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Shifting Geopolitical Tectonic Plates

A more fragmented world will need the IMF more, not less

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THE RUSSIAN INVASION of Ukraine has opened a new chapter in international relations, with important implications for the global economic order.

The outbreak of large-scale warfare on European soil, with its associated human tragedies, brings back memories of the continent's darkest times. Within three days of the invasion, the Group of Seven, consisting of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States, soon followed by other countries, deployed a range of economic sanctions against the aggressor.

As discussed in our latest *World Economic Outlook*, the war and the associated economic sanctions will have a major impact on the world economy, slowing down activity and increasing price pressures.

Like an earthquake, the war has an epicenter, located in Russia and Ukraine. The economic toll on these two countries is extremely large. According to our projections, Ukraine's economy will shrink by 35 percent and Russia's by 8.5 percent in 2022.

The war has also caused seismic waves, radiating from the epicenter, and impacting economies far and wide. The first impact is on the price of commodities. Because Russia and Ukraine are major producers and exporters of oil, gas, metals, and grains the price of these commodities has soared, causing hardship around the world and contributing to a significant increase in inflation. Second, trade flows have been heavily disrupted, with a major impact on Russia's and Ukraine's close trading partners, especially in the Caucasus, central Asia, eastern Europe, and the Baltics, but also more broadly via supply chain disruptions. The war has also caused a major refugee crisis in Europe, with close to 6 million people fleeing Ukraine in less than three months. Third, the war caused financial conditions to tighten, through the weakening of many economies and indirectly via a faster-than-expected tightening of monetary policy in advanced economies.

The earthquake analogy is perhaps most apt because the war reveals a sudden shift in underlying "geopolitical tectonic plates." The danger is that these plates will drift further apart, fragmenting the global economy into distinct economic blocs with different ideologies, political systems, technology standards, cross border payment and trade systems, and reserve currencies. The war has made manifest deeper divergent processes. We need to focus on and understand these if we want to prevent the ultimate unraveling of our global economic order.

In that respect, the earthquake analogy has its limits, offering some reason to be moderately hopeful. These "geopolitical plates" are man-made reflecting history, institutions and people. While each plate or bloc may carry tremendous inertia, ultimately people—and their governments—can chart their own course. Reason and mutual economic interest can prevail.

In this context, the deeper economic force at play is the rising power of emerging market economies, especially China. The economic rise of China and other emerging market economies is a direct consequence of their integration into the world economy: international trade and economic growth surged in the past 40 years precisely because the world was not segmented. Yet the rise in these countries' economic might was not matched by a similar rise in their financial and global institutional firepower.

Nowhere is this more evident than when we look at the importance of the US dollar in the international monetary and financial system. Scholars of the system, like myself, have long pointed out that the dominance of the US dollar is absolute and organic but ultimately fragile. It is absolute because no other international currency comes close to challenging the role of the dollar as an international means of payment, unit of account and store of value. It is organic because this dominance does not derive from organized rules. Dollar-gold convertibility ended in 1971, and yet the dominance of the dollar has, if anything, increased due to interlocking and self-reinforcing network effects, and the unquestioned liquidity and safety of US Treasuries. It is also ultimately fragile because the US share of global output, and therefore the share of global output it can safely pledge through its official debt instruments, is bound to decline as emerging market economies rise. With a shrinking share of world output, the United States cannot indefinitely remain the sole supplier of safe assets to the world. This is what Helene Rey and I have dubbed the "new Triffin Dilemma."

No one can reasonably predict when or how the current absolute dominance of the dollar will be supplanted by a multipolar system. This is one of the fault lines in the current economic order. How this transition is implemented could have a major effect on the global economy and the future of multilateralism. At one end of the spectrum, we could end up with separate blocs. This would solve the Triffin dilemma by making the world smaller, but also less efficient. On the other end, the world economic system could remain integrated, but the interactions and possible coordination between multiple reserve currencies, including the US dollar, remain undefined.

In this vacuum, the war, and the unprecedented and coordinated freezing of the international reserves of the Central Bank of Russia represent major new developments. Powerful centrifugal forces have been set in motion, which, if not carefully checked, could lead to further economic fragmentation.

By design, the freezing of central bank reserves represents a major strike to the heart of "Fortress Russia," the economic and financial bulwarks the Russian authorities have put in place since the invasion of Crimea in 2014. A large war chest of international reserves—37 percent of Russian GDP—was supposed to insulate Russia against financial sanctions. With much of the reserves frozen, Russia is now highly dependent on continued energy exports to fund its war effort—a major vulnerability.

But sanctions on central banks call into question the broader usefulness of dollar international reserves in the first place, especially if the conditions under which restrictions on their use appear arbitrary, at least from the perspective of the countries holding them. This poses a "geopolitical Triffin dilemma" where the expectation of future restrictions on the use of reserves, instead of insufficient fiscal space, could trigger a move away from dollar assets.

In that respect, the war has brought the potential instability of the current global economic order into sharp relief. In this new environment, the IMF is being confronted with some serious existential questions. As a global institution whose objective is to promote global economic integration, it may become increasingly difficult to operate in a geopolitically polarized environment. The path of convenience would be to scale ambitions down and focus on the bloc historically aligned with the original signatories of the Bretton Woods Agreement. But that would fail to rise to the historical challenge.

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Instead, we must recognize that a fragmented world is a more volatile and vulnerable world, where access to safe assets is more restricted and the global financial safety net is less comprehensive. This is a world that needs the IMF more, not less. As an institution, we must find ways to deliver on our mission to provide financial assistance and expertise when needed and to maintain and represent all our members, even if the political environment makes it more challenging. If geopolitical tectonic plates start drifting apart, we'll need more bridges, not fewer. FD

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