Box A. The macroeconomics of de-globalisation

*by Amit Kara and Iana Liadze**

The Covid-19 pandemic has revived protectionist measures.[1] The most proximate trigger for this switch is a desire to prioritise national security interests and public health concerns over the long- standing economic rationale for free trade, which is to maximise productivity (Ricardo, 1817) and tap new markets. The macroeconomic consequences of protectionism will depend on the specific form that it takes but, if history serves as a guide, a more restrictive global trading environment is likely to reduce cross-border capital flows, bear down on productivity and economic growth, raise the neutral global interest rate, R*, and exert upward pressure on wage and price inflation. Low-and middle-income countries that have benefitted from globalisation are particularly vulnerable in this environment, as are workers that are exposed to global trade in developed economies.

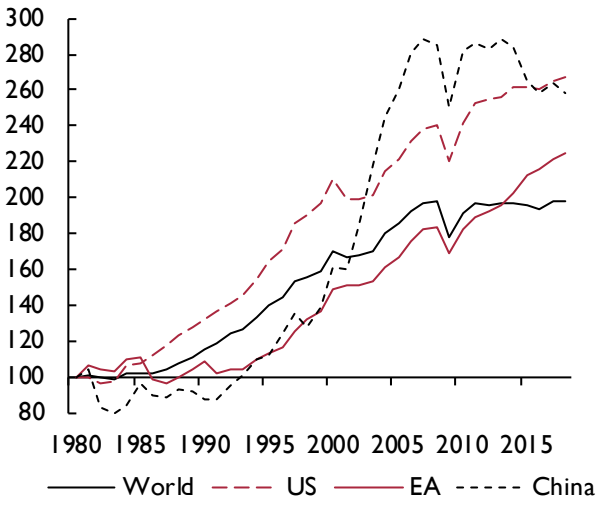
A comprehensive description of globalisation goes beyond the trade in goods and services and includes the movement of people and capital and the sharing of technology and ideas. That said, the two statistics that are most widely used to express the march to globalisation are the ratio of world trade to world GDP (figure A1) and its foreign direct investment equivalent (figure A2) that summarises cross-border capital flows.

Figure A1 shows the trade-to-GDP ratio. The figure shows that growth in world trade outpaced GDP from the mid-1980s and reached a peak just before the Global Financial Crisis (GFC) in 2008. The trade-to-GDP ratio has stagnated since.

The ratio at the global level however, masks important differences across economies. For example, the ratio has continued to rise in the US and Euro Area after the GFC. The story is different in China, where the period around the GFC marks an important switch point. The ratio flattened after that point and in fact, started to fall after 2012. On this metric, the US and Euro Area have remained on the globalisation path in the decade since the start of the GFC, but China and the World have retreated.

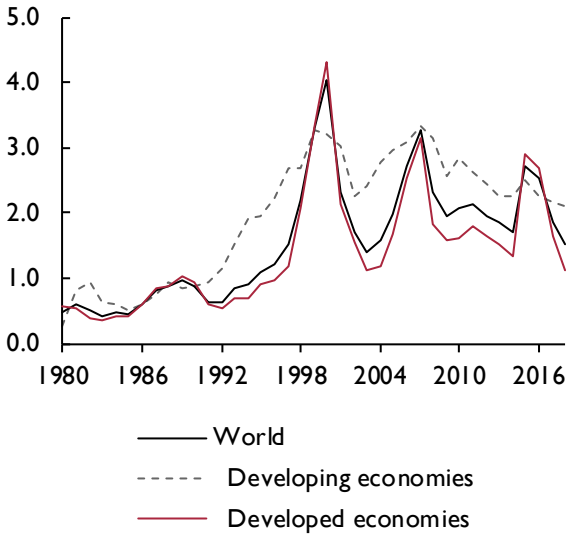
What explains the divergence between China and the US and Euro Area? The main reason is the structural changes in the Chinese economy since the GFC. China turned away from an exports, manufacturing and investment-driven growth model, all of which tend to have a high import content, to one that depends more on services and consumption, which have a relatively low import intensity. This has had a large impact on commodity exporting economies as well as other emerging economies in Asia which are also more exposed to the Chinese economy (IMF, 2016). Although China is a stand-out example, it is worth emphasising that the structural shift away from investment in the post-GFC period is more widespread. For example, countries that rely on commodities also cut back on import-intensive capital spending in response to lower prices (IMF, 2016).

