Deglobalization and its Discontents: The Pandemic Effect

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Highlights

- The pandemic has turbocharged the deglobalization process that was already well underway. The pandemic's onset has led to increased protectionism and onshoring, and has exposed the vulnerabilities of relying too much on efficient rather than resilient supply chains.
- The pandemic has also exacerbated U.S.-China decoupling, which has sped up the deglobalization process. American companies have expedited their plans to change business models and move supply chains closer to U.S. shores.
- While globalization has its flaws, no country will be immune to the damage inflicted by deglobalization. It will be a gradual and painful process leading to slower economic growth. Weakening economic interdependency among countries may also increase the likelihood of conflict.

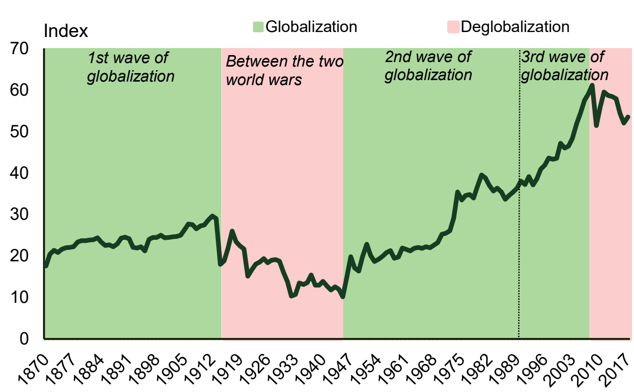
Deglobalization is a term regularly thrown around, often in reference to the U.S and China clash. The term is used to describe a reduction or break in interdependence between worlds' economies, cultures and populations that includes the cross-border movement of goods, services, people, information and technology.[1] This note will explore deglobalization by narrowly focusing on the economic aspect.

Many are noting that the pandemic risks driving deglobalization forces, beyond the tensions between two superpowers. But this pattern was unfolding well before the pandemic hit.[2] In fact, the deglobalization process started soon after the global financial crisis (GFC). Several factors have put these forces in play, including rising income and wealth inequality, off-shoring leading to job losses, and migrant crises leading to anti-immigrant stands. In turn, this has contributed to the rise of populism that has led to stricter visa regimes designed to discourage the cross-border movement of people and goods.

The pandemic is now acting as an accelerator towards increased protectionism and re-onshoring by exposing the vulnerabilities of relying too much on long supply chains, particularly when it comes to public health concerns and national security. All of this is taking place in an environment of reduced international cooperation and in a vacuum created by the U.S. as it steps away from trade liberalization.

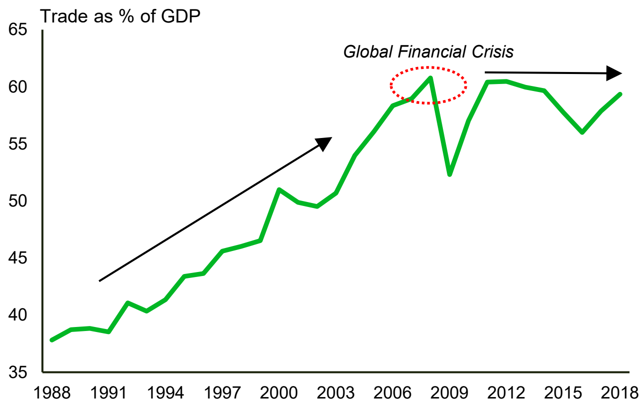
The health crisis has served to press further on long standing tensions between the U.S. and China by deepening the divide

Chart 1: Globalization Comes in Cycles



Note: Trade openness index data for 1870 - 1949 are from Klasing and Milionis (2014). Data from 1950 - 2017 are from Penn World Tables (9.0).
Source: OWID, TD Economics.

Chart 2: Globalization Peaked Right Before the GFC



Source: World Bank, TD Economics.

in trade, technology and investment. U.S. companies have expedited their plans to change their business models and move supply chains closer to home. All of this is happening at a time when U.S.-China relations were already at their lowest.

Although many countries had previously criticized the economic decoupling of the U.S. and China, the pandemic has politicized international cooperation and has prompted countries to lean more towards self-reliance. While necessary in some instances such as health security, inward looking policies applied across the board will weaken the recovery and create economic and geopolitical instability. Weakening economic interdependency among countries may also increase the likelihood of economic, political and military conflict. If the deglobalization process continues uninterrupted, it will be slow and painful, leading to lower short-term and long-term economic growth.

