



Geopolitical Fragmentation and Global Uncertainty: The Idea of Free Trade under Threat

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Article History

Received: 28 April 2026; Revised: 25 May 2026; Accepted: 06 June 2026;

Published: 30 June 2026

Abstract: Adam Smith and David Ricardo argued long ago that free and fair trade makes countries better off. Protectionism, however, is back. Average tariffs on manufactured goods more than doubled between 2024 and 2025, discriminatory trade actions rose to five times their 2015 levels, and global uncertainty indices stayed close to record highs. This paper looks at the shift in two steps. It first revisits the theoretical arguments for and against open markets, to see why protectionism has returned in its present form. It then estimates what the resulting instability costs, using a bivariate linear model of annual world trade growth and GDP growth against global uncertainty measures for 2004 to 2024. Three measures are compared: the Geopolitical Risk Index (GPR), the World Uncertainty Index (WUI) and the World Trade Uncertainty Index (WTU). A one-standard-deviation rise in WUI is associated with a fall of about 3 percentage points in annual trade growth, and the cumulative loss reaches nearly 5 points after three years. GDP growth falls by roughly 1 percentage point. GPR has no statistically significant effect.

Keywords: free trade, protectionism, geopolitical risk, trade policy uncertainty, world trade, regression

1. INTRODUCTION

UN Trade and Development (2025) expects the global economy to slow, mainly because of escalating trade conflicts and renewed protectionism. It cautions

To cite this paper:

Kiran Lamba & Geeta Khainchi (2026). Geopolitical Fragmentation and Global Uncertainty: The Idea of Free Trade under Threat. *Asian Journal of Economics and Business*. 7(1), 101-116.

that the instability could worsen debt distress in developing economies, and it argues that regional integration and multilateral cooperation are now more urgent. Geopolitical tension also affects trade directly. Using a gravity model, Mulabdic and Yotov (2025) estimate that surges in geopolitical tension reduce international trade volume by 30% to 40%, which is comparable to a 14% global tariff increase. Services trade is hit hardest, agriculture comes next, and manufacturing declines by less.

Few ideas in economics have been argued over for as long as free trade. Since Adam Smith (1776) set out the case for absolute advantage and exchange, mainstream economists have held that countries gain by specialising and trading. That view shaped post-war tariff reductions, the growth of trade and the building of global institutions. Critics appeared early, though. Alexander Hamilton (1791) and Friedrich List (1841) said that opening up too soon stops young industries from growing, and today's sceptics make a related point: unrestricted trade leaves a country dependent on strategic rivals. The security argument has gained ground quickly. COVID-19 showed how fragile global supply chains can be, and the rivalry between the United States and China has turned semiconductors and critical minerals into bargaining tools. Tariffs are now higher than anyone expected a decade ago, and multinational firms have to cope with rules that can change from one month to the next.

This paper links the history of trade policy to current evidence by asking two questions. Can established trade theories explain today's turn towards restriction? And what does the uncertainty it creates cost the world economy? The rest of the paper is organised as follows. Section 2 reviews the theoretical foundations and the return of protectionism, Section 3 reviews the literature, and Section 4 describes long-run trends in trade and geopolitical risk. Section 5 sets out the data and empirical framework, Section 6 presents and discusses the regression results, and Section 7 concludes with policy recommendations.

2. THEORETICAL BACKGROUND

2.1. The case for free trade

Economists have long asked how openness to international trade affects national welfare. Adam Smith (1776) rejected the mercantilist habit of hoarding bullion and located a nation's wealth in its productive capacity. In his account, a country that can make a good at a lower absolute cost than its trading partners

should specialise in that good and import the rest. David Ricardo (1817) generalised the argument through comparative advantage: even a less efficient country gains from trade if it specialises where its opportunity cost is lowest. John Stuart Mill (1848) added reciprocal demand, showing that the terms of trade, and therefore the division of the gains, depend on how strongly each partner demands the other's goods.

In the twentieth century the question changed from what countries trade to why they trade. The Heckscher–Ohlin model (Heckscher, 1919; Ohlin, 1933) ties trade patterns to differences in factor endowments: labour-abundant countries export labour-intensive goods, and capital-rich countries export capital-intensive ones. Leontief (1953) found that US exports did not fit this prediction. The Leontief Paradox, as it came to be called, drew attention to human capital and technological differences. Vernon (1966) added a dynamic element with the product life cycle, in which advanced economies innovate first and production moves to lower-cost countries as technologies become standard. Krugman (1979) used economies of scale and a taste for variety to explain intra-industry trade between similar economies. Melitz (2003) made the firm the unit of analysis and showed that differences in firm productivity decide which firms can export.

