flourished, leading to increased productivity, job creation, and improved living standards for billions of people.

Was it too good to last?

Despite the benefits of globalisation, there are loud calls for economic and trade disengagement, to retreat back to a fragmented world of exclusive economic blocs last seen in the 1980s. Such a reversal risks unwinding and disentangling the intricate web of interconnectedness and interdependence that serves as the backbone of the global economy that we have come to know today.

Domestic exigencies – often in response to unaddressed socioeconomic challenges – have been putting pressure to deviate from the collaborative spirit of multilateralism, creating barriers to trade, investment and cooperation. This poses a challenge to the APEC region. Indeed, the APEC Putrajaya Vision 2040 embodies a vision rooted in the principle of open and collaborative multilateralism; economic and trade disengagement stands in stark contrast to this objective. A fragmented world is antithetical to APEC's vision of an open, dynamic, resilient and peaceful Asia-Pacific community by 2040.

Amid an evolving global policy landscape, understanding the potential impacts of this fragmented world is increasingly important. This policy brief seeks to discuss the concept of trade disengagement and geoeconomic fragmentation. It then estimates the potential impacts of geoeconomic fragmentation on APEC trade, if it were to occur. Can the APEC region, or the blocs within it, be expected to win, lose or come out even in a geoeconomically fragmented world? Do the types of goods traded make a difference? And do restrictive policies perform better (or worse) than facilitative policies?

Overview of trade disengagement

Trade disengagement and geoeconomic fragmentation involve the increasing adoption of targeted economic and trade policies and the division of the global economy into strategic blocs driven by geopolitical preferences. Certain economies may choose to disengage economically from some partners while facilitating ties with others. This is antithetical to the principles of globalisation and multilateralism, which seeks to treat all trade partners the same.

While geoeconomic fragmentation is already being discussed as a risk to economic growth,¹ it is still an unfolding situation. Various policies have already been launched – from tariff increases and outright trade bans to additional regulatory burdens and policy uncertainty – but the full form of trade disengagement policies has yet to reveal itself.

After several decades of achievements in trade liberalisation and global economic integration, globalisation has plateaued. In a recent report, the World Trade Organization (WTO) observes that the use of trade-restrictive measures like tariffs and non-tariff barriers has increased since 2020, leading to a slowdown in cross-border movements of goods, services and capital.²

What policies can lead to trade disengagement?

Recent articles and scientific journals have documented the economic decoupling between China and the United States, which together represent 42 percent of global gross domestic product (GDP) and 21 percent of total merchandise and services trade.³ However, in the digital sphere, the lines of trade disengagement can be more complicated. Referred to as 'digital balkanisation' or the 'splinternet', these lines are formed when there are contrasting and sometimes conflicting rules around digital governance and cross-border data transfer. These regulations cover various issues such as personal data protection, digital resilience,

cybersecurity, cloud computing and artificial intelligence. Economies leading policy development in these areas have not always worked toward harmonised or interoperable regulations, which can increase costs or even hinder digital services trade between economies.⁴

Economic disengagement is not limited to bilateral relationships but extends to the formation of economic blocs. For example, some economies have introduced restrictions on the purchase⁵ or sale⁶ of information and communications technology (ICT) hardware depending on the economy of origin or destination. Other economies have introduced restrictions on the export of certain key minerals or their extraction technology.⁷

Conversely, facilitative bloc-forming policies have also been implemented. For example, some economies have introduced incentives or subsidies to encourage firms to relocate their supply chains.⁸ While these facilitative policies may have some merits – such as diversifying supply chains – they can also cause economically inefficient distortions in trade patterns. These policies, involving a combination of targeted trade-restrictive and -facilitative policies, contribute to the formation of geoeconomic blocs and lead to a redirection of trade and investment flows, potentially resulting in global GDP losses, depending on the ability of economies to adapt.⁹

What have we observed so far?

Impact on the global economy. In its analysis of the likely impacts of geoeconomic fragmentation, the WTO projects that a global trade conflict could lead to a reduction in global GDP of about 1.96 percent and a reduction in global trade of about 58 percent.¹⁰ Restrictive trade policies directly reduce bilateral trade flows and also generate spillover effects such as reduced capital flows, slower technological diffusion, and disrupted global value chains (GVCs) on a global and regional scale.

Reducing imports from one economy via trade-restrictive measures encourages other economies to fill the void and enhance their market share. Also, economies affected by those restrictive measures tend to redirect their exports through a third economy which may not be affected by these measures. This complicates the impact of targeted economic or trade policies, as spillovers can have unintended and complicated consequences, reflecting an interconnected global economy.

