Atlantic Council
GEOECONOMICS CENTER

ISSUE BRIEF

Fragmentation and the role of the IMF

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I. Introduction

The global economy and international financial system have evolved dramatically since the founding of the Bretton Woods system in 1944. A trend toward greater trade openness defined the decades following the establishment of the system. And while the Bretton Woods arrangement of fixed exchange rates was abandoned in 1973, this new international economic order continued to facilitate global economic integration and financial liberalization. Yet the trend of ever-more globalization, which has largely defined the past fifty years, appears to have stalled. Trade openness has remained effectively flat since the global financial crisis (GFC) (figure 1), while cross-border assets have trended down or sideways since the COVID-19 pandemic and Russia's 2022 invasion of Ukraine (figure 2).

By fostering financial stability and supporting economic growth, the International Monetary Fund (IMF) provided a stable foundation which supported this trend of increased cross-border trade and investment. The IMF, through its surveillance and lending operations, was established to act as an impartial referee to ensure that member countries pursued sound economic and financial policies. It also expanded the global financial safety net (GFSN) – which acts as an insurance mechanism to provide liquidity to countries facing economic crises. The IMF, as the lender of last resort to the global economy, acted as the primary provider of crisis support up until the GFC.

This postwar system, of which the IMF was a core component, supported decades of economic prosperity, broad-based increases in living standards, and a marked decline in global poverty rates. However, the global economy had no shortage of crises in the intervening years. Experiences ranging from the Latin American debt crisis to the Asian financial crisis have incrementally eroded the IMF's credibility and led member countries to seek alternative insurance mechanisms that do not come with "strings attached" (e.g., IMF program conditionality), thereby reducing member countries' reliance on the IMF.

The onset of the GFC led countries to double down on self-insurance mechanisms. It also led to a substantial diversification of the GFSN, as bilateral swap lines

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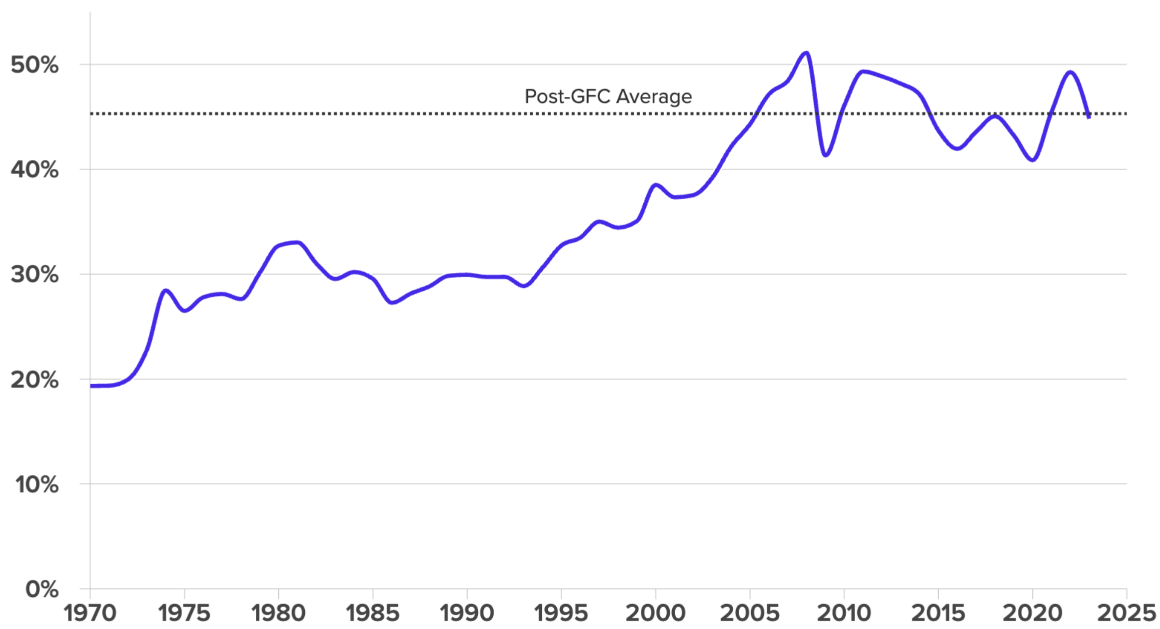
The Bretton Woods 2.0 Project examines the deep challenges facing the Bretton Woods Institutions and leverages data, research, and convening to propose new solutions for the future of the IMF, World Bank, and World Trade organization.

Figure 1. Global goods trade

Sum of exports and imports, percent of GDP



Source: IMF; World Bank; The External Wealth of Nations Database; author's calculations.
Note: Country composition changes over time.