Figure A1. Global trade (export plus import volumes) as a share of GDP (1980=100)



Source: NiGEM database.

Figure A2. Foreign direct investment as a share of GDP (%)



Source: UNCTAD.

Box A. (continued)

Figure A2 shows the flow of FDI (as a share of GDP). FDI flows appear cyclical at the global level with peaks around the dot-com bubble and the start of the GFC. Abstracting from the cyclicality of flows, the broad takeaway from this figure is that FDI flows have stagnated since the start of the century and trended lower since the GFC. Bordo (2017) has argued that risk aversion, the economic slowdown and tighter financial sector regulations can explain the slowing of FDI flows since the GFC, a trend that is likely to gain momentum if the focus on self-reliance and security impedes cross border financial flows.

Macroeconomic consequences of de-globalisation

Although the post-GFC experience of relatively slow trade growth is the most recent, there are important differences which make this episode less relevant for our outlook. Chief among these is the trigger for the post-GFC slowdown. The post-GFC slowdown was mainly driven by less demand for investment goods rather than our primary concern, which is de-globalisation that is driven by protectionism.

A more useful period to assess the macroeconomic implications for protectionism might simply be the long period of globalisation that started in the early 1980s. The factors that drove that globalisation are multifold and include the integration of China and Eastern Europe into the global economy, technological advances that enabled deeper and widespread adoption of global value chains (Arslan *et al.*, 2018; Aubion and Borino, 2018), the changing mix of aggregate demand toward capital goods (Auboin and Borino, 2018), financial sector liberalisation and lower trade barriers and transport costs. Future protectionist measures are likely to reverse many of these policies, including new restrictions on technology transfers and financial flows and higher tariffs and non-tariff barriers.

The literature on the macroeconomic consequences of this episode of globalisation is rich and points to a material impact on inflation dynamics, cross-border financial flows and productivity. We discuss each of these in turn.

Starting with inflation, BIS (2017) show that the strength of the relationship between the output gap/labour market slack and prices and wages has diminished in the G7 since the early 1980s. As figure A1 above shows, this is roughly the start of the period of globalisation. This is also the start of the period when central banks in the US and UK made concerted efforts to contain inflation (Batini and Nelson, 2005) and as such the estimated coefficients in a reduced form Phillips curve could be driven by the renewed focus on inflation control rather than globalisation.

However, there is other evidence to show that common global factors are significant in country-level inflation dynamics over this period (Borio and Filardo, 2007, at the cross-country level and Batini, Jackson and Nickell, 2005, for the UK). In so far as the flattening of the wage and price Phillips curve is driven by globalisation rather than other factors, protectionism could lead to a steepening.

Cross-border capital flows have increased since the 1980s as countries in the emerging world started to integrate into the global economy. The savings glut hypothesis, proposed by Bernanke (2005) and elaborated by Carney (2017), identified factors that have contributed to a rise in global savings and a reduction in R*. De-globalisation that restricts cross-border capital and trade flows could drive R* higher.

By boosting competition, globalisation forces a reallocation of resources towards more productive firms (Melitz, 2003). This is evident in several countries and across different sectors, although the size of the impact may not be large (Constantinescu *et al.*, 2016). Again, increased protectionism could disrupt existing global value chains and impinge on the competitiveness of domestic producers (Rincón-Aznar, Mao and Tong, 2020).

Conclusions

The outlook for global trade, technology transfer and capital flows is uncertain. On the one side, businesses looking to maximise productivity and minimise costs will, as before, continue to drive global trade but, on the other hand, a new protectionist agenda will act as a headwind to trade growth and cross-border technology transfers (Harding and Harding, 2019).

The type of protectionism matters, but if history serves as a guide, a more restrictive environment is likely to result in less productivity and economic growth, lower cross-border financial flows, higher R* and upward pressure on wage and price inflation.

Emerging economies that are export-oriented are particularly vulnerable if the global trading environment turns hostile. One of the most important challenges for policy makers in developed and emerging economies will be the disruption caused to local

The macroeconomics of de-globalisation (continued)

labour markets. Studies have shown that the emergence of China has led to a reduction in US employment and wages in sectors that were most exposed to competition (Autor *et al.*, 2013). De-globalisation does not automatically imply a reversal of fortunes for these sectors or workers, rather a new form of disruption that is triggered by a different type of structural change.

Note

1 See https://www.macmap.org/en/Covid19 for a list of trade restrictions imposed by governments in response to the pandemic.

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