Impact on investment flows. Some firms may respond to geopolitical risk by resorting to ‘friend-shoring’, or relocating supply chains to economies perceived as friendly to their home economy. Friend-shoring distorts and redirects foreign direct investment (FDI) flows,

particularly in strategic, technology-intensive sectors such as semiconductor manufacturing.¹¹

While some economies may benefit from a diversion of investment in their direction, attracting capital they otherwise would not, these gains could be offset by adverse effects stemming from a net decline in external demand due to increased economic uncertainty.¹² The unpredictable impacts of geoeconomic fragmentation on neutral or non-aligned economies can also deter investment in those economies.¹³

Impact on the commodity sector. Geoeconomic fragmentation has a direct and substantial impact on commodity trade and prices. Given the geographically concentrated nature of commodity production and the worldwide dispersion of demand, geoeconomic fragmentation can lead to increased volatility of commodity prices, ultimately resulting in greater price swings across a broader spectrum of goods.

If commodity-abundant economies are incentivised to clarify geopolitical allegiances and impose targeted trade policies, the uncertainty in supply and logistical costs could lead to instability in commodity prices.¹⁴ Research suggests that these trade barriers would reduce output for all economies. And, it would be more severe for low-income economies, with projected output losses of 10.8 percent in the short run and 4.3 percent in the long run.¹⁵

Impact on the food sector. The food sector is especially vulnerable to commodity market disruption and output losses due to geoeconomic fragmentation. The International Monetary Fund (IMF) warns of potential long-term GDP losses of 1.2 percent on average for low-income and vulnerable economies, which could worsen food security concerns.¹⁶ According to data from the Food and Agriculture Organization of the United Nations (FAO), although the food price index is slightly lower than it was in 2022, food prices remain higher than the pre-pandemic levels.¹⁷

In addition, the prevalence of moderate or severe food insecurity continues to be elevated compared to the pre-pandemic period.¹⁸ Restrictions on food trade and logistics have further dampened agricultural supply, leaving food products unharvested, undistributed or stolen.¹⁹

Impact on the digital sector. Trade disengagement also slows down innovation and technological diffusion. By participating in trade, firms gain access to novel sources of cutting-edge technologies embodied in trade and can themselves contribute through their own innovations. However, fragmentation limits these opportunities for learning and collaboration. In fact, studies have shown that such technological and knowledge diffusion is strongly associated with the level of imported goods, especially strategic goods, pointing

to the synergistic relationship between trade and innovation.²⁰

Trade disengagement is especially apparent in the digital economy, which was once hailed as the sector that will catalyse global economic integration. Policy differences are impeding efforts to establish global standards for software codes, data sharing, cybersecurity, and the commercialisation of private content, causing bottlenecks in data storage and cloud computing agreements and contributing to the fragmentation of the digital economy.²¹

Fragmented regulations could force firms engaged in cross-border digital trade to adhere to different rules when offering the same product in different economies or lead them to avoid certain markets altogether.²² This poses the risk of the internet fragmenting along geopolitical lines, potentially obstructing the free flow of data and information, as well as hindering cross-border investment that is crucial for digital innovation.

As with brick-and-mortar trade, geoeconomic fragmentation in digital trade is especially detrimental to developing economies as they could be forced to choose between competing blocs.²³ By aligning with one bloc over another, they are forced to forgo the innovation and knowledge benefits of engagement with the other bloc.²⁴ Digital and technological trade restrictions can also hinder emerging markets and low-income economies' access to certain markets and technologies, slowing down their own technological advancement and economic development.²⁵

Who wins, who loses in a fragmented world?

Geoeconomic fragmentation is an unfolding situation. As the rhetoric and geopolitical lines are being defined, exactly how this fragmentation will unfold in terms of trade and investment policy is still to be determined. What is becoming clear, however, is that this is involving targeted trade measures – both tariff and non-tariff, such as outright bans or additional regulatory requirements – that restrict trade with some groups of economies or facilitate trade with others.

For this policy brief, we ask: How will full-blown trade disengagement and geoeconomic fragmentation likely

impact APEC trade? Considering the interconnectedness of economies, who will benefit and who will lose out when geoeconomic fragmentation policies are implemented?

Suppose that the 21 members of APEC are divided into three blocs – A, B and C – with seven economies in each bloc. In this hypothetical world, A and B are opposing blocs, choosing to disengage with members of the opposite bloc (or increase trade with members of the same bloc). Members of bloc C, on the other hand, are neutral and not subject to any targeted trade policies. While the analysis presented here is based on a counterfactual world where there is geoeconomic fragmentation, the composition of blocs reflects real-world events, trading relationships, and positions taken in international organisations. Figure 1 shows descriptive statistics for these blocs in terms of their share of APEC's output and trade.