Later evidence has questioned how widely the gains from trade are shared. Autor et al. (2013) studied the rise of Chinese import competition in the United States and found higher unemployment and lasting wage losses in the local labour markets most exposed to it. Trade raises national income in aggregate, but gains and losses fall unevenly across workers and communities, and labour moves between sectors much more slowly than standard models assume. This helps explain why governments now give more weight to industrial resilience and national security than to efficiency alone, a shift often described as the “new protectionism”. The aggregate gains from open trade are still large. Even so, the social and political costs in particular localities can no longer be set aside.

2.2. The case for protection

While free-trade theory focuses on market allocation efficiency, protectionist traditions examine when government intervention becomes necessary to safeguard security, maintain social stability, or nurture domestic industry.

Mercantilism, which dominated European economic thought from the sixteenth through the eighteenth centuries, viewed international trade as a vehicle for national power. Thinkers like Thomas Mun (1664) advocated active export promotion and import restriction to maintain trade surpluses and accumulate precious metals.

Alexander Hamilton (1791) in his Report on Manufactures, alongside Friedrich List (1841), formalized the infant-industry argument. They argued that industrializing nations cannot compete against established industrial powers under open market conditions. Temporary protection gives emerging industries the necessary runway to achieve economies of scale and technological maturity. List famously observed that Britain, having built its industrial dominance through protection, urged other nations to abandon the very instruments that enabled its rise.

By the mid-twentieth century, protectionism took on structural formulations. Prebisch (1950) and Singer (1950) posited that the terms of trade for primary commodity exporters systematically deteriorate relative to exporters of manufactured goods. This insight provided the theoretical backbone for import-substitution industrialization across developing regions. National security offers another durable ground for protection: relying on foreign suppliers for critical military inputs or strategic technology such as advanced semiconductors or specialized steel presents strategic risks that cost savings cannot justify (Baldwin, 1985).

Game theory introduced further arguments. Brander and Spencer (1985) showed that in concentrated industries with high barriers to entry, targeted government subsidies can shift oligopoly profits from foreign competitors to domestic firms. Modern protectionism also employs non-tariff measures such as strict environmental rules or technical standards that protect domestic producers under the umbrella of safety or sustainability goals.

2.3. The return of protectionism

Global economic integration has slowed markedly since the early 2000s, with trade policy becoming deeply entangled with national security and geopolitical strategy. Three core drivers fuel this change: severe supply-chain vulnerabilities exposed by the COVID-19 pandemic (Baldwin & Evenett, 2020), strategic tech competition between the United States and China, and the resurgence of

state-directed industrial policy. Today's environment differs from 1930s tariff wars because traditional duties now operate alongside production subsidies, export controls, and regulatory barriers. The US tariff hikes of 2018–2019 provided an early preview; Fajgelbaum et al. (2020) demonstrated that targeted import prices failed to decline, meaning tariff costs passed completely onto domestic consumers and importing firms.

One result has been a preference for “friend-shoring” and “near-shoring”, where governments steer supply chains towards trusted allies even if production costs more (see Zarea & Su, 2026). The US Inflation Reduction Act (2022) and the CHIPS and Science Act (2022) subsidise domestic clean energy and semiconductor production. Both are examples of strategic trade policy justified mainly by national security rather than commercial return. The European Union's Carbon Border Adjustment Mechanism (CBAM) works differently. It puts a carbon charge on imports to prevent carbon leakage and to protect EU producers from competitors facing weaker environmental rules (Regulation (EU) 2023/956).

Rodrik (2011) called this tension the “globalization paradox”: deep economic integration is hard to combine with democratic accountability and national sovereignty. Trade measures are now used openly as instruments of power. The United States restricts exports of advanced AI semiconductors, and China limits exports of critical raw minerals, with effects that spread through global production chains. Officials speak of “de-risking” rather than full decoupling. The multilateral system has also weakened. The WTO Appellate Body has been unable to hear appeals since late 2019, which has made unilateral trade actions easier (World Economic Forum, 2025). State intervention now shapes global trade flows in ways that traditional efficiency-based models do not capture.

3. REVIEW OF LITERATURE

The United States, Germany, Japan, Taiwan and South Korea all protected their domestic industries in the early stages of development. They gained from international trade once those industries had grown stronger. Several of them returned to protection later, when competition in international markets became tougher or when they faced an economic crisis. In many cases protection was also a bargaining tool, used to press other countries for better terms in trade negotiations.