The rise and fall of globalization

Much like the rise and fall of empires, globalization comes and goes in cycles (Chart 1). Understanding globalization's history is imperative in understanding where we may go from here. Modern globalization can be divided into three waves; first wave (1870 – 1914), second wave (1945 – 1989) and third wave (1989 – 2008).

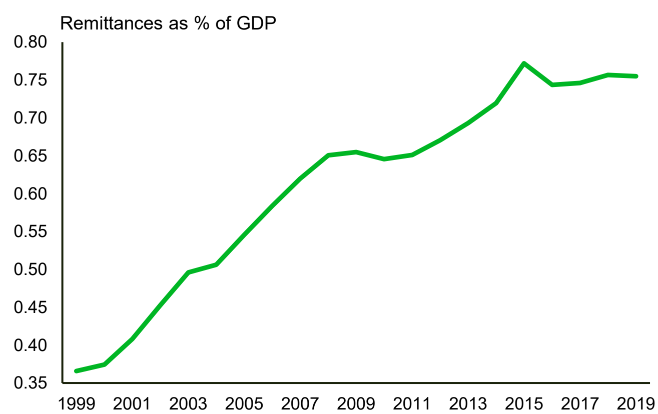
The first wave saw economic integration increase due to several technological advances. These advances – such as the steam ship – allowed goods to be moved more freely and cheaply between countries. Globalization stalled at the outbreak of the first world war in 1914 until the end of the second world war in 1945. This period (1914-1945) was peppered with several incidents that contributed to the collapse of economic and financial integration. These incidents include the Spanish flu pandemic; withdrawal of Russia from world trade; monetary instability; the Great Depression and increased protectionism.[3] There are uncanny similarities between the early 20th century and the direction we are moving in today.

The second wave originated from the ashes of World War II and lasted for more than four decades. The creation of new multilateral institutions such as the General Agreement on Tariffs and Trade (GATT) — the World Trade Organization's (WTO) predecessor — in the aftermath of the war allowed countries to open their economies to more trade. While the second wave was primarily led by advanced economies (AEs), emerging markets (EMs) – such as China and India – were the drivers behind the third wave. This wave saw globalization reach its peak as China and India started opening their economies. The fall of the Berlin wall in 1989 and the collapse of the Soviet Union also allowed Eastern Europe, Russia and Central Asia to connect with the rest of the world. Improvements in technology and the creation of global value chains were one of the biggest reasons why the third wave – for all its flaws – contributed to strong global growth and a sharp decline in world poverty.

Deglobalization was already underway

The build-up of globalization's third wave was cut short by the GFC in 2008, when global trade flows peaked and

Chart 3: Global Remittance Growth Has Also Stagnated



Source: World Bank, TD Economics.

Chart 4: The Importance of Exports is Decreasing in China's Economy

Source: World Bank, TD Economics.

have since stagnated (Chart 2).[4] Global trade grew faster than global GDP growth during the third wave, but that is no longer the case. In fact, world trade volume dropped in 2019, while the global economy continued to expand. The WTO is forecasting trade to drop between 13% to 32% this year – much more than the forecasted drop in global GDP. Trade isn't the only victim. Foreign direct investment (FDI) in 2018 had fallen by 70% from its peak in 2007. Remittance flows – a measure of cross border movement of people – have also slowed in recent years (Chart 3). Both FDI and remittances are expected to be at unprecedently low levels this year.

The flattening of the growth of global value chains is an important reason behind the global trade slowdown. China – once labelled "the world's factory" – had started looking inwards since the "Made in China" policy plan came to the fore in 2015.[5] China's exports – which reflect the inward nature of new Chinese policymaking – had fallen from 36% of GDP in 2008 to 18% of GDP in 2018 (Chart 4). China has also been rebalancing its economy from being export and investment oriented towards being more consumption oriented. This rebalancing may not be a "bad thing", as it is necessary for China's economic growth to be sustainable. However, this rebalancing has slowed globalization's trajectory.

The U.S. in recent years has also enacted protectionist policies and moved away from trade liberalization (for example, withdrawing from the Trans Pacific Partnership). To put things in perspective, the average tariff on U.S. imports right before the pandemic was at its highest level since 1993.[6] In recent years, the U.S. has imposed tariffs on imports of several goods and services, prompting the spread of protectionism elsewhere as economies, such as China and the European Union (E.U.), retaliate. The net result is a reduction in bilateral trade and the movement of people, not just between the U.S. and China, but also other economies.