Geoeconomic fragmentation policies, in turn, are assumed to have an impact on trade costs faced by trading partners. For example, trade-restrictive policies imposed by bloc A economies raise bilateral trade costs with bloc B economies, and vice versa. To remain conservative in our estimates, we assume that these restrictive trade policies only amount to a 10 percent increase in bilateral trade costs.

We also consider the case where, instead of restrictive trade policies, the opposing blocs implement facilitative trade policies among members of their own bloc. In this case, instead of a 10 percent increase in trade costs between blocs A and B, we assume a 10 percent cost decrease among members of the same bloc. Bloc C economies, as the neutral group, are not the target of either restrictive or facilitative policies, so the bilateral prices they face remain static, but, as will be discussed later, they may still be affected indirectly through changes in bloc A and B economies' trading propensities.

Constructing the counterfactual is the more technically nuanced part of the analysis (see the methodology note²⁶ for details). We take into account bilateral trade elasticities (i.e., how much bilateral trade changes if bilateral prices vary) between all APEC economies as trade policy changes do affect bilateral prices and impact trade flows. To facilitate discussion, our counterfactual analysis is calculated at the bloc level

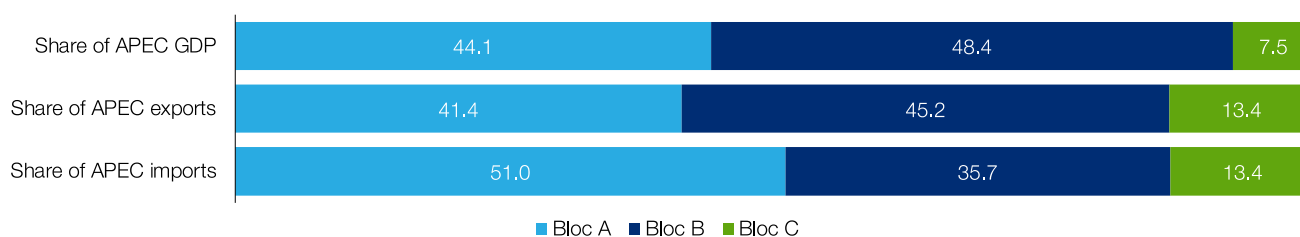


Figure 1. Bloc-level descriptive statistics, 2020 (%)

Source: CEPII BACI and Gravity Database; World Bank; APEC Policy Support Unit (PSU) calculations.