Desiderio (2025) argues that the reasons for protection depend on a country's level of development. Developing economies mostly protect to build infant industries, create jobs, catch up industrially and support structural transformation. Industrialised economies, by contrast, tend to protect strategic industries and jobs and to respond to geopolitical, technological and environmental pressures. Balcilar et al. (2018) find that geopolitical risk is an important factor behind investment, business cycles and the wider economy, and Das et al. (2019) report that it has a significant effect on economic growth.

Recent literature suggests that modern protectionism has moved beyond tariffs and now amounts to a structural realignment of international commerce (Aiyar et al., 2023). It takes the form of reshoring, nearshoring, friend-shoring and targeted reindustrialisation, all aimed at reducing vulnerability in global supply chains (Witt et al., 2023). Ossa (2014) shows that the welfare cost of a trade war is high when no multilateral trade agreements are in place. Sudden changes in United States trade policy repeatedly shock the world economy (Zheng et al., 2025), and the US-China trade conflict since 2018, together with the decision to withdraw from the Trans-Pacific Partnership, created major uncertainty worldwide (Chodor, 2019). This raises the question of how trade policy uncertainty and geopolitical risk affect global trade and economic growth.

4. GLOBAL TRADE AND GEOPOLITICAL RISK

The progressive integration of national markets into a single global trading system represents one of the defining economic developments of the past two centuries. Figure 1 plots the volume of world goods trade since 1800, deflated and indexed to the 1800 level.

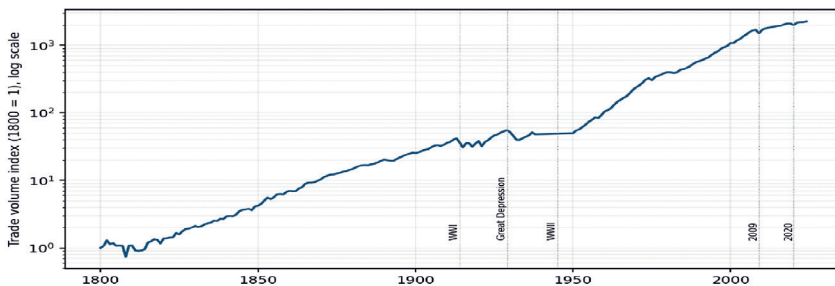
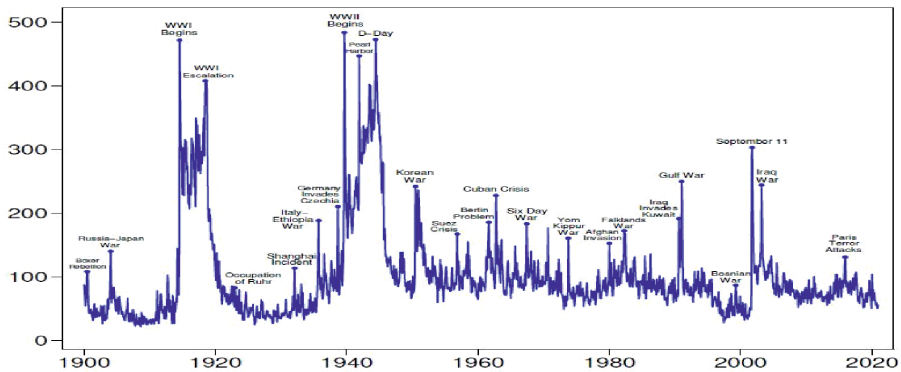


Figure 1: Long-run expansion of international trade, world trade volume index (1800 = 1). Source: World Trade Organisation (2024); Federico and Tena-Junguito (2016)

By 2024, combined global import and export volumes stood more than 2,000 times higher than their 1800 baseline. This expansion has suffered major interruptions, contracting sharply during both world wars, the Great Depression, the 2009 global financial crisis, and the 2020 pandemic. Prior to 2008, global trade volume routinely expanded faster than world economic output. Post-2012, however, trade growth slowed relative to GDP, stagnating completely by 2023. Caldara and Iacoviello (2022) constructed a Geopolitical Risk index (GPR) that tracks news coverage of war, terrorism, and interstate conflicts. Their long series is shown in Figure 2.



Note: Historical Geopolitical Risk Index from January 1900 through December 2020. Index is normalized to 100 throughout the 1900-2019 period.