(BSL) and regional financing arrangements (RFA) overtook the size of IMF resources in the safety net. To safeguard economic stability and protect against external shocks in the wake of the GFC, country authorities enacted capital controls, referred to as capital flow management measures (CFMs) in IMF parlance, in addition to accumulating foreign exchange reserves. This use of CFMs and international reserves as a self-insurance mechanism was further amplified by the COVID-19 pandemic and its associated financial distress.

Now, following the economic and financial disruptions stemming from Russia's invasion of Ukraine and rising geopolitical tensions, countries are increasingly utilizing industrial policies and current account restrictions to direct and manage trade flows as well – a trend that is best illustrated by the broad threat (and imposition) of tariffs that President Trump has made during the first month of his second term. These restrictions on capital and trade flows have contributed to the stalling of global integration and will likely result in greater volatility across the global economy in the coming years. Moreover, the displacement of the IMF as the anchor of the GFSN calls into question whether the GFSN can and will provide equitable support to all countries facing economic crises. As the global economy and international financial system enter a new era—characterized by increasing fragmentation rather than integration—ensuring that the international system has an effective insurance mechanism is more important than ever.

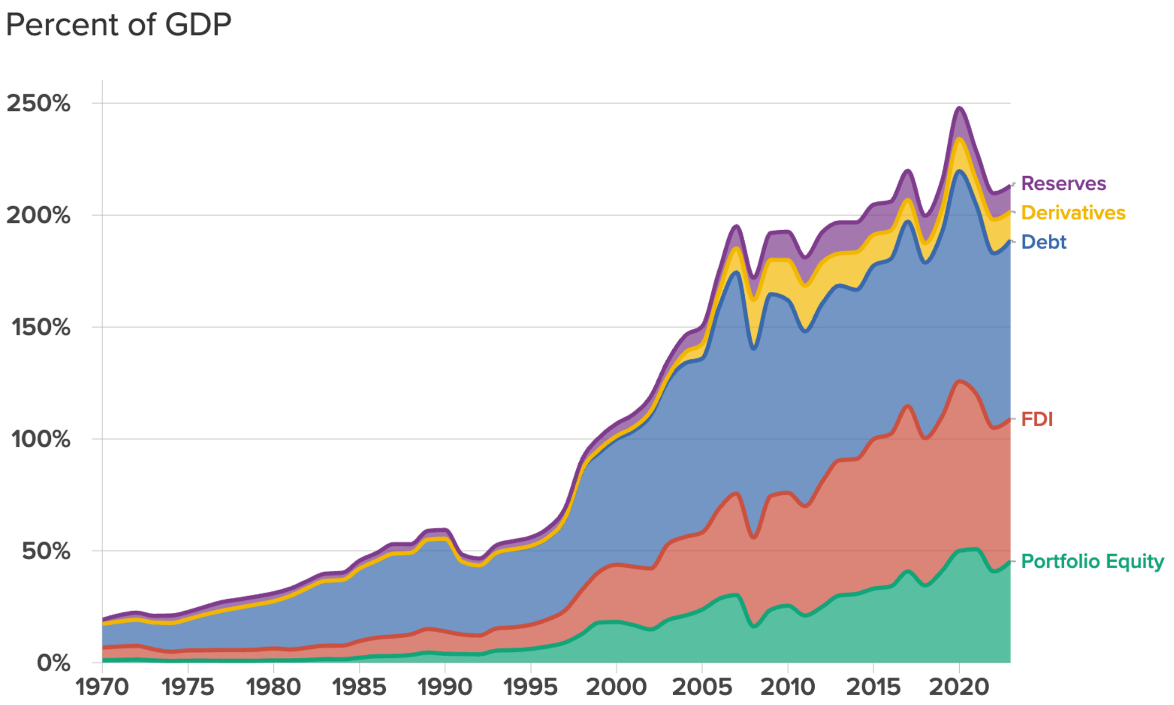
This report[1] is organized as follows. In Section II, I document the rise in fragmentation across capital and trade flows. Section III discusses how the emergence of these fragmentary forces has coincided with changes in the size and composition of the GFSN. Section IV explores how these forces of fragmentation could affect global development prospects and financial stability at the country- and system-level. Section V concludes with policy recommendations to revitalize the IMF and preserve the core insurance mechanism which underpins global development and financial stability.

II. Fragmentation dynamics in capital and trade flows

At its core, the decision by a country to enact restrictions on capital and trade flows is a function of economic and/or (geo) political factors. While these actions can protect against economic volatility and support domestic policy objectives, they often also result in distortionary effects on the global economy, particularly if such actions incite retaliatory measures.