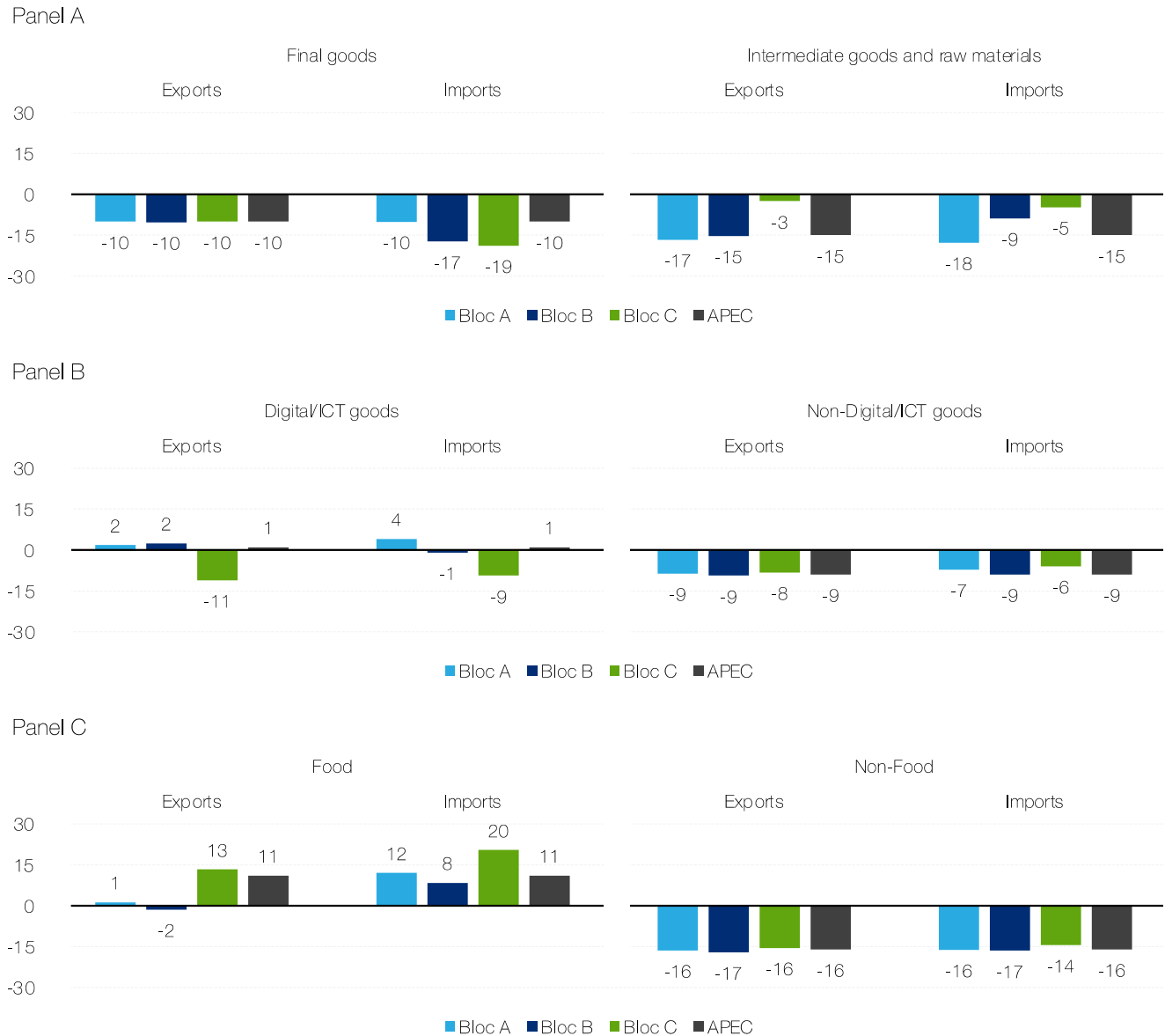


Figure 2. Impact of cross-bloc restrictive GF policies on APEC trade by bloc (%)

GF=geoeconomic fragmentation; ICT=information and communications technology. Note: Results show the percentage difference between the counterfactual (i.e., with restrictive GF policies resulting in 10% price increase between blocs A and B) and the baseline estimates. Underlying elasticity estimates were calculated using the Arellano-Bond generalised method of moments to control for reverse causality as well as Huber-White standard errors to correct for heteroscedasticity; time- and economy-level idiosyncrasies are also controlled for. Source: CEPII BACI and Gravity Database; World Bank; APEC PSU calculations.

and not at the individual-economy level. In other words, for this paper, we seek to answer the counterfactual question: How much more, or less, trade would blocs A, B and C have relative to the baseline if geoeconomic fragmentation policies were implemented?²⁷

How do cross-bloc restrictive policies affect APEC trade?

Impact on APEC trade by bloc. Figure 2 shows the results of the counterfactual analysis where we assume trade-restrictive policies are implemented by blocs A and B. In general, all the blocs and sectors included in

the analysis are estimated to lose out in an APEC region characterised by geoeconomic fragmentation except for sectors trading in essential goods like food.

Estimated losses are highest for trade in the final goods and non-food sectors. While the losses are across the board, the results nevertheless show some heterogeneity in the level of impacts, which could be reflective of the different supply chain linkages underlying the different goods.

Although the negative impacts on trade are generally consistent across all blocs, some variation is observed,

particularly in digital/ICT goods and food trade. This variation may reflect trade inelasticities as many goods in those categories are essential goods, and are less affected by a fall in demand after an increase in prices in comparison to other goods.

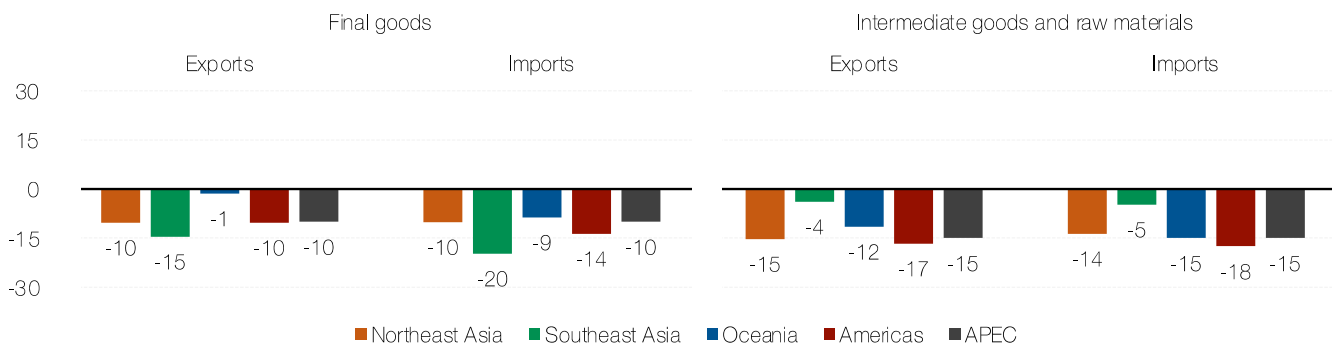
Even bloc C, the neutral bloc, stands to lose from the implementation of trade-restrictive policies between blocs A and B. While the negative impact of higher trade costs on blocs A and B trade is to be expected, it seems the net distortions and diversions of trade result in a net

loss to bloc C as well due to the implications for global supply chains.