Figure 2: Historical Geopolitical Risk index, January 1900 to December 2020, annotated—source: Caldara and Iacoviello (2022).

While GPR spikes during acute crises such as world wars, the Korean War, the Cuban Missile Crisis, it generally hovered near its historical average across the 1990–2020 period. That era of low baseline risk has ended. The annual average GPR index jumped to 158 in 2022 following Russia’s invasion of Ukraine, reaching 188 during the first nine months of 2026. While conflict zones like Ukraine and Venezuela register the highest values, countries like China, Australia, and several North European nations display risk levels well above their long-term historical norms.

Geopolitical conflict represents only one component of global instability. Ahir, Bloom, and Furceri (2022) developed the World Uncertainty Index (WUI) by quantifying frequency counts of the word “uncertain” across Economist Intelligence Unit country reports. Isolating mentions adjacent to trade terms yields the World Trade Uncertainty Index (WTU). Earlier work

by Baker, Bloom, and Davis (2016) quantified broader Economic Policy Uncertainty (EPU), while Caldara et al. (2019) demonstrated that trade policy uncertainty directly depresses global commercial activity.

5. DATA AND METHODOLOGY

5.1. Data

Table 1 outlines the core datasets utilized in this study. Monthly and quarterly series are aggregated into calendar-year averages. The primary econometric specification covers 2004–2024 (21 annual observations), while extended time series support local projection estimations in Section 5.3.

Variable	Source and Definition	Coverage Used
World trade volume growth	Annual change in world goods trade volume index (WTO; Federico & Tena-Junguito)	1991–2024
World GDP growth	Real annual world output growth (UNCTAD)	2004–2026
Geopolitical Risk (GPR)	Caldara & Iacoviello monthly index (1985–2019 = 100)	1985–2026
World Uncertainty Index (WUI)	Ahir, Bloom & Furceri GDP-weighted quarterly global average (EUI)	1990–2026
World Trade Uncertainty (WTU)	Trade-focused uncertainty index, GDP-weighted quarterly (EUI)	1996–2026

Supplementary data include counts of liberalizing versus discriminatory trade measures (2015–2025), sectoral tariff changes, and regional trade growth rates. Two analytical caveats apply. First, because trade series end in 2024, index readings for 2025 and 2026 are included solely for comparative context. Second, annual aggregation smooths intra-year timing; shocks occurring late in a calendar year typically influence trade flows in the following year, which same-year regressions cannot fully capture.

5.2. Model specification

The empirical setup employs a bivariate linear specification relating annual trade and GDP growth directly to global uncertainty:

$$\text{Growth}_t = B_0 + B_1 (\text{Uncertainty}_t) + e_t$$

Where B_0 captures expected growth under average uncertainty conditions, ' B_1 ' is the slope, and 'et' is the error term. We estimate three specifications. The first is a benchmark in which trade growth depends on GDP growth alone:

$$\text{Trade Growth}_t = B_0 + B_2 \cdot (\text{GDP Growth}_t) + e_t$$

The second and third specifications regress trade growth and GDP growth on standardized, log-transformed uncertainty measures. Because the variables are scaled to zero mean and unit standard deviation, the slope coefficient ' B_2 ' reads directly as the percentage-point change in annual growth that follows a one-standard-deviation rise in uncertainty. As robustness checks, we add GPR alongside WUI and include lagged WTU values to allow for delays in policy transmission.

5.3. Dynamic effects and robustness

To see how trade responds to uncertainty shocks over time, we use the local projections (LP) method of Jordà (2005). We estimate the following equation sequentially for each future horizon $h = 0, 1 \dots H$:

$$\Delta Y_{t+h} = \beta_{0,h} + \beta_{1,h} \text{Uncertainty}_t + \gamma h \Delta Y_{t-1} + \varepsilon_{t+h}$$

In this equation, the dependent variable, ΔY_{t+h} , represents trade growth in the future period h . The term $\beta_{0,h}$ is the intercept, which picks up average growth at each horizon. The variable we care about is *Uncertainty*, the level of economic or trade policy uncertainty in period t . Its coefficient, $\beta_{1,h}$, shows how trade growth responds to an uncertainty spike today, h periods ahead. Plotting these $\beta_{1,h}$ estimates across horizons gives an impulse response function (IRF) without imposing the structure that a Vector Autoregression (VAR) would require. We also include ΔY_{t-1} as a control, so that the estimate does not simply reflect momentum already present in trade growth. Its coefficient is γh . The last term, ε_{t+h} is the error term and covers unobserved factors. Overlapping multi-year horizons create serial correlation, so standard errors are Newey–West heteroskedasticity-and-autocorrelation-consistent (HAC) errors (Newey & West, 1987). For robustness we also re-estimate the models with raw index levels, drop the crisis years (2009, 2020 and 2021), leave out the 2019 trade-war shock, and add GDP growth as a control.