1 The views expressed in this report are my own and do not reflect those of my employer.

Figure 2. Gross foreign assets



Source: IMF; World Bank; The External Wealth of Nations Database; author's calculations.
Note: Country composition changes over time.

Restrictions on the capital account have traditionally been used to (1) prevent an appreciation of the real exchange rate; (2) enable the more independent pursuit of monetary policy; and (3) support financial stability (Jinjarak et al., 2013). While second-best to more conventional financial and monetary policies (Erten, Korinek, and Ocampo, 2019), authorities have turned to the use of such measures when traditional policies are constrained.[2] By utilizing CFMs to alter the composition and volume of capital flows, countries have demonstrated a revealed preference for self-insurance rather than maintaining open capital accounts and relying on the GFSN during periods of stress. While interventions in the capital account have been primarily motivated by the desire to protect the domestic economy from international spillovers, the growing prevalence of investment screening procedures suggests that capital account interventions are increasingly being driven by domestic political objectives in addition to a desire for self-insurance.

Interventions on the current account, on the other hand, have historically been more closely linked to domestic political considerations. Trade restrictions are often imposed on strategic competitiveness grounds (i.e., to protect domestic industry) or for national security considerations (i.e., to reduce reliance on other countries). Recently, these trade restrictions have also been coupled with domestic regulation and subsidies (industrial policy) which have altered global trade flows. Restrictions on the current account, importantly, can also influence capital account flows. As countries redirect trade flows to reduce bilateral exposures, lower levels of cross-border investment can result as firms curtail investment in countries that are no longer large export markets.

Taken together, elevated levels of intervention to direct and manage capital and trade flows are contributing to a rewiring of the global system. While still at an early stage, initial evidence suggests that domestic and international politics are beginning to play a more active role in the global economic arena than in preceding decades. The subsections below document recent trends in fragmentation across the current and capital account.

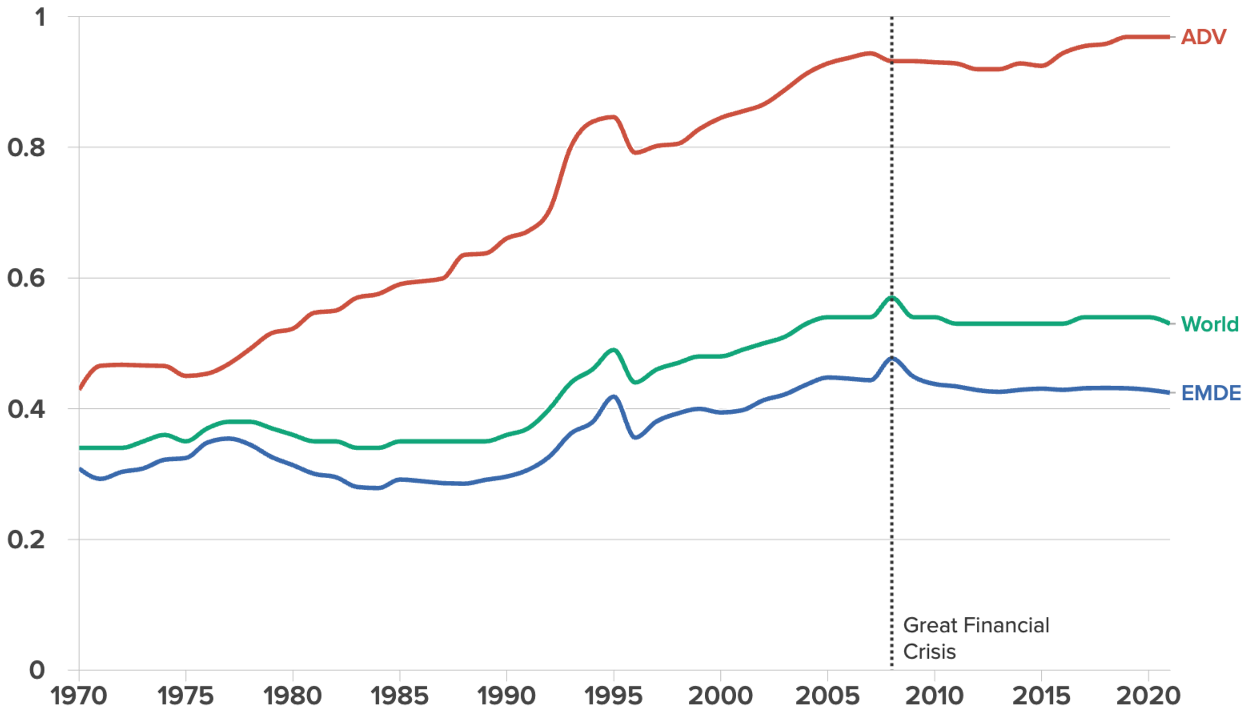
A. Capital account developments

Following decades of financial liberalization, the global average capital account openness remains below its pre-GFC peak (figure 3). Yet, this trend was largely driven by advanced econ-