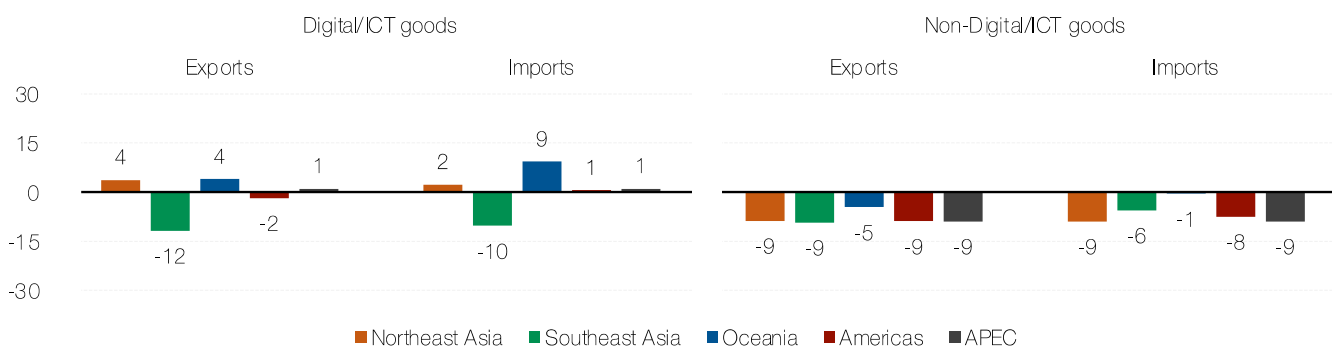
Note that for this analysis we are considering blocs as the aggregate of seven economies. It is possible that certain economies within a specific bloc can have a net positive impact from the implemented policies, but this is smaller in magnitude compared to the loss incurred by other members of the same bloc.

Impact on APEC trade by region. Figure 3 illustrates the results of our counterfactual analysis, where we simulate trade-restrictive policies implemented by blocs

Panel A



Panel B



Panel C

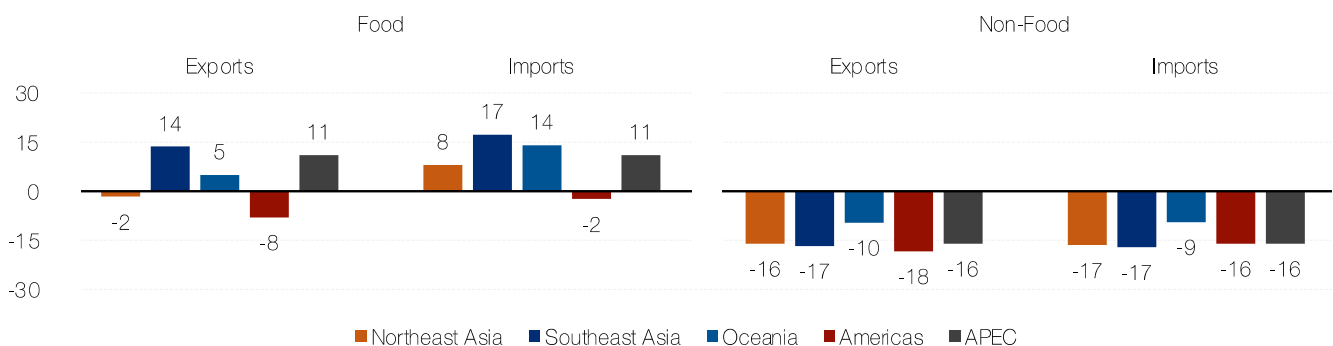


Figure 3. Impact of cross-bloc restrictive GF policies on APEC trade by region (%)

GF=geoeconomic fragmentation; ICT=information and communications technology. Note: Results show the percentage difference between the counterfactual (i.e., with restrictive GF policies resulting in 10% price increase between blocs A and B) and the baseline estimates. Underlying elasticity estimates were calculated using the Arellano-Bond generalised method of moments to control for reverse causality as well as Huber-White standard errors to correct for heteroscedasticity; time- and economy-level idiosyncrasies are also controlled for. Source: CEPII BACI and Gravity Database; World Bank; APEC PSU calculations.