6. RESULTS AND DISCUSSION

6.1. Trends in uncertainty and trade

The standardised log GPR reached 1.7 in 2022, fell to 0.8 in 2023 and 1.2 in 2024, then rose to 1.4 in 2025 and 2.4 in 2026. Log WUI was 3.8 in both 2025 and 2026, and log WTU was 2.7 and 2.8 in those two years. WUI in 2025 is twice its 2019 level. GPR and WUI are only moderately correlated ($r \approx 0.47$). This is expected, since GPR responds to news headlines about immediate events, while WUI reflects longer-run concerns reported by professional country analysts.

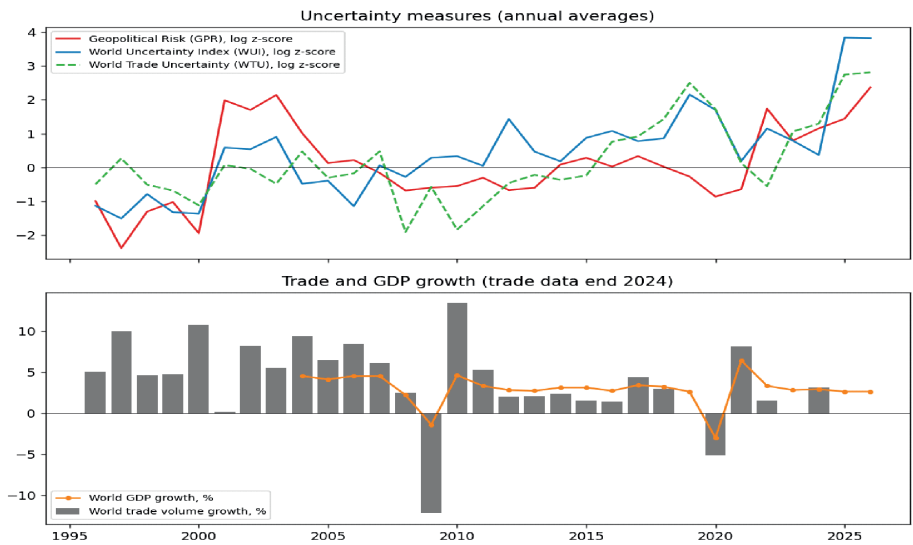


Figure 3: Uncertainty measures (log z-scores) and world trade and GDP growth. Trade data end in 2024.

Trade and GDP growth remain tightly linked. Over 2004–2024, the baseline regression yields:

$$\text{Trade Growth} = -3.73 + 2.28 \cdot (\text{GDP Growth}) \text{ [} R^2 = 0.73 \text{]}$$

Output growth accounts for nearly three-quarters of trade variation. However, this elasticity has shifted over time. From 2004 to 2011, world trade expanded at 1.5 times the rate of GDP growth; between 2012 and 2024, trade expansion slowed to 0.7 times GDP growth. Global trade growth was 0.01% in 2023 and 3.09% in 2024. Notably, regression residuals from the baseline equation were persistently negative from 2021 through 2023 (-2.7,

-2.2, and -2.6 percentage points), indicating that global trade expansion lagged expectations based on economic output alone, precisely as trade policy tensions mounted.

6.2. Regression results

Table 2 summarises the three central specifications. Baseline estimates show trade sensitivity to aggregate output exceeds unity: every 1-percentage-point increase in global GDP growth yields a 2.28-percentage-point boost in trade growth.

Table 2: Results of OLS Regression

<i>Sr. No.</i>	<i>Dependent Variable</i>	<i>Explanatory Variable</i>	<i>Slope Coefficient</i>	<i>R²</i>
1.	Trade growth	GDP growth (benchmark)	2.28 (5.12)	0.73
2.	Trade growth	Uncertainty (WUI)	-3.21 (-4.42)	0.22
3.	GDP growth	Uncertainty (WUI)	-1.11 (-2.16)	0.19

Standardized WUI exhibits a consistent negative relationship with growth metrics. A one-standard-deviation increase in WUI is associated with a 3.21-percentage-point drop in annual trade growth ($p < 0.01$) and a 1.11-percentage-point decline in GDP growth ($p < 0.05$). Bivariate uncertainty models explain less total variance (R^2 of 0.22 and 0.19) than GDP growth alone.