2 Following the GFC, policymakers across the world—including in Brazil, Iceland, Indonesia, Korea, Peru, and Thailand—opted to recalibrate CFMs to manage fallout from the crisis. Tightening controls on capital inflows was pursued by countries seeking to restore macroeconomic stability and manage capital flows. On the other hand, countries tightening controls on outflows sought to manage financial stability and exchange rate movements (Binici and Das, 2021).

Figure 3. Capital account openness

(Chinn-Ito Index, Normalized 0-1)



Source: Chinn and Ito (2006); author's calculations.

omies (ADV). Emerging market and developing economies (EMDE) exhibited much less of an increase in openness—with policymakers relying on both "gates" and "walls" to manage the volatility associated with international capital flows.[3]

A return to the trend of increasing financial openness now appears even less likely following the global health and geopolitical disruptions from the COVID-19 pandemic and Russia's invasion of Ukraine, which led to a prioritization of domestic supply chains and a more activist approach to economic statecraft. Anecdotal evidence suggests that restrictions on capital flows, particularly for geopolitical and national security reasons, are growing in relevance. Between 2019 and 2021 alone, thirty-one governments have introduced or reformed their foreign direct investment (FDI) screening policies relating to national security (Evenett, 2021).

Underneath the aggregate data which illustrates the stagnation of financial openness, there are two forces at play:

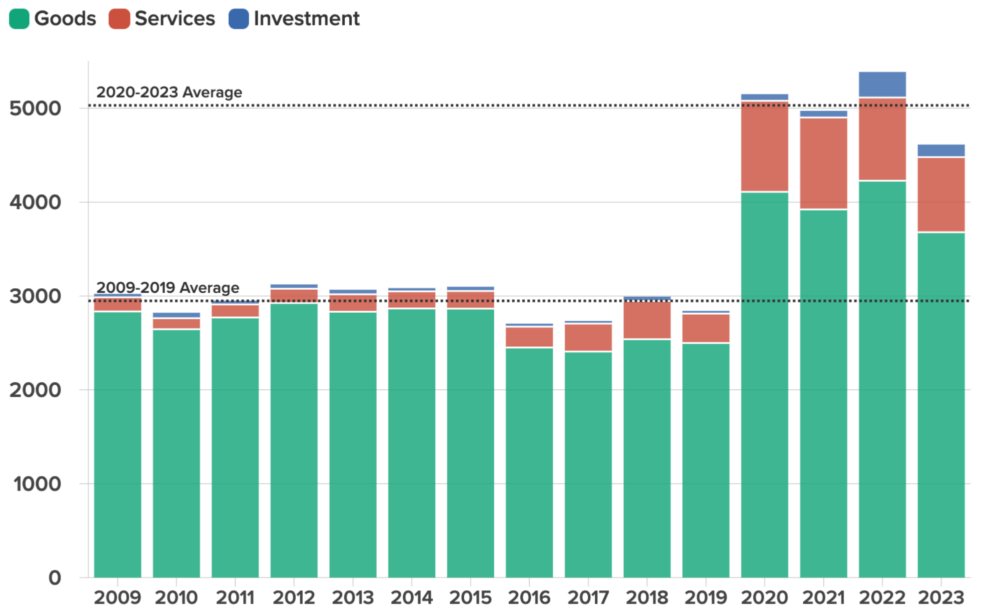
1. The use of CFMs, primarily by EMDEs, to manage the volume of flows which can exacerbate economic and financial vulnerabilities; and,
2. The implementation of investment screening mechanisms, disproportionately used by ADVs, to prevent inbound (and increasingly outbound) investment on the grounds of strategic considerations and national security.

Importantly, CFMs have tended to be used to manage or restrict "hot money" flows, that is portfolio investment in debt or equity securities which can be subject to quick reversal during risk-off periods of the global financial cycle (Miranda-Agrippino and Rey, 2021). These flows also have fewer clear benefits for economic growth and development. Investment screening in ADVs, on the other hand, deals primarily with FDI flows which are more closely associated with positive development impacts. Through restrictions on the capital account, policymakers' revealed preferences suggest that domestic influences could potentially contribute to a growing dislocation in global capital flows; as EMDEs are increasingly skeptical of capital flows from ADVs with less clear economic benefits (e.g., portfolio investment) while ADVs impose restrictions on the flows most closely associated with positive development impacts (e.g., direct investment).