A and B, with impacts summarised by geographical regions within APEC. The examination of the impact of these cross-bloc restrictive policies by region reveals a scenario where each region grapples with significant repercussions, illustrating the looming risk of geoeconomic fragmentation among all APEC member economies regardless of region.

Throughout all regions, the prevailing trend leans heavily toward the negative, indicating adverse trade effects irrespective of location. Nevertheless, there exists some variation in the estimated impact levels across regions, hinting at differing degrees of vulnerability. Notably, there is variation across regions concerning the trade of digital/ICT goods and food,

reflecting varying sensitivities to trade disturbances in these sectors.

Even after taking into account this variability, no region is a clear winner when blocs A and B impose trade-restrictive policies on each other. This absence of clear winners highlights the pervasive nature of the negative impacts on APEC trade, regardless of regional nuances.

How do intra-bloc facilitative policies affect APEC trade?

Impact on APEC trade by bloc. Figure 4 summarises the impact of intra-bloc facilitative trade policies –

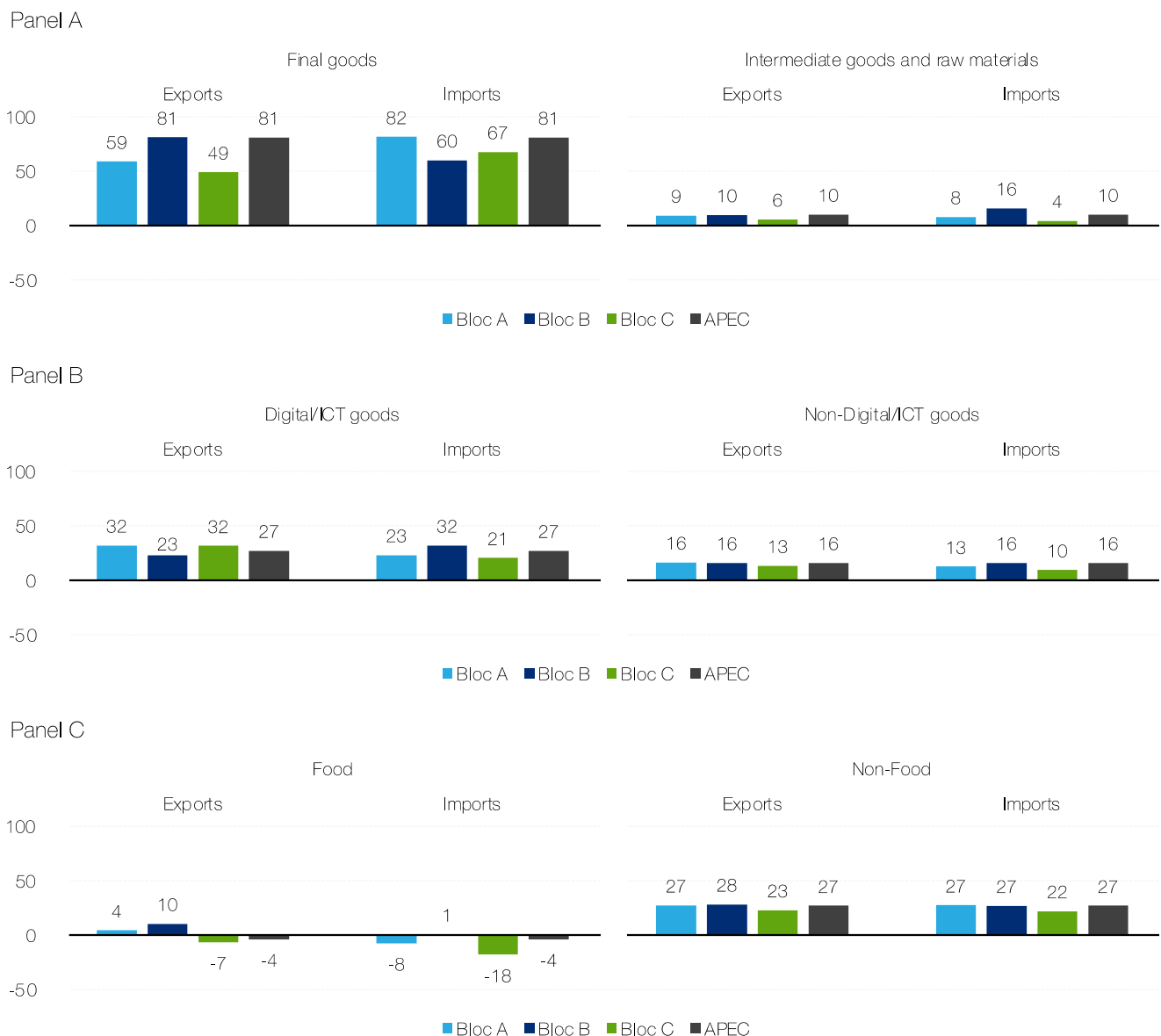


Figure 4. Impact of intra-bloc facilitative GF policies on APEC trade by bloc (%)