Adding additional indices reinforces these patterns. In joint specifications, GPR shows no statistically significant impact on trade growth (0.24, $t = 0.35$) or GDP growth (0.71, $t = 1.40$), while WUI coefficients remain robustly negative (-2.43 for trade, -1.06 for GDP). Entered with a one-year lag, WTU yields a trade coefficient of -2.21 ($t = -1.96$). Estimating models in raw index levels yields similar conclusions: a one-standard-deviation rise in WUI corresponds to a 5.4-percentage-point reduction in trade growth ($t = -3.4$). When GDP growth is included as a direct control variable alongside WUI and GPR, the standalone WUI coefficient drops to -0.81 ($t = -1.01$). However, excluding crisis shock years (2009, 2020, 2021) while controlling for GDP restores WUI significance (-1.56, $t = -2.15$; $R^2 = 0.79$).

6.3. Dynamic effects

Table 3 tracks local projection impulse responses over time. Following a one-standard-deviation WUI shock, trade growth drops by 3.13 percentage points

in the initial year, with cumulative losses expanding to 4.88 percentage points by year three.

Table 3: Results of Local Projection responses over time

<i>Index</i>	<i>Same Year (t)</i>	<i>1 Year Later (t+1)</i>	<i>2 Years Later (t+2)</i>	<i>3 Years Later (t+3)</i>
WUI	-3.13 (-5.96)	-4.07 (-4.57)	-4.63 (-5.84)	-4.88 (-3.01)
WTU	-1.57 (-1.90)	-1.51 (-0.75)	-2.78 (-2.14)	-3.20 (-2.13)
GPR	-0.39 (-0.44)	0.37 (0.26)	0.64 (0.31)	1.28 (0.44)

Note: Standardized log uncertainty inputs; Newey–West standard errors in parentheses.

WTU shocks produce smaller immediate effects (-1.57 points) that compound to a 3.20-percentage-point loss by year three. GPR effects remain statistically insignificant across all horizons.

6.4. Discussion

The structural divergence between GPR and WUI impacts stems from index construction. GPR tracks volatile media headlines, generating short-lived spikes around major international shocks. Outside major conflict years like 2022, GPR offers limited empirical variance. In contrast, WUI captures sustained economic anxiety recorded in forward-looking analyst reports, aligning closely with corporate capital investment and trade commitments. This finding accords with Bloom (2009), who demonstrates that elevated uncertainty leads firms to delay capital expenditures, and Handley and Limão (2017), who show that policy uncertainty deters export market entry.

Trade contracts about three times as much as output when WUI rises (-3.21 against -1.11 percentage points). One reason is the composition of trade, which is dominated by capital equipment, durable goods and intermediate industrial inputs. Novy and Taylor (2020) show that when firms face greater policy uncertainty they postpone orders for imported materials and run down inventories, so trade volumes fall by more than output does.

7. CONCLUSION AND POLICY IMPLICATIONS

This study examined the tension between open international trade and economic nationalism at a time of rising geopolitical volatility. Trade theory points to the efficiency gains from open markets. Protectionist arguments explain why countries still put domestic development, national security and

local supply networks first. Current trade policy shows a clear return of state intervention driven by strategic rivalry. The empirical results lead to four conclusions, which reflect that trade growth is still closely tied to global output, although the elasticity has fallen since 2012. Secondly, the World Uncertainty Index (WUI) has a statistically significant negative effect on both trade and output growth. Third, an uncertainty shock lowers cumulative trade growth by roughly 5 percentage points over three years. Finally, the Geopolitical Risk Index (GPR) shows no systematic relationship with trade or output growth.

Hence large economies, above all the United States and China, can reduce uncertainty themselves by making policy transparent and predictable. Tariff changes can be announced well in advance, introduced through phased transition periods, and capped by binding ceilings in trade agreements. Institutions matter too. If governments notify the WTO promptly, keep open online tariff databases and maintain a working dispute settlement system, firms can price risk and keep their investment plans on schedule.

Furthermore targeted trade finance, export credit insurance and transitional funding can also stop a short-term disruption from becoming a permanent loss of markets. Since the effects of trade realignment fall unevenly on particular manufacturing regions, adjustment support should go directly to the workers and communities most exposed. In the end, countries can strengthen their security and supply-chain resilience without giving up the gains from global trade, provided they keep commercial rules clear and reliable.

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