3 "Gates" is a colloquial term used to describe periodic capital controls which are imposed on a narrow set of assets, while "walls" refers to durable capital controls across a wider range of assets. For a discussion, see Klein (2012).

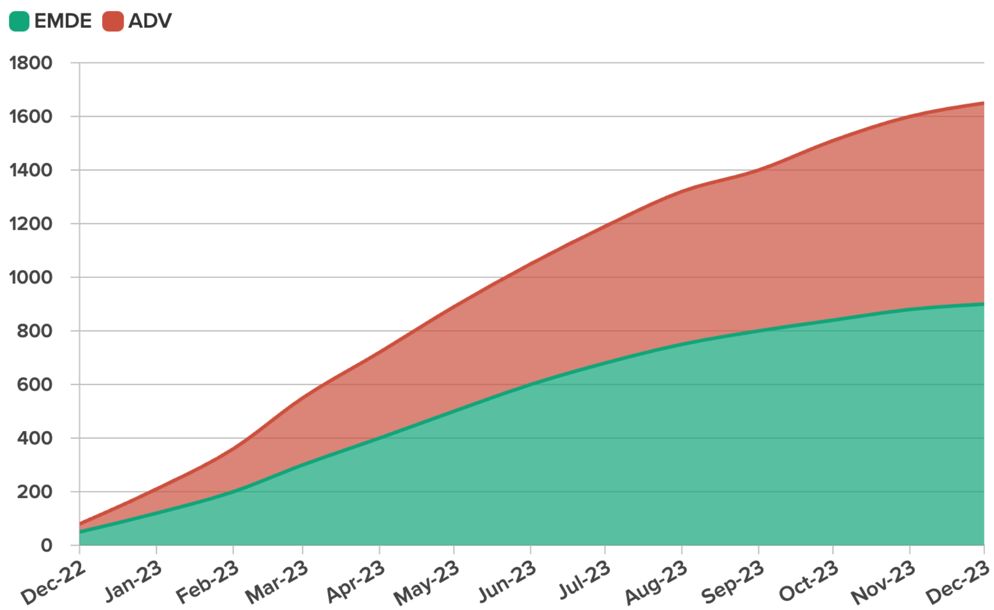
Figure 4. Cross-border restrictions and industrial policies

A. Harmful trade and investment restrictions



Source: Global Trade Alert data; New Industrial Policy Observatory database; author's calculations.

B. Cumulative industrial policy actions



Source: Global Trade Alert data; New Industrial Policy Observatory database; author's calculations.

Source: Global Trade Alert data; New Industrial Policy Observatory database; author's calculations.

B. Current account developments

While restrictions on capital account flows have come back in vogue as a self-insurance mechanism aimed at stemming economic and financial volatility, current account restrictions have historically been more deeply rooted in domestic political considerations. Nonetheless, the implementation of harmful trade restrictions has clearly increased since the onset of the pandemic (figure 4). Second, while trade restrictions historically have been used by EMDEs in the name of strategic competitiveness, ADVs have rapidly expanded their use of such "industrial policy" measures in the last year—with ADVs implementing more industrial policy measures than EMDEs since December 2022 (figure 4).

This rapid expansion of trade restrictions has resulted in a tit-for-tat dynamic between countries which could upend the rules-based trading system if the trend continues (Evenett et al., 2024). National security considerations are an important factor driving the increase in trade restrictions, as recent US export controls on advanced computing technology illustrate. Importantly, trade restrictions (as well as capital account restrictions) imposed for national security are explicitly outside the purview of the IMF, hampering the ability to limit the proliferation of such actions.[4] The lack of a clear boundary for what defines a policy enacted on national security grounds risks continued disruption in the international financial system.