GF=geoeconomic fragmentation; ICT=information and communications technology. Note: Results show the percentage difference between the counterfactual (i.e., with facilitative GF policies resulting in 10% price decrease within members of blocs A and B) and the baseline estimates. Underlying elasticity estimates were calculated using the Arellano-Bond generalised method of moments to control for reverse causality as well as Huber-White standard errors to correct for heteroscedasticity; time- and economy-level idiosyncrasies are also controlled for. Source: CEPII BACI and Gravity Database; World Bank; APEC PSU calculations.

resulting in 10 percent lower trade costs – implemented within members of blocs A and B. In general, the results show a clear positive impact for all blocs for most goods. However, when examining the impact on food trade, some variations emerge compared to the previous case where cross-bloc restrictive policies were implemented. This variation warrants further investigation, suggesting potential underlying factors like price rigidity and non-market influences affecting trade dynamics in this sector.

Despite potential complexities, it is clear that all blocs reap benefits from trade-facilitative policies, even when

the direct beneficiaries are members of the same bloc (within A and B). This reflects the interconnectedness of economies and complexity of global supply chains. Simply put, facilitating trade with some economies leads to increased demand for goods from those economies, which increases demand for the inputs for producing those goods, and in turn the demand for the inputs for producing those inputs, and so on, with potentially many different economies participating in, and affected by, the shifting demand patterns along the supply chain.

Impact on APEC trade by region. Figure 5 depicts the results of our counterfactual analysis, where we