U.S.-China decoupling is dangerous business

The U.S. and China are mired in the Thucydide's trap – a conflict between an existing power challenged by an upcoming power. The pandemic has accelerated U.S.-China decoupling at a time when the world was already moving away from a unipolar world (led by the U.S.) to a bipolar world where both the U.S. and China are vying for economic dominance. The decoupling between the U.S. and China is increasing the pace of deglobalization which is seen across the board – in trade, technology and investment. This decoupling is also reflected in the latest data. China's direct investment in the U.S. in the first quarter of this year fell to just $200 million, down from an average $2 billion last year.

The pandemic is already forcing multinational U.S. companies to quickly alter their business models and reorient their supply chains closer to American shores or to U.S.-allied countries. Apple already moved its production from China to Vietnam during the pandemic, where they benefit from lower unit costs and relative safety from U.S. tariffs. A recent survey found that 95% of U.S. buyers plan to move their supplier base from China to elsewhere. However, supply chains today are extremely complex, therefore shifting them elsewhere is going to be a long and arduous process.

Decoupling can also lead to the reemergence of opposing blocs as in the cold war – those allied with the U.S. and those with China. There are no winners from such a decoupling, only losers. It is also dangerous business. The last time such a decoupling took place (between U.K., Germany and later the U.S.), it brought an end to the first wave of globalization, contributed to two world wars and a global depression.

The pandemic has accelerated deglobalization

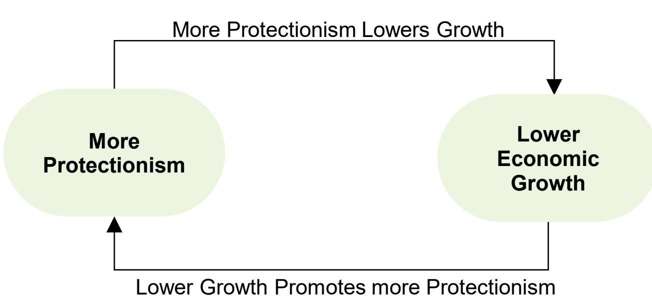
Although deglobalization was already on its way, the pandemic has sped up this process. What's worse is that the pandemic-induced-deglobalization is taking place in an environment of reduced international cooperation. The power vacuum created by the U.S. as it steps away from being the flag-bearer of trade liberalization has exacerbated the problem.

The rhetoric coming from world leaders since the pandemic's onset indicates that they are already looking inwards and closing out from the rest of the world. For example, E.U.'s trade commissioner said "We need to think about how to ensure the E.U.'s strategic autonomy." The French Finance Minister asserted "We have to decrease our dependence on a couple of large powers, in particular China". Australia's Prime Minister said "Open trading has been a core part of our prosperity over centuries. But equally, we need to look carefully at our domestic economic sovereignty as well." These statements are not coming from populist politicians from two ends of the political spectrum, but from those in the "mainstream". Japan is also looking into ways to break supply chain dependence on China and is paying firms to relocate out of China.[7]

The pandemic has exposed vulnerabilities of relying too much on efficient rather than resilient supply chains. This crisis has also increased the focus on deglobalization related to public health concerns and national security. Some countries – soon after the pandemic had hit – had imposed export bans over concerns about inadequate domestic production of medical equipment and pharmaceuticals. A similar uncooperative approach is likely to be used when a vaccine comes on the market.

The pandemic exposed a greater tendency for countries to look inwards at their ability to be self-reliant in certain sectors such as health equipment, supplies and pharmaceuticals. But, this requires an adaptable domestic manufacturing base which had been eroded over time within a number of countries. This raised the risk that relying too much on imports for critical drugs and vaccines can lead to possible drug shortages in times like these, as in the case of Canada.[8] However, this line of argument requires some caution, as it can quickly turn into a slippery slope for other sectors in the economy. First, import-substitution policies to grow and protect domestic industries will involve "cherry-picking" (Governments deciding which domestic industries should grow and which shouldn't), which will take countries back to the realm of industrial policy.[9] Second, a precedence of self-reliance set in one sector can lead to other – non-essential – sectors lobbying the government to give their sector the same kind of treatment.

Chart 5: Deglobalization Is Pushing Countries into a Vicious Cycle of Low Growth and Protectionism



Source: TD Economics.