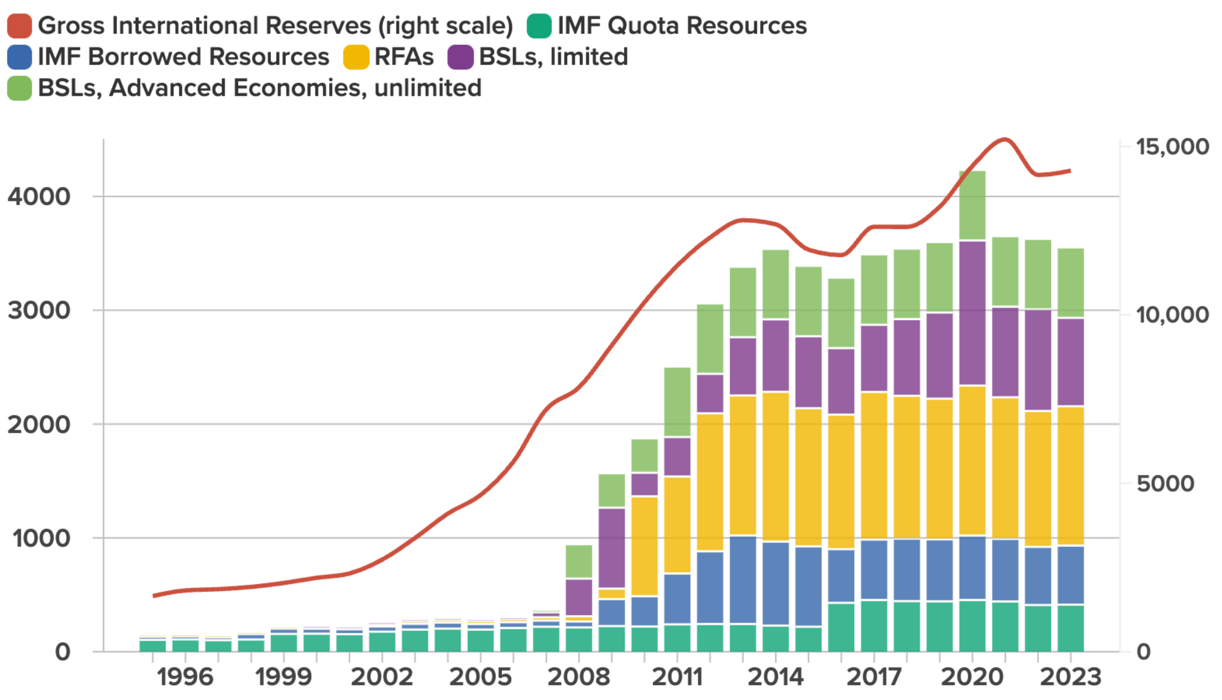
III. The evolution of the global financial safety net

Alongside countries' reconsideration of capital and trade flow restrictions, the GFSN changed drastically. Following the GFC, country authorities enacted a multitude of measures to support and expand the safety net. In addition, countries bolstered self-insurance by accumulating larger stockpiles of foreign exchange reserves (figure 5).

While expanding the GFSN was a welcome development during the crisis period, the increase in GFSN resources was not universally provided to all countries. BSLs, in particular, have become a key component of the GFSN (table 1). Swap lines from the Federal Reserve have been crucial to calming dollar liquidity and funding issues in periods of market turmoil. However, not all countries have access to such measures. As a result, regional financial arrangements have also grown in

Figure 5. Evolution of the global financial safety net

Billions of US Dollars



Source: International Monetary Fund, 2024 External Sector Report.

4 The IMF's latest review of its institutional view on capital flow management measures acknowledged that capital account measures issued on international security grounds require different treatment than other CFMs (IMF, 2022).

Table 1. Available financing from swap arrangements

Arrangement	Number of Participants	Size (USD bn)
Federal Reserve Swaps	32	420
People's Bank of China Swaps	54	511
Chiang Mai Initiative	13	322
Japan (BoJ and Finance Ministry)	8	184
European Central Bank Swaps	4	130
Contingent Reserve Arrangement	5	100
North American Framework Arrangement	3	9
Latin American Reserve Fund	8	7
Eurasian Fund for Stabilization and Development	5	5
Arab Monetary Fund	3	5
South Asian Association for Regional Cooperation	8	2

Source: Truman (2021)

prevalence. The European Stability Mechanism (ESM) has provided euro area members with access to financial resources during stress periods—notably during the euro crisis. The Chiang Mai Initiative was also created between Asian countries following the 1997–1998 Asian financial crisis to ensure that a liquidity pool was available in times of stress.[5] However, the Chiang Mai Initiative swap lines have yet to be utilized.

The introduction of BSLs and RFAs have weakened the IMFs role as the key provider of liquidity to countries in crisis. Moreover, the provision of liquidity now falls under the purview of domestic institutions or regional arrangements, potentially introducing more explicit political dynamics into crisis support. Nonetheless, access to certain BSLs and RFAs, such as the European Stability Mechanism, requires a country to negotiate a program with the IMF as a prerequisite to access.

As a result, countries now have a more complicated decision to make when experiencing periods of economic and financial stress. Importantly, not all countries have access to these swap arrangements. Sub-Saharan African countries, for examples, are not a part of any major swap arrangement. At the very least, greater coordination among providers of crisis liquidity is needed to ensure that the GFSN is able to provide timely financial support to all countries facing crises in the coming years.