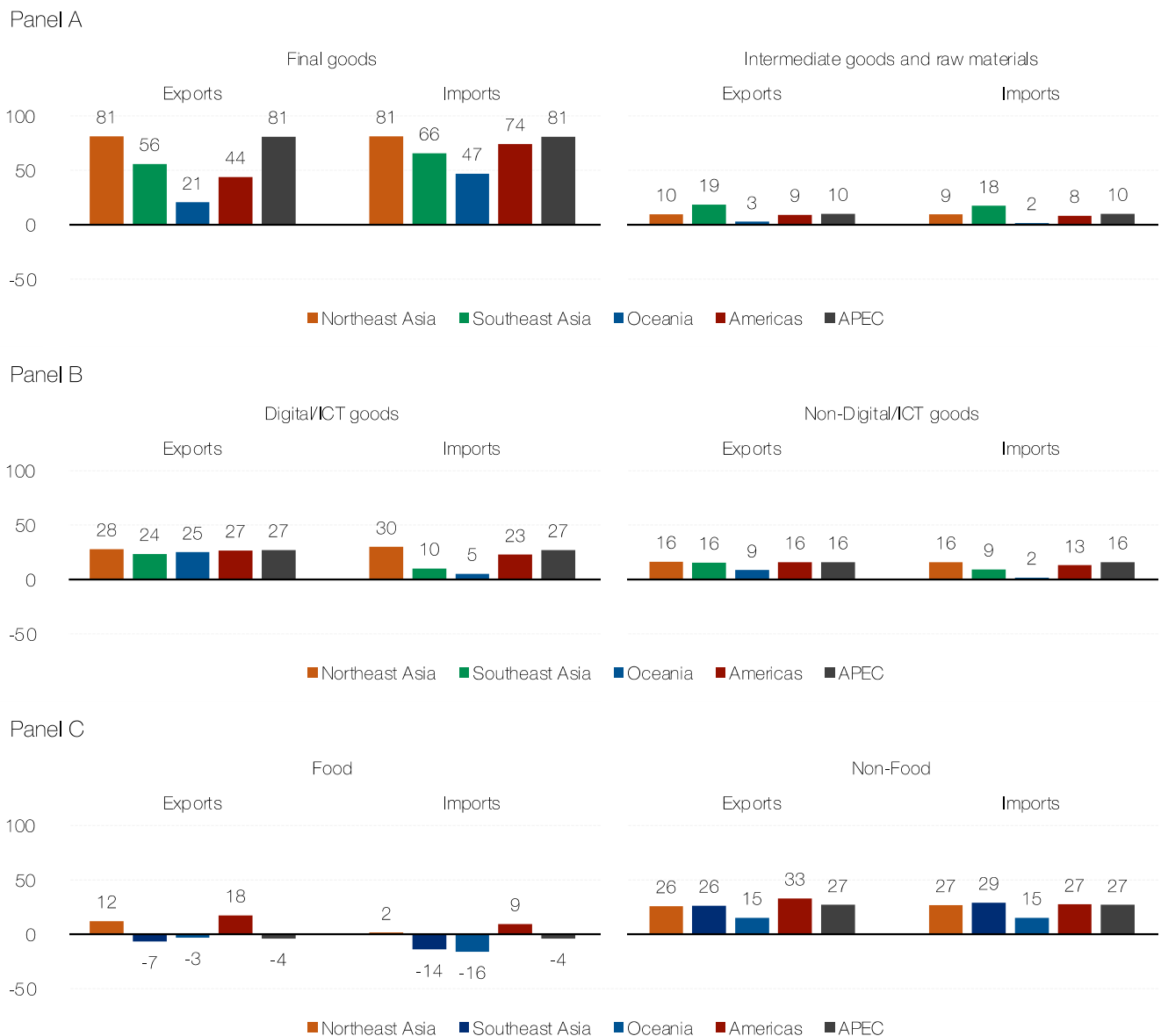


Figure 5. Impact of intra-bloc facilitative GF policies on APEC trade by region (%)

GF=geoeconomic fragmentation; ICT=information and communications technology. Note: Results show the percentage difference between the counterfactual (i.e., with facilitative GF policies resulting in 10% price decrease within members of blocs A and B) and the baseline estimates. Underlying elasticity estimates were calculated using the Arellano-Bond generalised method of moments to control for reverse causality as well as Huber-White standard errors to correct for heteroscedasticity; time- and economy-level idiosyncrasies are also controlled for. Source: CEPII BACI and Gravity Database; World Bank; APEC PSU calculations.

simulate intra-bloc trade-facilitative policies implemented by blocs A and B, with impacts summarised by geographical regions within APEC. The effects of intra-bloc facilitative policies on APEC trade by region show an overall positive trend. Across all regions, there is a general improvement in trade conditions.

However, food trade shows variations compared to the restrictive case as discussed earlier. The patterns observed here are in the opposite direction compared to those seen in the restrictive case but could still be reflecting the underlying trade inelasticities of demand for food products. At the same time, there is a clear positive impact on digital/ICT goods trade.

Conclusion

There are many reasons why trade disengagement and geoeconomic fragmentation are happening, and this policy brief does not venture to opine on these causes or their merits. But what the analysis shows is that the likely impacts of these policies, which lead to geoeconomic fragmentation, are complicated and extend beyond their intentions. Even economies that are not the target of these policies can be indirectly affected by the changing trade patterns and welfare-reducing economic distortions.

In 2023, APEC Leaders who were meeting in San Francisco reiterated their commitment to 'deliver a free, open, fair, non-discriminatory, transparent, inclusive, and predictable trade and investment environment' while reaffirming the importance of a 'rules-based multilateral trading system'.²⁸ The counterfactual analysis in this policy brief supports a continuation of this commitment and raises several policy implications that APEC economies may wish to consider.

What are key policies to consider?

Economies need to avoid policies and actions that contribute to trade disengagement and geoeconomic fragmentation. Theoretically and empirically,

globalisation and multilateralism have been associated with a win–win situation. It logically follows that their antithesis, that is, trade disengagement and fragmentation, will be a lose–lose proposition. This is what economic theory tells us, and this is what the counterfactual analysis in this policy brief confirms at the macroeconomic level.

Economies therefore need to rebuild trust in each other as trading partners. This involves adhering to trade and economic policy commitments that are in line with free trade and economic integration. Policies that promote the formation of exclusive blocs are shown to generally result in subpar outcomes relative to open multilateralism. This also involves avoiding actions that undermine trust in trading partners, including protectionism or actions that inject policy uncertainty into an already volatile market.

There is a need to strengthen international institutions of regional cooperation and integration. These include formal bodies like the WTO as well as informal fora like APEC. Amid geopolitical tensions and market volatilities, economies could find it attractive to revert to protectionism or to limit economic activity to a smaller set of economies. In this regard, multilateral institutions could play an important role in providing an avenue where economies can discuss, debate and achieve consensus on supporting economic cooperation rather than resorting to unilateral actions.

Geoeconomic fragmentation is an ongoing process, which means it is not a done deal. Economies still have the space to affirm their consensus for regional cooperation and reverse this trend. Walking back from trade disengagement is especially incumbent for the APEC region, which has open multilateralism and economic integration at its core.

Notes

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