Going forward, the pandemic-induced acceleration of automation, digitization and robotics will make it easier for companies to bring outsourced work onshore. The scale of this crisis will prompt countries to look inwards by domesticating supply chains, raising tariffs, and introducing other non-tariff barriers (bans, quotas, licenses). However, such an inward-looking approach can lead countries to get stuck in endless negative spirals. For example, if country A becomes more protectionist, it is likely to be followed by country A's trading partners retaliating by becoming more protectionist as well. Which may in turn prompt country A to further increase protectionism.

The perils of deglobalization

There is no denying that globalization has its flaws. There is also nothing to suggest that the trajectory of globalization's 3rd wave was maximizing positive outcomes. And while some corrections to globalization were long overdue – for example, to slowdown the rising inequality – an overcorrection can result in too much deglobalization too soon. Such a reversal of globalization trends will have long-lasting effects.

Protectionist measures can keep jobs at home, companies self-reliant and appeal to certain voters. However, such measures tend to reduce innovation and productivity. Supply chain disruptions will also put upward pressure on inflation for both businesses and consumers. Such disruptions will also reduce consumer choice and welfare. Creating hurdles for cross-border movement of people (as in the U.S. and to some extent Europe) can stifle economies of skilled labor and talent. More protectionism will also allow AEs to subsidize their industries, keeping EMs – especially low-income countries – mired in recession for longer. These factors combined would lead to lower short-term and long-term growth.

While protectionism can lead to lower economic growth, the relationship between protectionism and growth isn't one-sided. Lower growth can also lead to more protectionism, as the lack of economic opportunity in a fragmented world can result in social unrest, populism and political polarization (Chart 5). This can, in turn, lead to lower growth. And the cycle continues. Once countries are trapped in this vicious high protectionism-low growth cycle, it will be difficult for them to break free.

A move away from globalization will not only see restrictions on the movement of goods and people, but also the movement of capital. Capital controls – limits, taxes, differential rates – can depreciate currencies, making countries more competitive globally. For the same reason, they can perpetuate currency wars and trade wars, not limited to the U.S. and China but other countries as well. Domestically, they can reduce business investment, tighten credit constraints and decrease potential growth.

A deglobalized world is also likely to be a less safe world. Trade, investment and the movement of people across borders ties the hands of all countries involved. This helps to reduce the likelihood of military conflict. The economic interdependence amongst European countries is a good case in point. The establishment of the European Coal and Steel Community (precursor of the E.U.) in 1950 made its signatories inter-dependent, as they had the common interest of the free movement of European coal and steel.[10] Europe has been living in relative harmony ever since the formation of that community.

Bottom Line

While globalization has its flaws, any tendency for the pandemic to turbocharge deglobalization can swing the pendulum too far in deepening economic and political instability that could take decades to reverse. Manifesting U.S.-China tensions already laid the ground work for a faster deglobalization process, and now the pandemic has politicized cross-border cooperation and has prompted countries to lean more towards self-reliance. Inward looking policies – especially at a time of reduced international cooperation – may weaken the recovery and create geopolitical instability. Unexpected events of the early 20th century contributed to the collapse of economic and financial integration. Today we stand at an eerily similar juncture.

End Notes

1. https://www.piie.com/microsites/globalization/what-is-globalization
2. Globalization can be divided into three major areas: economic globalization, cultural globalization, and political globalization. The primary focus of this note is economic globalization.
3. https://www.piie.com/blogs/realtime-economic-issues-watch/pandemic-adds-momentum-deglobalization-trend
4. There are a broadly three ways in which the damage caused by deglobalization can be estimated; trade in goods and services (for example, trade as a share of GDP); movement of people/labor (for example, remittances as a share of GDP); movement of capital (for example, FDI as a share of GDP).
5. The goals of Made in China 2025 include increasing the Chinese-domestic content of core materials to 40 percent by 2020 and 70 percent by 2025. The plan focuses on high techfields including pharmaceutical, automotive, aerospace, semiconductor, IT and robotics manufacturing, all of which have been dominated by foreign companies.
6. https://www.economist.com/leaders/2020/05/14/has-covid-19-killed-globalisation
7. https://www.japantimes.co.jp/news/2020/03/06/business/japan-aims-break-supply-chain-dependence-china/#.XpnFWJl7muU
8. https://www.cbc.ca/news/opinion/opinion-pandemic-drug-shortages-1.5604791
9. Industrial policy is a country's official strategic effort to encourage the development, growth and protection of certain parts of the economy.
10. The original signatories were Belgium, France, Germany, Italy, Luxembourg and Netherlands.