IV. Potential impacts of fragmentation on global development and financial stability

Given the growing evidence of increasing use of restrictions on capital and trade flows for economic and (geo)political purposes, as well as the growing complexity of resources

5 The Chiang Mai Initiative is a multilateral currency swap arrangement between ASEAN member states, China, Japan, and South Korea that was created in 2000 to manage regional liquidity problems without having to rely on the IMF.

which comprise the GFSN, it is worthwhile to set out what this fragmenting international system implies for global development and financial stability. The conceptual framework below informs the policy recommendations in Section V of this report.

Fragmentation alone will not necessarily result in worse development outcomes and weaken financial stability. Rather, fragmentation compounds the intricacies inherent in the trade-offs that international financial institutions and domestic policymakers already navigate. The commentary below focuses on the impact of direct financial fragmentation; namely, the use of CFMs and economic statecraft which realigns global capital flows and the shifting of the GFSN from a primarily centralized structure at the IMF to a multipronged structure composed of international reserves, BSLs, RFAs, and IMF resources. Though it is also worthwhile to note that increasing fragmentation can have indirect effects (i.e., through uncertainty and risk aversion), as discussed in IMF (2023).

A. Global development

All else being equal, financial fragmentation is likely to have a negative impact on growth in developing countries. A decrease in global capital flows—particularly FDI, which has a stronger association to knowledge transfer and positive development outcomes (see Pazarbasioglu, 2020)—will decrease the resources available for developing economies to invest and place greater pressure on already limited fiscal space.[6] Increased fragmentation can also raise the cost of sending remittances (IMF, 2023), which are the largest source of external financing for low- and middle- income countries (Ratha et al., 2024). However, if the current trend of fragmentation turns out to be a correction from "unhealthy globalization" (Setser, 2024) or "hyper-globalization" (Rodrik, 2024) rather than a true retreat from global integration, then these negative development impacts may be muted.

On the other hand, a partial reversal of the trend in capital account liberalization could result in better distributional outcomes, since episodes of capital account liberalization are associated with a persistent increase in the share of income accruing to the top of the distribution (Furceri and Loungani, 2018). Greater financial fragmentation, moreover, could also result in more stable, albeit potentially lower growth. The increasing use of CFMs, in particular, can be a second-best alternative to monetary policies (e.g., relaxing constraints on the policy trilemma), enabling more independent monetary policy in a world with an increasingly correlated global financial cycle (Jinjarak et al., 2013; Miranda-Agrippino and Rey, 2021).

B. Financial stability

Increased financial fragmentation is likely to have differentiated effects on financial stability at the country versus system level. At the country level, greater fragmentation may well reduce financial instability through two channels: a more proactive approach to managing international financial flows through CFMs and an overall reduction in the buildup of capital flows which can contribute to the onset of crises (Forbes et al., 2014; Reinhart and Rogoff, 2011). Moreover, reduced access to international capital markets could help facilitate greater domestic financial development. Though reduced access to international capital markets could also come at the expense of lower growth in the near term.

At the global system level, however, an increase in fragmentation is likely to contribute to greater financial stability risks. A reshaping of global capital flows—which in the case of greater geopolitical tensions, could result in greater flows between a smaller subset of "friendly" countries—increases financial vulnerabilities by reducing international diversification (IMF, 2023). EMDEs are more exposed to these dynamics, potentially resulting in a greater reliance on the GFSN for support. Importantly, however, macrofinancial regulations have a role to play in increasing the robustness of the global financial system to fragmentary effects (Claessens, 2019).

V. Conclusion and policy recommendations

The earlier sections of this report have documented evidence illustrating that the global economy may be entering a new era as countries retreat from largely unfettered trade and capital flows which have underpinned global development since the founding of the Bretton Woods system. To be sure, the revival of restrictions on cross-border flows has, in some cases, resulted from countries' learning from past crisis experiences. Imposing limits on flows, particularly on the capital account, can serve as self-insurance and mitigate negative economic and financial impacts during periods of crisis. More concerning, however, is the increasing motivation to redirect or restrict cross-border flows due to domestic political considerations (i.e., industrial policies and national security). While this trend is still in its early stages, a structural shift in the use of such measures could result in a new type of beggar-thy-neighbor dynamic that the IMF has a limited ability to adjudicate.

Against this backdrop of emerging fragmentation, the GFSN—of which the IMF was once the primary support mechanism—has become increasingly complex. The arrival of BSLs and RSFs, while crucial in the support they have added to the system following the GFC, tend to offer support only to a limited set of countries. Ensuring the GFSN can efficiently provide liquidity to countries experiencing economic distress has thus become a more difficult task.

Increased financial fragmentation will have direct consequences for the world's ability to solve public goods problems. Fractured global capital flows will meaningfully impact attempts to invest for the Sustainable Development Goals and other international prerogatives including the clean energy transition.

6 It is important to note that the growth and development impact of FDI flows is far from certain. More recent assessments suggest FDI may only be positively correlated with growth when certain initial conditions, including low human capital and financial development, are met. See Benetrix, Pallan, and Panizza (2023) for more information.

Moreover, fragmentation will complicate financing for low- and middle-income countries that are already grappling with high levels of debt and limited fiscal space.

While it is true that countries have long deployed tools of economic statecraft to advance foreign policy goals, the rapid resurgence of such measures has never occurred amid such a deeply integrated global economic and financial system. The net result of fragmentation will only become apparent as more time passes. On the one hand, global development prospects and financial stability could remain relatively stable. On the other hand, the use of cross-border restrictions risks isolating the least developed countries, which could fall even further behind on their path to development. Regardless of the outcome, the shape of the global system will look quite different in this new era of fragmentation.

Revitalizing the IMF to ensure that it can retain its role as an impartial arbiter of economic and financial policies is critical. Moreover, ensuring an agile and effective GFSN in this incipient system will require greater coordination, in which the IMF can play a key role as convener. Recommendations to support these aims include:

1. **Advance global coordination efforts to ensure effective crisis liquidity support.**

Access to liquidity support in times of crisis is now much more complex than in the years prior to the financial crisis. While the emergence of BSLs and RFAs have added much needed support to the GFSN, they have also eroded the IMF's role as the central liquidity provider. Limited success with the IMF's short-term liquidity swap, meant to provide countries with access to foreign currency, demonstrates that certain BSLs (e.g., Federal Reserve swap lines) are best placed to address liquidity shortages in specific currencies. Nonetheless, continued efforts to advance coordination are necessary. The IMF's convening role for forums such as the Group of Twenty (G20) Sovereign Debt Roundtable showcase efforts to advance cooperation across a more diverse creditor base for debt restructurings. The scope of these conversations should be expanded to address crisis liquidity support, with a particular focus on assuring timely backing for EMDEs that do not have access to more immediate BSL and RFA financing.

2. **(Attempt to) address the elephant in the IMF boardroom.**

As countries increasingly pursue policies on the basis of domestic interests, equitable representation at the IMF and other international institutions is more important than ever. Increasing geopolitical competition between China and the United States will likely render any significant redistribution of voting rights at the next Quota Review obsolete. Nonetheless, marginal improvements are still worth pursuing. The decision to add an additional Executive Board chair for sub-Saharan Africa this year is notable in this regard. Further consideration should also be given to diversifying the leadership roles within the IMF to reflect lesser represented regions.

3. **Expand IMF analytical research on EMDE policies to deal with cross-border flows.**

The IMF has made significant progress in updating its institutional view on capital flows, most recently with its revised institutional view (IMF, 2022) and the introduction of the Integrated Policy Framework, which both acknowledge the potential benefits of CFMs in certain circumstances. Still, the Fund's analytical work could go further. In particular, the Fund could, and should, invest in analytical work analyzing the policies available to EMDEs amid increasing financial fragmentation. Greater emphasis should be placed on the benefits and costs of unorthodox exchange rate policies and capital controls (as discussed in Mühleisen, 2023). In-depth analysis on these and related topics will support more informed decisions and underscore the potential costs arising from increasing fragmentation. While likely to be the subject of substantial disputes at the IMF Executive Board, greater consideration should also be given to global imbalances and the role of source countries in capital flow dynamics.

4. **The IMF should proactively contribute to discussions on the effects of policies motivated by national security.**

The emergence of national security as a driver of capital and trade flow restrictions poses perhaps the largest threat to the current international financial system. While this topic may be outside the purview of the IMF, the Fund can still contribute productively to policy debates. Ultimately, the boundaries of justifiable national security actions are likely to be defined in forums outside of the Bretton Woods institutions (i.e., the G20). The IMF, however, should continue to document the potential disruptive and unintended consequences of such actions (as in Gopinath et al., 2024). The success of the IMF in this domain will ultimately be determined by its ability to rebuild its credibility as an impartial arbiter of economic policies.

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Acknowledgements

The author wishes to thank the Bretton Woods 2.0 Next Gen Fellow Amulya Natchukuri for their research assistance. The author also wishes to thank the leadership and staff of the GeoEconomics Center including Amin Mohseni, Cate Hansberry, Josh Lipsky, Mrugank Bhusari, and Sophia Busch.

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